APCoP
Asia-Pacific Community of Practice on Managing for Development Results

Asia–Pacific and Latin American
Interregional Forum on Managing for Results

Decentralization and the Changing Role of Central Finance Agencies

Forum Report and Expert Papers

28–29 November 2012
Manila, Philippines

APCoP
Asia-Pacific Community of Practice on Managing for Development Results

Asia–Pacific and Latin American
Interregional Forum on Managing for Results

Decentralization and the Changing Role of Central Finance Agencies

Forum Report and Expert Papers

28–29 November 2012
Manila, Philippines

Contents

Message from the Secretariat iv

Foreword and Executive Summary v

Welcome Remarks vii

Opening Remarks ix

PART I 1

Results-Based Public Sector Management and the Challenges of Decentralization 3

Session I: Decentralization and What It Means for Central Finance Authorities 4

Session II: Design and Management of Decentralized Revenues and Transfers 10

Session III: Design and Management of Decentralized Spending and Transfers 15

Closing Session: Decentralization, Results, and the Role of Development Partners 21

PART II 23

Promoting Effective and Macroeconomically Sound Fiscal Decentralization: The Role of Central Finance Agencies
By Teresa Ter-Minassian 25

Design and Management of Decentralized and Intergovernmental Revenues
By Paul Smoke 37

Design and Management of Decentralized Spending and Transfers
By Ehtisham Ahmad 51

Appendixes

1 Program at a Glance 63

2 Profile of International Experts 66

3 Participants List 68

Message from the Secretariat

Farzana Ahmed
Principal Coordinator, APCoP Secretariat
Lead Specialist (Public Sector Management)
Strategy and Policy Department
Asian Development Bank

This report is presented by the Secretariat of the Asia–Pacific Community of Practice on Managing for Development Results (APCoP), which also served as secretariat for the forum. Established in 2006 by the Asian Development Bank (ADB), APCoP now comprises over 700 senior government officials from ADB member countries with the common objective of institutionalizing results-based approaches in public sector management (PSM).

APCoP's mandate is to promote learning and knowledge exchange in Managing for Development Results (MfDR) through regional conferences, training of country officials on results-based PSM, assisting country-based communities of practice (CoPs) on MfDR, and dissemination of good MfDR practices and knowledge products. APCoP, through its secretariat at the Results Management Unit of ADB's Strategy and Policy Department (SPRU), collaborates with centers of excellence in Singapore and the Republic of Korea, and other ADB departments in mainstreaming results-based approaches in PSM. In recent years, this dialogue has been expanded with interregional exchanges with other regional CoPs in Africa and Latin America and the Caribbean.

This conference is one of two conferences on decentralization being supported by the ADB regional technical assistance on Enhancing Knowledge Sharing and South–South Cooperation between Asia and Latin America. Mexico City will host the second conference in May 2013.

Cristina Regina Bonoan led the preparation of this report with valuable support from the APCoP secretariat. The secretariat acknowledges the contributions of the participants, experts, the secretariat of the Community of Latin America and the Caribbean, and staff of the Inter-American Development Bank and ADB, whose presentations and comments provided the basis of this report.

Foreword and Executive Summary

Roberto Garcia Lopez
Executive Secretary,
Latin American and the Caribbean Community of Practice on MfDR (CoPLAC);
Inter-American Development Bank

Rolando Tungpalan
Deputy Director General
National Economic and Development Authority, Philippines;
Member, Coordinating Committee, Asia–Pacific Community of Practice (APCoP)

Forum Background

APCoP and CoPLAC share a common mandate to strengthen the capacities of their member countries to manage for development results and recognize the critical role of a results-oriented public sector in achieving this. Both CoPs hold forums for the exchange of ideas, sharing of experiences, and South–South dialogue.

This Interregional Forum on Decentralization and the Changing Role of Central Finance Agencies brought together academics, experts, and senior government officials to share their experiences in promoting results and delivering services in a decentralized context. Decentralization also includes deconcentration of central authority. It also offered a unique opportunity to engage and learn from the diverse decentralization experiences in Asia and Latin America

As countries decentralize, public sector institutions at the national and subnational levels must adapt to the challenges and seize opportunities in the delineation of roles by developing coordinated systems, procedures, and capacities to deliver services effectively, efficiently, and sustainably.

Decentralization has changed the way central finance agencies coordinate financial management across ministries and levels of government. Coordination with subnational governments demands strict and flexible central finance agencies that create and implement rules to ensure subnational fiscal responsibility while maintaining resourcefulness and skillfulness in designing and managing transfers to subnational governments. These various demands manifest the importance of central finance agencies in promoting effective decentralization and the local governments in providing services. The forum highlighted how countries met the challenges related to macroeconomic stability and fiscal sustainability in a range of decentralized settings.

Forum Sessions

The introductory session on Results-Based Public Sector Management (RBPSM) provides the framework for understanding and promoting results orientation of PSM functions at the national and local governments through better linkages in PSM functions and processes, and their interrelationships across sectors and agencies towards a common national objective.

To provide a deeper understanding on the impacts of decentralization in delivering results, the forum working sessions focused on three major areas:

Session I. Decentralization and What it Means for Central Finance Authorities. This session examined the risks posed by decentralization on macroeconomic stability and fiscal sustainability and how central finance agencies can minimize these risks through effective design and implementation of subnational fiscal rules. It featured the experiences of Brazil, Ecuador, India and Indonesia in fostering strong social and political support and setting clear targets for subnational fiscal rules, and putting central finance agencies as change agents.

Session II. Design and Management of Decentralized Revenues and Transfers. This session discussed common problems and challenges in subnational revenue generation and how improving the design of intergovernmental fiscal transfers can address these. It featured the experiences of Indonesia and Mexico in ensuring that subnational governments have adequate resources through increased revenues and intergovernmental fiscal transfers.

Session III. Design and Management of Decentralized Spending and Transfers. This session considered issues on expenditure assignments and the preconditions for enhanced accountability, responsible spending, and increased transparency to deliver improved services, and for sustainable growth. It argued that delivering results entail a shift in the focus of equalization transfers from entitlements to service delivery. It featured the experiences of Brazil, People's Republic of China, Peru, and Thailand in minimizing expenditure overlaps and reducing disparity in service delivery, use of Treasury Single Account, and equalization initiatives in Thailand.

The working sessions were structured into: (i) the main expert presentation, (ii) the commentaries from expert and country panel discussants, and (iii) the roundtable discussions. The different backgrounds of the experts provided wide-range perspective on the issues and ensure an informed discussion. More importantly, the forum encouraged active engagement by the participants to allow them to learn from each others' experiences and real life perspectives of having lived through the process of managing decentralized systems.

The closing session summed up the lessons that participants learned from the two-day dialogue and provided insights on good approaches to better manage the issues and challenges brought about by decentralization in their respective countries.

Welcome Remarks

Stephen Groff
Vice-President
Asian Development Bank

Secretary Abad, Minister Roberto Gallardo, distinguished guests and fellow colleagues from the Asian Development Bank (ADB). It is indeed a pleasure for me to make a few remarks at this Interregional Forum on Managing for Development Results (MfDR)—with the special focus on the Changing Role of Central Finance Agencies in Decentralization and Delivering Results.

This forum is the result of an innovative partnership between three banks—ADB, the CAF Development Bank of Latin America, and the Inter-American Development Bank (IADB)—that aims to increase knowledge sharing, policy dialogue, and cooperation between Asia and the Pacific, and Latin America and the Caribbean.

It brings together members of the communities of practice (CoPs) on MfDR of Latin America and the Caribbean and the Asia-Pacific—both of which are sponsored by IADB and ADB, respectively. Even before the partnership, these two CoPs have been cooperating in promoting the results agenda of the 2005 Paris Declaration. In fact, in preparation for the 2011 High Level Forum, they worked together with the CoP on MfDR for Africa to deliver the Seoul Statement—a partner-country driven statement to the donors in support of the results orientation of public sector management as one of the key means to ensure sustainable development effectiveness.

CoPs, as we all know, are one of the most useful vehicles for promoting a common understanding of issues and knowledge sharing. They have been identified as one of the key modalities to promote South–South dialogue among members. Sharing development knowledge and expertise can help solve common development challenges within and across regions. While developing countries have achieved substantial results in various domains, expanding opportunities for direct cooperation remains an urgent need and an area of great potential. In this respect, the regions of Latin America and the Caribbean and Asia and the Pacific have a lot to share that is both common and different.

I will not expound on the advantages of South–South Cooperation—as I am sure that we all agree on its benefits. I will therefore briefly talk about the subject of decentralization.

Decentralization, deconcentration, devolution are the terms used to describe processes that countries have embraced in their own way—and has been driven by the realization that the most effective and accountable government is that government which is closest to the people. ADB, and I am sure IADB, does not necessarily prescribe decentralization as the panacea for effective development, but we have been there to support the transition of many of our member countries in their desire to move from a centralized to a more decentralized form of government. This has been done through support at the policy level, through legal and regulatory reform, and through various investment and technical assistance projects. There is one clear lesson that we have learned: this is not an easy road and there is no one-size-fits-all approach. However, countries can

benefit significantly from learning from the experiences of each other. CoP meetings such as these will allow you to share your experiences and perhaps take home some new ideas.

Both regions have different lessons to share. Asia has much to share in its experiences in education systems, science and technology, outward-oriented policies that led to the formation of regional supply chains, public–private sector partnerships and regional financial cooperation initiatives. Similarly, Asia could benefit from studying Latin America's experiences in poverty reduction and social safety net policies, agriculture policies and the promotion of sustainable cities.

At the same time, there are challenges that are also similar. Both regions comprise countries covering a broad development spectrum—from fragile states to developed states. And even with the developed and middle-income countries, they share the common paradox of extreme deprivation and poverty in urban slums that share the skyline with the high-rise towers of leading cities. Reconciling these two faces is the major development challenge of our time.

In closing, I would once again like to congratulate the two secretariats of the CoPs of Latin America and the Caribbean, and Asia and the Pacific in taking up the challenge of putting together such a forum. I wish you a productive two days.

I now have great pleasure in handing over to Secretary Abad to give the opening remarks.

Thank you.

Opening Remarks

Florencio B. Abad
Secretary
Department of Budget and Management
Philippines

Thank you Steve, Director Jain, and the other officials of the Asian Development Bank (ADB), distinguished guests and participants to this forum, ladies and gentlemen, good morning. If I appear rather slow today, it is because I had to stay up late last night to pass my budget in the Senate. I hope to be able to get it done before the holidays.

I have entitled my address to you this morning in this manner: "The Aquino Administration: By the People and Back to the People." "By the people" because that was how this administration uniquely ascended to power. As in 1986 in that historic People Power Revolution, in 2010 our people—once again lifting themselves up from the clutches of desperation and hopelessness—presided over another popular presidential draft, the second in our history, and elected a reluctant Benigno S. Aquino III as president of our country. While his mother, our icon of democracy, Corazon Aquino, was swept to power by the unprecedented People Power Revolution of 1986, her son, Noynoy Aquino successfully fought his political battle in the treacherous arena of electoral politics. The domain of traditional politics is dominated by what we call the 3Gs of Philippine politics: guns, goons, and gold. Against all odds, Noynoy Aquino prevailed. And I say "back to the people" because that is the underlying political agenda of this administration. In a word, we call it empowerment. In your conference theme, I believe, that's at the heart of decentralization. This is the democratic project of the Aquino administration.

Today, we experience and enjoy various degrees of democracy in this country. We also know that democracy is for naught if we fail in ensuring other fundamental freedoms, not only the political but also the economic and social. In our case, we continue to experience these problems even after we regained in a dramatic fashion our democracy 25 years ago, especially in the last decade where corrupt and inept governance further deepened poverty, underdevelopment, and social conflicts in our society.

In this backdrop, People Power again emerged just 2 years ago when Pres. Aquino was elected with a resounding mandate. The resurgence, as I mentioned, happened not via mass action in the streets to topple a dictatorship but through a clear instruction by the people through their ballots to rebuild public trust in government institutions, bolster their capacity to deliver, and to bring the power back to the people. In response to this phenomenon, President Aquino entered into a social contract with the people to reduce poverty and promote inclusive economic growth through honest and effective governance.

What does this mean for local governance and decentralization in this country? Let me tell you that the beginnings of the decentralization process in the Philippines started under the restoration of institutions under Pres. Corazon Aquino. In particular, this was our new democratic constitution that was ratified in 1987 and it asserted that "local government units shall enjoy local autonomy." This constitutional provision was later on fleshed out under the Local Government Code, which was passed in 1991. This, for one, paved the way

for automatic allocation and release of 40% of all national internal revenue taxes to local governments. These early reforms were essentially inspired by People Power, by the desire to reverse the inefficient, unresponsive, and politically manipulable framework of central control by the national government—or at that time, by the Marcos dictatorship. More importantly, local autonomy at that time was driven by the desire to make local government units, or what we call LGUs, more responsive to the needs of constituents on the ground. After all, the LGUs are supposedly the closest and most proximate representations of government for the people.

Was this early reform successful? We have seen mixed results and extreme cases. But more fundamentally, we see in local governments today the predominance of a sociopolitical culture that has been at the root of problems of dependency and poverty in this country. We call it patronage. Patronage is a situation where citizens, especially the poor, are tied to relationships of dependence and inequity with a few elites. It is where, for the life cycle of a poor person, he depends on the generosity of the patron for survival in exchange for keeping him in power. The patron's ability to stay in power and keep the loyalty of his clients is a function of how he is able to influence the allocation of resources and decision making by institutions of the national government. Politics then becomes the patron's guarantee of sustaining influence. In the end, the continued reign of patronage and influence peddling weakens the ability of the state and its component public institutions to govern. That is, to fairly mediate competing interests, allocate scarce government resources, and equitably facilitate economic opportunity.

Democracy will continue to be just formal and nominal if we do not decisively address the culture of patronage. And thus, the Aquino administration is pursuing a democratic project to supplant patronage with a new culture of empowerment. Empowerment, I believe is achieved when people are given a free reign on their lives; when they are given equal opportunity; when those in the margins are given a fair shot through public investments in their welfare; and when they are given a greater "voice and vote." We believe that empowerment can be achieved by pursuing these imperatives: (i) restoring people's trust in government and its formal institutions, (ii) strengthening public institutions' capacity to deliver results, and (iii) building a consolidated constituency for sustained reforms.

If there is one area of governance where we should truly pursue these imperatives of empowerment, it should be in local governance. Let me start with the need to fortify the local governments' capacity to deliver services and undertake key projects. For one, we can work on improving the absorptive capacity of national government agencies but it will only be possible up to a point. At the same time, we have realized that selected local government units already have the capacity to deliver frontline services, particularly in social protections and livelihood and for some, infrastructure development. With this, we thought, why don't we push resources down to local government units with proven capacity. With this, various national agencies have entered into partnerships with leagues of local government units in the implementation of priority social infrastructure projects, such as schools, water supply, rural health centers, among others.

This administration wants to encourage and support local government units to adapt better service delivery and resource management systems. For one, we are pursuing a local government public financial management program to strengthen the revenue planning, budgeting, and implementation capacities of local government units.

This leads to my next point: we assert that local autonomy and devolution should come together with greater accountability. This addresses the first imperative of empowerment of working to rebuild public trust. In light of this, the local government public financial management support program that we are pursuing also seeks to strengthen local government unit accountability, transparency, and financial stewardship through enhanced monitoring and evaluation as well as stronger internal audit. Of course with the prevailing culture of patronage, we can only make local government units swallow accountability to a certain extent. We realize that there is a greater need to incentivize the adoption of accountability by local government units. We pursued this—this was the initiative of the late Secretary Jessie Robredo—through the seal of good housekeeping and the performance challenge fund of our Department of Interior and Local Government. Under these initiatives, local government units that disclose budget information to their constituents and

fulfill good governance benchmarks may have greater access to additional funds for their priority projects. We are also tying up the implementation of joint projects by national agencies and local government units to the latter's fulfillment of governance standards.

There is another paradigm of devolution that we should consider: the empowerment of citizens, particularly the communities as well as the civil society organizations who represent them. We must emphasize to local government units that greater devolution requires greater accountability. And that greater accountability requires giving a greater voice and vote to their constituents. Empowerment should not stop at the level of local government units themselves—ultimately it should reach the constituencies or the people.

An initiative that may be of interest to you, who mostly represent central finance agencies, is the bottom up budgeting exercise that we are starting, or experimenting on starting this year. In 609 municipalities with an allocation of P8.4 billion for local programs and projects, which were developed through this new process. We told these municipalities that before they can access resources, they must partner with community and civil society organizations in their localities in arriving at projects for their communities.

By next year, for the crafting of the 2014 national budget, we hope to be scaling up the bottom up process by expanding the initially covered set of 609 municipalities to more than 1,200. We envision that through the years, the national budget will be shaped more and more by the local governments and communities rather than by the central government alone.

Empowerment requires the building of a consolidated constituency that will support as well as sustain the demand for critical governance reforms. We assert that we cannot succeed via the government's actions alone. We need our allies and partners from the broad and diverse community of civil society organizations, community organizations, business groups, professionals, academe, and development partners. With this, I would like to applaud ADB for its commitment to participating in this constituency for reform, particularly in supporting decentralization reforms in our country.

Our journey in our reform agenda so far is not without difficulty but we have the momentum now. The president's moral courage and political will to implement a clear agenda for people empowerment, our efforts are now bearing fruit in terms of stronger economic growth, renewed investor and donor confidence, and unprecedentedly high public trust in the government and its institutions. What matters now is to ensure that we move forward to our destination and not in the reverse. In local governance, we want to continue to devolve and not recentralize. With a strong constituency for reform, we believe that any reversal will lead to grave political and economic consequences. To further move us forward one thing should continue to inspire us: that same inspiration that installed the president in 2010. That is People Power, a paradigm for progress through the active and meaningful participation of citizens in governance: not just in the streets, not just in the voting booths, but in the less dramatic but important day to day challenges of governance.

Thank you and good morning.

PART I

Results-Based Public Sector Management and the Challenges of Decentralization

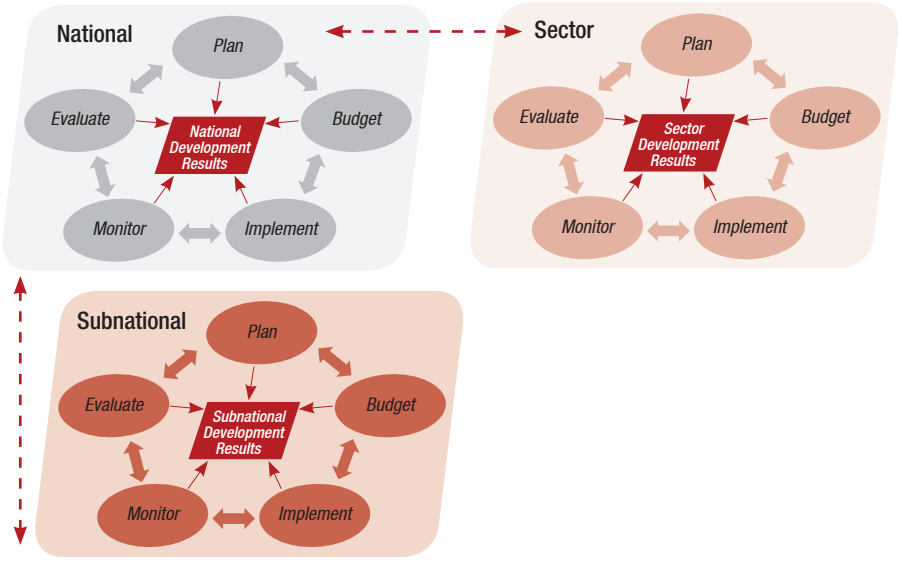
Following the Paris Declaration in 2005, the challenge for development partners was promoting managing for development results (MfDR) at the country level. The community of practice (CoP) was recognized as an important vehicle to promote MfDR. This led to the establishment of the Asia–Pacific Community of Practice (APCoP) in 2007 and the Community of Practice for Latin America and the Caribbean (CoPLAC) in 2008.

The CoPs were established to share good practices and to elevate the importance of South–South Dialogue in the development effectiveness agenda. Since their establishment, APCoP and CoPLAC have undertaken joint activities to advance the delivery of results in public sector management (PSM). In 2011, APCoP and CoPLAC were instrumental in defining the results agenda at the High-Level Forum held in Busan, Republic of Korea. This year, both CoPs are looking at the impact of decentralization on the delivery of results.

Anchored on delivering results at the government level, the CoPs look at the five core components of management: planning, budgeting, implementation, monitoring, and evaluation. APCoP and CoPLAC believe that in order to deliver results, these components must have common results-orientation. It is also important that clear linkages exist among these components and that integration or coordination occur at both at horizontal and vertical levels of government. The coordination depends on the degree of decentralization, the strength of central government control, and other factors. Decentralization may either hasten or stall the delivery of results and it is critical to understand how, where, and when this comes about. The importance of vertical integration demands a deeper understanding of decentralization.

APCoP and CoPLAC jointly organized the inter-regional forum to discuss and analyze the changes, challenges, and opportunities that decentralization brings to the delivery of results at different levels of government. The forum examined the impact of decentralization on the traditional processes and institutions involved in central finance functions.

Figure 1 Horizontal and Vertical Integration



Session I: Decentralization and What It Means for Central Finance Authorities

From the presentation of Teresa Ter-Minassian*

This session examined the risks posed by decentralization on macroeconomic stability and fiscal sustainability, and how central finance agencies can minimize these risks through effective design and implementation of subnational fiscal rules. It featured the experiences of Brazil, Ecuador, and India in addressing design and implementation issues of fiscal rules through strong social and political support, robust legal basis, and by setting clear targets for subnational governments, while the experience of Indonesia highlighted the role of central finance agencies as change agents.

Promoting Effective Decentralization: The Role of Central Finance Agencies

In the last two decades, decentralization has seen a decrease in central government control of fiscal stabilization instruments, and a rise in unsustainable subnational fiscal behavior. Avoiding soft budget constraints help minimize these risks. As opposed to hard budget constraints, subnational soft budget constraints refer to the possibility for subnational governments spending beyond their allocated resources. This may lead to the perverse incentive for subnational governments to spend inefficiently based on the reliance on the central government to bail them out. Poorly designed and implemented decentralization can lead to soft budget constraints that

(i) encourage the expectation to increase spending without carrying its full cost,
(ii) promote overspending, and
(iii) discourage efforts to mobilize own revenues.

"The demanding preconditions for effective reliance on market discipline and the weaknesses of negotiated arrangements explain the popularity of subnational fiscal rules…. But fiscal rules are no magic bullet for ensuring subnational fiscal discipline."

-Teresa Ter-Minassian

Effectiveness of Fiscal Rules: Political Support, Design, and Implementation

The demanding preconditions for effective reliance on market discipline and the weaknesses of negotiated arrangements explain the growing popularity of subnational fiscal rules. The most popular are ones on budget balance and the gross debt of subnational governments. There is also an increasing reliance on rules limiting subnational government spending. Nevertheless, fiscal rules are not a magic bullet to ensure fiscal discipline and depend on political and social support to be effective. Other considerations for fiscal rules to be effective include: robustness of the legal basis, soundness of design, the state of subnational public financial management systems, and conditions for enforcement.

On design issues, among the questions to ask is whether rules should be imposed by the central government or self-imposed by the subnational units. Rules from the center create less ownership but may be more consistent. On the other hand, self-imposed rules increase social and political support and the likelihood of implementation, but fail to guarantee consistency. Another important design issue is coverage. Ideally, rules should cover not only operations of subnational government that are recorded in the budget but also quasi-fiscal operations and contingent liabilities. It is important to consider whether to target overall balance or merely the primary balance that excludes interest

* International economic and fiscal policy expert (former director of the International Monetary Fund's Fiscal Affairs Department).

payments. Finally, escape clauses should be flexible enough to allow for temporary suspension of rules during periods of shocks beyond the control of the authorities.

On implementation issues, robust public sector management systems remain critical. Fiscal rules are unlikely to be implemented if unsupported by good standardized systems of accounting, compliance monitoring, and reporting of government operations. One question to consider is whether compliance monitoring should be done by the central government or delegated to an independent fiscal watchdog, an increasing trend in advanced countries. Enforcement tools for noncompliance must be in place including sanctions, such as withholding of transfers to discipline subnational governments. Finally, stipulations that require deviations from a rule to be corrected over a certain period of time are also important.

Avoiding Soft Budget Constraints

To avoid subnational soft budget constraints, central finance authorities should refrain from:

(i) maintaining significant discretion to support subnational governments, whether in the form of transfers, borrowing controls, and definition of budget targets. More discretion increases political pressures that encourage subnational government expectations of bailouts;
(ii) failing to delineate respective spending responsibilities, particularly in concurrent functions;
(iii) controlling most budgetary resources, which may give rise to unfunded mandates or vertical imbalances;
(iv) relying on market discipline when its preconditions for functioning are not in place. Conditions for effective market discipline include: a consistent record of no bailouts, competitive and well-developed markets, no privileged access to credit for subnational governments, adequate transparency of subnational accounts, and political responsiveness to market signals;
(v) using unconditional bailouts in cases of subnational debt crises.

On the other hand, central finance authorities should aim to:

(i) promote sound fiscal rules;
(ii) support the implementation of sound fiscal rules through budget transparency requirements, timely monitoring, and nondiscretionary application of sanctions when needed;
(iii) take appropriate steps to strengthen market discipline on subnational borrowing, particularly reducing access to preferential credit;
(iv) support the design and adoption of appropriate subnational insolvency frameworks;
(v) support the development of sound subnational public financial management systems and effective tax administrations.

