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Intergovernmental Fiscal Relations: Universal Principles, Local Applications

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1. Introduction

Decentralization is an increasingly important phenomenon in many countries around the world, both large and small. It is therefore critical to understand the actual and potential impact of intergovernmental relationships on such key questions as the ability of central governments to conduct sound macroeconomic policies, the incentives for sub-national governments to behave in a fiscally responsible way, and the efficient and accountable delivery of public services. In particular, four questions must be answered with respect to intergovernmental finance in any country:

(1) Who does what? -- the question of *expenditure assignment.*

(2) Who levies what taxes? -- the question of *revenue assignment*.

(3) How is any imbalance between the revenues and expenditures of sub-national governments that results from the answers to the first two questions to be resolved? -- the question of *vertical imbalance*.

(4) To what extent should fiscal institutions attempt to adjust for the differences in needs and capacities between different governmental units at the same level of government? -- the question of *horizontal imbalance*, or *equalization.*

Ideally, these questions should be approached in the specific circumstances of each country with the aim of achieving to the extent possible the policy objectives relevant to that country. Such objectives may include not only the normal public finance trio of efficiency (allocation), equity (distribution), and stabilization but also economic growth as well as such nebulous but politically resonant goals as 'regional balance' and maintaining national integrity and political stability. There may be conflicts between these objectives as well as differences between local and central perceptions of the weights to be attached to them. Moreover, like all public policies, intergovernmental fiscal policies must take into account both political constraints (such as the strength of different regions and groups in political decisions) and economic constraints (such the development of financial markets). Finally, all policy change must of course start from where one is. Since every country has its own history, the current state of fiscal institutions in large part reflects the results of an accretionary process of policy change over time. To understand, let alone to resolve, the intergovernmental fiscal puzzle in any country thus requires substantial institutional as well as analytical knowledge.

The key questions of intergovernmental fiscal relations must therefore be answered, as it were, 'locally.' Nonetheless, there are certain aspects of these complex questions that seem to come up in most countries, and the present paper attempts to digest and reflect upon what we have learned to date about such 'universal' principles. The balance of the paper is organized as follows. Sections 2 through 4 review the three key instrumental components of intergovernmental fiscal relations in any country – expenditures, revenues, and transfers. Section 5 discusses sub-national borrowing and the implications of decentralization for macroeconomic management. Section 6 considers several institutional aspects of decentralization. A brief Section 7 concludes.

2. Expenditures

In many ways, the basic requirement for efficient and effective sub-national government may be thought of as the 'matching principle.' Ideally, to the extent possible, benefit areas should be matched with financing areas as in the benefit model of local finance.[2] In addition, expenditure responsibilities should be matched with revenue resources, as discussed in the present section, and, finally -- as discussed below -- revenue capacities should be matched with political accountability.

Assigning Expenditures

The basic rule of efficient expenditure assignment is often taken to be to assign each function to the lowest level of government consistent with its efficient performance.[3] So long as there are local variations in tastes and costs, there are clearly efficiency gains from carrying out public sector activities in as decentralized a fashion as possible.[4] Under this approach, apart from the important issue of distribution,[5] almost all public services (other than national defense, foreign policy, and surprisingly few others) should in principle be delivered at the local level, with local decision-makers deciding what services are provided, to whom, and in what quantity and quality, and with local taxpayers paying for the services provided. In practice, of course, although there are some functions (such as street maintenance) that are local everywhere, the allocation of functions to sub-national governments varies considerably from country to country.

This approach to expenditure assignment need not be consistent with the matching principle. There is nothing that guarantees that the 'bundle' of services thus assigned to any particular level of government will be matched by the set of revenue instruments assigned to that same level. On the contrary, as discussed later, in virtually every country there is a fundamental imbalance in the vertical assignment of expenditures and revenues -- and hence an apparent need for intergovernmental fiscal transfers to close the budgetary gap.

In any case, in the framework considered here, the essential economic role of local government is to provide to local residents those public services for which they are willing to pay. Local governments are -- or at least should be -- accountable to their citizens for the actions they undertake, certainly to the extent those citizens finance those actions. Such accountability is the public sector equivalent of the 'bottom line' in the private sector. Three conditions need to be satisfied to achieve accountability in this sense in sub-national finance:

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[2] This model and the alternative "ability" model are discussed in some detail in Bird (1999).

[3] In the context of the European Union, this has come to be called the "subsidiarity principle:" see Breton, Cassone and Fraschini (1998) for a useful discussion.

[4] Oates (1972) has labeled this "the decentralization theorem."

[5] Distributional issues are obviously important – often critical – in the design of intergovernmental fiscal relations but they cannot be adequately treated in the present paper. For discussion, see Bird (1999) and Bird and Rodriguez (1999).

(1) Sub-national governments should, whenever possible, charge for the services they provide.[6]

(2) Where charging is impracticable, sub-national governments should finance such services from taxes borne by local residents (Section 3), except to the extent that the central government is, for whatever reason, willing to pay for them through transfers (Section 4).

(3) Where the central government does pay, as a rule, sub-national governments should be accountable to the central government to at least some extent (Section 6).

To apply these rules, an essential first step is to establish clear lines of responsibility and accountability. But *clarity* of assignment in terms of specifying exactly what services each governmental agency is responsible for delivering is only part of the story. Clarity must, as just noted, be matched by *accountability*, in terms of both political democracy and transparency of operation, as well as by *authority* in terms of both the ability to manage expenditures and to determine (within limits) revenues. Moreover, even in the best of all possible worlds full clarity in expenditure assignment may never be fully attainable, for several reasons.

First, with respect to many important spheres of public sector activity -- for example, education -- different jurisdictional levels may play critical roles. The central government may, for example, appropriately set national standards for graduates and for teachers and may also establish the basic curriculum to be covered. Regional governments in turn may, within this framework, develop their own policy goals -- for instance, with respect to school facilities -- and deploy appropriate regulatory instruments in an attempt to achieve them. Local governments may be responsible for actually paying teachers and maintaining facilities. And, of course, educational services are finally delivered by local schools which may often, experience suggests, produce better outcomes if they have a substantial degree of budgetary autonomy and hence can react to input from teachers, parents, and the local community (Burki et al., 1999). Three or more levels of government may thus play important roles in delivering educational services.