Box 1 Commentaries by Expert Discussants: Decentralization and The Big Picture

Paul Smoke

Assess the true extent of macroeconomic risk. It is important to be concerned about the macroeconomic risks of decentralization. However, in many countries, subnational government expenditures make up a small percentage of total public sector spending. In addition, the amount of discretion that subnational governments have over expenditures and revenues should also be considered. In cases where central governments maintain significant control over spending and revenue generation decisions, decentralization is weak and the danger to macroeconomic stability is limited. In some countries, subnational governments are not permitted to borrow or, even if allowed, are not creditworthy. Central agencies may in some cases resist decentralization, based on perceived macroeconomic risks that may not exist. Therefore, the significance of such risks should first be assessed. In addition, in aiming for improved results, it is important to recognize that the fiscal system is not the only requirement for effective decentralization. There are many factors to consider, such as downward accountability, service delivery standards, and establishment of other basic systems.

Design of fiscal framework is not enough. In many countries, there has been a heavy focus on designing strong fiscal frameworks to limit problematic subnational fiscal behavior. There are, however, many cases in which well-crafted frameworks are developed but are not implemented, or decentralization is undertaken so rapidly that a proper framework is not developed. Effective fiscal decentralization requires both good design and good implementation.

Breaking rules sometimes serve productive purposes. It is important to follow clear rules and principles in establishing well-functioning and empowered subnational governments in the early stages of decentralization. However, sometimes breaking rules serves productive purposes. In Cambodia, decentralization was not initially about better service delivery but on building political credibility. While "finance follows function" is a cardinal rule of decentralization, Cambodia provided unconditional transfers without functional assignments to local governments and set up a basic financial management system to establish a foundation for eventually stronger decentralization that more fully meets basic principles.

Getting the right balance. A critical challenge of fiscal decentralization policy is to achieve the right balance between central government control and local autonomy. The primary questions to ask are: where do we begin and what things should be set in place and in what sequence, as decentralization unfolds.

Ehtisham Ahmad

Contextualize decentralization and fiscal rules to make it work. In considering decentralization and fiscal rules, there are issues one needs to focus on depending on the context and the particular set of circumstances. For instance, decentralization issues differ in relation to climate change and natural disasters. It is an open question whether central government or local government should address issues relating to climate change and disaster preparedness, but when disasters strike, central finance agencies need to relax the rules. As for the implementation of sanctions, if local governments are responsible for the most important basic services, particularly benefiting the marginalized, then the credibility of the sanctions is often in question: Do you cut basic health care or do you allow the rule to lapse? Finally, in post-conflict reconstruction, the question of rules may be premature.

Fiscal rules per se are inadequate; systems and structure must be in place. In more advanced countries where there are no capacities or resource constraints, the real problem is the inadequacies in structure and information flows. Political economy can be utilized to set standard rules and reporting. It is also important that central finance agencies avoid game-play by subnational governments. Game play can be prevented through consistent standards and aligned incentives structures at different levels of government. Lastly, it is important that the basis for more accountable local governments is established by utilizing yardstick competition to discipline local officials and by linking results to resources.

Designing and Implementing Fiscal Rules: Brazil, Ecuador, India, and Indonesia

From the country presentations made by: Marcelo Piancastelli, former Undersecretary of the Federal Treasury of Brazil; Maria Dolores de Almeida, former Vice Minister of Finance of Ecuador; Atul Sarma, former Member of the 13th Finance Commission of India; and Mulia Nasution, former Secretary-General of the Ministry of Finance of Indonesia.

The presentations by country experts highlighted the experiences of Brazil, Ecuador, India, and Indonesia in addressing design and implementation issues of fiscal rules through strong social and political support, robust legal basis, establishing clear targets for subnational governments, and the critical leadership of central finance agencies in the reform process.

Brazil: Effective Fiscal Rules Require Political and Social Support

For 4 decades, Brazil suffered from high inflation rates and monetary and fiscal mismanagement. In 1994, the implementation of the Real Stabilization Plan finally brought disinflation to Brazil. The private sector and central government adjusted more quickly than subnational governments. While the Real Plan stabilized inflation and improved central government financial management, most subnational governments remained bankrupt. Thus, laws were passed to address subnational governments' fiscal positions.

The worsening economic conditions and two financial crises helped spur strong political and social support, which ultimately contributed to the effectiveness of fiscal rules enshrined in the Fiscal Adjustment Plans and the Fiscal Responsibility Law. The Fiscal Adjustment Plans set conditions for subnational government compliance for a three-year period, negotiated with every state, and assessed annually. After 3 years, new targets were established or revised, based on the following criteria:

- ratio of the subnational governments' financial debt to their net revenues,
- constraints on payroll,
- targets for tax revenues,
- privatization of banks and state companies, and
- investment targets

The Fiscal Responsibility Law was adopted, which helped improve transparency and accountability of subnational governments by tying requirements with eligibility to hold office. Specifically, a failure of governors to submit their reports to the central government by the prescribed dates would result in their inability to hold office even if they won the election.

The Fiscal Adjustment Plans and Fiscal Responsibility Law served as pillars in the success of Brazil's economic policy by facilitating the achievement of subnational primary surpluses over the last several years. These surpluses permitted a sustained decline in the ratio of subnational debt to revenues.

Ecuador: The Importance of a Robust Legal Basis and Fiscal Watchdogs

In Ecuador, the constitution, the Decentralization Law, and the Organic Code on Public Planning and Finance set the legal basis for subnational fiscal rules. The constitution provides the institutional framework for decentralization. It establishes consistent fiscal rules for subnational governments and central governments. These include rules requiring that permanent expenditures be financed by permanent revenues and that public borrowing be used exclusively for investment programs and projects.

On the other hand, the Decentralization Law clarifies the spending responsibilities for each level of

"Well-designed fiscal rules can play a role but do not substitute it with the need to develop strong institutions for fiscal policies"

-Dolores de Almeida, Ecuador

government. In addition, it links spending resources with intergovernmental fiscal transfers and defines the fiscal transfer rules.

The Organic Code on Public Planning and Finance links public planning with finance by providing for multiyear, results-based budgeting. It establishes ex and post ante debt regulation and promotes transparency and accountability by creating incentives on the submission of financial information. Subnational governments that fail to submit financial information within the prescribed period are temporarily denied transfers from the central government.

Well-designed fiscal rules can play a role but do not obviate the need to develop strong institutions for fiscal policies. The undersecretary for Fiscal and Intergovernmental Relations created by the Ministry of Finance is tasked to manage intergovernmental fiscal transfers, monitor debt limits and the capacity of subnational governments to pay, and consolidate fiscal information on the subnational governments.

India: The Role of the Finance Commission in Planning and Setting Accountable and Sustainable Budgets

The unsound financial situation in India for 2 decades prompted the creation of the Finance Commission. It is a unique, independent institution operating on a five-year term tasked to provide recommendations in structuring public finances. In 2000–2005, the 11th Finance Commission was tasked to provide recommendations on intergovernmental fiscal transfers. Its output was a restructuring plan, which sought to:

- lower the combined revenue and fiscal deficits of the Union and the States,
- increase tax and non-tax revenues,
- increase capital expenditure, and
- focus spending on basic needs.

To achieve the commission's objectives, the 2003 Fiscal Responsibility and Management Budget Edict was adopted. The edict sought to eliminate deficits by introducing transparency and accountability in subnational spending. To help continue the reform process and complete unachieved targets, the recommendations of the 11th Finance Commission were forwarded to subsequent finance commissions. The 12th Finance Commission set new targets for subnational governments while the 13th Finance Commission consolidated the recommendations of the two previous commissions and created a road map for fiscal consolidation. The political economy of the reform process saw some outside forces resist reforms, which prevented the achievement of some targets. However, through the leadership of the finance commissions, fiscal correction was promoted by establishing links between fiscal targets and creating incentives to reduce debt and fiscal deficits. Thus, at the end of the various fiscal adjustments, 11 states registered surpluses.

Indonesia: Setting Order After the Big Bang

For 14 years, the Ministry of Finance in Indonesia performed critical roles in the transformation process of the country. It managed the legal reform process brought about by the change from authoritarian to democratic form of government and the accompanying decentralization reforms. It was very instrumental in the passage of several laws that transformed reform ideas into concrete rules and regulations such as the laws on the state, treasury, audit, and local government.

As a response to the ongoing decentralization process, the Ministry of Finance reformed several aspects of the Central Government Financial Management System. In the budget planning, it introduced performance-based budgeting and prioritized allocating resources for less development regions specifically in areas of infrastructure, health, and education. The ministry spearheaded improvements on procurement and disbursement procedures to strengthen budget discipline and enhance responsibility in the budget execution process. On revenue administration and treasury management, it devolved land and building tax to subnational governments together with the appropriate tools and manpower. To optimize the use of national assets, the Ministry of Finance transferred physical assets to local governments and improved local borrowing regulations. Improvement in local borrowing regulations were designed to ensure that infrastructure and other investment projects can be financed by local governments.

The Ministry of Finance encourages fiscal responsibility from subnational governments through a mix of capacity-building programs, borrowing controls, and a set of incentives and sanctions. It developed accounting standards, which were then introduced to local governments through various pilot projects. The ministry minimizes macroeconomic fiscal risks by tightening controls on local borrowing and monitoring local projects that may pose fiscal risks, such as public–private partnership projects. Lastly, the Ministry of Finance introduced a reward and sanctions system to local governments by providing incentives for improved budgeting and financial management while withholding the release of transfers as a form of sanction for noncompliance of established rules.

Box 2 Roundtable Discussion: Marrying Theory and Practice

Following the presentations on soft-budget constraints, the effectiveness of fiscal rules, and the importance of institutions in promoting effective decentralization, questions and experiences were shared by participants related to the relevance of fiscal rules in various country contexts. Discussions revolved around the possible tensions between the roles of central finance agencies vis-a-vis subnational governments.

Balancing fiscal stability and decentralization. Benjamin Diokno from the Philippines pointed out that the need to recognize that, in many countries, central finance agencies are not necessarily the champions of decentralization. These agencies often perceive decentralization as a threat to fiscal stability and debt sustainability. Particularly given the current global fiscal crises, there is a need to balance the possible tensions in maintaining fiscal stability vis-a-vis deepening fiscal decentralization.

Ensuring sufficient local government resources through improved revenue streams. In response to questions raised by Marwanto Harjowiryono from Indonesia and Abdul Khaliq from Pakistan, Teresa Ter-Minassian emphasized the importance of ensuring that local governments have sufficient resources either through increasing revenue streams or through responsible borrowing. To ensure the smoothness of revenues over the cycle, it is important to establish mechanisms that would allow the capture of gains during periods of high commodity prices to finance spending during lean seasons or economic recession.

Monitoring how transfers are spent and the importance of timely and transparent information. Karin Slowing from Guatemala pointed out the tendency of the finance ministries to focus more on transferring resources to local governments rather than making sure that these resources were spent wisely. Central finance agencies should play a crucial role not only in facilitating transfers but also in monitoring how these funds are spent. Thus, the information flow between all levels and the perspectives of other central ministries and subnational governments are crucial to sound intergovernmental fiscal management.

Horizontal and vertical linkages among central ministries and levels of government. In relation to the oversight role of central finance agencies, Carmencita Delantar from the Philippines underscored the importance of synchronizing the functions of planning, budgeting, investment programming, and revenue administration among the different ministries. The posting of financial information by subnational governments, allowing monitoring by civil society watchdog groups, and ex post audit of all branches and levels of government help ensure transparency in budget execution.

Session II: Design and Management of Decentralized Revenues and Transfers

From the presentation of Paul Smoke*

This session discussed principles, trends, and challenges in subnational revenue generation and how better design of own-source revenue and intergovernmental transfers can help address challenges. A broad overview was followed by expert presentations on efforts in Mexico and Indonesia to improve subnational government access to fiscal resources.

Basics of Subnational Revenues

Subnational revenue inadequacy is a common problem. It is very well known that subnational governments are unable to raise enough revenues on their own to finance all of their expenditure functions. The key challenge is to ensure that they raise revenues as much as possible and do so in a way that meets basic principles. One key concern is the selection of subnational taxes, which should be levied on immobile bases and structured to be as efficient and equitable as possible. A fundamental goal of fiscal federalism is to create a fiscal linkage between the benefits received from local services and the costs of providing them. This relationship promotes efficiency and also helps develop accountability between elected councils and their constituents. A number of recent studies have vindicated the notion that subnational government revenue generation can promote good results. There is some limited but encouraging evidence, for example, that subnational jurisdictions that rely more on own-source revenues spend less on administration and more on service delivery.

> *"Even if you design good borrowing and property tax systems, if fiscal transfers are very generous and do not create incentives for subnational revenue generation, then the fiscal system reformsare not going to have the intended results"*
>
> *-Paul Smoke*

Defining own-source revenues. Central governments have a tendency to keep tax bases that should not necessarily be centralized and to control the bases of subnational taxes. There may be more subnational autonomy on rates, but often within a defined range. True own-source revenues allow subnational governments some control over the base and/or the rate.

Sources of subnational revenues. One of the most common local taxes is the property tax. Subnational governments may also collect various types of taxes from businesses. Other suitable subnational taxes, such as motor vehicle taxes, tend to be underused in developing countries, even though many of the costs of motor fuel use are imposed on subnational governments. In some cases, natural resource revenues are shared subnationally, but if sharing is based on origin, they are disequalizing if such resources are concentrated in certain areas. For taxes that may be appropriate for a local level but are difficult to collect locally, local governments may piggyback on taxes already being collected by the center. In addition, the center may share some of its revenues with subnational governments according to rules it determines, but these are transfers rather than own source-revenues. User charges can be important as subnational non-tax revenues, and there may be subnational discretion over them.

Political economy. There is a tendency to assume that subnational elections generate sufficient accountability to create incentives for citizens to pay

* Professor of Public Finance and Planning, New York University Wagner School of Public Service.

local taxes. In fact, an election is a blunt accountability instrument and must often be complemented by other mechanisms. Political economy factors more generally affect local tax performance. Even with a technically sound property tax system, for example, citizens may be unwilling to pay if they do not trust their government and benefit from compliance. Where sufficient trust does not exist, increasing local revenues may require negotiation between local governments and constituents to link payments to services.

Minimizing cost of administration. Some major revenue sources, as noted, cannot be administered locally due to their nature and complexity. If administered centrally, the center can share proceeds as it wishes or allow local governments to piggyback within limits. The center can share on the basis of origin, which is disequalizing, or by formula, which can be redistributive. In short, the center has inherent advantages in revenue-generation. How sharing occurs has major implications for subnational government.

Responsive Intergovernmental Fiscal Transfers

Intergovernmental fiscal transfers have multiple objectives. First, they may enhance revenue adequacy by supplementing limited and/or inelastic local tax bases. Second, they alleviate overall vertical fiscal gaps by matching revenues to expenditure needs. Third, they improve horizontal equalization among jurisdictions. Fourth, they influence spending patterns by reducing spillovers and promoting national spending priorities.

Matching transfers to objectives. If the goal is to encourage spending on a particular type of service, then a conditional transfer is a good instrument. Redistribution, however, is better promoted by a formula-driven unconditional transfer. Most transfer systems include a mix of instruments.

Creating good incentives. Generous fiscal transfers that do not create incentives for own-source revenue generation may undermine local tax performance. Similarly, infrastructure transfers that are generous may leave no incentives for creditworthy local governments to borrow even for revenue-generating investments. Thus, it is essential to be aware of the incentives created by transfers if intergovernmental fiscal reform is to be effective.

Monitor performance. Data is important in designing transfers and in measuring their impact. Data are unavailable or problematic in many countries, and measuring certain variables can be challenging. It is, however, usually possible to make improvements.

Navigate tensions. There is ongoing tension between central control and local autonomy. The center wants to control local finances and stimulate tax effort while local governments want autonomy and revenues for their jurisdiction. A national framework is needed and some national priorities are legitimate, but subnational autonomy is also needed to attain the benefits promised by decentralization. Design and implementation of an effective intergovernmental fiscal system requires the ability to navigate these tensions in the context of the overall framework and to revise policy as needed to meet evolving conditions.

Box 3 Commentaries by Expert Discussants: How to Eliminate the Vertical Imbalance

Teresa Ter-Minassian

Spending has outpaced revenue decentralization. Decentralization has moved much faster on the spending side than on the revenue side in Latin America, resulting in large gaps between subnational own revenues and spending. There are also large imbalances within each level of government. While some subnational governments are able to fund most of their spending responsibilities with their own revenues, many remain dependent on central government transfers. In general, vertical gaps are larger at the regional than at the local level because local authorities have well-consolidated revenues e.g., property tax. However, in Argentina and Brazil, the vertical gap is smaller in states than in municipalities.

Diversity in subnational revenue systems implies different reform priorities. In some countries, an increase in subnational own revenues is needed to raise the overall tax ratio, i.e., the tax burden is too low to finance adequate level of public service and to reduce dependence on revenues from nonrenewable resources. Except for Brazil, Latin American countries need to reduce vertical imbalance to increase subnational fiscal responsibility and political accountability.

Options to improve the performance of existing subnational taxes include:

(i) the elimination of widespread exemptions and incentives,
(ii) increase in tax rates, and
(iii) improvement in subnational tax administration.

The design of intergovernmental fiscal transfers affects the degree of subnational revenue efforts. Discretionary transfers have adverse effects on revenue-generating efforts. Thus, transfer reform should concentrate on reducing discretion while increasing the flexibility of formula-based transfers over the cycle. Most Latin American countries need to refine existing equalization mechanisms.

Ehtisham Ahmad

Purpose and effects of taxation. Taxes are not merely for raising revenues. They affect incentives, distribution in households, and can be evaded. Taxes influence production, distribution, and incentives to cheat.

Tax policy and administration. In dealing with the tax agenda and administration, countries should consider:

(i) emphasizing accountability;
(ii) recognizing that the objective is not to completely eliminate the vertical imbalance but to give subnational governments handles at the margin and ensure that they use those handles;
(iii) acknowledging the ability of subnational governments to administer the taxes;
(iv) differentiating between intermediate and local levels;
(v) using simple taxes (e.g., value-added tax with full coverage and no exemptions);
(vi) recognizing that effective tax policy and administration requires integration of bases, tax rates, and an arms-length institution; and
(vii) looking at autonomy in relation to tax policy and administration (e.g., tax-sharing schemes cannot be considered local taxation due to lack of local control over taxation rates)

In designing taxes, countries should avoid too many exemptions for distribution purposes. Property tax competition among local governments to attract more investors should also be avoided..

Badly designed transfers can negate incentives placed on the tax side. For equalization transfers, avoid transfer designs that result in "fiscal dentistry" or "gap filling transfers," which destroy incentives provided by other forms of revenues. This may include the current trend toward standardized bases for equalization transfers wherein transfers are computed based on actual needs or actual revenue. It is important to clearly define current responsibilities and investments or earmark transfers on a performance basis, similar to the reforms undertaken in Indonesia.

Ensuring Adequate Resources though Increased Revenues and Transfers: Mexico and Indonesia*

From the country presentations made by: Emilio Pineda, Fiscal and Municipal Management Lead Specialist, Inter-American Development Bank of Mexico; Marwanto Harjowiryono, Director General Fiscal Balance, Ministry of Finance of Indonesia.

Country experts drew attention to the experiences of Mexico and Indonesia in subnational revenue generation. The experience in Mexico highlighted the importance not only of increasing taxing powers but also creating incentives for subnational governments to utilize them. On the other hand, the presentation on Indonesia highlighted efforts focused on sustaining public service delivery during the early decentralization process. Early efforts focused more on the smooth transfer of significant human and financial resources to provinces, districts, and municipalities even as own-source revenues remain limited.

Mexico: Expanding and Incentivizing Taxing Powers

The 1990 fiscal decentralization in Mexico created huge fiscal vertical imbalance, which required a vast majority of subnational spending to be financed by transfers from the federal government. Subnational government revenues consisted of 40% earmarked transfers, 43% non-earmarked transfers, 10% local taxes, and 7% *convenios,* which are a form of discretionary transfers. The high degree of discretion on non-earmarked transfers and *convenios* affected the incentives of the subnational governments to generate own-source revenues. It encouraged the perception that time would be better spent in the capital bargaining for higher transfers with the Ministry of Finance rather than strengthening local tax administration efforts. Aside from transfers, federal investments in different states were also prone to yearly political bargaining.

In this context, the 2007 fiscal reform was implemented based on two interrelated strategies of new taxes and incentives. To increase subnational revenues, new taxes were created and incentives granted to those states that utilized their taxing powers. If a state increased its own revenues, federal non-earmarked transfers were increased on a per capita basis. From the point of view of the central government, these strategies provide additional sources of revenues by giving the right incentives to use these new revenue sources.

Another component of Mexico's fiscal reform strategy involved generating timely, reliable, and useful information to enhance accountability across levels of government. A new constitution promoted transparency in subnational government finances and assured harmonized accounting.

Indonesia: Transferring Resources for Regional Development

The purpose of intergovernmental fiscal transfers in Indonesia is to support the operations of the entire government and the delivery of public services. There are three levels of government in Indonesia:

(i) the central government,
(ii) provinces, and
(iii) rural districts and/or municipalities.

The general principle behind fiscal decentralization is "finance follows function," which holds that given the significant responsibilities transferred to subnational governments, most of the money should also be transferred to them. The focus of decentralization is more on spending rather than revenue. In addition, greater autonomy is given to the third layer of government, which are the rural districts and municipalities.

In line with the principle of local autonomy, a large share of vertical transfers (about 80%) is in the form of unconditional block grants, utilized

to finance local government needs. In addition to block grants, there are conditional specific purpose grants targeted to finance national priorities and to improve public service delivery, particularly in poorer regions. Subnational governments in Indonesia are also allowed to borrow to finance local economic development.

Currently, the share of intergovernmental fiscal transfers in Indonesia covers 80% of subnational government expenditures. Only 20% is financed by own-source revenues. The intergovernmental transfers have two components:

(i) shares from tax revenues, which include property taxes, personal income tax, and tobacco excise tax; and
(ii) shares from resource revenues, which consist of forestry, mining, fishery, oil and gas, and geothermal resources.

Box 4 Roundtable Discussion: Reinforcing Revenue-Generating Techniques

The roundtable discussion focused on the practical challenges of revenue generation for subnational governments, particularly in garnering political support and implementing reforms. In response to questions and points raised by participants, the experts underscored some key lessons in reinforcing local revenue generation.

Ensure autonomy over some resources. Autonomy over some resources creates better linkages between taxpayers and elected councils. This can be done either through specific revenue assignments or by setting up transfers and decision-making systems similar to what Cambodia implemented.

Transparency promotes a virtuous cycle of tax collection and increased revenues. In response to the point made by Jalal Ahmed from Bangladesh on the increasing mistrust by citizens that leads to poor tax collection, Paul Smoke suggested that it might be necessary to break the vicious cycle by redesigning the current performance-based grants and making it more transparent. Transparency can begin to change the rules of the game and lessen the capture of resources by patronage politics, but this takes time.

Incremental process may help institutionalize reforms. In response to the point raised by Nader Yama from Afghanistan on the challenges of generating support for decentralization reforms from constituents and central ministries, Mr. Smoke explained that pursuing decentralization policy in an environment where appropriate conditions do not exist requires careful planning. Particular kinds of pilot programs may help set the conditions that can over time be transformed into more institutionalized reforms. Incremental reforms such as those implemented in Cambodia may help the decentralization process in Afghanistan to unfold.

Avoid the "race to the bottom" form of competition. Thanh Hung Vo from Viet Nam brought up the trend for local governments in his country to lower their property taxes to attract investments and take advantage of higher transfers for local governments with investors. Mr. Smoke pointed out that most evidence in the United States suggests that local taxes are typically marginal in the overall cost structures of firms. Businesses choose particular states because of access to resources, labor, markets, and transport. Thus, subnational tax breaks primarily serve to undermine the revenue base of subnational governments.

Consider the kinds of tax and the capacities and incentives of subnational governments to collect them. Abdul Khaliq from Pakistan inquired about the suitability of lower-tier governments to collect taxes and pointed out that this may encourage them to be more frugal. While acknowledging that this is an important point, Mr. Smoke underscored the need for subnational governments to have appropriate capacity and incentives to collect revenues and that some bases cannot be managed at the subnational level. Mr. Ahmad reiterated that due to the inherent externalities of taxes, broad-based taxes are better collected by higher government.

Balance potential revenues with other considerations. Given the potential revenues from natural resources, Karin Slowing from Guatemala pointed out the challenges of balancing costs with the need for more revenues. Mr. Ahmad explained that the risks related to natural resource utilization should be considered in opting for shared taxation. Due to negative externalities of exploration or extraction, one option is to utilize production-specific excise with proceeds going to local governments dealing with these externalities. Mr. Ahmad added that natural resources yield asymmetric sharing and raise very political issues. In the case of Aceh in Indonesia, the central government needed to balance the cost of secession vis-à-vis other government considerations. Thus, solutions are particularly case specific.

Session III: Design and Management of Decentralized Spending and Transfers

From the presentation of Ehtisham Ahmad*

This session considered issues on expenditure assignments and the preconditions for enhanced accountability, responsible spending, and increased transparency to deliver improved services and sustainable growth. It argued that delivering results entails a shift in the focus of equalization transfers from entitlements to service delivery. It featured the experiences of Peru and the People's Republic of China in utilizing Treasury Single Account. It also drew attention to the efforts of Sao Paulo, Brazil in minimizing expenditure overlaps and reducing disparity in service delivery, and discussed equalization initiatives in Thailand.

Challenges and Opportunities on Expenditure Assignment

In assigning spending responsibilities to subnational governments, using the Government Financial Statistics Manual (GFSM) of the International Monetary Fund (IMF) can solve various issues. Nevertheless, challenges in accountability, fiscal responsibility, transparency, and sustainability remain.

The basic question that underlies the decentralization process is "who does what and who is held accountable." The challenge is ensuring that subnational governments are accountable to their electorates. In order to get accountability, voters must know that a specific level of government is in charge and that they are paying for those services at the margin. Due to lack of a standardized format to categorize the cycle of revenues, establishing accountability in spending has been cumbersome.

Another challenge is ensuring that subnational governments are responsible in using funds received from central government, supranational agencies, or donors. Issues arise when donors insist on keeping separate accounts because these provide subnational governments the ability to hide or postpone liabilities. In addition, transparent and sustainable management issues arise related to the use of credit due to incomplete and asymmetric information. Costs and efforts for projects are generally known only to private partners.

Challenges and Recommendations for Better Earmarked Transfers

The problem with earmarked transfers is that it overrides local preferences and undermines accountability for local responsibilities. It is hard to ensure that funds are not diverted to other expenses that may be important for local officials. To address these challenges, competition could be induced among recipient jurisdictions with the use of a simple performance criterion depending on the ability of the subnational government to deliver outputs and outcomes. Once significant resources have been transferred to local governments, imposing minimum standards to recover these resources will no longer be effective. A more effective option is to execute social contracts with subnational governments in their areas of interest.

In designing equalization transfers, the focus should shift from entitlements to service delivery. This shift should be based on standardized factors to ensure that subnational governments cannot influence the magnitude of the transfer by their actions or inactions. Standardized spending responsibilities should address differential costs of provision

* Visiting senior fellow, London School of Economics Asia Research Center and Center for Development Research (ZEF), University of Bonn.

for assigned services. To determine economic outcomes and implications, simplicity in the design of equalization frameworks and the ability of a specific institution to manage them are important. In many countries, a specific section in the Ministry of Finance manages grants. An independent grants commission could also be established.

On the other hand, performance-based transfers should be based on simple inputs that can be monitored to make the conditionality relevant. In addition, designing performance-based grants would require establishing linkages between outcomes and service objectives, thus focusing on outcomes that lead to intended results.

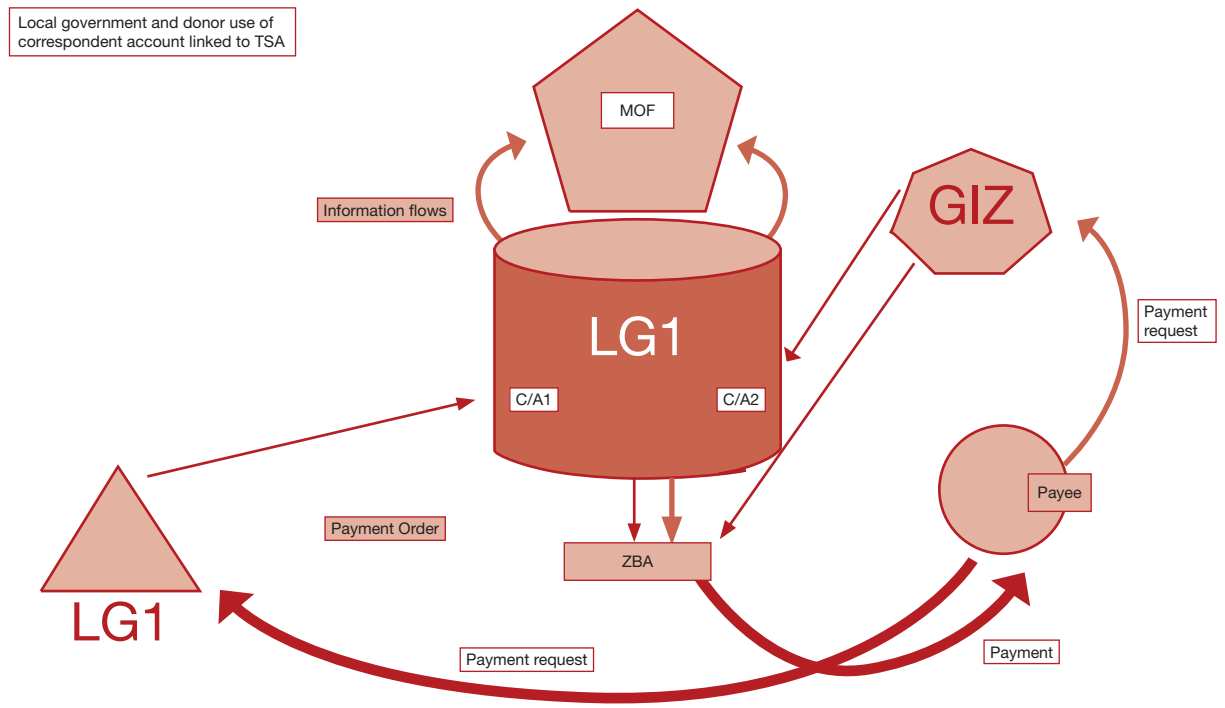
Treasury Single Account for Transparency

Information is vital in ensuring transparency in subnational government spending, which has promoted the widespread use of the Treasury Single Account (TSA). A set of uniform standards is a critical requirement for a TSA to work. Depending on a country's size and reporting standards, different models of TSAs ensure central government access to full information.

Figure 2 shows how TSA worked in a particular unitary country in Africa. Previously, subnational government staff had to go to the central government office to have their payments cleared. Under the current system, subnational governments issue payment orders represented by the red arrow to the zero balance accounts. Information is sent simultaneously to the TSA as shown by the blue arrow. Overnight payment is made to the account of the subnational government in a commercial bank. This illustrates how local governments control the entire budget process. In addition, donors (represented by the German Aid Agency, GIZ, in the diagram) can open a corresponding account within the TSA for the benefit of the local government.

For big countries using the GFSM2001 such as the People's Republic of China, TSAs are limited to own resource revenues of subnational government and central government transfers. Subnational

Figure 2 Treasury Single Accounts with Donors or Local Government



Source: Ahmad. 2013. Design and Management of Decentralized Spending and Transfers.

governments do not issue their own treasury bills. Cash management is done by the central government for forward planning and to smoothen out overall spending. However, for small unitary states without proper government financial systems, it is important to first establish zero balance accounts for the TSA to properly function. For small unitary states using GFSM, zero balance accounts may not be necessary.

Box 5 Commentaries by Expert Discussants: Requisites for Clear Expenditure Assignment

Paul Smoke

Information is necessary for downward accountability, but is insufficient. It is important for countries and donors alike to think more about how to encourage citizens to engage local governments. Citizens must know how to use the information and the available avenues to engage with their local governments and influence how available resources are used.

Management and capacity of the civil service. It is important to look at the way the civil service is managed as the civil service is typically an important part of costs in many sectors. Capacity building for better management of expenditures is also important. The inability of subnational governments to attract and/or properly remunerate qualified people is part of the reason why donors support parallel mechanisms that rarely lead to adequate local capacity building and institutionalized good public expenditure management.

Systems and processes must be in place. In thinking about public expenditure results, it is important to recognize that systems and processes need to be in place for sustainability. Some reform activities focus too much on quickly improving results by using shortcuts. Efforts to improve service delivery in fact also need to focus on developing and institutionalizing these critical systems and processes.

Teresa Ter-Minassian

Decentralization is often driven by political rather than economic motives. This fact often leads to the assignment of expenditure responsibilities that are not optimal from an efficiency standpoint. The externalities present in the delivery of services and the dynamic evolution of capacities by various levels of governments make it difficult to determine which level of government is better equipped to deliver specific goods and services. Therefore, both clarity and flexibility are important in expenditure assignments—clarity at any point in time about how expenditure assignments work, and flexibility to adjust, given that capacities to deliver these goods and services vary over time.

Clarity in expenditure assignments is important to avoid duplication, save resources, and promote accountability. Vested interests of the bureaucracy in both local and central government levels may contribute to the difficulty in achieving clarity. This tension between central governments and subnational government is also evident when it comes to the issue of the appropriateness of nationally defined minimum standards, as efficiency considerations may collide with distributional considerations. Finally, it is important to recognize the difficulty in determining the amount of resources needed by individual subnational jurisdictions to carry out assigned spending responsibilities at a standard level of efficiency.

Strengthen and link planning and budgeting. In order to ensure subnational fiscal sustainability and to support the pursuit of value for money in subnational spending, it is important to strengthen planning and budgeting. In particular, lengthening the time horizon beyond 1 year is useful to minimize spending commitments that start small but grow over time. It is useful to facilitate the observance of numerical fiscal rules and reduce the volatility and uncertainty of budgetary resources for subnational spending agencies. Equally necessary is the improvement of subnational government capacity to prepare reliable forecasts in the main revenue and nondiscretionary categories.

Encourage systems based on relatively simple and transparent formulas that are administered and reviewed periodically by independent bodies. Finally, in the design of transfers, the experiences of other countries show how susceptible transfers are to political pressures and how difficult it is to get consensus in reforming transfer systems. A priority for subnational fiscal management reform is to ensure sound systems for monitoring the budget execution, accounting, and reporting, with a comprehensive coverage to include assets, liabilities, and potential contingent liabilities.

Treasury Single Account and Clear Transfer Objective Toward Better Spending: Peru, the People's Republic of China, Brazil, and Thailand

From the country presentations made by: Jose Arista of Amazon Regional Government in Peru; Jinyun Liu, Deputy Director General Department of Treasury Ministry of Finance in the People's Republic of China (PRC); Giulia Puttomatti, Advisor to the Secretary of Finance in Sao Paulo, Brazil; and Weerachai Chomsakorn, Executive Director Office of the Decentralization to Local Government Organization Committee, Prime Minister's Office in Thailand.

The presentations by country experts illustrated three ways of supporting improved subnational government spending by: (i) using Treasury Single Account (TSA) and the International Monetary Fund's (IMF) Government Financial Statistics Manual (GFSM), (ii) minimizing overlaps in expenditure assignments, and (iii) clarifying the objective of transfers.

Peru: Treasury Single Accounts and Integrated Financial Management System

Being new to decentralization, Peru has had the chance to study the experiences of other Latin American countries and learn from the challenges that these countries experienced. Peru is a unitary state with three levels of government: central, regional, and local.

The central government collects most of the taxes such as the general sales tax, income tax, excise tax, and customs duties. It allocates resources to districts according to population. Local governments or districts collect taxes on property, vehicle, and land. On the other hand, regional governments have no other source of revenue except transfers provided by the central government. They cannot create or collect any tax and borrow without the approval of the Ministry of Economy and Finance. In case of internal debt, regional governments must follow the rules on fiscal prudence.

In order to manage resources, the central government facilitated the use of the TSA for all transactions made through the state bank. All entities that manage state resources must use the integrated financial management system. These two elements, the integrated system and single treasury account allowed the central government to control and manage financial development. The TSA is critical because all the transactions made by subnational governments use the integrated system and are conducted through the state bank. As a result of the tight control of the central government, Peru was able to achieve economic growth and fiscal sustainability.

The People's Republic of China: Managing Fiscal Decentralization through TSA Reform

The TSA Reform in the PRC that started in 2000 was divided into several stages. The first stage of reform began at the central government where zero-balance accounts were established in commercial banks and GFMIS was used to ensure that relevant information is collected. The next stage included the establishment of TSA at the provincial level. Each province established its own TSA and uses its own information system. Thereafter, the Ministry of Finance (MOF) sent sample systems with the required modules and functions to provinces. The provincial governments were allowed to use the system directly or improve the existing system to fit their locality. TSAs were also setup at cities and counties following processes similar to that of the provincial governments. For counties, the MOF designed a simpler system. Currently, 900 counties use the system developed by the MOF after making some improvements applicable to their situation. In general, TSAs are established at the local level by following a step-by-step process. Each level

of government is responsible in managing their own TSA.

The TSA implementation in the PRC yielded positive results in the management of the fiscal decentralization process. With its establishment, budget disbursement has become efficient. Transparency has greatly increased and monitoring has become easier to undertake. Currently, the MOF can access information on where the money goes and to whom it was paid. The TSA has proven to be beneficial in cash management, which is done mainly at the central government and certain provincial governments in the PRC.

Brazil: Performance Budgeting and Cost Accounting Systems in the State of Sao Paolo

In 2011, with assistance of the Fiscal Affairs Department of the IMF, the state of Sao Paulo began to streamline the performance budget results-based program and the cost accounting system. These programs were implemented to:

(i) minimize overlaps in expenditure assignments,
(ii) reduce the disparity in the delivery of essential public services,
(iii) strengthen capacities to manage own spending responsibilities of subnational governments,
(iv) improve transparency and accountability mechanisms, and
(v) generate appropriate indicators to measure the effectiveness of the state's public policy program.

The introduction of performance budgeting in Brazilian states, including Sao Paulo, has its roots in the 1988 Federal Constitution, which incorporated program budgeting in a multiyear plan similar to the Malaysian five-year plan. In the state of Sao Paulo, it had been fully adopted in the 2003 multiyear plan. In 1995, the Federal State Reform Plan established management autonomy and commitment to results in the three levels and branches of government. In the states, a supplementary law established contract management and payment by results, which were initially adopted by the finance secretariat and eventually the education secretariat. In the early years of 2000, Sao Paulo implemented a results-oriented strategic management in three steps:

(i) increasing administrative and financial autonomy,
(ii) defining goals and indicators, and
(iii) fully adopting payment by results method.

After the preparation and approval of the 2012–2015 Plan, the state government strengthened the team to support capacity building and pilot tested its implementation.

The management by results is appropriate, given the existing conditions of capabilities and systems and because the state organized its public programs focusing on results. Thus, much of the methodology has been adopted by the state entities and was easily disseminated. The program team was able to set goals with sector linkages to the strategic guidelines in the multiyear plan. They were able to identify data and information required to generate indicators and defined goals and targets of the multiyear plan. However, the current multiyear plan needs improvement. It needs to be harmonized with standard nomenclature and concepts to allow for effective execution and to generate useful information. It was estimated that by 2014, the implementation of new methodology on the existing financial systems would be able to provide comprehensive and reliable data to support both the cost accounting system and the performance budget results-based program.

Thailand: Decentralization Plan with Clear Transfer Objectives

In Thailand, the 1997 Constitution provides the objective for decentralization, i.e., improved service delivery to every Thai. To this end, the Decentralization Act was adopted, which established the Decentralization Committee with the main function of creating the country's decentralization plan. The focus of the first decentralization plan was to reduce the duplication of functions in infrastructure, promote the quality of life, and conserve and manage the environment and resources, arts, culture, and local wisdom. The plan was meant to be implemented within 10 years and transfer 245 tasks from central to local governments. To transfer these responsibilities, the Decentralization Committee grouped the tasks into three categories:

(i) those that can be transferred immediately,
(ii) those that need capacity building before they can be transferred, and
(iii) those that need amendment of laws to be transferred.

After the first decentralization plan, 181 out of 245 tasks were transferred to local governments

while 44 tasks were transferred during the second decentralization plan.

Despite these plans and decentralization efforts, issues remain that needed attention of the central government to ensure further decentralization in Thailand. The first wave of decentralization is similar to Indonesia's "big bang approach" without regard to the existing capacities of local governments to perform the transferred functions. The poor performance of local governments was exacerbated by the lack of interest of central government to develop and implement training programs for local government staff and officials. Finally, due to the apparent lack of capacity of local governments, interest in continuing the decentralization by central agencies has waned. Citizens fail to appreciate the accomplishments of local governments in service delivery.

Box 6 Roundtable Discussion: Weighing the Costs for Better Results

The roundtable discussion focused on (i) the possible challenges in the use of the Treasury Single Account (TSA), (ii) the importance of transparency and yardstick competition, and (iii) issues of capacity and the high turnover in the local civil service. The experts addressed the issues raised and underscored some key lessons in improved subnational government spending.

Subnational governments remain the managers of their funds under a TSA. TSA helps obtain information on subnational government spending. Nevertheless, reservations remain on how it might undermine central government trust in subnational governments and its impact on subnational government spending autonomy. In response to Emilio Pineda (Mexico) and Abdul Khaliq's (Pakistan) concerns on how the monitoring of subnational government transactions might possibly be inimical to local autonomy, Ehtisham Ahmad clarified that under a TSA, subnational governments remain the managers of their funds and exercise full control of the budget process. In addition, by providing all levels of government with full information on who spends what and when, TSAs promote accountability for subnational spending and improves overall cash management.

Transparency promotes accountability and yardstick competition. Responding to the issue of subnational governments that fail to effectively spend the resources transferred to them, Teresa Ter-Minassian emphasized the importance of transparency and "yardstick competition," which arises when constituents are able to benchmark the performance of incumbents against those in other jurisdictions. Mr. Ahmad added that poor information flows allow subnational governments to "hide" spending information that reduce local accountability, negate yardstick competition, and also facilitate diversion of resources and game-play vis-a-vis central agencies.

Transparency creates demand for improved civil service spending and capacity. The local civil service constitutes a significant part of subnational government expenses and often faces capacity constraints as pointed out by Mulia Nasution from Indonesia and Mr. Yama from Afghanistan. Rapid turnover of staff (through promotion or hiring by donors) also contribute to the lack of capacity at the local level. Paul Smoke explained that it is important to create incentives for the staff through a clear promotion scheme. He added that in the case of Indonesia, decentralization saw staff from the center transferred to subnational governments to prevent disruption of services in the country. However, these transfers carried over the inefficiencies of the former system that the central government continues to subsidize through transfers. To eliminate these inefficiencies, Mr. Smoke encouraged the creation of pressures from below by ensuring that citizens are informed of the staffing requirements for every service. In turn, this will apprise citizens of the costs of providing those services by comparing it with other jurisdictions. Mr. Smoke also suggested the possibility of using conditional grants as a tool to solve the inefficiencies in the local bureaucracy.

Closing Session: Decentralization, Results, and the Role of Development Partners

The Inter-American Development Bank (IADB) and the Asian Development Bank (ADB) can facilitate the delivery of results in member countries in various ways. The Asia-Pacific Community of Practice (APCoP) and the Latin American and the Caribbean Community of Practice (CoPLAC) were established to promote management for development results (MfDR) through:

South–South dialogues. The communities of practice (CoPs) create opportunities to bring together senior officials and policy practitioners to engage in dialogue and encourage peer learning.

Developing knowledge products. In addition to the results-based public sector management (PSM) frameworks developed APCoP and CoPLAC, there is strong demand for CoP publications that highlight the success stories of other countries in delivering results. These help participants to apply the concepts and principles discussed during forums and workshops.

Closing the "information gap" on MfDR and Results-Oriented public sector management by facilitating the engagement of other actors (civil society, academe, chief executives) in MfDR discourses. While participants recognize the importance of delivering results both at the central and subnational levels, they emphasized that other actors have been instrumental in shaping the trajectory of decentralization reforms and the delivery of results in their respective countries.

Considering the various challenges that decentralization brings to the delivery of results, participants shared specific country needs for IADB and ADB. Participants and experts agree that the uniqueness of each country requires an understanding of local conditions to design technical assistance. Considering that systems are interdependent, development partners were asked to spearhead country reforms with results orientation using a more holistic rather than "patchwork" approach.

Development partners were requested to continue engaging at the country level to ensure sustainability. However, to ensure the effectiveness of decentralization in the delivery of results, the design of technical assistance should aim to:

(i) build on country priorities in a manner that promotes innovative sustainable reforms;
(ii) support a strategic approach that considers asymmetric information, targets capacity building to specific reforms, tailors reform path to country conditions, and uses performance-based approaches to create incentives for improved performance (Smoke);
(iii) support reform and implementation of macroeconomically sound intergovernmental fiscal arrangements (Ter-Minassian); and
(iv) align incentives and accountability on decentralized spending and transfers (Ahmad).

PART II

EXPERT PAPERS

This section features the papers prepared by fiscal decentralization experts to provide the theoretical bases for the country panelists and roundtable discussions. Initial drafts of the papers were sent to participants in the weeks leading to the forum.

The following papers were prepared by three international decentralization experts:

(i) *Promoting Effective and Macroeconomically Sound Fiscal Decentralization: the Role of Central Finance Agencies* by Teresa Ter-Minassian
(ii) *Design and Management of Decentralized and Intergovernmental Revenues* by Paul Smoke
(iii) *Design and Management of Decentralized Spending and Transfers: Underpinnings for Successful Decentralization by* Ehtisham Ahmad.

The drafting of the papers involved close collaboration among the experts, including regular team discussions with the Asia-Pacific Community of Practice team to identify issues and country examples to be highlighted.

Promoting Effective and Macroeconomically Sound Fiscal Decentralization: The Role of Central Finance Agencies

By Teresa Ter-Minassian

I. Introduction

Traditional (first-generation) theories of fiscal federalism (Tiebout, 1956; Musgrave, 1959; Oates, 1972) emphasized the potential efficiency gains from fiscal decentralization. Based on the key assumptions of benevolent governments, differences in preferences and significant citizen mobility, they argued that expenditure functions should be assigned to the lowest level of government capable of internalizing the benefits from those functions. This would improve preference matching, because local governments can be expected to know their citizens' preferences better than the central government, and because citizens unsatisfied with their local government's performance can vote local officials out of office, or even move to a different locality ("vote with their feet").

The normative prescriptions of first generation theories have been subject to a broad array of criticisms, especially over the last two decades. **Second generation theories** (Quian and Weingast, 1997; Oates, 2005; Weingast, 2009)[1] have focused on **political economy influences on decentralization processes**, such as:

- Political motivations for decentralization and its timing, pace, and sequencing, that going well beyond a quest for efficiency gains in resource allocation. Such motivations may include helping keep countries together in the face of ethnic or other conflicts; reducing "excessive" powers of central government; and promoting "yardstick" competition among or within government levels;
- Representation failures in electoral processes, reflecting voters' information asymmetries and the power of economic elites to buy influence; and
- De facto limitations to citizens' mobility.

Second-generation theories have also called attention to the **role of incentives, institutions, and capacity constraints** in shaping the decentralization process and its success in delivering its hoped-for efficiency gains.

At the same time, based on practical experiences with decentralization particularly in developing countries, some contributions to the fiscal federalism literature have called attention to **macro-economic risks from unsustainable fiscal behaviors of subnational governments** (Prud'homme, 1995; Ter-Minassian, 1997; Tanzi, 2001), as well as to the risk of deepening regional income inequalities through decentralization.

[1] See Ahmad and Brosio (2006) for a review of such theories.

While the concerns raised by these strands of the literature are unlikely to reverse, in most cases, the ongoing worldwide trend toward decentralization, they point to the importance of deepening the reflection on how political economy factors, economic agent's incentives, and countries' institutions affect the process of fiscal decentralization, with a view to **maximizing its results in terms of efficiency and citizens' welfare, while containing macro-economic risks**.

The seminar for which this paper has been prepared aims to stimulate such a reflection among senior government officials in Asia and Latin American countries that are currently at different stages of the decentralization process. This paper—which complements two others specifically devoted to expenditure assignment and management, and revenue assignment and transfers, respectively—focuses on the risks that **"soft budget constraints" (SBCs)** on subnational governments (SNGs) pose for macro-economic stability and fiscal sustainability, and also for the effectiveness of decentralization in terms of resource allocation and the delivery of public goods and services.

The paper begins with a discussion of the nature and possible causes and consequences of SBCs. It also focuses on possible approaches to hardening subnational budget constraints, and the challenges posed by their design and implementation. It then discusses policy and institutional reform options to deal with the consequences of SBCs, in particular subnational debt crises. It concludes with a section summing up what central finance agencies (in particular ministries of finance and planning) should and should not do in seeking to avoid subnational SBCs.

II. Causes, Consequences, and Possible Remedies for Soft Budget Constraints

The concept of soft budget constraint was initially put forward in the literature on transition economies (Kornai and others, 1992) to characterize the relation between a government and its enterprises. In this context, the term refers to the fact that, especially in planned economies, the state can be expected to step in to cover, through subsidies, the losses that its enterprises incur; this in turn saps the enterprises' incentives to be efficient in their operations.

In the inter-governmental fiscal relations context, a **SBC** arises when the inability of a principal (the central government, CG) to credibly commit to not bailing out an agent (a SNG) induces the latter not to respect its budget constraint. In the absence of a hard budget constraint, a SNG expects to be able to increase spending without carrying the full cost of such an increase. This **creates incentives to overspend** (run deficits and accumulate debt, in the expectation of an eventual bailout). **The SBC also discourages SNGs' efforts to mobilize own revenues, and to be efficient in spending.**

A number of flaws in intergovernmental fiscal arrangements can give rise to subnational SBCs:

- CGs' reliance on markets to impose fiscal discipline on their SNGs, when the essential pre-conditions for the effectiveness of such discipline are lacking
- Ineffective "cooperative federalism" arrangements
- Weaknesses in more hierarchical control mechanisms:
  - significant discretion in direct control of subnational borrowing by the CG,
  - inappropriate design and/or inadequate enforcement of subnational fiscal rules;
- Unclear expenditure assignments or unfunded CG mandates for SNGs;
- Little or no revenue autonomy for SNGs; and
- Substantial discretion in intergovernmental transfers.

These potential sources of SBCs are examined in turn in what follows.