It is not meaningful to consider a particular service to be "assigned" to the local level, when much of the relevant policy and regulatory framework, and indeed much of the financing, may come from higher levels of government -- and the actual service delivery may be at a lower institutional level. Clarity as to who is responsible for what is indeed important, but many different public sector actors may appropriately be involved in the provision of any particular public service. What matters is thus not so much that each expenditure function, broadly understood, is clearly assigned to one level of government or another, but rather that it is clear to all *exactly* who is responsible for doing *precisely* what.

Second, clarity in expenditure responsibility is sometimes taken to mean that much attention needs to be paid to the problem of coordination. In this regard, however, it should be recalled that the principal argument *for* decentralization is that coordination (or cartelization, or monopoly, as it might

[6] The role (and limitations) of user charges are not further considered here: for extensive discussion, see Bird and Tsiopoulos (1997).

also be called) is not delivering the goods, or at least not delivering the right goods in the right quantities to the right people. Moreover, what may at first glance appear to be undesirable duplication or overlapping of functions may in some instances reflect either useful redundancy in a complex system (Landau, 1969) or desirable governmental competition (Breton, 1996). On the other hand, in the real world duplication and confusion may indeed often imply waste and the need for better intergovernmental coordination. The answer, however, is not to abandon decentralization but rather to design intergovernmental fiscal relations to minimize real coordination problems and to establish effective coordinating institutions (Section 6).

Of course, even the best-decentralized public sector is undoubtedly far from a perfectly competitive market structure. Outcomes are thus unlikely ever to be optimal in the technical economic sense.[7] Nonetheless, the most appropriate response is to establish as hard budget constraints as possible for all relevant decision-makers and to make the operation of the system as transparent as possible rather than to revert back to, in effect, the discredited central planning approach. 'Letting 100 flowers bloom' in the form of relatively uncoordinated decentralized public sector suppliers striving to meet clearly specified and publicly accountable mandates may, in the end, provide a better laboratory for the development of new and better public sector services than any conceivable centralized alternative (Oates, 1999).

Managing Expenditures

No matter where sub-national governments get their funds, they are unlikely ever to have enough to do all they or their citizens want and expect. Successful local government requires scarce public funds to be managed as efficiently and used as effectively as possible. Both financial honesty and political accountability require that budgeting and financial procedures are properly established and implemented. Budgeting, financial reporting, and auditing should be *comprehensive, comprehensible, comparable, verifiable*, and *publi*c. It is equally important, however, to ensure that budgeted resources are applied as efficiently and effectively as possible to achieve desired public outcomes. Adequate and appropriate procedural norms are important in any financial system. But substantive outcomes are what really matter. Proper public expenditure management must therefore (a) adequately control the total level of revenue and expenditure, (b) appropriately allocate public resources among sectors and programs, and (c) ensure that governmental institutions operate as efficiently as possible (World Bank, 1998). With respect to sub-national governments, what seems particularly critical in this respect is that they have sufficient *authority* to manage on both the expenditure and revenue sides of their budgets.

For this reason, as discussed later, it is important to ensure that correct incentives exist on the revenue side. Specifically, effective sub-national governments must have significant revenue sources, for which they are economically and politically responsible, under their control. They must also be able to

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[7] Of course, as Goodin (1996) emphasizes, how important the failure to achieve economic optimality is depends upon the extent to which policy-makers are actually trying to do so. Moreover, as Fleiner (1999) notes, from a broader political economy perspective, economic efficiency may well be much less important than maintaining political stability and the legitimacy of the state.

predict with considerable certainty the intergovernmental transfers that they can anticipate in any financial period.[8] On the expenditure side, substantial earmarking of substantial parts of intergovernmental transfers to localities to centrally favored expenditures such as infrastructure investment has characterized many decentralization efforts. Presumably motivated in part by the desire to prevent local governments from 'wasting' transfers on expanding local payrolls, such earmarking has often had the paradoxical effect of exacerbating local fiscal problems. Although not fully effective -- since money is fungible, there is usually some substitution of transfers for own-source revenues -- the result has usually been to expand capital spending to some extent, while making the already difficult problem of funding operating and maintenance expenditures even more difficult. Such earmarking, even to the extent it succeeds in its stated objective of fostering local investment, has little to be said in its favor. It distorts local preferences, exacerbates perverse incentives already found in the local finance system, and often connects revenue sources with expenditures in totally illogical ways.[9] Moreover, excessive earmarking (like the related process of 'mandating' sub-national governments to spend in accordance with central preferences rather than their own) significantly reduces the scope for effectively managing expenditures by sub-national governments, even if they had both the will and the capacity to do so.

Good sub-national budgeting should take place within the framework of an medium-term expenditure framework (MTEF) both to ensure the proper financing of investment projects and to reduce the scope for short-term political manipulation of budgets -- for example, to expand pre-election public employment in an unsustainable fashion.[10] An essential first step in this direction is to put sound budgetary and financial procedures into place, especially in the more important sub-national governments such as states and large cities. Sub-national budgets, like central budgets, should be comprehensive, accurate, periodic, authoritative, timely, and transparent. The budget law should be uniform and clear, and it should be enforced. Moreover, expenditures should be subject to external audit to ensure that the law is followed. All this would seem to require a strong central hand to ensure that the rules are in place, and complied with. For example, the central government should establish a 'framework' budget law and require adequate external audit (such as by a private sector firm). It should not, however, require sub-national budgets to be subject to prior approval, or much of the point of decentralizing in the first place will be lost.

A strong budgeting and financial system along these lines will satisfy two essential requirements of good government. First, it will establish the basis for financial control. Second, it will provide reasonably accurate, uniform, and timely financial information. But even the best set of financial

[8] It is not generally appropriate to have exactly the same budget period for local and central governments, since the former cannot determine their budgets until they know the size and nature of the transfers they are likely to receive from the latter.

[9] See Bird (1998) for a more extensive discussion of the pros and cons of earmarking.