1. Inappropriate Reliance on Market Discipline

If a CG relies on financial markets to impose fiscal discipline on its SNGs, but markets expect the CG to eventually support a SNG in difficulty, the SNGs may increase their debt well beyond their capacity to service it, before they see their borrowing costs rise significantly. **Markets expectations about future bailouts are often shaped by past histories of such actions**. This is illustrated, for instance, by a comparison of the experiences of the United States (US) and Canada with that of Germany. In the former two countries, which are characterized by a long history of no bailouts, interest rates on subnational debt vary significantly across SNGs and over time, reflecting markets' assessments of the evolving creditworthiness of individual SNGs. In contrast, given Germany's history of a bailout (mandated by the country's Supreme Court) of two states in difficulty in 1992, as well as various characteristics of the German federalism,[2] yields on Laender's debt vary little, irrespective of the financial state of the Laender. Therefore, **CGs with significant histories of previous bailouts should not rely solely or primarily on financial markets to discipline their SNGs**, at least not before having established an extended and consistent record of no further bailout of SNGs in difficulties.

Markets may also fail to exert discipline on SNGs because they are forced to lend to them, or are provided regulatory incentives to do so. Despite a declining trend in the last decades, privileged access of SNGs to bank credit is still quite widespread, especially in emerging and developing countries. It can result from subnational ownership of regional or local banks, portfolio requirements imposed by the CG on nationwide banks, or lower prudential requirements for bank lending to SNGs. In turn, heavy exposure of banking systems to SNGs' debt magnifies financial spillovers from subnational debt crises, making it more difficult for a CG to resist pressures for bailouts. Therefore, rapid and broad-based progress in eliminating privileged channels of subnational access to credit would be important to allow increased reliance by CGs on market discipline over their SNGs.

Market discipline on SNGs can also be weakened by information asymmetries. Subnational fiscal accounts often lack the degree of transparency that would be required to allow lenders to accurately assess the credit worthiness of SNGs. For example, such accounts often do not conform to standardized public accounting requirements; they tend to be made public with substantial delays; and are not always appropriately audited. Rarely do they include a detailed account of contingent liabilities—stemming from guarantees to own enterprises, public–private partnerships (PPPs), or others—or of unfunded liabilities to their employees. **Substantial progress in strengthening subnational public financial management (PFM) systems, including accounting and reporting, is crucial to minimize SBC risks, as well as to increase local political accountability and incentives to efficiency, and to reduce corruption**. The Brazilian Fiscal Responsibility Law of 2000 constitutes a good example of a reform to substantially strengthen the transparency of subnational fiscal accounts in the country.[3]

Finally, a further obstacle to effective reliance on market discipline is the generally **limited sensitivity of politicians to early market signals of deteriorating creditworthiness perceptions**. A possible approach to countering such tendencies is to require prospective subnational borrowers to maintain a minimum standard rating by independent agencies, based on objective and transparent indicators. But, the effectiveness of such ratings would also be adversely affected by information asymmetries. This underscores the importance of the transparency efforts mentioned above.

[2] See Rodden, 2003 and 2006 for details.

[3] See Ter-Minassian, 2010 for a discussion of the Brazilian FRL in an international perspective.

2. Ineffective Cooperative Arrangements

SBCs can also emerge in intergovernmental systems where subnational borrowing constraints are defined within the framework of annual or multiyear negotiations **(cooperative arrangements)**. Examples of such arrangements can be found in the so-called "domestic stability pacts" agreed between central and subnational governments in some European countries (Austria, Belgium, and Germany) to promote compliance with the European Union's Stability and Growth Pact (SGP) targets, which are formulated in terms of the general government as a whole.[4] Another example is constituted by the Australian Premiers' Conference and Loan Council, which are essentially for a for dialogue and peer pressure between and within the two main levels of government of the federation.[5]

By their very nature, **cooperative arrangements leave ample scope for discretion and negotiation**. Their outcomes are therefore very influenced by political power balances, and institutional features, such as the role of subnational leaders in national parties, governing coalitions, and parliaments. SNGs with significant political power (individually or jointly with others) will not only try to negotiate more lenient ex-ante borrowing limits, but also expect to be able to extract ex-post support from the center if they get into difficulty by violating agreed budget constraints. While in principle the bargaining power of a SNG could be expected to be positively correlated with its size (Wildasin, 1997), in fact smaller SNGs more often benefit from bailouts (Rodden et al., 2003). In some countries, the political alignment of a SNG with the political party or coalition in power at the CG level has been found to be associated with softer budget constraints.[6]

In summary, cooperative arrangements can work effectively as for a for dialogue among representatives of different government levels about intergovernmental issues, but are unlikely to be sufficient by themselves to secure adequate subnational fiscal discipline, and therefore **need to be complemented by institutions (such as fiscal rules) that limit the scope for discretion in the setting and enforcement of a hard budget constraint**.

3. Administrative Borrowing Controls

Administrative control mechanisms on SN borrowing are mostly utilized in unitary states, although some large federations (e.g., India) utilize them as well, especially as concerns foreign borrowing. Such mechanisms (essentially CGs' authorizations for individual subnational borrowing operations) **can give rise to SBC, to the extent that they provide significant scope for discretion, and thus political bargaining**. This is especially the case in countries where the executive branch is relatively weak, and SNGs have substantial influence on the legislative branch.

In the absence of clear and consistently applied criteria for authorizing subnational borrowing, based on objective indicators of ability to service the debt, both the SNGs and financial markets may expect a more accommodating attitude of the CG towards jurisdictions politically aligned with the ruling party or coalition. Moreover, it may be difficult for a CG to refuse bailouts to a SNG experiencing debt-servicing difficulties, if it (or a previous government) had authorized a significant portion of that debt.

4. Poorly Designed or Weakly Enforced Subnational Fiscal Rules

The demanding pre-conditions for effective reliance on market discipline and the weaknesses of negotiated arrangements explain the **growing popularity of subnational fiscal rules**. The number of countries utilizing

[4] In other European countries (e.g., France, Italy, and Spain) so-called domestic stability pacts have involved in practice the imposition by the CG of (more or less strong) subnational fiscal rules. See Bordignon, 2006; and EC, 2012, for discussions of such arrangements.

[5] See Craig, 1997 and Morris, 2007 for overviews of the Australian inter-governmental fiscal system.

[6] But, see Bordignon and Turati, 2003, for a different finding with respect to local governments in Italy.

such rules has grown rapidly in recent decades (Sutherland and others, 2006; IMF, 2012).[7] An increasing share of countries uses more than one rule. The most popular combination is one of limits on the budget deficit and on gross debt of SNGs. However, the number of countries using subnational expenditure rules is also rising. In contrast, few SNGs use revenue-based rules.[8]

But, **fiscal rules are no magic bullet for ensuring adequate subnational fiscal discipline.** The effectiveness of subnational fiscal rules depends crucially on sound design, a robust legal basis, adequate implementation tools, and firm enforcement. As the next sub-sections show, meeting all these prerequisites is far from trivial, and **significant flaws in this respect can lead to the emergence of SBCs.**

a. Key Issues in the Design of Subnational Fiscal Rules

A first issue is whether rules are more likely to be effective if they are **self-imposed** by individual SNGs, rather than **mandated by the CG**. Obviously, in terms of ownership, a rule democratically adopted by a subnational jurisdiction is preferable to one dictated from the center. Moreover, especially in large federations, constitutional guarantees of autonomy for the constituent states and/or provinces may make it impossible for the CG to impose numerical fiscal rules on the SNGs. On the other hand, individually chosen subnational fiscal rules may not satisfactorily address the "common pool" problem, and may result in an overall subnational fiscal balance inconsistent with short-term macro-economic stabilization requirements, or even national fiscal sustainability. This is especially likely to be the case if individual SNGs have "rational expectations" of bailouts from the CG, based on past history,[9] or on the reality of political power balances in the country.

Even if constitutional restrictions prevent a CG from mandating the adoption of specific numerical fiscal rules to its SNGs, **the CG can play a catalytic role in bringing about the adoption of sound rules** through its own example (i.e., by adopting a national fiscal responsibility law to serve as a model for subnational ones[10]) and by using available financial and/or political incentives to follow such an example.

A key issue in the design of subnational fiscal rules is their **coverage**. Rules that fail to include SNGs' contingent liabilities arising from non-commercial activities of enterprises they own, or from PPPs they enter into, open scope for the emergence of SBCs. There are plenty of examples in this respect, ranging from advanced countries, such as the United Kingdom and the so-called European periphery,[11] to emerging markets such as Mexico, China, India and Colombia, to cite just a few. The quantification of such fiscal risks is, however, often a complex task, a fact that contributes, along with political resistances to their disclosure, to the generally inadequate coverage of subnational fiscal rules to date.

Another important issue is the nature of the numerical targets for subnational fiscal rules, including:

- **Budget Balance or Public Debt?**

Debt rules are more directly linked to fiscal sustainability than balance-based rules, since they capture the impact of below-the-line operations that do not affect the budget balance but increase the gross public debt (such as a securitization of previously unrecognized debts, or a recapitalization of public enterprises or banks). Such operations are quite common in many countries. Debt-based rules also have the advantage of

---

[7] The share of advanced countries with at least one subnational fiscal rule has risen from 20% in the 1980s to nearly 90% in 2011. That of emerging market countries has gone from 0 to over 90% over same period.

[8] An example is ceilings on revenues in some US states.

[9] In this context, it is interesting to note that US states began adopting balanced requirements in their constitutions in the second half of the nineteenth century, in the wake of a refusal by the federal government to provide bailouts, which led to a number of states having to default on their loans and undertake painful fiscal adjustments (Henning and Kessler, 2012).

[10] As was done e.g., in Argentina and India in the 1990s.

[11] For example, in the Spanish regions (*comunidadesautonomas*) and the Portuguese island of Madeira.

requiring the fiscal stance to be adjusted in the event of a lasting shock, such as a devaluation, that impact the foreign exchange-denominated component of the debt.[12] Therefore, in many countries subnational fiscal rules include limits on the ratio of gross debt to subnational revenues, along with limits on subnational deficits.

- **Primary or Overall Balance?**

Rules targeting the primary (non-interest) balance have the advantages of focusing on an indicator that is relatively more controllable by the authorities and better reflects current, rather than past, policy decisions. However, their observance may not be sufficient to ensure consistency with short-term financing constraints and/or longer term public debt sustainability, unless they include a requirement for the authorities to adjust the primary target in response to significant and sustained deviations of the interest bill from its anticipated path, or in response to shocks (e.g., a devaluation) affecting the debt stock.

- **Current or Overall Balance?**

Rules targeting the current balance (the so-called golden rules) respond to the objective of avoiding the all-too-common concentration of fiscal adjustment on public investment (with related potential longer-term adverse effects on growth and competitiveness). However, they are not necessarily consistent with short-term stabilization objectives and financing availability and with longer-term public debt sustainability. Also, they privilege the accumulation of physical over human capital (which may be inappropriate in many countries), and are susceptible to accounting manipulations (e.g., the classification of support to loss-making public enterprises as capital spending).

- **Actual or Cyclically Adjusted Targets?**

There is substantial empirical evidence that **subnational fiscal rules, while helping in many instances promote fiscal discipline, can also promote pro-cyclicality in subnational fiscal policies.**[13] Adopting cyclically adjusted targets should in principle help avoid such pro-cyclicality. There are, however, a number of theoretical and practical considerations that hinder, and in many circumstances prevent the use of, such an approach.

First, the difficulties of estimating cyclically adjusted fiscal aggregates are even more significant at the subnational than at the national level. Most countries do not have reliable and timely estimates of regional or local output, even less of output gaps. Using national indicators of the cycle as a proxy can be adequate when the cyclical shocks are reasonably evenly distributed across the national territory, but, as evidenced by the recent global financial crisis, this is rarely the case.

Second, financing constraints tend to be tighter at the subnational than at the national level, as market access is typically lower and more expensive for SNGs than for their corresponding CG. This suggests that the use of a subnational fiscal rule allowing cycle-related deviations from a balanced-budget (or other sustainable balance) target should be accompanied by a requirement that SNGs use their budget surpluses during booms to accumulate liquid assets to be drawn down during downturns.[14]

---

[12] However, debt rules should include escape clauses that allow such adjustments to be distributed over an adequate period of time, to avoid either low quality measures or an outright violation of the rule in the event that the shock is unexpected and large.

[13] See, for instance: Alt and Lowry, 1994; Bohn and Inman, 1996; Poterba, 1994; and Sorensen and others, 2001. In contrast, Fatas and Mihov, 2006 found that balanced budget rules for the US states constrain their fiscal policy volatility, but also reduce its responsiveness to output fluctuations, and that the first effect dominates the second. Therefore, they concluded that on balance, fiscal rules contribute to output stabilization.

[14] An example in this respect are the so-called "rainy day funds" mandated by some state constitutions in the US.

Third, consideration should be given to increased use of expenditure rules at the subnational level. Such rules, while not necessarily avoiding pro-cyclicality during downturns (since they set ceilings, not floors, for public expenditures) help moderate it during upswings and, by promoting subnational savings and asset accumulation during such periods, can help cushion the impact of subsequent recessions on spending.

Finally, to reduce the risk of pro-cyclicality at the subnational level, broader reforms may be needed in the system of inter-governmental fiscal arrangements. In particular, one criterion for the choice of revenues to be assigned to SNGs should be a low elasticity to cyclical developments. This (as well as equity considerations) argues against the assignment of revenues from natural resources and from company taxes to the subnational level, as well as against a mainly derivation-based revenue sharing mechanism for this type of revenues. As regards other shared revenues, it may be desirable to use a sharing formula based on moving averages, rather than current values, of CG revenues, to help smooth cyclical fluctuations of SNGs' resources.

A further important issue in the design of subnational fiscal rules relates to the inclusion of **escape clauses**. These clauses should specify as clearly as possible the nature and magnitude of the shocks to be accommodated; the length of period during which the rule would be relaxed or put into abeyance; a path of return to full observance of the rule; and the responsibility for activating the clause and monitoring its implementation. Existing rules vary significantly in terms of the degree of discretion afforded to SNGs in invoking and implementing the clause.[15]

b. Main Implementation and Enforcement Issues

The capacity of SNGs to implement fiscal rules largely depends on the state of their public financial management (PFM) systems.[16] SNGs often lag behind their respective CGs in PFM. The CG has an important role to play in many countries in promoting and supporting the strengthening and modernization of budgeting, budget execution, accounting, and reporting systems at the subnational level. Whenever feasible in the light of possible constitutional constraints, the CG should ensure that common accounting and reporting standards are enacted for all levels of government (possibly with simplified regimes for small local governments), to facilitate adequate transparency of SNGs' operations, as well as a timely monitoring of the observance of any existing fiscal rule for these governments. Brazil provides an excellent example in this respect.

There is also a case for supporting the adoption of a fiscal rule with the creation of **fiscal"watchdogs"** responsible for: assessing the likelihood of compliance of a proposed budget with the rule; closely monitoring its execution; alerting to, and preferably quantifying, emerging risks to the budget outcome; and possibly recommending adequate remedial steps (Kopits, 2011).

The effectiveness of subnational, as well as national fiscal rules, hinges critically on the enforcement mechanisms supporting them. Such mechanisms should have a solid legal basis; their application should be non-discretionary; and the penalties envisaged be severe enough to act as deterrent to non-compliance, but not unrealistic, which could ultimately lead to their non-application. Penalties are typically of a financial nature, e.g., in the form of withholding of CG transfers to non-complying jurisdictions, but occasionally also entail the personal responsibility of the relevant officials (e.g., in Brazil). The effectiveness of enforcement mechanisms is likely to be greatly enhanced if they are supported by explicit **requirements to correct deviations** from the rule within a reasonable, pre-specified time period.[17]

---

[15] See Ter-Minassian, 2010 for details.

[16] For details, see the paper prepared by E. Ahmad for session 3 of the seminar.

[17] Examples of such correction mechanisms are provided by the "debt brake" provisions supporting the national fiscal rules in Switzerland and Germany, and also envisaged in the EU Fiscal Pact.

5. Other Features of Intergovernmental Systems Leading to the Emergence of Soft Budget Constraints

As indicated above, **a sound overall design of intergovernmental fiscal arrangements is important to minimize the risk of emergence of SBCs**. The key prerequisites in this respect can be briefly summarized as follows.[18]

a. Reasonable Clarity about Respective Spending Responsibilities of the Different Levels of Government and Avoidance of Unfunded Mandates

Overlapping spending responsibilities make it difficult for voters to know which level of government is responsible for the provision of the public goods and services concerned, and to penalize a poor performance of SNG officials in such provision by not re-electing them. Unfunded spending mandates are likely to result in a lack of subnational incentives for sound public expenditure management, as SNG officials can blame inadequate transfers of resources by the CG for the failure to meet their spending responsibilities. Unfunded mandates can also give rise to subnational bailout expectations, and thus to SBCs.

b. Significant Revenue-Raising Autonomy at the State and Local Levels

A heavy dependence of SNGs on transfers does not promote either their fiscal responsibility, or political accountability to their electorates. Although both the choice of appropriate tax handles to be devolved to the subnational government level, and the building of adequate subnational capacities to administer devolved taxes are not trivial tasks, **the capacity of SNGs to raise own revenues at the margin is crucial to avoid SBCs.**[19]

c. An Appropriate Design of Inter-governmental Transfers

From the standpoint of minimizing SBC risks, **it is important that inter-governmental transfers be formula-based**, since, as mentioned above, discretionality creates scope for political favoritism and bailout expectations. The formulas should be transparent, based on factors that cannot be manipulated by SNGs, and their correct application should be easily verifiable.[20]

The transfer formulas should also ensure a degree of horizontal redistribution among SNGs consistent with the country's tolerance of regional disparities. Failure to do so often leads to political and social tensions that can undermine the fiscal responsibility and sustainability of the poorer regions, ultimately requiring bailouts by the CG.

In summary, ensuring adequate subnational fiscal discipline and preventing subnational debt crises is a complex endeavor that goes to the core of the design of inter-governmental fiscal arrangements. **The specific mix of borrowing controls that is likely to be most effective depends on country-specific circumstances**, but in most cases is likely to involve a combination of: well designed, and firmly and evenly enforced fiscal rules, with an adequate degree of flexibility; minimal discretion in the CG's support to SNGs; and institutional reforms to increase the effectiveness of market discipline on SNGs.

---

[18] Desirable features of expenditure and revenue assignment and management are covered in much greater detail in the papers prepared for this seminar by E. Ahmad and P. Smoke, respectively.

[19] See in particular Ambrosanio and Bordignon, 2006; and Bird, 2009 for discussions of these issues.

[20] See Boadway and Shah, 2007 for a comprehensive discussion of issues related to the design of transfers, including the practical difficulties of avoiding or neutralizing strategic behaviors of the recipients of formula-based transfers.

III. What If Efforts to Avoid Soft Budget Constraints Do Not Work?

The demanding requirements for avoiding subnational SBCs outlined in the previous section help explain why **efforts to promote subnational fiscal discipline and prevent subnational debt crises do not always work**. Unfortunately, there are numerous examples of such crises in both advanced and developing countries' histories (Liu and Waibel, 2010). For example, in the US, eight states defaulted in 1842, and nearly one third of municipal governments did so during the Great Depression of the 1930s. In more recent years, prominent examples of local fiscal crises in the US include those of New York City in 1975, Orange County in 1994, and the District of Columbia in 1995. Other local crises and bankruptcies have occurred in the US in the aftermath of the recent global financial crisis.

There have also been many cases of local government financial distress in Japan and Western European countries. Among emerging markets, irresponsible provincial fiscal behavior in Argentina contributed to the country's debt default of 2001. Brazil experienced three subnational debt crises in the 1980s and 1990s. The 1995 Tequila crisis in Mexico exposed the vulnerability of subnational debt to the peso devaluation, and led many Mexican states to default. In the Russian Federation at least 57 out of 89 regional governments defaulted over 1998–2001. In India, many states experienced fiscal stress in the late 1990s to the early 2000s, with a rapid increase in fiscal deficits, debt and contingent liabilities.

Subnational debt crises typically entail serious consequences, namely more or less severe disruptions of the provision of public goods and services for the population of the SNG in crisis; and adverse **spillovers** on other SNGs, and possibly the whole nation. Such spillovers are generally of a **financial** nature (increased market perception of financing risks, reflected in rising borrowing costs, and in some cases, propagation of debt rollover difficulties). They may also include **social and political** costs, especially for other SNGs (or even the CG) politically aligned with the jurisdiction in crisis.

1. Bailouts

The threat of such consequences frequently leads to **bailouts by higher-level governments**. These can take different forms: discretionary gap-filling budgetary transfers; assumption and restructuring, involving a reduction of the Net Present Value; or outright forgiveness of the subnational debt by the central government.

Subnational bailouts are costly not only because they entail additional financial burdens for the central government, and, when large, can jeopardize the latter's creditworthiness and medium-term fiscal sustainability, but also because **they give rise to moral hazard and thus further soften the subnational budget constraint.** The degree of such moral hazard depends on their frequency (although even a single episode can lead to expectations of further ones, as witnessed by the above-mentioned case of the German Laender); and the severity of the conditions attached to them. Bailouts involving a temporary takeover of the SNG in question by higher level authorities, the dismissal and possibly penalization of the subnational officials involved, and a firm enforcement of, often painful, fiscal adjustment measures are less likely to provide incentives to other SNGs for fiscal irresponsibility.

Also crucial in determining the extent of moral hazard created by a bailout is whether or not it is accompanied by **strengthened preventive measures**, in particular institutional reforms such as the adoption or strengthening of subnational fiscal rules, measures to increase the transparency and reliability of subnational budget information, and steps to reduce discretionality in inter-governmental fiscal arrangements.

There are **few international examples of a consistent record of no bailouts**. Among those are the US, where since the mid 1800s, the federal government has refrained from interventions to support individual states in difficulty;[21] and Canada, where the provinces undertook severe fiscal adjustment in the early nineties, without federal intervention, to prevent a brewing debt crisis.

[21] The US federal government does conduct, however, active fiscal stabilization policies, which help smooth the impact of adverse systemic shocks on the states' finances.

Also, there are **relatively few examples of successful subnational bailouts** (not leading to moral hazard and thereby not increasing SBCs). The 1996-97 state and municipal bailout in Brazil can be considered a good example in this respect, as it led to a sustained improvement of the subnational finances in the country.

2. Subnational insolvency frameworks

There is a limited but growing international experience with **formal ex-ante frameworks for subnational debt resolution**, setting out pre-specified rules for the allocation of default costs. The US has such a framework for local governments only (Chapter 9). So does Hungary, which enacted a Municipal Bankruptcy Act in 1996. South Africa did so in 2003.

Specifically, formal insolvency framework aim to clarify how, in the event of a subnational default, the debt will be restructured in an orderly manner; which and how essential public services will be maintained; and what structural adjustment measures must be undertaken by the defaulting jurisdiction to restore its solvency.

If appropriately designed and implemented, such frameworks can provide a number of benefits:

- help reduce disruption in the provision of public services, and the related political pressures for bailouts;
- facilitate orderly workouts, minimizing problems stemming from holdout creditors;
- also facilitate the eventual return of defaulting jurisdictions to credit markets; and
- help prevent both SNGs' and lenders' expectations of bailouts, thus effectively hardening subnational SBCs.

The **design of insolvency frameworks** must balance the protection of creditor rights with that of core functions of the SNGs involved. It should also create sufficient political costs for leaders of defaulting jurisdiction to minimize moral hazard. It requires consideration and definition of **many complex issues** (Liu and Waibel, 2010). These include:

- The role of the judiciary. While Chapter 9 in the United States and Hungary's legal insolvency mechanism deal with insolvency through the courts, South Africa's legal framework is a hybrid, envisaging administrative intervention in the early stages of debt distress, followed by judicial intervention if the latter degenerates into insolvency;
- Who can file for bankruptcy? The class of eligible filers differs across countries;[22]
- The specific triggering procedures;
- The creditors' majority required to bail-in holdouts;
- The order of priority of claims (typically wage or pension arrears, followed by secured credits, and lastly unsecured ones);
- Conditionality. This also varies across countries, with the US Chapter 9 being relatively stricter in this respect.[23]

The design of insolvency frameworks must take into account, among other things, relevant characteristics of a country's legal system (including the constitutional status of SNGs and their relations with the higher level government[s]); the state of the judicial system; and the size and capacity of the jurisdictions involved. Very complex frameworks can result in prohibitive legal costs for smaller jurisdictions. On the other hand,

[22] In the United States, only the municipality in distress can file for bankruptcy under Chapter 9, conditional on being insolvent, having worked or attempted to work out a plan to deal with its debts, and having been authorized by the state to file for bankruptcy. In South Africa, any creditor can file a claim against the municipality. Similarly, in Hungary, a creditor can petition the court if a municipality is in arrears for more than 60 days.

[23] Chapter 9 is designed to carry a strong stigma for the distressed municipality, to minimize moral hazard. In addition to the financial costs, there are significant political ones. State laws in the United States for distressed municipalities commonly provide for a transfer of control over municipal affairs.

they can also encourage both municipalities in difficulty and their creditors to seek extra-judicial resolution mechanisms such as arbitration.

IV. What Can Central Finance Agencies Do to Avoid Subnational Soft Budget Constraints?

In the light of the analysis in the previous sections, it may be useful to draw up a brief list of important do's and don'ts for central finance agencies trying to minimize the risk of subnational SBCs, with a view to ensuring both macro-economic soundness and effectiveness of fiscal decentralization.