[10] Of course, unless there is an adequate MTEF at the *central* level, it is difficult to require one locally. On the other hand, given the growing importance of local governments in many countries, it is increasingly difficult to have an adequate MTEF at the central level in any case without explicitly taking aggregate local revenues and expenditures into account in the budgeting and planning exercise.

procedures does nothing to ensure that scarce public resources, even if properly spent and accounted for according to law, have been spent in the best possible way or as efficiently as possible. Nor does even the best-enforced set of budgetary procedures ensure that aggregate fiscal discipline will be adequately maintained. To attain favorable outcomes in these respects, additional important fiscal institutions need to be put in place.

For example, with respect to *fiscal discipline*, the MTEF mentioned above can provide an essential baseline for measuring and monitoring the budgetary impact of policy changes. Similarly, as already mentioned, it is critical for fiscal discipline that the amount of revenue expected from intergovernmental transfers is predetermined and is not subject to political re-negotiation during the budgetary year. Moreover, as discussed further below, sub-national governments must not be able to depend on central government 'bail-outs' of imprudent financial decisions, such as unsustainable borrowing or expenditure increases. On the other hand, sub-national governments should be able to increase expenditures to the extent the full fiscal consequences of such increases are borne by local residents and, equally importantly, they should be able to *reduce* expenditures if they so wish.[11]

Similar institutional safeguards should be in place to ensure allocative and operational efficiency within affordable fiscal limits. *Allocative efficiency* requires that managers at all levels must receive adequate and accurate information on the effectiveness and social outcomes of the programs for which they are responsible -- for example, through the revenues produced by properly-designed user charges and/or through participatory interaction with clients at both the budgetary and implementation stages (Vergara, 1999). Moreover, they must have strong incentives to respond to these signals, for example, by facing a predetermined spending limit, which can be altered only if they can 'sell' more services in the sense that their client groups are willing to pay for them.[12]

Operational efficiency may best be achieved in most cases by allowing line managers -- such as the school managers mentioned earlier -- significant discretion, within budgetary cash limits, to reallocate funds among inputs or perhaps even across budgetary periods, subject to the attainment of predefined operational (performance) goals as well as compliance with appropriate internal and external financial control and audit systems. Emphasis is thus shifted from input controls -- hiring so many persons at such and such a wage or renting so many square meters of space -- to output controls -- providing health care of a determined quality to so many persons within a specified time period or issuing so many marriage licenses.

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[11] As Rodden (1999) notes, Brazilian states are constitutionally restricted in the extent to which they can reduce expenditures, even those funded solely from their own revenues. Such limitations are clearly not conducive to good expenditure management.

[12] Although as noted earlier the distributional aspect of intergovernmental finance is not considered in detail here, it should be mentioned that the distributional arguments often made against user charges and local taxes are generally weak: see, for example, the review of the literature in Bird and Miller, 1989.

Shifting the emphasis in public finance from inputs to outputs in this way is an essential step in improving policy outcomes at any level of government. It carries with it some risks,[13] and it is by no means as yet fully clear how best, or to what extent, this shift can be accomplished in the difficult circumstances facing most countries of the region. Nonetheless, there is already considerable experience in some parts of the world with such techniques as client surveys,[14] participatory budgeting, performance budgeting, and user financing (Burki et al., 1999). The path to success is by no means clearly marked. But at last, it seems, we are beginning to see more clearly some of the directions in which countries should begin to move in terms of expenditure management if leaders are seriously interested in making life better for the citizens whom they supposedly represent.

3. Revenues

Before discussing the appropriate design of sub-national taxes, it may be useful to make it clear exactly what is meant by a sub-national tax. A *completely* sub-national tax might perhaps be defined as one that is (i) assessed by sub-national governments, (ii) at rates decided by sub-national governments, and that (iii) is also collected by sub-national governments, with of course (iv) its proceeds accruing to sub-national governments. In the real world, however, many taxes may possess only one or two of these characteristics, and the 'ownership' of the levy may be unclear.

In many countries, for example, although part of the proceeds of many taxes may accrue to sub-national governments, the rates (and bases) of these taxes are determined by the national government, which also assesses and collects them. For most purposes, such taxes are best thought of as simply central government taxes accompanied by transfers allocated to the sub-national sector. This interpretation is particularly plausible because there is little connection between the amount transferred and the amount collected locally. On the other hand, what looks to be a central tax coupled with a related transfer program may from some perspectives really be a sub-national tax. If, for example, a sub-national government (a) decides whether or not to impose a particular tax, (b) determines the tax base, (c) sets the tax rate, and (d) receives all the revenues, then even if the tax is collected by the central government, the only role the latter plays is as a collection agent. Presumably, the central government has a comparative advantage in tax collection, and the sub-national government has contracted for its services in this respect. In this case, there is no intergovernmental transfer at all, except in the narrowest accounting sense.

Intermediate cases between these extremes may easily be found. In Brazil, for example, the states impose and collect their own VATs, but the rate of the tax is set centrally and uniformly. On the other hand, in Canada most provinces do not levy their own personal income taxes, but rather impose surcharges on the federal income tax, with the tax actually being collected by the federal government and remitted to the provinces. As a third example, in Russia although the VAT base and rates are set centrally, VAT proceeds are shared with the regional governments on a derivation basis. In fact, the

[13] For example, there must still be full accountability by clearly identifiable decision-makers with respect to all expenditure decisions to reduce the possibility of fraud.

[14] For an interesting Indian example, see Paul (1995).

VAT is actually collected locally and the (variable) federal share is remitted -- not always in a timely fashion -- to Moscow. In which of these three cases is sub-national tax power the strongest? Theory and experience suggests that it is in Canada, the only one of the three in which the sub-national governments do not in fact collect the tax in question. Why? Because the most critical aspect of sub-national taxing power is who is politically responsible for setting the tax *rate.*

Two basic principles of assigning revenues to sub-national governments may be suggested. First, 'own-source' revenues should ideally be sufficient to enable at least the richest sub-national governments to finance from their own resources all locally provided services primarily benefiting local residents. Second, to the extent possible, sub-national revenues should be collected only from local residents, preferably in relation to the perceived benefits they receive from local services. This approach is in turn based on three simple principles: (1) More attention should be paid to matching expenditure and revenue needs at different levels of government. (2) In addition, more effort should be made to ensure that all governments bear significant responsibility at the margin for financing the expenditures for which they are politically responsible. (3) And, finally, sub-national taxes should not unduly distort the allocation of resources.

The bottom line underlying this argument is that unless local governments have a significant degree of freedom to alter the level and composition of their revenues, neither local autonomy nor local accountability are meaningful concepts. In particular, as just noted, sub-national governments should be able to set tax *rates* (albeit perhaps within limits). Though this condition is satisfied in practice in few developing or transitional countries, such rate flexibility is essential if a tax is to be adequately responsive to local needs and decisions, while remaining politically accountable to their citizens.

Local governments should not only have access to those revenue sources that they are best equipped to exploit --such as residential property taxes and user charges for local services -- but they should be both encouraged and permitted to exploit these sources. A potential danger in permitting local governments even limited freedom to tax is often asserted to be that they will not utilize fully all the revenue sources open to them, thus allowing the level and quality of public services to deteriorate. If intergovernmental fiscal structures are properly designed, however, this should not be a real problem. If the service in question is one of national importance (research?) or one in which there is a strong national interest in maintaining standards (poverty alleviation?), it should presumably be funded -- and the extent to which it is achieved, monitored -- by the central government. If it is not a matter of national interest, why should the central government be concerned? Of course, this argument assumes that the central government has both adequate information and a pre-determined transfer system, as discussed further in Sections 4 and 6 below.

In a democracy, if local electors do not like what their local government does, or does not do, they can (try to) throw the rascals out at the next election. The freedom to make mistakes, and to bear the consequences of one's mistakes, is an important component of local autonomy in any country. Indeed, unless local governments are given some degree of freedom with respect to local revenues, including the freedom to make mistakes (for which they are held accountable), the development of responsible and responsive local government is likely to remain an unattainable mirage. Of course, if the essential conditions for such development in any setting -- effective democracy and adequate information -- are not satisfied, or if those who fail to collect local taxes or to spend revenues efficiently are bailed out by discretionary transfers, the rascals may not be thrown out but rather re-elected as a reward for their success in obtaining a larger share of other people's money. Countries that, for whatever reason, fail to set up an appropriate intergovernmental fiscal structure are likely to have both more problems in managing decentralization and less satisfactory policy outcomes.

Another possible problem with decentralizing revenue authority is that local governments may attempt to extract revenues from sources for which they are not accountable, thus obviating the basic efficiency argument for their existence. To avoid this danger, it may be desirable to limit local government access to taxes that fall mainly on nonresidents -- such as most natural resource levies, pre-retail stage sales taxes[15] and, to some extent, nonresidential real property taxes. One way to deal with this problem may be to establish a uniform set of tax bases for local governments (perhaps different for different categories such as big cities, small towns, and rural areas), with a limited amount of rate flexibility being permitted in order to provide room for local effort while restraining unproductive competition (through establishing a floor on rates) and, if an 'exportable' base is available, unwarranted exploitation (through a rate ceiling). If inappropriate tax bases are assigned to sub-national governments, wasteful competition and undesirable tax exporting are likely to result.

These general points may be illustrated with reference to two distinct, and important problems in sub-national taxation. The first is how to finance regional governments. This problem is of course especially important in larger and especially federal countries, but it is by no means confined to those countries. The second problem, found everywhere, is how to finance 'local services,' more narrowly understood.

Financing Regional Governments.

The present assignment of taxes in most countries with important regional levels of government, such as India, Brazil, and Russia, seems particularly deficient. One problem is that there is a significant vertical imbalance between expenditures and revenues, with consequent implications for autonomy, efficiency, and accountability. Another problem is that the present confused and confusing sub-national tax system in these countries results in significant costs — costs of administration, costs of compliance, and costs arising from tax-induced inefficiencies in the allocation of scarce resources.[16]

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[15] Even most 'retail, sales taxes fall to a considerable extent on business inputs, even in developed countries. One Canadian study, for example, found that up to 50 percent of the retail sales tax base in some provinces consisted of such inputs (Kuo, McGirr, and Poddar, 1988).

[16] For a detailed discussion of the latter problem, see Bird and Mintz (forthcoming). A particular problem arises in some countries because of the uneven geographical distribution of natural resources and the resulting severance of the link between "local" taxes and benefits when sub-national governments are able to tax such resources beyond any level conceivably justified on environmental or benefit grounds, as is often the case. The ideal solution is of course to prevent them from doing so (Mieszkowski, 1983), but if this is not possible, considerable care must be taken in designing other aspects of intergovernmental finance, particularly transfer systems, in order to offset the resulting distortion as much as possible. Unfortunately, this problem cannot be further discussed here.

In principle, multi-tiered governments work best when taxes and the benefits of public spending are as closely related as possible — when citizen-voter-consumers residing in a particular political jurisdiction both pay for what they get from the public sector and get what they pay for (that is, benefit from the expenditures financed by the taxes they pay). Obviously, when citizens reside in several overlapping jurisdictions (local-state-nation) this so-called 'principle of fiscal equivalence' (Olson, 1969) suggests that they should pay taxes to each level corresponding to the benefits they receive from each jurisdiction. In this framework, intergovernmental transfers would exist essentially to restore this equivalence when, for example, some benefits flow from one jurisdiction to another or (negatively) when some taxes levied by one jurisdiction are in fact paid by persons residing in another jurisdiction.[17]

Considerations of administrative efficiency and feasibility may dictate that higher (or lower) levels of government impose certain taxes or carry out certain expenditures even when it would not be strictly appropriate to do on equivalence grounds. Vertical fiscal flows, like those that dominate the intergovernmental fiscal scene in most countries, are motivated largely by this consideration, at least with respect to those flowing to richer jurisdictions. In contrast, if more adequate sub-national taxes are made available, this 'fiscal gap' (Boadway and Hobson, 1993) argument for transfers disappears. There is then no case for universal intergovernmental fiscal transfers, since in this system the richest units of government at sub-national levels should be essentially self-sufficient (Bird, 1993). Any grants from higher levels of government made for reasons of regional equalization in this system should then be clearly *infra*-marginal, so that, as McLure (1999) notes, all sub-national governments face the full marginal tax price of the spending decisions for which they are responsible, thus yielding the hard budget constraint emphasized by such authors as Tanzi (1996).