The main mistakes to be avoided include:

- seeking to maintain significant discretion in various types of relations with SNGs (transfers; borrowing controls; definition of budget targets);
- resisting a clear delineation of respective spending responsibilities, especially in concurrent functions; differences in capacity of SNGs may advise asymmetric arrangements in the assignment of spending functions, as well as periodic revisions of the continued appropriateness of such asymmetries over time;
- devolving spending responsibilities but trying to keep control of most budgetary resources, thereby giving rise to unfunded mandates or excessive vertical imbalances, and depriving SNGs of an adequate degree of revenue autonomy and related accountability;
- relying on market discipline when preconditions for its effective functioning are not in place; and
- unconditional bailouts in case of subnational debt crises.

Moreover, central finance agencies can, and should, proactively take steps to:

- promote the adoption of subnational fiscal rules appropriate in the country's conditions, and support their enforcement through budgetary transparency and standardized accounting requirements, timely monitoring, and firm non-discretionary application of sanctions when needed;
- take appropriate steps (as discussed in Sect. II above) to strengthen market discipline on subnational borrowing;
- support the design and adoption of appropriate subnational insolvency frameworks; and
- support the development of sound subnational PFM systems; and of effective subnational tax administrations (through e.g., the modernization of practices, information technology systems, and local property cadastres; and the exchange of taxpayer information).

References

Ahmad, Ehtisham, and Giorgio Brosio, eds., 2006, *Handbook of Fiscal Federalism.* Cheltenham, UK: Edward Elgar.

Ahmad, Ehtisham and Vito Tanzi, 2002, *Managing Fiscal Decentralization.* Routledge, London.

Alt, J.E. and Lowry, R.C. (1994), " Divided Government, Fiscal Institutions, and Budget Deficits: Evidence from the States", *The American Political Science Review*, No. 88, (4).

Ambrosanio, Flavia, and Massimo Bordignon, 2006, "Normative versus Positive Theories of Revenue Assignments in Federations" in *Handbook of Fiscal Federalism*, ed. E. Ahmad and G. Brosio, 306–38. Cheltenham, UK: Edward Elgar.

Boadway, R., and A. Shah, editors. 2007. *Intergovernmental Transfers: Principles and Practice*. Washington, DC, United States: World Bank.

Bohn, H. and Inman, P. (1996), "Balanced Budget Rules and Public Deficit: Evidence from the US. States", *Carnegie-Rochester Conference Series on Public Policy, 45.*

Bordignon, Massimo, 2006, "Fiscal Decentralization: How to Harden the Budget Constraint" in *Fiscal Policy Surveillance in Europe,* ed. Wierts P., S. Deroose, E. Flores, and A. Turini, Palgrave McMillan.

Bordignon, Massimo and G. Turati, 2003, "Bailing-out Expectations and Health Expenditure in Italy". CESifo Working Paper no. 126.

Craig, Jon, 1997, "Australia" in T. Ter-Minassian, ed: *Fiscal Federalism in Theory and Practice.*

European Commission (EC) 2010–12, "Public Finance Report", Brussels, Belgium, various issues.

Fatas, A. and Mihov, I. (2006), "The Macroeconomic Effects of Fiscal Rules in the US States", *Journal of Public Economics*, No. 90.

Franco, Daniele and Stefania Zotteri, 2008, "Ensuring Fiscal Sustainability: Which Role for Fiscal Rules? The Experience of European Countries", paper presented at the conference on "Sustainability and Efficiency in Managing Public Expenditures" Honolulu, Hawaii, July 2008.

Franco, Daniele, Fabrizio Balassone and Stefania Zotteri, 2007, "Rainy Day Funds: Can They Make a Difference in Europe?" Bank of Italy Occasional Paper N. 11.

Henning, C. Randall and Martin Kessler, 2012, "Fiscal Federalism: US History for Architects of Europe's Fiscal Union", Peterson Institute of International Economics Working Paper no. 12-1.

Kopits, G. (2011), " Independent Fiscal Institutions: Developing Good Practices", *OECD Journal on Budgeting*, Nov. 2011.

Kornai, Janos, Eric Maskin and Gerard Roland, 2003, "Understanding the Soft Budget Constraint," Journal of Economic Literature, American Economic Association, vol. 41(4), pp. 1095–1136, December.

Liu Lili and Michael Waibel, 2008, "Subnational Borrowing, Insolvency and Regulation" in Shah A. *Macro Federalism and Local Finance*, The World Bank (Washington, DC).

Morris, Alan, 2007, "Commonwealth of Australia" in A. Shah, ed., *The Practice of Fiscal Federalism: Comparative Perspectives,* Forum of Federations, Mc Gill-Queens University Press, Quebec, Canada.

Musgrave, Richard, 1959, *Theory of Public Finance,* New York: McGraw-Hill.

Oates, Wallace E. 1972, *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.

_____. 2005, "Toward a Second-Generation Theory of Fiscal Federalism" International Tax and Public Finance, Vol. 12, No. 4, 349–373.

Qian, Yingyi, and Barry R. Weingast, 1997, "Federalism as a Commitment to Preserving Market Incentives." *Journal of Economic Perspectives* 11 (Fall): 83–92.

Poterba, J. (1994), "State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics", *Journal of Political Economy*, No. 102.

Prud'homme, Remy, 1995, "The Dangers of Decentralization." *World Bank Research Observer* 10: 201–220.

Rodden, Jonathan A., 2006, "Achieving Fiscal Discipline in Federations: Germany and the EMU," in *Fiscal Policy Surveillance in Europe*, ed. by Peter Wierts and others (Palgrave Macmillan).

Rodden, Jonathan A., Gunnar S. Eskeland, and Jennie Litvack, 2003, *Fiscal Decentralization and the Challenge of Hard Budget Constraints*. Cambridge, MA: MIT Press.

Sutherland, Douglas, Robert Price, and Isabelle Joumard, 2006"Fiscal rules for sub-central governments: design and impact", OECD Network on Fiscal Relations Across Levels of Government *Working Paper* no. 1.

Tanzi, Vito, 1996, "Pitfalls on the Road to Fiscal Decentralization," Carnegie Paper No. 19, April 2001.

Ter-Minassian, Teresa, ed., 1997, *Fiscal Federalism in Theory and Practice* (Washington: International Monetary Fund).

_____. 2010, "Preconditions for a successful introduction of structural fiscal balance-based rules in Latin America and the Caribbean: a framework paper", IADB Discussion Paper no. 157.

_____. 2010, "*A Lei de Responsabilidade Fiscal do Brasil sob uma perspectiva internacional*", in *Lei de Responsabilidade Fiscal: Históricos e Desafios,* Caderno FGV Projetos, no. 15, Fundação Getulio Vargas, Rio de Janeiro.

Tiebout, Charles M., 1956, "A Pure Theory of Local Expenditures". *Journal of Political Economy*, no. 64.

Weingast, Barry, 2009, "Second Generation Fiscal Federalism: the Implications of Fiscal Incentives", *Journal of Urban Economics*, Vol. 65, no. 3.

Wildasin, David, 1997: "Externalities and Bailouts: Hard and Soft Budget Constraints in Intergovernmental Fiscal Relations" Working Paper 1843, World Bank.

Design and Management of Decentralized and Intergovernmental Revenues

By Paul Smoke*

I. Introduction

As **decentralization has become more common** in developing countries, subnational revenue generation and intergovernmental transfers have received considerable attention in the public finance literature and in practice. Intergovernmental fiscal specialists have elaborated well-defined principles for selecting and designing subnational revenues and transfers. Such advice has not always been followed, and even where it has, **subnational revenue generation has rarely met expectations and intergovernmental transfers have often experienced considerable challenges**.[1]

This state of affairs raises a number of **fundamental questions**.

- Why is it **important** for subnational governments to have adequate revenues?
- What is the **right balance** between own-source revenues and transfers?
- Why has it been such a **great challenge** for subnational governments in many countries to get the resources they need?
- What is **known about how** to best design and manage subnational government revenues and intergovernmental transfers?
- How can **progress be made** in improving on the current situation?

This paper briefly and selectively considers these questions, most of which do not have easy answers. The next section concisely highlights the critical importance of allowing for subnational government revenues, but within the context of a sound national fiscal system. This is followed by an overview of core principles for designing subnational revenue systems and an overall assessment of how they have been used in practice (Section III), and then some observations on how subnational revenue system reforms might be pursued more effectively (Section IV). Section V considers basic principles of intergovernmental transfers and the challenges of applying them in practice, while Section VI outlines some approaches for better use of transfers and improving their linkages to other elements of the subnational fiscal system.

II. The Critical Role of Subnational Revenues in the National Fiscal Context

Decentralization and policies to strengthen existing subnational governments are adopted for many reasons.[2] In official terms, reform is often justified as an avenue to improve service delivery, accountability,

* Professor of Public Finance and Planning and Director of International Programs, New York University, Robert F. Wagner Graduate School of Public Service.

[1] There are many references on this subject, including Bahl and Linn (1992); Shah (1994); Ter-Minassian (1997); Bird and Vaillancourt (1998); Litvack, Ahmad and Bird (1998); Smoke (2001); Ahmad and Tanzi (2002); Ebel and Taliercio (2005); Bardhan and Mookherjee (2006), Bahl and Bird (2008), Tanzi (2010), United Cities and Local Governments (2010), Bird (2011).

[2] Literature on this topic is reviewed in Connerley, Eaton and Smoke (2010) and Eaton, Kaiser and Smoke (2011).

and responsiveness to citizens, commonly with expectations that such changes will ultimately help build democracy, promote economic development, alleviate poverty, and/or generate stability in politically fragmented or post-conflict environments. There is also broad agreement, however, that **decentralization is fundamentally a political phenomenon** and that it is undertaken only when there are political incentives to do so. These incentives may or may not coincide well with the more normative public service and social development justifications for decentralization.

Whatever the motives, once the decision is made to decentralize or try to improve the performance of an existing decentralized system, it is critical **to develop provisions that try to maximize benefits derived and minimize problems that may be encountered**. This includes the need to allow subnational governments the resources needed to meet expenditure obligations (see also the Ter-Minassian and Ahmad papers prepared for this conference). It is well known that **central governments have an inherent advantage in generating revenues** and **subnational governments have inherent advantages in providing certain services. In fact, there is *almost invariably an imbalance between the appropriate expenditure role and the feasible revenue generation role of subnational governments, almost invariably necessitating intergovernmental transfers*.**

Although transfers are essential, there are **critical reasons to ensure that subnational governments raise a reasonable share of the resources they spend**. Enhancing subnational revenue generation can **reduce subnational government demands on central government budgets**. Equally important, **subnational revenue generation creates a fiscal linkage between benefits received from local public services and the costs of providing those services**. This factor, when combined with an element of subnational government autonomy in determining the level of funds to be derived from local source, helps to develop accountability between elected subnational councils and their constituents. Greater reliance on locally generated revenues under conditions of democratic accountability can also create an incentive for subnational governments to spend more of their resources on delivering services and less on administrative expenses.

Although some subnational government control of revenues is essential, **revenues derived locally need not be from purely local taxes, and subnational governments need not directly collect all revenues**. A range of revenue instruments is available.

- **Own-source revenues** involve some local control over the revenue base and/or rate and are often primarily administered by subnational governments.
- **Assisted revenues** are those for which subnational governments **request central (or higher level, e.g., state/provincial for municipal) government assistance in collecting certain local taxes on their behalf**, e.g., local taxes levied on businesses that a higher-level government collects its own taxes from.
- **Surcharges** allow subnational governments to add a charge ("piggyback") on higher-level taxes (e.g., VAT, sales or excise taxes), providing them with some revenue autonomy while tapping the benefits of more centralized administration.

Tanzi (2010) outlines and assesses **four distinct approaches to intergovernmental fiscal arrangements**. These include:

- empowering subnational governments to set up their **own local tax systems**,
- **retaining all taxes centrally and sharing the proceeds** with subnational levels through transfers,
- assigning **selected taxes for the exclusive use of subnational governments**, and
- **sharing revenue from certain nationally–collected taxes** with subnational governments (perhaps allowing some limited minor subnational tax options).

There are conceptual and practical advantages and disadvantages to each of these basic options, and in multi-tier systems, arrangements may differ among levels of government. A set of **core principles** (outlined below) provide guidance from a fiscal perspective on how to structure revenue systems, but **there is no single"generalizable" or "optimal" solution**. Although the principles are valuable, it is not sensible to speak

authoritatively about subnational governments generically given great variation in structures, functions and performance across and within countries.[3] Some countries have more levels of governments than others do, and levels of development vary widely. Appropriate revenue systems and reforms for established, capacitated, and economically dynamic state, provincial or urban governments in a more advanced developing country, for example, may have little relevance for a least developed country where the institutional landscape is dominated by recently created, weak, and poor local governments in rural areas.

Thus, the arrangements chosen by a particular country would depend not only on various technical considerations embodied in public finance principles, but also on **historical trajectories** (e.g., levels of government that have been important are likely to remain important even if fiscal principles suggest they should play a smaller role), **political forces** (e.g., types and levels of political competition) **and a range of other factors** (levels of capacity, degree of development of governance, social capital, etc.). These various factors may change substantially over time and suggest the possible **need for the intergovernmental fiscal system to evolve** in any given country.

Whatever the intergovernmental structure, it is important from a national fiscal perspective to **develop an appropriate balance between (a) policies to support autonomous subnational revenue generation and well structured transfers and (b) policies that provide mechanisms and incentives to promote good use of public resources** (as noted above and also discussed in the Ter-Minassian and Ahmad papers). National determinations must also be made about the relevance of **intergovernmental tax competition, the desired degree of fiscal redistribution, and a number of other considerations that should figure into the design of a revenue system**. How the government processes and makes decisions on these considerations is at least implicitly shaped by the relative importance of a country's overarching decentralization goals—economic development, service delivery, democratization, post-conflict resolution, etc.—as they evolve with broader economic and political dynamics.

The successful use of subnational revenues also depends on developing a **multi-dimensional constitutional, legal, and administrative framework for decentralization and the means for its implementation and enforcement**. This framework goes beyond fiscal decentralization/financial management specific dimensions that focus on local government legal status, powers and functions, autonomy, planning and budgeting systems, revenue and expenditure control, etc.[4] **Revenue generation ultimately depends on a broad enabling environment, including elements not specific to decentralization or under central finance agency control.** Property rights, for example, affect property tax policy and administration, and provisions for local governance mechanisms (elections and other accountability instruments) and civil society rights create the space for developing citizen engagement that disciplines subnational government behavior.[5] These factors can considerably influence the extent to which subnational governments are likely to be accountable to their constituents in how they raise and spend public resources.

III. Principles/Issues for Subnational Revenue Generation in Theory and Practice

The foundational principles of **fiscal federalism** remain the starting point for assigning and assessing subnational government expenditure and revenue functions. These principles apply standard public finance concepts in the spatial and multi-level context of national geography, demography, and administrative structures.[6] The principles are relevant to different degrees for designing overarching systems and individual revenue sources.

---

[3] This diversity is a theme throughout the fiscal decentralization literature. A useful summary is provided in United Cities and Local Governments (2010).

[4] This topic is discussed, for example, in; Litvack, Ahmad and Bird (1998); Smoke (2007), Boex and Yilmaz (2010).

[5] Yilmaz, Beris and Serrano-Berthet (2010) summarize subnational accountability requirements.

[6] Fiscal federalism is introduced and revisited by Oates (1972, 1999). Other selected work includes Ter-Minassian (1997), Smoke (2001), Ahmad and Tanzi (2002), Ebel and Taliercio (2005), Bahl and Bird (2008), Boadway and Shah (2009) and Bird (2011). Literature on "second generation" fiscal federalism includes Oates (2005) and Weingast (2009).

A. Core Principles

There are multiple versions of the basic fiscal federalism principles.[7] The following list is a reasonable approximation of the most commonly cited set of principles.

- **Adequacy**: Subnational governments must have revenues adequate for budgetary needs (based on "finance follows function" and "no unfunded mandate" principles)
- **Buoyancy**: Revenues should be able to grow at least in proportion to the subnational economy and expenditure needs
- **Stability**: Revenue systems need to be structured so as to limit large fluctuations in yields that would undermine subnational government ability to provide services
- **Efficiency**: Revenue policy should minimize distortions of economic decisions of individuals and firms (e.g., resulting from interjurisdictional revenue differences, selectively differentiated assessment ratios and rates, etc.); and ensuring correspondence between payments and benefits (including limiting tax exporting).
- **Equity**: Subnational revenues should allow for appropriately fair treatment among equals and across different income or other types of groups.
- **Autonomy**: Subnational governments require discretion to make independent decisions (creating a link between revenue generation and service delivery).
- **Administrative feasibility**: ensuring the scale and complexity of administration is consistent with capacity and affordable to the subnational government.
- **Political feasibility**: maximizing the likelihood of acceptance of a source through consistency with political reality, e.g., taxpayers see value for money, fair treatment, less visible/onerous (small payments over time versus large lump sums), etc.
- **Integration/consistency**: ensuring the logic of the full set of subnational revenues and consistency with the rest of the national fiscal system, (e.g., limiting overlap with central taxes and revenue disincentives in transfer and lending mechanisms).

These principles are intended to ensure that subnational revenues meet key public finance goals in multi-level government systems with distinct territorial jurisdictions.

B. Assessing Subnational Revenue System Design and Implementation

Assessing subnational revenue assignment and challenges experienced in design and implementation involves a number of key questions:

- Does the **division of revenue sources** between central and subnational governments generally meet accepted principles?
- Are **individual revenue sources** designed to meet accepted principles?
- To what extent is the **full set of sources** reasonably consistent with core principles (given that different revenues are better at meeting certain individual principles)?
- To what extent is the subnational revenue system **implemented as designed**?

International experience suggests that central governments rarely assign revenue sources that should not be decentralized to subnational governments, e.g., taxes on mobile bases, taxes that seriously compete with national revenue sources, etc. **Common and generally accepted subnational sources** include property taxation, fees and charges, licenses, limited types of business taxation, and sometimes at intermediate or urban levels, other sources, such as motor vehicle taxes and licenses and business or sales taxes.[8] **Piggybacking on national taxes** is often recommended and sometimes practiced, but more typically

[7] A recent synthetic overview is provided in Bird (2011).

[8] Bird (2006), Bahl and Bird (2008), Smoke (2008), and Bird (2011) review key literature in more detail.

in federal or larger countries and more commonly for intermediate levels of government than for local levels. These revenue sources are not particularly controversial in most cases, although the details of how they are structured and managed may be.

More controversy surrounds other potential subnational revenues, such as VAT, business taxation (including business value taxes),[9] **and natural resource taxation**. Some countries, such as Brazil and Indonesia, successfully use such sources. Debates draws on fiscal principles, but they are often embedded in concerns about the type of system involved (federal or unitary), dealing with interregional conflict, financing regional and metropolitan versus other local governments, etc. In some cases, certain problematic sources of revenue emerged in a specific context, became productive, and were difficult to modify or eliminate, even during major reforms. Examples include octroi and its variations (in South Asia and elsewhere), the regional services council levy (a payroll and turnover tax) in South Africa, and the graduated personal tax in Kenya and Uganda (an unusual and complex hybrid of a PAYE tax, a presumptive income tax, a wealth tax, and a poll tax).

There is agreement that many governments, especially in developing countries, err on the conservative side and assign fewer revenue sources than would be justified based on application of fiscal federalism principles, although there is variation.[10] Subnational sources are highly limited, for example, in Cambodia, Egypt, and Uganda, but more extensive in countries such as Brazil, Kenya, the Philippines, and South Africa. Central management of many major revenue sources is, as noted above, often justified because of the nature of the bases and advantages of centralized administration. If and how these resources are shared with subnational governments, of course, is a critical consideration.

The structure of individual revenue sources and their collective effects are difficult to definitively assess because of the diversity of experience and data limitations, but there seem to be **nontrivial lapses in adherence to the basic principles**.

- Own source revenues are often too limited, but determining overall revenue **adequacy** (including transfers) is complicated by the relatively common vagueness, inconsistency, and incomplete adoption of functional assignments. A possible indicator of inadequacy is the tendency in some countries for subnational governments to use unproductive and even unofficial sources.
- **Buoyancy** is elusive due to the revenues sources assigned to subnational governments and the common failure to take administrative actions to ensure base growth (e.g., revaluing and indexing property assessments). Buoyancy can be improved by use of piggybacking on productive taxes where feasible.
- **Stability** should be attainable in principle from subnational revenue sources, but in practice this depends on good administration and the willingness of subnational governments to enforce collection during difficult economic times or periods of political pressure, e.g., leading up to subnational elections.
- **Efficiency** is compromised in subnational revenue systems to various degrees and in different ways. This can result from the choice of instruments (e.g., turnover taxes); differential treatment of taxpayers in pursuit of policy objectives (e.g., favorable tax rates for some locations or industries); poorly developed and/or enforced assessment and collection rules (increasing opportunities for political manipulation of tax burdens); and adoption of taxes with "exportable" burdens.[11]
- Horizontal **equity** is of more concern in subnational tax policy than vertical equity since the scope for subnational redistributive taxation is limited. Equity ultimately depends on design and implementation, e.g., if there is preferential treatment of certain taxpayers or groups by regulation or weak/selective administration.

[9] This is a VAT levied on the basis of income (production, origin) rather than consumption (destination), which is discussed by Bird (2005, 2006).

[10] See United Cities and Local Governments (2010), especially the concluding chapter by Martinez-Vazquez and Smoke.

[11] Tax exporting may be considered desirable in certain instances, such as taxes paid by foreign tourists.

- **Autonomy** over revenues varies considerably, but it is often limited by central governments concerned about national fiscal management and/or local capacity. Subnational governments may fail to take advantage of autonomy if they do not know how to do so, where decentralization is new, where capacity is weak, or where political conditions or fiscal system disincentives weaken motivation.
- **Administrative feasibility** may be compromised by subnational pursuit of non-revenue raising objectives and or the adoption of poorly defined or unduly complex administrative procedures by subnational governments.[12]
- **Political feasibility** depends on specific political conditions, but adoption and effective use of subnational taxes is often challenging, especially in the poorest countries where citizens are not used to receiving and/or paying for services.
- **Integration/consistency** in the fiscal system is often of great concern. Problems appear in the form of insufficient harmonization of central and subnational taxes or weak incentives for subnational revenue generation in intergovernmental transfer programs, which may also undermine the need/ability for even fiscally capable subnational governments to borrow for infrastructure investment.

The **extent to which allowable subnational revenues are successfully implemented on the ground varies considerably across countries**. In some cases, revenue sources assigned to subnational governments have not been implemented at all. National agencies with regulatory power may restrict how certain sources are used, and individual local governments may elect not to use sources assigned to them. **Variations also exist within countries** for various reasons—for example, in federal systems, such as India, there are differential state policies, and in many countries, such as South Africa, major urban areas raise a much greater share of their resources than smaller urban and rural jurisdictions.

C. Underlying Forces

Clearly there are challenges with inadequately developed or incompletely implemented subnational revenue frameworks. Several factors are often cited as contributing factors.

First, there are **technical tradeoffs** inherent in using revenue principles. Some tax bases, such as sales or business turnover, may be productive and buoyant, but they can difficult to administer where capacity is weak, and yields may suffer during downturns. A number of potentially stable sources, such as the property tax, are administratively complex and will not be buoyant if improperly managed. Some efficient revenue sources, such as user charges, may be inequitable in terms of burden relative to income. Thus, objectives must be prioritized in designing revenue systems and a blend of sources is needed.

Second, even if there is an inclination to follow conceptual principles, a **lack of appropriate and reliable information** for revenue policy design and administration can create significant challenges. Available information may be kept in different agencies and some definitions may change over time, challenging data assembly and consistency.

Third, **national politics** may support or undermine reform.[13] Politics influence which functions and revenue powers are decentralized, how they fit with larger fiscal architecture, the degree of subnational autonomy, and the process and support structures that enable subnational governments to assume new roles. Reluctance to decentralize often reflects an unwillingness of the center to devolve functions and resources.

Fourth, **national institutional actors** that must elaborate subnational revenue powers, structures, and procedures and support subnational governments to use them may have insufficient capacity or incentives, and they may be not cooperate with each other. Disagreements between Ministries of Finance and Local

[12] See, for example, Taliercio (2004, 2005), Ebel and Taliercio (2005), Lewis (2006), Mikesell (2007).

[13] This is discussed in Manor (1998); Eaton (2004); Ahmad and Brosio (2006); Smoke, Gomez, and Peterson (2006); Connerley, Eaton, and Smoke (2010); and Eaton, Kaiser, and Smoke (2011).

Government can result in incomplete or inconsistent policies that complicate effective use of subnational revenue powers. Even within a Ministry of Finance, various reforms—revenues, transfers and lending—may be under different departments that function independently or competitively, resulting in inconsistencies on important policies and procedures.

Fifth, the **role of international development agencies/donors** should be recognized, particularly in aid-dependent countries.[14] They have arguably modified behavior over time, but they long supported technical approaches to revenue reform, irrespective of political and institutional feasibility. There is also a residual tendency to draw on the positive experiences of industrialized and transition countries to recommend reforms that may be difficult for developing countries, particularly outside of major urban centers, to implement successfully, such as complex valuation models for property taxation.

Finally, **revenue generation is inherently political**. How subnational governments use revenue powers—depending on where local political power lies—may, for example, lead to over- or under-taxing or businesses relative to individuals or particular sectors relative to others, creating behavioral distortions and inequities. Under certain scenarios, high levels of autonomy may lead to massive elite capture or exploitation of certain groups. Without adequate development and enforcement of a local government framework and adoption of appropriate accountability relationships beyond simple elections, local populations may not be capable of securing their "preferences" from local politicians, the basis of fiscal decentralization, and they may be unwilling to pay local tax obligations.