The most immediately important sub-national revenue issue facing most larger countries is probably to develop a satisfactory revenue base for regional governments, that is, one for which those governments are politically responsible. While more can be done in the form of regional excise taxes, especially on vehicles and fuels, in most countries (Bird, 1999b), if regional governments have significant expenditure responsibilities, there are really only two important possibilities -- a surcharge on the central personal income tax (PIT) or a surcharge on the central value-added tax (VAT). If a country wants its local governments to be *both* large spenders (for example, on such social services as education and health) *and* less dependent on grants, it must provide them with access to national tax bases. 'Piggybacking' through surcharges seems to be the only viable way to do this while retaining an important element of political accountability.

The possibility of local income tax surcharges now seems to be broadly accepted.[18] Unfortunately, few developing countries have sufficiently robust central income taxes to offer much hope that sub-national governments will soon be able to derive much revenue from this source. A potentially more promising alternative answer for sub-national revenues in at least some countries may thus turn out to be a surcharge on the VAT. Such a tax already exists and works well in Canada, and it now seems feasible to implement it even in countries with less well-developed tax administrations.[19] At least in the

17 Note that such transfers would be horizontal, between provinces or municipalities, and not between levels of government.

18 For an early proposal along these lines, see, for example, Bird, and Wallich (1992).

19 The Canadian experience is discussed in Bird and Gendron (1998). For further discussion of the

larger countries with federal features, such as India and Brazil, this path to increased regional taxation seems to warrant further exploration.

Financing Local Services

Turning to local taxes, apart from user charges, there seem to be only two major possibilities -- a revised, and revived, property tax and an improved form of local business taxation.

The Property Tax. Almost without exception, much can and should be done to strengthen the deficient property taxes now in place in most countries. The tax should be simplified and applied uniformly. Cadastral maps should be updated, and valuations made more consistently and currently. Improved use should be made of flows of information from property registries, local building license authorities, public utilities, etc. In addition, as Dillinger (1991) has argued, from a revenue perspective, more attention should generally be paid to improving the 'sharp end' -- collection and enforcement -- rather than to the technically more costly (and less immediately productive in terms of revenue) mapping and surveying of the traditional cadastral approach.

Nonetheless, property taxes are not easy to administer, particularly in countries where inflation is endemic, and they are never politically popular owing to their visibility and to certain inherent administrative difficulties. Even in the most sophisticated countries, local property taxes seldom yield enough to finance local services. No developed country, which depends significantly upon property taxes for local fiscal resources, has a local government sector that accounts for more than 10 percent of total public spending (Bird and Slack, 1991). Similarly, property taxes seldom account for more than 20 percent of local current revenues -- or less than 1 percent of total public spending -- in developing countries (UNCHS, 1996). The property tax is a useful, even a necessary, source of local revenue, but it cannot easily provide sufficient resources to finance a significant expansion of local public services in most countries. Indeed, many countries have been hard-pressed even to maintain the present low relative importance of property tax revenues in the face of varying price levels and political difficulties.

These facts reflect both the political and the administrative realities of property taxation. One reason for the commonly observed phenomenon of widespread resistance to the property tax, for example, is simply because it is often a very visible tax. The tax generally has to be paid directly by taxpayers in periodic lump sum payments. Taxpayers who pay taxes directly to government tend to be more aware of the size of their tax bill than those whose take-home pay is reduced by weekly or monthly tax deductions. The need to make periodic large payments may well add to the accountability and responsibility of governments, but it also increases the sensitivity of taxpayers to even nominal increases in taxes.

The inelasticity of the property tax has a similar effect. Since the base of this tax does not increase automatically over time, the periodic nominal increases in property tax bills needed to maintain real revenues when price levels rise require increased tax rates. In terms of political accountability, the need to confront the people with the cost of government is a virtue of the property tax. However, the downside, at least from the government's point of view, is the heightened visibility of nominal tax increases and the accompanying political resistance.

"regional VAT", see Bird (1999) and references there.

Finally, property taxes best finance such services as roads and garbage collection. The quantity and quality of these services (or their absence) is thus readily linked to the property tax. When potholes develop in their street, taxpayers are understandably quick to question the taxes that supposedly finance street repair. Again, the very feature that in principle makes the property tax a good source of local government revenue makes it especially vulnerable to political resistance in practice.

Other problems result from property tax administration. Often, property is supposed to be assessed on the basis of its market (rental or capital) value, usually defined as the price struck between a willing buyer and a willing seller in an arm's length transaction. Even in countries with well-developed property tax systems, however, discrepancies arise between assessed values and market values within classes of property, between classes of property, and across municipalities for both political and technical reasons (Bird and Slack, 1993). Since taxpayers can easily compare their property taxes with those of similar properties in their neighborhood, such discrepancies may result in both assessment appeals and general opposition to the tax.

For such reasons, experience around the world suggests that the political costs of reliance on residential property taxes are so high that no government with access to politically 'cheaper' sources of finance will willingly do so. Both intergovernmental transfers which can be spent as local governments wish and local taxes on business which can largely be exported, must, as a rule, be curtailed if local citizens are to be confronted more openly (through their local tax-bills) with the true economic (and political) costs of the decisions made by those whom they have elected.

In particular, the temptation to indulge in politically painless but economically inefficient tax exporting suggests that constraints should be placed on local taxation of nonresidential property.[20] As discussed below, some local business taxation may be justified on benefit (efficiency) grounds, but it should always be strictly constrained in order to preclude localities from attempting to shift the costs of services to outsiders.

Other policy reforms are needed to turn the property tax into a responsive instrument of local fiscal policy. First, and most importantly, as emphasized earlier, local governments must be allowed to set their own tax rates. Few countries currently give local governments much freedom in this respect. Secondly, the tax base must be maintained adequately. In countries with inflation, some form of index adjustment may be advisable (World Bank, 1989). National assessing agencies must, if necessary, be provided direct financial incentives to keep the tax base up to date. Finally, procedural reforms are often needed to improve collection efficiency, valuation accuracy, and the coverage of the potential tax base. None of these steps is easy, but countries that want to have local governments to be both responsive and responsible must follow this hard road. There are no short cuts to successful local property taxation.