IV. Policies for Improving Subnational Revenue Generation

The subnational revenue generation challenges outlined above are derived from **three interrelated factors—system design, political and institutional obstacles to reform, and lack of attention to implementation**. The potential solutions fall into two broad categories—subnational revenue policy and strategic implementation.

A. Subnational Revenue Policy

The starting point for improving subnational revenue generation is to develop policies that create an environment that is conducive to reform. Key considerations include:

- Subnational governments need **adequate revenues** (tax, non-tax, user charges and transfers) to discharge their functional obligations and to pursue other activities that meet needs of their constituents and support economic development
- **Sufficient autonomy** in the use of subnational government revenues is essential for the benefits of fiscal decentralization to be realized
- Concerns about subnational revenue use, which creates central government reluctance to provide adequate subnational revenue access and discretion, can be alleviated by well **structured regulatory and managerial systems**
- The **focus of subnational revenue policy should be on revenue raising** rather than other policy objectives
- Reform focus should be on allowing and/or improving use of **a limited number of productive sources** of revenue; those with limited revenue potential should be de-emphasized or eliminated, and non-sanctioned revenues should not be allowed
- Where possible, allow subnational governments to **piggyback** on selected national revenues (or as applicable local governments on state/provincial revenue) that are productive but best administered at a higher level

[14] See Donor Partner Working Group on Decentralization and Local Governance (2011).

- Efforts are often needed to **develop better information** on tax bases and taxpayers, to **simplify** tax structure and administration, and to i**mprove revenue administration/collection.**

B. Strategic Implementation

Although appropriate subnational revenue policy is necessary, it is not sufficient to improve subnational revenue generation. Revenue policy needs to be implemented strategically at both the national and subnational level.[15] In this regard, it is important to:

- Implement policies that **allow for visible change but do not overwhelm the capacity** of subnational governments or test the tolerance of local taxpayers
- **Provide appropriate support for subnational governments** that need assistance to adopt new or improve existing revenue generation policies
- **Allow for, where possible, differentiated access to/discretion over subnational revenues**, such that subnational government characteristics and performance are used to distinguish among types and individual units of government
- **Improve the coordination of national and subnational agencies** that have a role in designing and supporting the implementation of subnational revenue systems and other reforms required for successful fiscal decentralization
- Create **better linkages between public services and local revenues**, which can be done through public education, consultation with taxpayers at the subnational level, and improved production and dissemination of information on revenue generation and subnational government expenditure performance.

More attention to implementation is particularly important given that, in many countries, the desired system identified by using normative revenue principles is often not easily or quickly attainable. In addition, it is important to emphasize that there is potentially **a close link between political and institutional constraints and implementation**—if the latter is approached strategically, a sound revenue system might be built gradually in a way that helps to overcome some of the constraints on reform. **Implementation, however, needs to be considered from both a national and subnational perspective**.

Subnational revenue reforms can be linked to broader national efforts to build capacity and to improve performance progressively. The central government often has considerable leverage over subnational governments, with the possibility of using access to powers, resources, and technical assistance to encourage adoption of new revenues and procedures, accountability mechanisms, and other reforms. Using such leverage implies that, at least to some extent, local autonomy should be earned. Allowing high levels of autonomy without enough capacity to assume functions and a degree of accountability to local citizens enables poor performance. At the same time, it is important to take some positive steps even in weak capacity environments. Getting an appropriate strategy and process in place is challenging and would need to be carefully explored and structured.

A strategic approach to implementation strategy at the subnational level is critical but also challenging. Even the most capable subnational governments would need to be strategic in implementing revenue reforms that require major changes in the nature and level of what residents pay for local services. Simple and more politically acceptable reforms, for example, could be undertaken before complex or controversial ones. For example, where movement to full property valuation is intended and current valuations are low, assessment ratios could be phased in and perhaps tied to specific improvements in service delivery. Similarly, user charges could move gradually towards cost recovery in order to avoid undesirable changes in service use, severe equity effects, and political and administrative resistance. **Although subnational implementation**

[15] Implementation literature includes Litvack, Ahmad, and Bird (1998); Shah and Thompson (2004); Falleti (2005); Bahl and Martinez-Vazquez (2006); Ebel and Weist (2006); Smoke (2007); and Smoke (2010).

strategies may not be seen as a direct central government function, the relevant national agencies must recognize that their cutting-edge subnational revenue reforms may not work effectively on the ground without such locally specific strategic approaches.

V. Principles/Issues for Intergovernmental Transfers in Theory and Practice

As indicated above, intergovernmental transfers are inevitably an important component of fiscal decentralization. If intergovernmental transfers are to be appropriately and systematically distributed to subnational governments**, several policy decisions must be made about their design features.**[16] **These include:**

- What are the main **objectives** of transfers in a particular case?
- How should the overall **transfer pool** be determined, i.e., how much funding will be available in total to be distributed to subnational governments
- How should available resources be **allocated** across eligible subnational governments?
- Should subnational governments face **restrictions** on how to use transferred resources, and if so to what extent?

Each of these design aspects can be discussed separately, but the transfer instruments chosen will in fact reflect all of them simultaneously.

A. Objectives of Transfers and Evaluative Criteria

Intergovernmental transfers can serve a number of purposes, but four are particularly prominent in international practice.

- **Vertical equalization** involves helping to fill the common gap between the yields of subnational own-source revenues and the costs of providing services assigned to subnational governments.
- **Horizontal equalization** is intended to alleviate the generally wide differences in the ability of subnational governments to mobilize resources on their own and the resulting disparities in the quantity and quality of public services provided. **Addressing interjurisdictional spillovers** involves encouraging the provision of public services that generate benefits beyond individual jurisdictions
- **Administrative Efficiency:** As noted above, higher-level governments have a distinct advantage in the efficient administration of certain types of revenues.

In pursuing these key objectives for developing transfer programs, there is also a set of **related features that should be considered when evaluating them**. These include:

- **Revenue adequacy and growth:** These ensure that the transfer system can provide enough revenue for subnational spending needs as they increase over time. Many countries fall short on this front.
- **Predictability, transparency and simplicity:** Sound fiscal planning requires that there be a degree of certainty associated with the volume and timing of resources from the center to allow proper planning and budgeting. Subnational governments should be able to ascertain how their share of a transfer was determined. This can be facilitated by relatively simple but explicit grant formulas, which also reduce the possibilities for capricious political manipulation.
- **Efficiency:** Transfers should not alter the behavior of subnational governments except where this involves the provision of the services that generate externalities or to use their resources in more considered and transparent ways. Transfers can create perverse incentives that need to be avoided. Subnational governments, for example, may view transfers as substitutes for their own resources and decrease their

[16] Literature on intergovernmental transfers is reviewed in: Bahl and Linn (1992), Shah (1994), Ter-Minassian (1997), Bahl (2000), Bird and Smart (2002), Schroeder and Smoke (2003), Shah (2006).

revenue generation efforts at raising local revenues. Similarly, if transfers are determined on the basis of the condition of existing infrastructure, subnational governments may have little incentive to maintain it. There are many other examples of problematic effects of transfers.

- **Equity**: Horizontal equalization is an important objective of transfers, but it is often inadequately pursued even in some countries with generous transfers, and the basis on which it is to be measured can vary and may be difficult to quantify. Even if full equalization of resource access was possible and desirable, equal expenditures on the same service across subnational governments does not guarantee equal levels of services, so that transfers need to account for accounts for differences in both expenditure needs and fiscal capacity.

Unfortunately, the objectives briefly enumerated here often conflict**, which means that constructing a grant system requires a careful consideration of priorities and the tradeoffs among the various goals.** Encouraging spending on services with external benefits, for example, can conflict with the presumption that subnational governments best know their own public service needs, and transfers that encourage local contributions to these services can disadvantage fiscally weaker subnational governments.

B. Determining the Transfer Pool

There are three basic ways by which the **aggregate size of the transfer pool** can be determined. They include:

- **Pre-defined (rule-based) pools** based on a specific portion of national revenues collected (or proceeds of a specific tax) can provide an increased degree of certainty to subnational authorities that they will receive transfers. This is particularly the case if the pool is tied to tax revenues collected in the recent past, e.g., where allocations for the current fiscal year depend on tax revenues earned in the previous fiscal year. Furthermore, if tied to buoyant revenue sources, such as an income tax, this approach can ensure a growing source of revenues for subnational governments. The allocation mandate may be fixed or subject to periodic adjustment, and it may be provided for the in constitution (as in Kenya), by law (as in Indonesia and the Philippines) or by administrative decision (as in Cambodia) The potential downside of the more rigid arrangements is that, by dedicating a certain proportion of national revenues to subnational governments, the center will lose some of its control over fiscal policy. The extent to which this might be a problem, of course, depends on the volume of resources being committed relative to the overall size of the national budget.
- **Subnational spending plans** can influence the determination of transfer pools, but this approach is only used in limited situations, such as transfers for eligible individual recipients of social welfare programs in more advanced countries. This can be risky for a central government trying to keep its overall spending level under control and balance a wide variety of competing demands for funds.
- **Annual budget decisions** are becoming a less common way of determining a transfer pool, although some countries, such as South Africa and Uganda, still do this. This approach gives the central government flexibility to respond to national fiscal conditions, but it creates uncertainty for subnational governments, making them vulnerable to fluctuating economies and the vagaries of political negotiation. Annual budget allocations may be used for specific-purpose transfers, however, even when the general-purpose transfer is rule-based, as in Indonesia.

C. Allocating Funds among Subnational Governments

There are several basic methods of allocating the transfer pool across eligible subnational government jurisdictions. Four are in relatively common use.

- **Tax sharing transfers** distribute all or some portion of a central government tax collected within the subnational government's territory to that government (often called origin- or derivation-based). Such transfers can be elastic if the tax being shared has strong growth potential; however, they are usually counter-equalizing since subnational governments with larger tax bases will derive more funds. The extent to which such tax sharing is used varies widely.

- **Formula-based transfers** are allocated by objectively defined criteria. These have become increasingly popular in many countries because they are transparent for the recipient governments and can provide them with considerable latitude in determining which spending objectives to prioritize. The lack of adequate data required for such an approach can be a challenge, and sometimes the formula may become too complex in an attempt to try to meet too many objectives.
- **Cost-sharing transfers** are designed to reimburse subnational governments for expenditures on particular priority activities deemed worthy of subsidization. Such grants can be either total- or partial-cost sharing (matching grant). Cost sharing is typically used for conditional transfers.
- **Ad Hoc Transfers** depend on the judgment of the transferring authority in determining how much of the transfer pool each jurisdiction will obtain. Such an approach creates uncertainty on the part of grant recipients and may open the door to arbitrary, subjective, non-transparent allocations. Such transfers are increasingly being replaced with more systematically allocated approaches.

D. Subnational Spending Autonomy and the Transfer Instrument

A final attribute of transfer instruments is the degree of autonomy enjoyed by recipient subnational government jurisdictions in using the transferred funds, which is directly reflected in the type of transfer instrument chosen.

- **Unconditional (general purpose) transfers** give the subnational government considerable autonomy over the use of the funds (within the legal limits of functional responsibilities allowed to subnational councils). This type of transfer is closest to the spirit of full devolution of spending powers advocated by proponents of decentralization. There has been a tendency to move towards unconditional transfers as countries have increasingly decentralized.
- **Conditional transfers** place some use restrictions on recipient governments, ranging from very broad (e.g., restricted to development expenditures) to multi-sectoral (e.g., social services, rural infrastructure, etc.) to very specific types of functions in a single sector (school construction, medicine purchases, etc.). The broadest type can be very flexible, while the narrowest type can be highly restrictive. Conditional transfers had to some extent been falling out of favor, but they have emerged again in recent years with the growing use of performance-based transfers and the increasing preoccupation with meeting high-profile expenditure targets, such as the Millennium Development Goals.

E. Pulling the Elements Together

The appropriate combination and design of transfer programs depends on the relative importance of different priorities and specific contextual factors.

- Where **decentralization and fiscal equalization are high priorities**, for example, unconditional transfers funded by a rule-based pool of resources and allocated with a formula that accounts for fiscal disparities across subnational jurisdictions would be a sensible approach
- In countries where the **delivery of certain services is a high priority and there are concerns about the willingness/ability of subnational governments to use resources for these purposes**, a dedicated pool of funds allocated conditionally according to clear criteria would be more suitable than a general-purpose transfer.

In many countries, one or more types of both unconditional (including tax sharing) and conditional transfers are used to meet different objectives. In all cases, it is important to be aware of the incentives created by transfers both individually and collectively.

VI. Policies for Improving Intergovernmental Transfers

Depending on the situation in a particular country, multiple steps could be taken to improve the structure and operation of intergovernmental transfer systems. A number of measures that can often be productive include the following:

- **Regularize the intergovernmental transfer system** to ensure some rule-based minimum of subnational resources. There is no universal rule principle for using derivation-based versus formula-allocated tax sharing, but the former may worsen fiscal disparities and increase the need for redistribution. There is also no normatively ideal balance between unconditional and conditional transfers, although a significant share of unconditional funds reinforces subnational autonomy and it is the better option to support subnational accountability and locally driven development when adequate capacity exists.
- **Simplify and coordinate** complex systems in countries where there are too many types of transfer programs that are managed by different agencies. This can improve the overall targeting of the various transfers, which may have different purposes, and increase administrative efficiency.
- **Increase transparency and improve data used in transfer allocation process**. This will help to improve transfer effectiveness. It will also help to assure subnational governments and the public that these resources are being allocated in a clearly specified and fair manner.
- **Expand and improve the use the use of equalization transfers**. Countries that do not use them should consider this to help offset the differential abilities of subnational governments to meet basic service needs. Countries that already use them should assess their approach and, as appropriate, move towards a system that (a) uses an explicit and stable rule to determine the pool of funds; (b) accounts for normatively defined expenditure needs and revenue capacity (as opposed to actual expenditures or revenues); and (c) allows more discretion in the use of transferred funds once minimum conditions are met.
- **Evaluate and as necessary improve mechanisms for allocating conditional transfer resources.** Beyond the basic guidelines noted above, best practice for conditional grant systems calls for simplification, moving toward using fewer separate block grants with clear sectoral objectives and providing subnational governments with sufficient flexibility for deciding on the best use of the funds while meeting the broader objectives defined by the upper level authorities.
- **Improve linkages between transfers and other components of the intergovernmental fiscal system**. In particular, it is important to ensure that transfers do not undermine the incentives of subnational governments to raise revenues from own sources or for creditworthy subnational governments to borrow for infrastructure investments.
- **Use intergovernmental transfers to meet broader policy and subnational government reform objectives where appropriate.** A number of countries have increasingly started to use transfers to reward subnational governments for compliance with government regulations and for their performance in delivering on their responsibilities (see the Ahmad paper prepared for this conference).
- **Enhance monitoring of the effects of intergovernmental transfer programs relative to stated objectives**. This will help to improve the design and targeting of intergovernmental transfers so that they better meet their intended objectives and minimize the types of perverse incentives that transfers may generate.

References

Ahmad, Ehtisham and Vito Tanzi. 2002. *Managing fiscal decentralization*. Oxford: Routeledge.

Ahmad, Ehtisham and Giorgio Brosio, 2008, Political economy of multi-level tax assignments in Latin American countries. Washington, DC: International Monetary Fund.

Bahl, Roy and Johannes Linn. 1992. *Urban public finance in developing countries*. Oxford University Press.

Bahl, Roy. 2000. Intergovernmental transfers in developing and transition countries: Principles and practice. Washington, DC: The World Bank.

Bahl, Roy and Jorge Martinez-Vazquez. 2006. Sequencing fiscal decentralization. *Policy Research Working Paper* No. 3914. Washington, DC: The World Bank.

Bahl, Roy and Richard Bird. 2008. Subnational taxes in developing countries: The way forward. *Public Budgeting and Finance*, 28(4), 1–25.

Bardhan, Pranab and Dilip Mookherjee. 2006. *Decentralization and local governance in developing countries: a comparative perspective.* Cambridge, MA: MIT Press.

Bird, Richard M. and Francois Vaillancourt, eds. 1998. *Fiscal decentralization in developing countries*. Cambridge: Cambridge University Press.

Bird, Richard and Michael Smart. 2002. Intergovernmental fiscal transfers: International lessons for developing countries. *World Development* 30 (6): 899–912.

Bird, Richard. 2005. A new look at local business taxes. *State Tax Notes* 36 (9).

_____. 2006. Local and regional revenues: Realities and prospects. In Richard Bird and Francois Vaillancourt, eds., *Perspectives on Fiscal Federalism*. Washington, DC: World Bank Institute, pp. 177–196.

_____. 2011. Subnational taxation in developing countries: A review of the literature. *Journal of International Commerce, Economics and Policy* 2 (1): 139–161.

Boadway, Robin and Anwar Shah. 2009. *Fiscal federalism: Principles and practice of multiorder governance*. New York: Cambridge University Press.

Boex, Jamie and Serdar Yilmaz, 2010. *An analytical framework for assessing decentralized local governance and the local public sector*. Washington, DC: Urban Institute.

Connerley, Ed, Kent Eaton and Paul Smoke, eds. 2010 *Making decentralization work: Democracy, development and security*. Boulder, CO: Lynne Rienner Publishers.

Development Partner Working Group on Decentralization and Local Governance. 2011. *Busan and beyond: Localizing Paris principles for more effective support to decentralization and local governance reforms* (Bonn: GIZ, 2011).

Eaton, Kent. 2004. *Politics beyond the capital: The design of subnational institutions in South America*. Stanford, CA: Stanford University Press.

Eaton, Kent, Kai Kaiser, and Paul Smoke. 2011. *The political economy of decentralization: Implications for aid effectiveness.* Washington, DC: The World Bank.

Ebel, Robert and Robert Taliercio. 2005. Subnational tax policy and administration in developing economies. *Tax Notes International* 37 (1): 919–936.

Ebel, Robert and Dana Weist. 2006. Sequencing subnational revenue decentralization. Washington, DC: The World Bank.

Falleti, Tulia. 2005. A sequential theory of decentralization: Latin American cases in comparative perspective. *American Political Science Review* 99 (3): 327–346.

Lewis, Blane. 2006. Local government: an analysis of administrative cost inefficiency. *Bulletin of Indonesian Economic Studies* 42 (2): 213–233.

Litvack, Jennie, Junaid Ahmad, and Richard Bird 1998, *Rethinking decentralization in developing countries.* Washington, DC: The World Bank.

Manor, James. 1998. *The political economy of democratic decentralization*. Washington, DC: The World Bank.

Mikesell, John. 2007. Developing options for the administration of local taxes: An international review. *Public Budgeting and Finance* 27 (1): 41–68.

Oates, Wallace. 1972. *Fiscal federalism*. New York, NY: Harcourt, Brace, Jovanovich.

_____. 1999. An essay on fiscal federalism. *Journal of Economic Literature* 37: 1120–1149.

_____. 2005. Towards a second generation theory of fiscal federalism. *International Tax and Public Finance*, 12 (4): 349–373.

Schroeder, Larry and Paul Smoke. 2003. Intergovernmental transfers in developing countries: Concepts, international practices and policy issues. In *Intergovernmental transfers in Asia: Current practice and challenges for the future.* Yun-Hwan Kim and Paul Smoke, eds. Manila: Asian Development Bank.

Shah, Anwar and Thompson, Theresa, 2004. Implementing decentralized local governance: a treacherous road with potholes, detours, and road closures. *Policy Research Working Paper* No. 3353. Washington, DC: The World Bank.

Shah, Anwar. 2006. A practitioner's guide to intergovernmental fiscal transfers. *Policy Research Working Paper* No. 4039. Washington, DC: The World Bank.

Smoke, Paul. 2001. *Fiscal decentralization in developing countries: a review of current concepts and practice.* Geneva: UN Research Institute for Social Development.

Smoke, Paul, Eduardo Gomez and George Peterson, eds. 2006. *Decentralization in Asia and Latin America: Towards a comparative interdisciplinary perspective.* Cheltenham: Edward Elgar.

Smoke, Paul. 2007. Fiscal decentralization and intergovernmental relations in developing countries: Navigating a viable path to reform. In G. Shabbir Cheema and Dennis Rondinelli, eds. *Decentralized governance: Emerging concepts and practice*. Washington, DC: The Brookings Institution, pp. 131–155.

_____. 2008. "Local revenues under fiscal decentralization in developing countries: Linking policy reform, governance and capacity." In Gregory Ingram and Yu-Hung Hong, eds. *Fiscal Decentralization and Land Policies*. Cambridge, MA: Lincoln Institute Press, pp. 38–69.

_____. 2010. Implementing decentralization: Meeting neglected challenges. In Ed Connerley, Kent Eaton and Paul Smoke, eds. *Making decentralization work*. Boulder, CO: Lynne Rienner Publishers, pp. 191–217.

Taliercio, Robert. 2004. Administrative reform as credible commitment: the impact of revenue autonomy on revenue authority performance in Latin America. *World Development* 32 (2): 213–232.

_____. 2005. Subnational own-source revenue: Getting policy and administration right. In *East Asia decentralizes: Making local governments work*. Washington, DC: The World Bank.

Tanzi, Vito. 2010. *Revenue sharing arrangements: Options and relative merit*. The MahbubulHaq Memorial Lecture" delivered at "The 26th Annual General Meeting and Conference" of the Pakistan Society of Development Economists (PSDE), Islamabad.

Ter-Minassian, Teresa, ed. 1997. *Fiscal federalism in theory and practice.* Washington, DC: International Monetary Fund.

United Cities and Local Governments. 2010. *Local government finance: The challenges of the 21st century*. Barcelona: United Cities and Local Governments.

Weingast, Barry. 2009. Second generation fiscal federalism: The implications for fiscal incentives. *Journal of Urban Economics*, Vol. 65, No. 3, pp. 279–293.

Yilmaz, Serdar, Yakup Beris, and Rodrigo Serrano-Berthet. Linking Local Government Discretion and Accountability in Decentralization," *Development Policy Review*, 28 (3): 259–293.

Design and Management of Decentralized Spending and Transfers

Underpinnings for Successful Decentralization

By Ehtisham Ahmad

Introduction

A key test of any decentralization process is whether it lives up to the promise of improved service delivery as well as enhanced political accountability. It is clear that the decentralization process per se does not guarantee improved service delivery (Ahmad and Brosio, 2009)—whether the process is of the gradual, overlapping kind, as in the Andean region (Bolivia and Peru), or a big-bang approach, as in Indonesia (2001) or Pakistan (2002,[1] 2010). In this paper, we consider the issues related to the assignment of spending responsibilities and the preconditions that are needed in order to realize the incentives for enhanced accountability, improved services as well as laying the foundations for sustainable growth.

Section 1 briefly recaps the arguments for decentralization, focusing on the spending side, paralleling the paper by Paul Smoke (this seminar). However, it is increasingly recognized that the design and financing of public policy are very closely interrelated and it is a mistake to treat the issues completely separately (Ahmad and Best, 2012—see also Ahmad, forthcoming for a discussion of the close interlinkages between policies and institutional underpinning for both revenues and expenses).

The context matters, and nominally similar organizational structures (see North 1990) may generate very different results or outcomes in different countries. Section 2 focuses on the need for tighter standards on the flow and availability of information on the sources and uses of funds. Some of the associated institutional requirements (especially on the spending side) are also discussed.

Section 3 discusses transfer design and the associated institutional arrangements, especially for equalization and performance-based transfers.

I. Spending and Accountability

Countries decentralize for many reasons, and often, the political dimensions dominate the purely technocratic, normative assignments. This often has to do more with satisfying disparate groups and keeping the country together than arguments related to efficiency in the provision of public services. However, whatever the motivation governing the degree and sequencing of decentralization, public policy has to be concerned with overall welfare, especially that of the marginalized and poorer sections of society, the effectiveness with which public services are delivered, and the scope for sustainable growth. This paper takes a "political

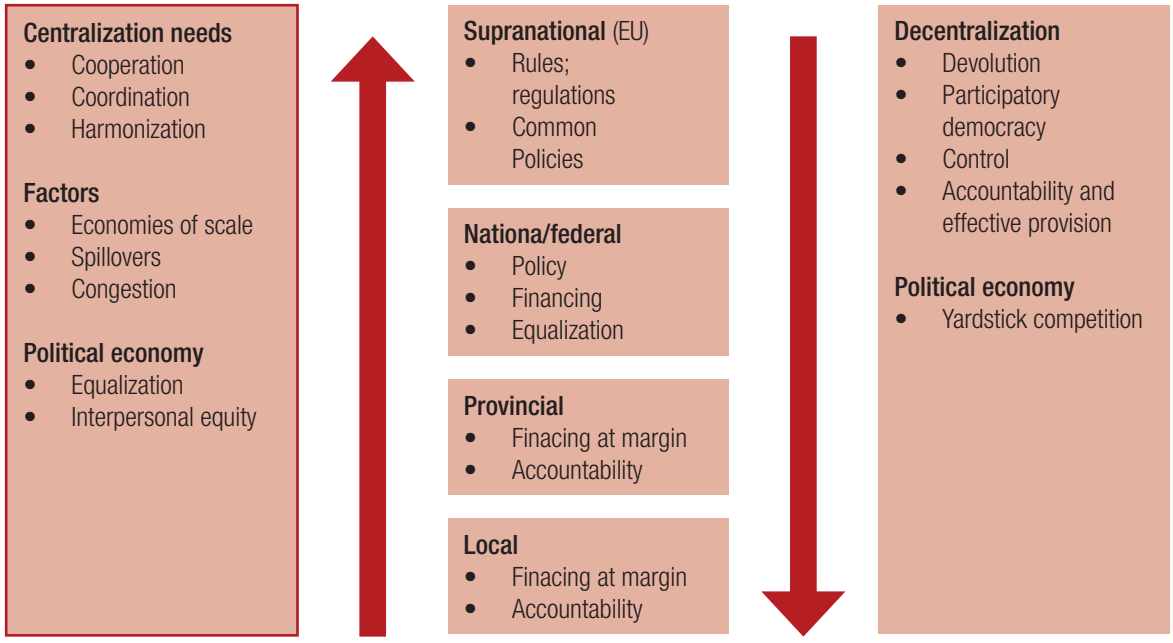
[1] The Asian Development Bank and the World Bank were actively involved with the decentralization in Pakistan, during the Presidency of General Musharraf, to the third tier or district level, which was however designed to break the power of the political parties at the provincial level, and thereby consolidate the power of the military-backed regime. This was remarkably reminiscent of the Suharto era in Indonesia.

economy" perspective in relation to the institutions needed for the effective provision of public services at the subnational level.