<u>Local Business Taxes.</u> Another critical problem in many countries is to reform the various unsatisfactory sub-national taxes on business. While the ability to distort market conditions through such taxes must of course be restrained -- for example, by establishing a uniform national base for local

[20] Studies in the U.S. (McLure, 1967) and Canada (Ballentine and Thirsk, 1982), where residential property taxation is much more important than in Latin America, suggest that 'exporting' local taxes on business is both a common and an important phenomenon. It seems unlikely to be less so in developing countries.

business taxation, with a minimum and maximum rate[21] -- there is both an economic (benefit) case for some regional and local taxation of business and, it seems, often an overwhelming political need for local leaders to impose such taxes. Indeed, in many countries, given the restrictions on (and unpopularity of) residential property taxes and the unreliability of central transfers, local business taxes have sometimes provided almost the only way in which local governments have been able to expand revenues in response to perceived local needs.

Unfortunately, most forms of local and regional business taxes found in developing countries -- corporate income taxes, trade taxes, business taxes, differentially heavy non-residential property taxes, and even so-called 'retail' sales taxes (usually levied in the form of levies based on estimated gross receipts) might introduce serious economic distortions. One way to reduce such problems that has recently been suggested is through imposing a so-called 'business value tax' (BVT) – in essence, a relatively low rate flat tax levied on an income-type value-added base.[22] In contrast to the earlier suggestion of a possible regional VAT surcharge, which was motivated mainly by the desire to provide more adequate own revenues to regional governments and hence to encourage greater fiscal responsibility and accountability, the BVT is intended primarily to improve the allocative efficiency of sub-national revenue systems. It therefore seems less likely to find an immediately welcoming political audience in most countries. Nonetheless, this line of action may offer a potentially promising alternative to the proliferation of increasing, and distorting, sub-national business taxes that otherwise seem likely to lie in the future of many countries.

4. Transfers

Regardless of the revenue sources made available to local governments, transfers from central to local governments will undoubtedly continue to constitute an important feature of the public finances of many countries. If, for whatever reason, services must be provided by local governments that do not have the fiscal capacity to finance them at levels considered adequate, if there are externalities associated with the services in question, or if a country wishes to take inter-regional differences in needs into account, transfers are needed. A well-designed system of intergovernmental transfers thus almost inevitably constitutes an essential component of any decentralization strategy.

Experience suggests that no simple, uniform pattern of transfers will be suitable for all circumstances. Since one size will not fit all, the first task of the fiscal tailor is to know as much as possible about the client. In particular, since transfers reflect closely the nature of a country's political system, their inherently political nature must be taken explicitly into account in designing transfer systems, at least to some extent. One way to do so that has been suggested is simple, if somewhat artificial: focus on the

[21] A minimum rate is needed to prevent distorting tax competition (with richer jurisdictions -- those with larger tax bases -- lowering rates to attract still more tax base). A maximum rate is needed to prevent distorting tax exporting (as when jurisdictions in which breweries or gas distribution pipelines are located impose especially heavy taxes on such facilities in the expectation that the taxes will ultimately be paid by persons not resident in the jurisdiction).

[22] The history of this idea, and various partial examples found around the world, are set out in detail in Bird (1999a). An empirical application of this approach to Canada may be found in Bird and Mintz (1999).

effects, rather than on the *instruments* used to achieve them (Bird, 1993). Transfers as such are neither good nor bad. What matters are their effects on such policy outcomes as allocative efficiency, distributional equity, and macroeconomic stability. If, for example, the sole objective of fiscal decentralization is the efficient delivery of public services, as is assumed in the benefit model, then all that matters is how transfers affect the effectiveness and efficiency of public sector operations.[23]

What is critical about intergovernmental transfers is thus not who gives them, or who gets them, or what the details of program design are, but solely their *effects* on policy objectives. As with user charges, the idea is to "get the prices right" in the public sector by designing transfers so that they do not weaken the hard budget constraint that exists if local citizens are not only able to determine what services they get but also have to pay for them (at least at the margin). Even if, as is likely to be the case in many countries, local democracy is neither perfect nor well-informed, it is still critical to ensure that transfers do not worsen outcomes by bailing out the incompetent and the irresponsible.

This focus on results suggests some desirable characteristics of transfer programs. As already stressed, efficiency requires that those responsible for the provision of any service have a clear mandate, adequate resources (including, of course, those they themselves raise), and sufficient flexibility to make decisions, while being held accountable for results. Transfers must be designed to satisfy these conditions. In addition to being "incentive-compatible" in this sense, *simplicity*, *objectivity* and *transparency* in transfer design are also important characteristics if the system is to work well.

Properly designed transfers may help rather than hamper sub-national efficiency and accountability even if they finance 90 percent of local expenditures. Poorly designed transfers will not, even if they finance only 10 percent of expenditures. There is no analytical rationale for the argument sometimes made that accountability requires, say, half or more of local expenditures to be financed from local sources. However, it is obviously important to ensure that larger, more powerful jurisdictions -- those where failure is likely to give rise to significant externalities and which are thus more likely to be bailed out (Wildasin, 1997)-- are self-financing to the greatest extent possible. Fortunately, these are also usually the places where potential local revenue bases are the greatest so that properly designed transfer programs may have the greatest galvanizing effect on local revenue mobilization.[24]

In reality, of course, many transfers are intended to achieve broader political goals, such as securing and maintaining stability either by rewarding friends or buying off enemies. Such objectives are by no means unimportant or irrelevant in many countries, as Breton (1996) has convincingly argued in general terms (and as Treisman (1999) has recently demonstrated empirically for Russia). Nonetheless, from the economic perspective taken here, it is important to minimize the collateral damage done to efficiency objectives by such political transfers.

Key Design Options

Three key factors in the design of intergovernmental fiscal transfers are the size of the 'distributable pool,' the basis for distributing transfers, and conditionality.

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[23] For some discussion of the distributive aspect of transfers, see Rao and Das Gupta (1995) and Bird and Rodriguez (1999).

[24] This point is developed further in Bird (1999b).

Determining the Distributable Pool. An important characteristic of any good system of intergovernmental grants is *stability*. Another is *flexibility*. How can these apparently contradictory characteristics be achieved simultaneously? Basically, there are only three ways to determine how much money is to be distributed through intergovernmental fiscal transfers: (1) as a fixed proportion of central government revenues or some other 'macro' basis, for example, as a percentage of GDP; (2) on an ad hoc basis, that is, in the same way as any other budgetary expenditure; and (3) on a 'formula-driven' basis -- for instance, as a proportion of specific local expenditures or in relation to some general characteristics of the recipient jurisdictions. Variants of all these methods are found around the world.[25]

If the central government wishes to maintain maximum political and budgetary control the best system might seem to be one in which the total amount to be transferred (the 'distributable pool' or the 'primary distribution') is determined annually in accordance with budgetary priorities. Under such a system, however, sub-national governments will neither be able to budget properly nor will they face an appropriately hard budget constraint. Moreover, central governments that are susceptible to pressure from sub-national governments may wish to insulate themselves from such pressures to some extent by adopting a less discretionary system.

A better way to provide both some degree of stability to local governments and some degree of flexibility to the central government is by establishing a fixed percentage of all central taxes (or current revenues) to be transferred. Sharing specific national taxes is less desirable than sharing all national taxes because over time central governments will understandably tend to increase more those taxes which they do not have to share. When national taxes are very sensitive to external shocks (such as a fall in export prices), however, this approach, although it may still be justified as sharing the pain between levels of government, may provide insufficient stability for the sub-national finance of such vital human capital development services as education and health. For this reason, it may therefore be desirable either to base the total amount transferred on a more stable macro measure such as a moving average of GDP growth -- as is done, for example, in Canada -- or perhaps to finance such services separately through a system of capitation grants.[26]

The Distributive Formula. A sound transfer system distributes funds among recipient jurisdictions on the basis of a formula. Discretionary or negotiated transfers are undesirable. The essential ingredients of most formulas for general transfer programs (as opposed to 'matching grants' which are intended to finance narrowly-defined projects and activities) are needs and capacity. *Needs* may be roughly proxied by some combination of population and the type or category of municipality, or more refined measures might be used.[27] A more difficult, but conceptually critical, problem is to include a measure of

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[25] See the country discussions in Shah (1994), Ahmad (1996), Ter-Minassian (1997), and Bird and Vaillancourt (1998).

[26] For an example of a grant system along these lines, see Bird and Fiszbein (1998).

[27] An example of refined measurement is the Australian system. Greater refinement need not mean better measures. Colombia, for example, includes a measure of "unsatisfied needs" in its transfer formula. The result, however, is that in effect the formula assumes that it costs more to provide a given unit of service in one locality than in another, even though there is no reason to expect any particular association between needs and costs (World Bank, 1996a).

the *capacity* of local governments to raise resources, given the revenue authority at their disposal. Even though, to remain transparent, formulas should not be too complex, any desired degree of inter-jurisdictional equalization can be build into such a formula (World Bank, 1996a).

One way to structure a good transfer system, for example, might be to provide each local government with sufficient funds (own-source revenues plus transfers) to deliver a (centrally) predetermined level of services. Because capacity-based transfers are in principle based on measures of *potential* revenue-raising capacity (not on *actual* revenues), no disincentive to fiscal effort is created by this approach. [28] Differentials in needs and in the cost of providing services (for example in rural or less densely-populated areas) may easily be taken into account in such formulas, if desired -- although caution is necessary in introducing refinements since it is all too easy to turn a simple, transparent formula into an obscure one subject to manipulation.

Conditionality. Once the total amount to be distributed has been decided, and the basic distribution formula determined, the key remaining question is whether the transfer should be made conditional on the provision of certain services at specified levels. Two quite different approaches may be taken. On one hand, to the extent the primary objective of transfers is to ensure that all regions of the country expected to provide services at acceptable minimum standards have adequate resources to do so, simple 'lump-sum' transfers, with no conditionality other than the usual requirements for financial auditing, will suffice (Shah, 1994). This approach essentially assumes that the fact that the funds flow to locally-responsible political bodies will ensure sufficient accountability and that it is neither necessary nor desirable for the central government to attempt to interfere with, or influence, local expenditure choices.

On the other hand, if the central government is, in effect, using local governments as agents in executing such national policies as providing primary education at a specified level throughout the country, then it would seem to make sense to make the transfer conditional upon the funds actually being spent on education or on the attainment of some level of educational performance (Bird, 1993). Since money is fungible, even transfers based solely on need do not ensure that the recipient governments will in fact use the funds they receive as the central government might wish—unless receipt is conditioned on performance and compliance is monitored in some way Although the extent to which fungibility is a problem depends upon whether the preferences of donors or recipients should rule, in the circumstances of most developing countries some conditionality often seems desirable -- particularly when important national services, such as education and health, are provided by sub-national governments.

Expenditure conditionality ensures that grant funds are spent on the specified service. it does not guarantee that grant funds do not simply displace "own" revenues that would otherwise have been spent upon the service in question. The extent of such substitution may vary greatly from service to service (Slack, 1980). *Performance conditionality*, which focuses on outputs rather than inputs -- for example, the proportion of students achieving certain standards rather than the amount spent on education -- has recently been put forth as an alternative. This approach has considerable merit. For

[28] It is often argued that formulas should include explicit measures of *effort* also, but, as discussed further in Bird and Fiszbein (1998), effort can be adequately taken into account in a capacity-based formula. While the difficulty of making good "capacity" estimates should not be understated, experience suggests that reasonable proxies may not be too hard to construct: for examples, see Bird and Wallich (1992) and World Bank (1996b).

example, it focuses on what is presumably the real policy objective: education. It also, however, makes much greater demands on the central government to interpret the inevitably incomplete (and perhaps biased) information it receives. Experience suggests that, while it is useful to attempt to develop such indicators, it would be unrealistic in most countries to think that the many problems in doing so will soon be solved (Bird and Banta, 1999).

Conclusion

To make a long story short, three distinct types of transfers have a role to play in most countries.[29] First, programs with strong national rationales and substantial interpersonal redistributive elements -- such as education and health -- might be separated out and basically funded by a national *capitation grant*. Such programs are essentially focused on redistribution among persons rather than regions. The other main direct national interest in what sub-national governments do -- the provision of physical infrastructure related not only to programs such as those just mentioned but also to other projects with significant spillovers to broader regions might then be financed on a *matching grant* (co-financing) basis. Neither of these transfers, however, will not work properly unless a final critical component of the system of intergovernmental transfers, which may be called an *equalization grant*, is put into place.