A useful typology of spending responsibilities and how different countries approach the issues is given in Chart 1 that addresses the subsidiarity principle. This states that assignments should be devolved to the lowest level capable of effectively providing them. This is a general principle of the EU legal framework, constraining the supranational level from legislation to areas where action at the national, regional or local levels is insufficient. [2] The concept has both legal and political ramifications. The focus is on scale as well as effects, including externalities, on other jurisdictions, and this has given rise to actionable cases where there is a legal connotation, as in the EU.[3] In political terms, the concept of subsidiarity is often taken beyond the multi-level government connotation to also include the boundaries between the private sector and the role of the state (at any level). The presumption, especially by conservative commentators in the US, is that as far as possible the private sector should be encouraged to provide public services, as this is expected to be more efficient than public provision.

Chart 1 shows the differing trends regarding the centralization/ decentralization debate in different countries or regions. The arguments for decentralization of functions are based largely on accountability and effective provision, given the subsidiarity principles. But it is not enough to legislate the assignments—the lower levels have to have the capabilities as well as the incentives to provide the services. Both these are linked closely to the financing issue, as well as incentives for effective provision. Thus, arguments that local governments lack "capacity" are not strictly binding if they have the financial resources to hire skilled workers.

Chart 1 Modified subsidiary principles



Adapted from Dafflon, in Ahmad and Brosio, *Handbook of Fiscal Federalism.*

[2] See http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf

[3] An interesting example is the European Court of Justice's rejection of a case brought by the German Government against an EU Directive on Deposit Guarantee Schemes (Case C-233/94).

An important hypothesis governing accountability comes through the electoral process when voters are able to assess the performance of their "elected" rulers in relation to the standards obtaining in neighboring jurisdictions.[4] Again, the incentives are critical, and voters are more likely to be responsive, if at the margin, local governments rely on own-source revenues—over which they control rates or bases—(see Ambrosiano and Bordignon 2006 for a discussion of the general issues, and Gadenne 2012 for an interesting assessment based on the case of Rio da Janiero).

Offsetting the decentralization trends are concerns that limit subsidiarity—mainly externalities such as spillovers (including with environmental considerations), congestion and economies of scale. Moreover, decentralization especially of resource bases could exacerbate inequalities across regions and also limit the extent of interpersonal redistribution that might be feasible. In all cases, there is a role for the Federal, Central or Supranational agencies to coordinate and harmonize essential policies. In the United States and some other federations, the maintenance of a unified economic space has been facilitated through a "commerce clause." In the EU, a common economic space is ensured through the common external tariff and harmonization of the country-level VATs (see the EU Sixth Directive) to minimize harmful competition. Thus, a combination of legal and regulatory frameworks is essential to ensure equality of treatment and opportunity. Again, for this to work efficiently, full information is needed on who spends what, and the buildup of assets and liabilities, and as the recent EU experience illustrates, inadequate attention to the standardized flow of information could jeopardize a common economic space.

Developing countries have tended to take either a gradual approach to decentralization—focusing on limited capacities and relying heavily on overlapping functional responsibilities and earmarking (especially in Latin America—such as in Bolivia and Peru).[5] While the gradual approach may be eminently sensible in the context of decades of centralized rules, and may prevent "wasteful spending" in countries like Peru, it does not guarantee that the local governments will take responsibility for functions or sub-functions, such as primary education. This is because they are not responsible for the full function, and for important economic components (such as wages or full operations and maintenance—see Section 2 below). For instance in Bolivia circa 2005, the local governments were not particularly concerned with primary education—beyond building the sports facilities. The Departments were responsible for building and maintaining schools, and hiring teachers, who were paid by the central government. Especially in the face of weak information systems (Brazil is an exception in Latin America—and Mexico is the other end of the spectrum),[6] the prospect of holding local governments responsible for any overlapping public function is tenuous at best. This limits the role that yardstick competition may play to discipline local officials and generate the incentives for accountability.

At the other extreme, some countries (especially in Asia—Indonesia a decade ago, and Pakistan in 2010) have adopted a "big-bang" approach, with a rapid devolution of functions. In the Indonesian case, this was from the center to the third tier—or districts—largely to prevent adding to centrifugal pressures that had been present in a large and diverse country. While the devolution was accompanied by a new revenue-sharing, the incentive structures were distorted by the design of transfers that encouraged the creation of new jurisdictions more than the effective provision of public services. Discontent with the level of public service provision has led to the gradual devolution of own-source revenues (through the property tax), as well as a new set of service delivery norms.

While simple norms can work to galvanize local opinion by providing standards to judge local government performance, these have to be accompanied by transfer design that do not distort incentives, as well as much freer flow of information on service delivery spending and outcomes in relevant neighboring jurisdictions. In the Indonesian context, ten years after the big bang, there is considerable work to be done to coordinate

[4] See Salmon (1987, 2006), Besley and Case (1995). A recent extension by Salmon posits that cross-country comparisons may be even more important for voters.

[5] See Ahmad and García-Escribano (2011).

[6] Mexican Ministry of Finance and Public Credit and IMF, FAD 2007—Ahmad et al.

and standardize information generated at the local level, and by the Ministries of Home Affairs and Finance (none of these sources agree on the details of local spending). Moreover, very detailed norms (that resemble GOSPLAN) may actually be unimplementable given the very limited information flows that are available at the present time.

In Pakistan, the Musharraf devolution at around the same time as Indonesia was also to the districts, but unlike Indonesia, neither functions nor financing was made clear. This was more a way of avoiding the provinces, which were also centers of civilian political power. This devolution was reversed with the return to democratic rule in 2008, and a new constitutional amendment (18th Amendment) devolved full functions to provinces in 2010. However, inadequate attention was paid to either financing or capacities—and many of the functions appear to have become unfunded mandates with a continuing deterioration in the standards of public service delivery and outcomes.

As the diverse examples above show, there are no perfect solutions to the issue of accountability and ensuring improved service delivery. It is however clear that critical ingredients in getting better outcomes, whether in "deconcentrated settings," or in fully decentralized environments, are to generate "standardized information on who spends what and what are the outcomes in terms of spending as well as the resulting assets and liabilities.

II. Expenditure Management and Accountability

The main issue from the perspective of implementing appropriate institutions for the management of public funds is to ensure that there are incentives to make local governments accountable to local electorates. Also, there should be responsibility for funds received from the center/supranational agencies and donors; and the use of credit should be managed in a transparent and sustainable manner. This involves more than a mere transplant of organizational structures from developed countries, but also to ensure that these are used effectively. Thus, the process is much broader than a ticking off of boxes in a PEFA matrix, much emphasized by the Bretton-Woods Institutions, but addressing the incentives for and ability to "play games."

1. Information flows

It is clear that poor information flows reduce local accountability, negate yardstick competition, and also facilitate game-play vis-a-vis the central or supranational/ international agencies. The gameplay has been clearly highlighted in the case of the EU and incentives for autonomous agencies as well as regional and local governments to "hide" information or "kick the can down the road." Limited information flows also facilitate rent-seeking and diversion of resources.

Relatively few countries in Latin America or Asia utilize, for both the central as well as the subnational governments, the full format of the IMF's Government Financial Statistics Manual 2001 (GFSM2001)—which is designed to ensure conformity of the financial information with the System of National Accounts.[7] Multiple formats in Mexico at the Federal level and across the states make it difficult to generate standardized information for general government. This makes it problematic to ensure comparability across subnational entities or engender accountable competition across states. Brazilian states, while not conforming to the GFSM2001, perform better than Mexico in that the Federation requires a standardized format to receive report and report on Federal resources as well as their own resources.

[7] A number of countries use transition matrices for the reporting of central or general government information to the IMF in the GFSM2001 format. Pakistan for example reports data only for the budgetary central government in the latest issue of the GFS Manual. This is inadequate, as much of the social spending takes place at the subnational level.

2. Preconditions for macroeconomic management and fiscal rules

Without a complete a complete and standardized format to categorize the cycle of revenues and expenses; in conjunction with a tracking of the cash flows; the likelihood of "game-play" by various levels of government or government agencies cannot be ruled out. A typical problem is the inconsistent treatment of budget coverage—with the frequent exclusion of spending of government agencies or liabilities parked in public enterprises. An additional problem is the ability of lower levels of government to hide or postpone liabilities, or bring forward expenditures. In a short-to medium-term framework of most fiscal rules, this can cause severe problems (as has been seen in the context of the Maastricht treaty).

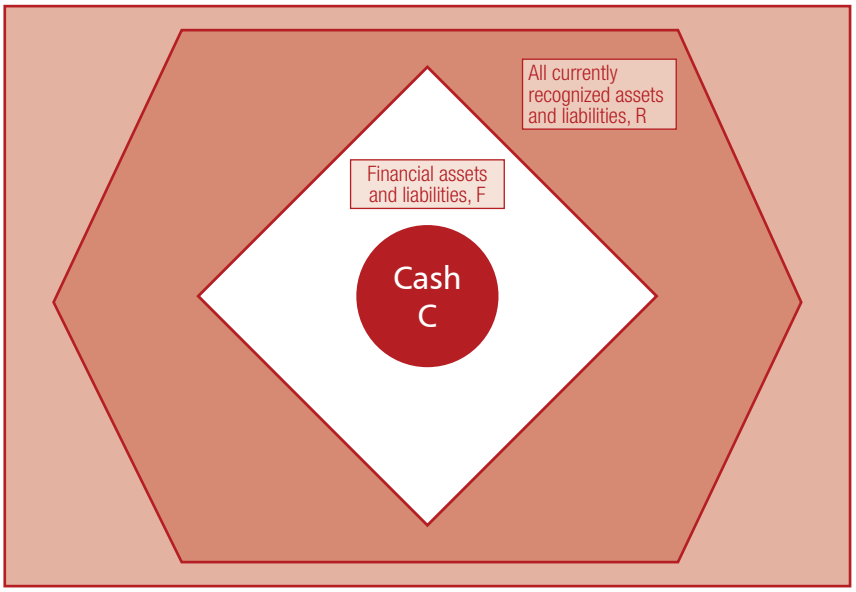
In the very simple example of Chart 2, the cash transactions of a government are shown as set C. This is a subset of F, which also includes financial assets and liabilities. In turn, F can be denoted as a sub-set of R, which also includes all currently assets and liabilities. It is relatively simple for governments to reduce deficits in cash (C) or financial assets (F), without affecting all recognized liabilities (R) or extended net worth based on future flows (E). For instance, (subnational or national) governments could engage in game-play, by

- Selling non-financial assets in R, for cash in F;
- Assuming future pension liabilities in E, for cash and financial assets in F;
- Securitization C of future revenue streams F (common in Latin American local governments;
- Treating borrowing F as revenue C (several US States).

The sets C, F and R are consistent with the IMF GFSM2001. These represent nested sets of information, and if presented in parallel with E, virtually removes the scope for game-play by governments at any level. Thus, any serious implementation of fiscal rules in multi-level countries/currency unions should be based on the consistent and systematic generation of information in the overlapping manner described above.

There is a growing popularity of performance budgeting at the center (in both Latin American and Asian countries, including Mexico and Pakistan), as well as participatory budgeting at the local levels. Often bilateral donors, seeking to improve budgetary outcomes, drive this tendency. It is clear that focusing on outcomes is a useful addition to a regular budget process, but does not eliminate the need for a consistent, standardized and timely flow of information, so that electorates and policy makers are able to judge the true costs of their policy choices.

Chart 2 Right and obligations associated with all future cash flows, E



The importance of the GFSM2001 cannot be over-stressed, not for reporting to the IMF, but for the efficient management of finances in multi-level countries and in common markets/currency unions.

This has implications for the assistance that could be provided by CEPAL, the IADB and the IMF to member countries—stressing the importance of a consistent chart-of-accounts for each subnational government consistent with GFSM2001. This will involve changes to the GFMISs at the national and subnational level being implemented in countries like Peru, and Bolivia. This also has implications for Brazil, as it seeks to upgrade its very successful SIAFI dating from the 1990s; and for countries in the EU as they struggle to get to grips with the discovery of liabilities in the extended public sector as well as at the regional and subnational levels.

Public–Private Partnerships—Kicking the Can Down the Road?

PPPs have been encouraged, including by international finance agencies, as a means of leveraging "private sector" expertise for public investment project, and also bypassing bureaucratic bottlenecks. This is believed to generate efficiencies, and improved value for money, especially at the subnational level. The expectation is that this will generate additional growth through the efficiencies and additional private finances that would be utilized.

The problem is that governments, especially although not exclusively at the subnational level; see PPPs as a means of circumventing budget constraints. This could generate legal obfuscations, and relevant official agencies or governments are either not fully aware of the liabilities, or the ability of the private partner to meet them. Sometimes, the issue of liability for full costs is avoided, often with respect to public infrastructure (highways and hospitals in Europe); and local governments only include the annual contractual cash payment on the budget, and generally only during the tenure of the concerned local government. Often, there is no provisioning for the eventual reversion of the assets to the public sector. Further, there is usually a continuation of public interventions with respect to prices or distribution.

There is also incomplete and asymmetric information, with costs and efforts for projects generally known only to the private partner, and significant incentives for either the private contractor or the government to renege (Danau and Vinella, 2012). An example of a growing recognition of limited commitment comes from the UK (which was in the forefront of the PPP revolution). In the 2002-3 upgrading of the London Underground, Metronet the contracting consortium could not borrow the full amount of funds needed for the project. Consequently, Transport for London, the decentralized agency responsible guaranteed 95% of Metronet's debt obligations. Metronet failed, and the UK Government (Department of Transport) had to pay Transport for London a sum of £ 1.7 billion to enable it to meet the guarantee (House of Lords, 2010). The direct cost to taxpayers was estimated to be as high as £410 million. Other examples from the UK, e.g., for wind farm projects, show that in these cases the private contribution was financed by complex financial instruments that are tantamount to debt—that has eventually to be taken over by the state.

As a result of the difficulties above, the International Accounting Standards Board (2011) has issued a new set of guidelines (IPSAS 32)[8] that force an upfront accounting for PPPs, and would significantly affect deficits and recognition of liabilities for general government—i.e., for both central and sub-central governments and related agencies. This ensures that the operator is effectively compensated for services rendered during the period of the concession period. It requires the government or granting public agency to recognize assets and liabilities in their financial statements, when the following are met:

- The government or granting public agency controls or regulates the services to be provided, the target beneficiaries or the price; and
- If the grantor controls through ownership, beneficial entitlement or otherwise, a significant residual interest in the asset at the end of the arrangement.

[8] See IASB (2011), IPSAS 32. This standard is also likely to affect the guidelines of Eurostat that are not so tightly defined.

In the schema of Chart 2, this would involve elements in the areas R and E. This avoids the situation where neither the public or private partner recognizes the asset/liability at the end of the period. Of course, as has been seen in Ireland and Spain recently (and with Mexican road-building program in the early 1990s), even if there are no explicit guarantees by the federal or state governments and there is sufficient pressure on the banking system, it is likely that the state will assume a significant portion of the liabilities.

The implications are that (1) the annual budgets for each level of government must be cast in a medium-term framework; (2) it is essential to undertake a full and careful evaluation of assets and liabilities and associated accounting and reporting of risks with a sufficiently long time horizon (using international standards, such as the GFSM2001); and (3) it is always important to be able to track the cash, and the design of national and subnational TSAs becomes critical.

3. Following the cash—TSAs and transparency

One of the most important common features of budget systems across the world, whether of the "traditional" line item variety (as in most developing countries—and Germany), or of the more modern flexible systems, that rely on spending agency accountability (as in Scandinavia), is a treasury single account (TSA). This institutional feature has been recommended by the IMF in a large number of countries as part of its Technical Assistance and Capacity Development. Despite some successes, as in PR China, establishing a TSA has proved elusive in countries from Mexico (the only OECD country without a TSA) to Pakistan.

The difficulty in establishing a TSA lies primarily in vested interests, both political as well as bureaucratic (for details, see Ahmad, forthcoming). But we concentrate here on the subnational aspects—should local governments have their own TSAs? Should they use a central TSA? What are the problems posed by donors, both multilateral (such as the World Bank) and bilateral agencies that may not trust the local governments to use their funds efficiently or without significant leakages?

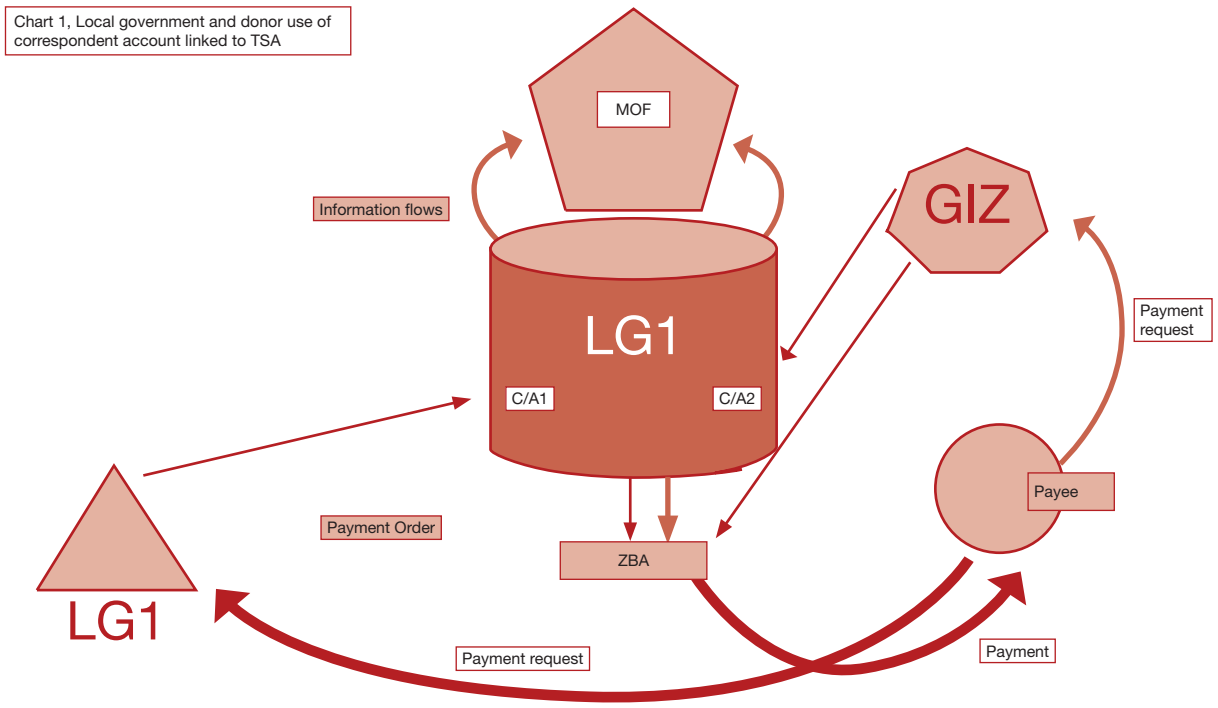
Some countries do not have sufficiently large subnational entities for it to be efficient to establish local TSAs.[9] In some cases, such as Cameroon, the IMF has recommended that the local governments use the central TSA. While this may be desirable in principle, the practice can be a severe problem. Suddenly, local governments face a closure of their bank accounts, and do not know where the money goes and their balances. And in order to issue payment orders, they have to send emissaries to the central Ministry of Finance and petition the Treasury to release funds. This adds to the complexity of the local budget process and could endanger the decentralization process.

What are the problems with donors—seen e.g., in a range of countries? The insistence to keep separate bank accounts for their spending poses the risk of parallel budget processes, and makes it hard for either local or central governments to get a grip on total spending. Besides obfuscating the budget process, it reduces the accountability for achieving results.

A solution is shown in Chart 3—with a modification of the TSA principle often used for "independent" bodies, including security agencies—the principle of establishing correspondent accounts (CA) within a TSA. Thus CA1 would be the account of local government 1; and CA2 that for a bilateral agency, say the GIZ.

[9] The Chinese provinces are larger than most countries and have their own TSAs, nested and linked with the Central TSA in Beijing. This is a very interesting model and could usefully be examined in the larger multi-level countries—e.g., other members of the BRICS and countries of similar size, such as Indonesia or Pakistan.

Chart 3 TSA with donors/local government



If there is a GFMIS, then the operations of the CA become the responsibility of the local government or the bilateral agency. They could issue payment orders to the extent of their resources in each account. Without a GFMIS, it may be necessary to establish a series of zero-balance accounts in commercial banks, again subject to the resources in the respective accounts. This cuts through the bureaucracy, and yet all levels of government have full information on who spends what and when. Thus, both cash management (best managed at the central level in most cases), and information flows are facilitated.

This small example illustrates that often the first best may makes matters worse, if implemented without thinking in inappropriate conditions. It is often necessary to work through why there is no TSA in a particular context, and then try and address the issues on a case-by-case basis. This involves work to understand the political economy constraints in each case.

III. Design and Management of Transfer Systems

All the carefully designed and implemented incentive structures described above could be negated if a transfer system were to cover all deficits and debts without any constraints. The creation of a level playing field through a system of equalization transfers is critical—this should enable all subnational governments to provide similar levels of services at similar levels of tax effort.

However, for investment needs and infrastructure gaps to maximize the growth potential, it would be useful to begin to create the preconditions for performance-based transfers. This would ensure that the investments produce results and are managed efficiently. Such transfers could also be used to promote central government objectives, such as social protection for the marginalized and most vulnerable. However, care needs to be taken should the transfers be implemented in areas of local government jurisdiction, as this could lead to a diversion of resources and additional "game play."

1. Earmarked transfers

Many countries try to achieve central government objectives in an increasingly decentralized context through a system of earmarked transfers. The biggest drawback of excessive earmarking is that it overrides local preferences, and is inimical to the basic philosophy underlying the decentralized processes—i.e., to generate accountability for local responsibilities. Moreover, a big constraint faced by countries with weak PFM systems, and poor information on who spends what, is that it is hard to ensure that the funds are not diverted to other heads that may be more important for local officials—or just stolen.

As described in Ahmad (2009), it may be possible to offset some of the PFM disadvantages by inducing competition among recipient jurisdictions, using simple performance criteria. The basic idea is that a medium-term budget framework is put in place, and the transfers in period t+2 are made conditional on achieving targets set for period t+1.

Thus, if growth and employment generation is an objective, and is not achieved by additional transfers given to the metropolitan areas, it may be useful to reconsider the strategy in the coming period. Also the relationships between the metropolitan administration and the decentralized subordinate municipalities would clearly need to be clarified. Eventually, when the PFM systems are strong enough, and the court systems function efficiently, one could consider "contract" based transfers (Spahn, 2006).

2. Equalization transfers

Design. Under a modern system of "equalization" the objective could be to "assign transfers so that subnational governments could provide equal standards of service at equal levels of tax effort" This is the modern mechanism that has been used across States in Australia, provinces in China, and municipalities and districts in Denmark, Hungary. A more restricted arrangement based on equalizing revenue capacities only is used in Canada—but a replication of this to other countries assume that local governments have some control over local revenue bases (either through control over rates or through elements involved in the tax administration.

Very simply, the equalization framework would be based on "standardized" factors. This ensures that local governments would not be able to influence the magnitude of the transfer by their actions or lack of actions (see Ahmad and Searle, 2006, for a description of alternative models).

The standardized transfers thus become more or less "lump sum" and do not distort incentives at the local level. The standardized spending responsibilities would address differential costs of provision for services assigned to them, with higher costs in remotely populated areas, as well as densely populated urban districts. Similarly, the own-revenue potential would be based on standardized revenue (spatial distribution of bases, assuming average rates), and the fact that a local government chooses not to exploit a revenue base would not lead to a higher grant. Thus, there would be an incentive to better utilize assigned revenue bases.

The equalization framework in Indonesia started out in 2001 on the basis of standardized factors, but these were changed into actual spending and transfers—converting it into an estimate of the actual gap. This completely changed the incentive structure, as the deficit came under the control of local governments and generated a trend towards inefficient expansion of spending, especially on personnel and benefits.

It is important to avoid complexity in the design of equalization frameworks—and the Australian model has been criticized as being so complicated that it becomes hard to judge the economic outcomes and implications. There has been a conscious attempt in the Commonwealth Grants Commission to simplify models and factors used to estimate disabilities. The Chinese application of the Australian equalization framework also used very simple factors, such as population. Clearly, population, which is also used as the basis for simple transfers (which makes it a very political variable), is still important as a factor for equalization. But using it in a standardized manner to evaluate relative costs or needs diffuses the perceived concerns with the population variable. Simplified versions could be used at municipal level; with a few criteria.

Overall, a modern equalization framework should shift the focus from "entitlements" to a political focus on service delivery by local governments. This helps with local oversight and could help also generate "yardstick competition."

Management. The options to implement an equalization grants system vary from the establishment of an independent Grants' Commission to entrusting the function to the Ministry of Finance or other line agency, such as the Ministry of Home Affairs or Local Governments, or both Ministries (as in Indonesia). Table 1 presents some international experiences.

The main objective of an independent Grants' Commission is to allay fears by the subnational entities that the grant allocations would be "fixed" by the Central Government, particularly the party in power at the Central level to favour their own supporters at the local levels. An independent Grants' Commission could be established to determine the relativities for making equalization transfers, in coordination with the local governments. It does not make payments directly, which are routed through the Treasury, but establishes the basis and monitors and collects the information needed to make the system work. In countries such as Australia, the Grants Commission is an independent agency with representation by the subnational governments. There are strong arguments in favour of making the Grants Commission a standing body, as this help considerably with interjurisdictional cooperation.

However, in countries such as Mexico or China, the Ministry of Finance manages the Grants function. Often there is a separate section within the Treasury/MOF to administer this function.

Table 1 Institutional arrangements for Equalization Transfers

	Is There a Separate Agency to Advise on Grants Distribution?	Ministry Administering Untied Grant Distribution	Is Local Government Involved in Grant Decisions?	Where a Separate Agency Operates			
				Is the agency permanent?	Does it operate under the Constitution or a law?	What is its range of functions?	What is the size of the agency?
Australia	Yes		Yes	Yes	Law	Narrow	Small
Canada		MOF	Yes				
China		MOF	?				
Denmark		MOF	Yes				
Ghana	Yes		No	Yes	Constitution	Narrow	Very small
Ethiopia		House of Federation and MOF	Yes				
India	Yes		Yes	No	Constitution	Narrow	Small
Japan		MoLG	Yes				
South Africa	Yes	MOF and MoLG	Yes	Yes	Constitution	Wide	Large
South Korea		MoLG	Yes				
Sudan	Yes	MOF	Yes	Yes	Constitution	Wide	Large
Uganda	Yes		Yes	Yes	Constitution	Wide	Small

MoLG = Ministry of Local Government; MOF = Ministry of Finance.

Source: Searle 2010 in Ahmad and Al Faris, *Fiscal Reforms in the GCC*, Edward Elgar.

3. Performance based transfers

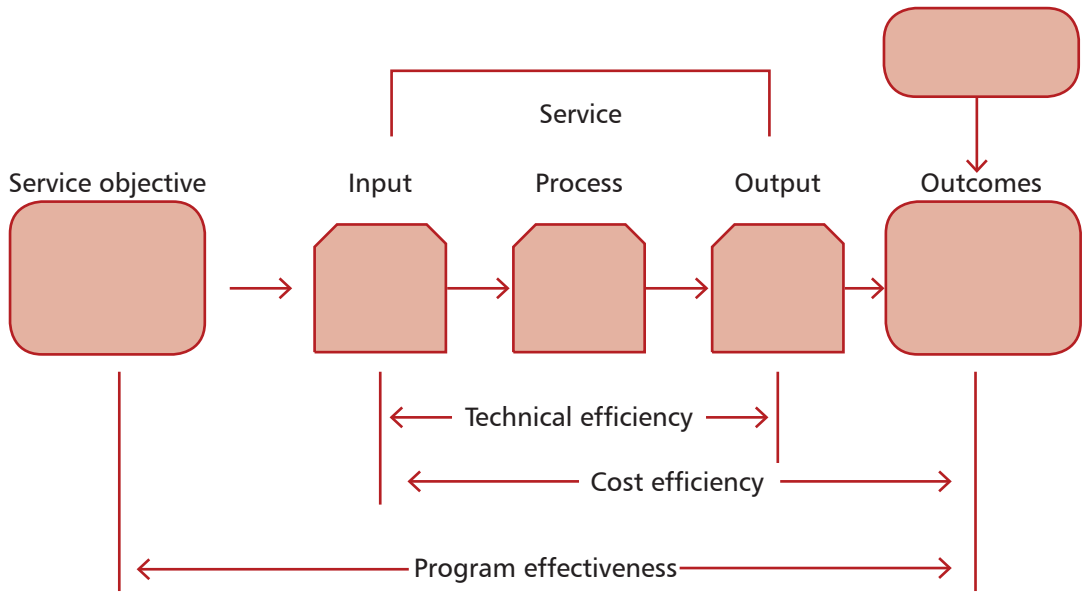
There is an expectation that results-based intergovernmental transfers could lead to positive infrastructure and service-delivery outcomes, with improved allocative efficiency, better implementation, and lower costs.[10] Such grants have been increasingly stressed by the international agencies, including the ADB and the World Bank.

Performance-based transfers have to be carefully designed and managed, especially if implemented in the sphere of subnational government competence. If inadequate attention is paid to the factors that could be attributed to local government actions, such transfers could lead to a diversion of own-resources to less productive activities, and also reduce accountability. The cycle from objectives to outcomes has to be carefully specified, and exogenous factors need to be taken into account (see Table 2).

The technical efficiency process is the regular budget process that links the allocation of funds through to the funds actually spent, as well as outcomes. These would be normally tracked through with the help of a GFMIS, preferably on a standardized basis for all subnational and central/federal governments. The IADB has assisted a number of Latin American countries, including Bolivia, with such subnational GFMISs, although with insufficient attention to the Chart of Accounts and tracking spending on a GFSM2001 compatible basis. In addition a linkage has to be made between the outcomes and the service objectives, and there is a degree of subjectivity in determining the exogenous factors that might have played a part.

If the performance-based transfers are based on complex input criteria, or detailed standards that cannot be monitored or enforced, the conditionality becomes irrelevant. Similarly, a focus on outputs rather than outcomes may lead to unintended or perverse incentives. Nonetheless, even in situations where information on budget spending is partial or subject to delays, physical outcomes may be relatively simple to identify quickly and accurately—this could be particularly useful for infrastructure projects. These could be measured and additional funding in future rounds could be made conditional on these outcome indicators (Ahmad and Martinéz, 2010). Care has to be taken to ensure that the positive incentives from a performance–based system are not negated by other badly designed transfers, for instance based on gap-filling or other distortive criteria.

Table 2 Performance Based Grants: Conceptual Framework



[10] UNCDF, 2010. "Performance-based Grant Systems: Concept and International Experience."

A performance-based system should supplement local government actions and responsibility, such as through meeting infrastructure gaps that are hard for local governments to address, and which can be easily monitored. In the longer run, more effective and standardized PFM systems are essential for information flows to improve efficiency and accountability. Similarly, incentive structures depend on whether or not subnational entities have access to own-source revenues and are subject to hard budget constraints. While, this mutual interdependency will take many years to work through in most developing countries, they could introduce simple and monitorable performance-based grants in specific sectors, or discrete areas that will improve outcomes.

References

Ahmad, E. and L. Jensen (forthcoming), "Governance and Institutions", in Ahmad E. and G. Brosio (eds.), Handbook of Fiscal Federalism II.

Ahmad, E. and M. Best (2012), "Financing social policy in the presence of informality," LSE_ARC Working Paper April 2012.

Ahmad E. and G. Brosio (2006), *Handbook of Fiscal Federalism,* Edward Elgar.

_____. (2009), *Does Decentralization Enhance Service Delivery and Poverty Reduction?* Edward Elgar.

Ahmad, E. and M. García-Escribano (2011), "Constraints to Effective Fiscal Decentralization in Peru" (with Mercedes García-Escribano), in Jorge Martinéz-Vaszquez and François Vaillancourt, (eds), *Obstacles to Decentralization: Lessons from Selected Countries,* Edward Elgar.

Ahmad E., and L. Martinéz (2010), "Intertemporal competition and aid," *Economics and Politics.*

Ahmad, E. and B. Searle (2006), "On the implementation of transfers to subnational governments," in Ahmad and Brosio (2006).

Ambrosiano, F. and M. Bordignon (2006), "Normative versus positive theories of revenue assignments," in Ahmad and Brosio (2006).

Besley, T. and A. Case (1995), "Incumbent behavior, vote-seeking, tax-setting, and yardstick competition," *American Economic Review,* 85, 25–45.

Dafflon, B. (2006), "The assignment of functions to decentralized government: from theory to practice," in Ahmad and Brosio (2006).

Danau, Daniel and Annalisa Vinella (2012), "Public–private contracting under limited commitment," *SIEP Annual Conference, 2012, Pavia*.

European Union: *The Maastricht Treaty*, http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf

Gadenne, Lucie (2012), "Tax me, but spend wisely—the political economy of taxes: evidence from Brazil," Mimeo, University of London.

House of Lords, 2010, *Private Finance Projects and Off-balance sheet Debt,* First Report of Session 2009–10, Vols. I and II, Report and Evidence, HL Paper 63, I–II.

IMF, *Government Financial Statistics Manual 2001* (GFSM2001), Washington DC.

Mexican Ministry of Finance and Public Credit and IMF, FAD 2007 Mexico: *Options for the Reform and Strengthening of Intergovernmental Fiscal Relations*, (Team led by E. Ahmad with M. García-Escribano, R. Blavy, (IMF) J. Draaisma (World Bank), J.A. González Anaya (Vice-Minister, SHCP), E. Revilla (DG SHCP), C. Berthaud, G. Brosio, I. Garrido, B. Lockwood (Consultants), March 2007).

North, D. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University Press.

Salmon, Pierre. (1987). "Decentralisation as an incentive scheme", *Oxford Review of Economic Policy* 3(2), 24–43.

_____. (2006). "Horizontal competition among governments", in: Ehtisham Ahmad and Giorgio Brosio (eds.,), *Handbook of Fiscal Federalism*, Cheltenham: Edward Elgar 2006.

Spahn, P.B., (2006), "Contract federalism," in Ahmad and Brosio (2006).

Ter-Minassian, T. (ed., 1997), *Fiscal Federalism in Theory and Practice,* IMF.

Searle, Bob (2010), in Ehtisham Ahmad and Abdelrazak Al Faris, *Fiscal Reforms in the GCC, 2010,* Edward Elgar.

UNCDF, (2010). "Performance-based Grant Systems: Concept and International Experiences."

APPENDIX 1

Program at a Glance

Asia-Pacific and Latin-American Interregional Forum on Managing for Results
Decentralization and the Changing Role of Central Finance Agencies
Manila, Philippines
November 28–29, 2012

Agenda

The forum will discuss and analyze the changes, challenges, and opportunities that decentralization brings to the traditional processes and institutions involved in central finance functions. It offers a unique opportunity for officials from the Asia-Pacific and Latin America to engage in South-South dialogue and learn from diverse country experiences on decentralization in the two regions.

DAY 1: Wednesday, 28 November 2012 (Auditorium D)

Time	Session
8:40–8:50	ASSEMBLY OF PARTICIPANTS
8:50–9:20	OPENING SESSION Stephen Groff Vice-President (Operations 2) Asian Development Bank Florencio Abad Secretary Department of Budget and Management Philippines
9:20–9:30	PHOTO SESSION
9:30–9:40	Presentation of the Forum Outline and Objectives
9:40–10:25	Results-based Public Sector Management: A Strategic Framework This session will focus on the basic features of a results-based public sector management cycle. Farzana Ahmed Asia-Pacific Community of Practice Discussant: Roberto Garcia–Lopez Community of Practice of Latin America and Caribbean Q&A
10:25–10:45	TEA BREAK

Time	Session
	DECENTRALIZATION and WHAT IT MEANS for CENTRAL FINANCE AUTHORITIES *This session will examine the drivers of decentralization and facilitating the transition for central finance authorities, focusing particularly on:* • *the political and economic drivers of decentralization;* • *how to minimize risks to macroeconomic stability and fiscal sustainability and to address such risks when they materialize;* • *the role of the central finance authorities in managing the decentralization process, promoting subnational fiscal responsibility, and resolving subnational debt crises*
10:45–11:15	**Teresa Ter-Minassian** **International Economic and Fiscal Policy Expert** **(former Director of the IMF Fiscal Affairs Department)**
11:15–11:35	**Discussants** • Paul Smoke • Ehtisham Ahmad
11:35–12:15	**Country Response** • Marcelo Piancastelli, Former Undersecretary of the Federal Treasury, Brazil • Maria Dolores de Almeida, Former Vice Minister of Finance, Ecuador • Mulia Nasution, Former Secretary-General of the Ministry of Finance, Indonesia • Atul Sarma, ICSSR National Fellow and Visiting Professor and Former Member of the 13th Finance Commission, India
12:15–13:00	**Roundtable Dialogue**
13:00–14:30	LUNCH
	DESIGN AND MANAGEMENT OF DECENTRALIZED REVENUES AND TRANSFERS *This session will examine economic, political, and institutional factors in shaping subnational revenue systems, focusing in particular on:* • *the benefits of own revenue mobilization in terms of fiscal responsibility and local political accountability,* • *main economic impediments to it (differences in revenue-raising capacities, and efficiency considerations),* • *main political obstacles to revenue devolution and subnational fiscal effort,* • *institutional constraints, and* • *the role of intergovernmental transfers in promoting subnational revenue effort and equalizing subnational revenue capacities the role of vertical and horizontal cooperation in strengthening subnational revenues.*
14:30–15:00	**Dr. Paul Smoke** **Professor of Public Finance and Planning** **New York University Wagner School of Public Service**
15:00–15:20	**Discussants** • Teresa Ter-Minassian • Ehtisham Ahmad
15:20–15:35	TEA BREAK
15:20–15:40	**Country Response** • Emilio Pineda, Fiscal and Municipal Management Lead Specialist, Inter-American Development Bank, Mexico • Marwanto Harjowiryono, Director General of Fiscal Balance, Ministry of Finance, Indonesia
15:40–17:00	**Roundtable Dialogue**

DAY 2: Thursday, 29 November 2012 (Auditorium D)

Time	Session
	DESIGN AND MANAGEMENT OF DECENTRALIZED SPENDING AND TRANSFERS *This session will focus on how to maximize efficiency gains from expenditure decentralization, in particular:* • *minimizing duplication and overlaps in expenditure assignments across levels of government;* • *reducing disparities in the delivery of essential public services; role of minimum standards;* • *strengthening subnational capacity to manage own spending responsibility;* • *strengthening transparency and accountability mechanisms, including appropriate indicators of effectiveness of subnational spending programs;* • *political economy influences on expenditure performance of subnational governments;* • *the role of equalization transfers; and* • *use of special-purpose intergovernmental grants for improving subnational outcomes*
09:00–09:30	**Dr. Ehtisham Ahmad** **Senior Fellow** **London School of Economics Asia Research Centre and ZEF University of Bonn**
09:30–09:50	**Discussants** • Teresa Ter-Minassian • Paul Smoke
09:50–10:30	**Country Response** • Giulia Puttomatti, State of Sao Paulo, Brazil • Jose Arista, Chairman, Amazon Regional Government • Jinyun Liu, Deputy Director General, Department of Treasury, Ministry of Finance, People's Republic of China • Weerachai Chomsakorn, Executive Director, Office of the Decentralization to Local Government Organization Committee, Thailand
10:30–11:30	**Roundtable Dialogue**
11:30–11:45	TEA BREAK
11:45–12:30	**CLOSING PANEL and WRAP UP** *This session will summarize key lessons on decentralization and its impact on central finance authorities, expenditure management and revenue management. It will identify challenges and opportunities of decentralization reform and areas that international donor partners can support.* • Teresa Ter-Minassian • Ehtisham Ahmad • Paul Smoke
12:30–13:00	**CLOSING SESSION**
13:00–14:00	LUNCH

APPENDIX 2

Profile of International Experts

Teresa Ter-Minassian
International Expert
Economic and Fiscal Policy

Mrs. Ter-Minassian is currently an international economic consultant, working in particular with the Inter-American Development Bank on fiscal issues in Latin America.

She holds degrees in Law from the University of Rome (Italy) and in Economics from Harvard University. She joined the International Monetary Fund (IMF) in 1972, working in the European, Western Hemisphere, and Fiscal Affairs departments. Her IMF career included:

- Leading IMF missions to Italy, Spain, Portugal, and Greece (1980–1988),
- Heading the IMF Task Force for the G7-commissioned first official study of the Soviet Union economy (1990),
- Leading IMF negotiations with Brazil and Argentina in 1997–2000, and
- Director of the IMF's Fiscal Affairs Department from 2001 to 2008.

Mrs. Ter-Minassian has published more than 40 papers on fiscal issues, especially in the macro-fiscal and intergovernmental fiscal relations areas, and the following books:

- *Promoting Fiscal Discipline* (co-editor with M. Kumar), IMF, 2007;
- *Fiscal Policy and Economic Reform* (co-editor with M. Blejer), Routledge, UK, 1997;
- *Macroeconomic Dimensions of Public Finance* (co-editor with Mr. Blejer), Routledge, UK, 1997; and
- *Fiscal Federalism in Theory and Practice* (editor, and author of Chapters 1, 7, and 18), IMF, September 1997.

Ehtisham Ahmad
Visiting Senior Fellow
London School of Economics Asia Research Centre

Dr. Ehtisham Ahmad is a visiting senior fellow with the London School of Economics (LSE) Asia Research Centre and also a senior fellow at ZEF, University of Bonn. Dr. Ahmad has held senior positions over the past 2 decades in the International Monetary Fund (Senior Advisor, Office of Executive Directors; Advisor and Division Chief, Fiscal Affairs Department); and was also a member of the core team for the World Bank's 1990 *World Development Report on Poverty*.

He has been special advisor to the finance minister of Saudi Arabia; as well as director of the Development Economics Research Program, STICERD, LSE in the late 1980s, and deputy director of the Development Economics Research Center at the University of Warwick (to 1986).

Dr. Ahmad has published articles and books in the areas of governance, federalism, fiscal issues, and intergovernmental fiscal relations, including:

- *Effective Federalism and Local Finance* (with Brosio, Giorgio), Edward Elgar, Cheltenham, UK (2011)
- *Does Decentralization Enhance Service Delivery and Poverty Reduction?* (with Brosio, Giorgio), Edward Elgar, Cheltenham, UK (2009)
- *Handbook of Fiscal Federalism* (with Brosio, Giorgio), Edward Elgar, Cheltenham, UK (2006)
- *The Theory and Practice of Tax Reform in Developing Countries* (with Stern, Nicholas), Cambridge University Press, Cambridge, UK (1991)
- *Social Security in Developing Countries* (with Drèze, Jean; Hills, John; and Sen, Amartya), Clarendon Press, Oxford (1991)

Paul Smoke
Professor
Public Finance and Planning
NYU Wagner School of Public Service

Paul Smoke, professor of public finance and planning and director of International Programs, teaches courses on public finance, development planning, governance, and development assistance in developing countries. His research and policy interests include urban and regional development and the political economy of fiscal reform and public sector decentralization. He previously taught in the International Development Program and chaired the Master in City Planning Program at the Massachusetts Institute of Technology, and he worked as a resident policy advisor with the Harvard Institute for International Development in Kenya and Indonesia. Smoke is a visiting scholar with the Fiscal Affairs Department of the International Monetary Fund and is an affiliated scholar with the Center on International Development and Governance at the Urban Institute.

His research and policy work has covered several regions and multiple countries, including Brazil, Cambodia, Egypt, Ethiopia, India, Nepal, Palestine, South Africa, Uganda, the USA, Viet Nam, and Yemen. He has worked with various international organizations, including the World Bank, various United Nations agencies, United Cities and Local Governments, Inter-American Development Bank (IADB), African Development Bank, Asian Development Bank, UK Department for International Development, the European Commission, Swedish International Development Cooperation Agency, and the German Society for International Cooperation. Recent efforts include supporting the Development Partners Working Group on Decentralization and Local Governance in their work on aid effectiveness, co-coordinating a global report on local government finances for United Cities and Local Governments, co-managing an initiative on the political economy of decentralization at the World Bank, and advising the development of a handbook on democratic decentralization practice for the United States Agency for International Development.

Dr. Smoke has published in numerous journals and authored or co-authored several books on decentralization and local governance. Professor Smoke received his Ph.D. from the Massachusetts Institute of Technology.

APPENDIX 3

Participants List

	Country	Name (First/Last)	Position/Designation	Organization/Office
		THE ASIA AND PACIFIC REGION COUNTRY GOVERNMENT REPRESENTATIVES		
1	Afghanistan	Mohammad Nader Yama	Director	Strategic Planning, Independent Directorate of Local Governance
2	Bangladesh	Jalal Ahmed	Additional Secretary	Ministry of Finance
3	Cambodia	Huot Synead	Deputy Director	National Committee on Subnational Democratic Development (NCDDS)
4	Cambodia	Oul Nak	Director	Council for the Development of Cambodia
5	China, People's Republic of	Shuanyou Ma	Director	Policy and Fiscal Affairs Department, Ministry of Finance
6	China, People's Republic of	Jinyun Liu	Deputy Director-General	Department of Treasury, Ministry of Finance
7	Indonesia	Marwanto Harjowiryono	Director General	Fiscal Balance, Ministry of Finance
8	Malaysia	Noor Ihsan Che Mat	Deputy Director	Development Budget Section, Economic Planning Unit, Prime Minister's Department
9	Pakistan	Abdul Khaliq	Additional Finance Secretary	Budget, Ministry of Finance
10	Philippines	Florencio Abad	Cabinet Secretary	Department of Budget and Management
11	Philippines	Carmencita Delantar	Director	Department of Budget and Management
12	Philippines	Rolando Tungpalan	Deputy Director General	National Development Office for Investment Programming, National Economic and Development Authority
13	Thailand	Weerachai Chomsakorn	Executive Director	Office of the Decentralization to Local Government Organization Committee, Prime Minister's Office
14	Viet Nam	Thanh Hung Vo	Deputy Director	State Budget Department, Ministry of Finance
		LATIN AMERICA COUNTRY GOVERNMENT REPRESENTATIVES		
15	Brazil	Marcelo Piancastelli De Siqueira	Secretary of Finance	
16	Brazil	Giulia Da Cunha Fernandes Puttomatti	Advisor to the Secretary of Finance	
17	Costa Rica	Roberto Gallardo	Minister	Ministry of National Planning and Economic Policy
18	Peru	Jose Arista	Chairman	Amazon Regional Government

NONGOVERNMENT COUNTRY EXPERTS				
19	India	Atul Sarma	ICSSR National Fellow and Visiting Professor (former member of the 13th Finance Commission)	Institute for Human Development
20	Indonesia	Mulia Nasution	President Commissioner (former Secretary-General of the Ministry of Finance)	Bank Bukopin
21	Philippines	Benjamin Diokno	Professor (former Minister of Department of Budget and Management)	School of Economics, University of the Philippines
22	Ecuador	Maria Dolores de Almeida	Economic and Fiscal Consultant (former Vice-Minister)	Ministry of Finance
23	Guatemala	Karin Slowing	Former Minister	Ministry of Planning
EXPERTS				
24		Teresa Ter-Minassian	International Economic and Fiscal Policy Expert (former Director of IMF Fiscal Affairs Department)	International Monetary Fund/ Inter-American Development Bank
25		Ehtisham Ahmad	Senior Fellow	Center for Development Research (ZEF) University of Bonn, and Asia Research Center London School of Economics
26		Paul Smoke	Professor of Public Finance and Planning	New York University Wagner School of Public Service
DEVELOPMENT PARTNERS				
27	**Inter-American Development Bank/ Latin American and Caribbean Community of Practice on Managing for Development Results**	Roberto Garcia Lopez	Executive Secretary	Latin American and Caribbean Community of Practice on Managing for Development Results and Inter-American Development Bank
28	**Inter-American Development Bank**	Emilio Pineda	Fiscal and Municipal Management Lead Specialist	Inter-American Development Bank
29	**Asian Development Bank**	Farzana Ahmed	Lead Results Management Specialist	Asian Development Bank

First Row (L-R) Carmencita Delantar (Philippines), Farzana Ahmed (ADB), Teresa Ter-Minassian (Expert), Roberto Gallardo (Costa Rica), Maria Dolores de Almeida (Ecuador), Rolando Tungpalan (Philippines), Neeraj Jain (ADB); *Second Row (L-R)* Weerachai Chomsakorn (Thailand), Mulia Nasution (Indonesia), OulNak (Cambodia), Jalal Ahmed (Bangladesh), Ehtisham Ahmad (Expert), Marwanto Harjowiryono (Indonesia), Abdul Khaliq (Pakistan), Noriko Ogawa (ADB); *Third Row (L-R)* Emilio Pineda (IADB), Thanh Hung Vo (Viet Nam), Benjamin Diokno (Philippines), James Nugent (ADB), Marcelo Piancastelli (Brazil), Atul Sarma (India), Jinyun Liu (People's Republic of China), Roberto Garcia Lopez (IADB/CoPLAC), Shuanyou Ma (People's Republic of China), Giulia Puttomatti (Brazil), Mohammad Nader Yama (Afghanistan); *Fourth Row (L-R)* Paul Smoke (Expert), Noor Ihsan Che Mat (Malaysia), Jose Arista (Peru), Karin Slowing (Guatemala).

Farzana Ahmed
Principal Coordinator, APCoP and
Lead Results Management Specialist, ADB
fahmed@adb.org
Tel +63 2 632 4444 loc 5224

Catherine Clarin
Results Management Assistant
cclarin@adb.org

Cristina Regina Bonoan
Technical Advisor

Mylene Buerano
Technical Coordinator

Sheryl Nazaret-Casas
Project Analyst

Ma. Rosario Baxa
Logistics Coordinator

Ma. Veronica Hitosis
Writing Consultant

For more information on APCoP and to access its resources, visit:
http://cop-mfdr.adb.org