It should be emphasized that such an equalization grant has two important, and distinct, rationales. The first rationale, and the most important from a systemic perspective, is to provide the necessary underpinning for decentralization in general, and for the other transfers proposed above in particular, by equalizing (to some level) the *fiscal capacity* of departments and municipalities. The basic economic case for such a general-purpose (unconditional) transfer is to enable poorer local governments[30] to respond adequately to central transfers intended to generate the appropriate level of public goods.[31] A second, more political, rationale that may be important in some countries may be to provide sufficient resources to enable all local governments, even the smallest and poorest, to provide a basic package of local services other than health, education, or construction of infrastructure.[32]

[29] The long story may be found in Bird (1999c). Although some or all of the features of these three types of transfers may be combined in a single instrument, it is nonetheless important to keep them analytically distinct.

[30] Note that this means 'poor' in terms of the capacity of these governments to raise resources out of local taxes imposed on local residents *not* necessarily in terms of how high the private incomes of those residents or the output of the locality may be. This distinction is important: local people can be rich, but the local government may nonetheless be poor because it has access only to a very limited range of taxes and charges.

[31] The case for at least some unconditional general transfer support to most (perhaps all but the very richest) local governments thus has nothing to do with redistribution but is rather based on an efficiency argument. Of course, this need not be the whole story in efficiency terms. There may, for example, be growth-deterring effects of such transfers on migration, although this matter cannot be further discussed here.

[32] Although from a purely economic point of view, this objective may appear to make little sense, one rationale, similar to the familiar 'basic needs' argument, might be that all citizens should be entitled to some basic level of local services, regardless of where they happen to live. Although the lack of local resources

5. Macroeconomic Aspects of Decentralization

An interesting aspect of the recent move to decentralize public sector activities in many countries around the world has been the revival of an old worry - - that sub-national governments, left to their own devices, will act in a macro-economically 'perverse' fashion.[33] The fear is that increased national transfers will induce sub-national governments to cut their own taxes while simultaneously expanding expenditures both through increased transfers and through 'leveraging' increased borrowing on their new (transfer) revenue base. Sub-national deficits, and hence total public sector spending and the overall public sector deficit, will thus expand. As a result, many countries have been developing new and more stringent controls over sub-national borrowing (Ter-Minassian, 1996).

When a central government transfers revenues to sub-national governments, as a rule it also transfers expenditures that are supposedly roughly equivalent. If so, sub-national expenditures in principle should, in the absence of behavioral reactions, increase by exactly the same amount as sub-national revenues. Revenues available for expenditure at the central level decline and those available at the sub-national level rise by the same amount, as do sub-national expenditures. The macroeconomic impact of such a change thus depends not on the amount of the transfers per se but rather on what happens to central expenditures and what happens to non-transfer ('own') sub-national revenues.

Sub-national revenues may decline as a result of increased transfers ('fiscal laziness,' decrease in fiscal effort, or 'substitution effect' of transfers), they may remain the same as in the absence of transfers ('flypaper effect'), or they may actually increase local own revenues ('stimulative effect' of grants). On the whole, the evidence, such as it is, suggests that at least up to now there is little or no evidence of a decrease in local fiscal effort in most countries.[34] If so, any macroeconomic problems arising as a result of increased transfers must then occur because the central government has not reduced its spending proportionately. Except when increased transfers are unaccompanied by increased expenditure responsibilities, the key to their impact on macroeconomic stability thus often lies largely in the behavior of central (non-transfer) spending. Moreover, since local governments do not control monetary policy, even the most irresponsible local politicians can cause macroeconomic problems only when their actions are in some way validated by central authorities, either by the central bank (monetizing sub-national deficits) or by the Ministry of Finance (bailing out sub-national governments).

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should not be confused with a lack of local capacity to make and implement suitable expenditure decisions (World Bank, 1995), it is nonetheless evident in many countries that many poor local governments will always be dependent on transfers. A critical question in transfer design is therefore how to provide the basic resources such fiscally non-viable municipal governments need to survive while maintaining adequate incentives for them to do what they can in terms of raising their own revenues. Fortunately, it turns out that the same basic general support transfer design needed to make the capitation systems for education and health and the matching grant system for infrastructure function efficiently can readily accommodate the politically necessary task of ensuring the survival of even the congenitally fiscally unfit.

[33] The literature on the alleged 'fiscal perversity' of sub-national governments from the point of view of macro stabilization dates back to the early Keynesian era, when it was argued that sub-national governments would tend to accentuate recessions by cutting back on their expenditures exactly when the economy needed stimulus (Rafuse, 1965).

[34] For a recent review of the evidence, see Burki et al. (1999).

Decentralization may complicate macroeconomic management, but it does not and cannot shift the final responsibility from the central government. If the latter wishes to avoid macro problems arising from sub-national debt, it can do so by not subsidizing such borrowing and by letting sub-national governments that borrow too much go bankrupt -- although the mechanics of how this might be done are by no means simple (World Bank, 1996b). In short, if intergovernmental fiscal relations are properly structured, macroeconomic problems arising from decentralization can largely be avoided.

Nonetheless, there have recently been some well-known examples of sub-national deficits and debt in practice, particularly in Argentina and Brazil (Dillinger and Webb, 1999). Similar concerns have arisen in other countries. Given the prevalence of bailouts and discretionary transfers in some countries, it is clear that there is reason to be concerned about this problem. In effect, central governments in many countries in practice appear to provide implicit (if not explicit) guarantees to sub-national borrowing. In these circumstances, they should indeed keep the door to the treasury under lock and key in order to obviate the possibility of local profligacy and hence demands on central funds. Such practices are common even in developed countries. In Canada, for example, although there are no restrictions on *provincial* borrowing, the provinces themselves severely restrict *local* government borrowing in a number of ways: the amount of debt, the type of debt instrument, the length of term, the rate of interest, and the use of debt funds, are all, as a rule, strictly controlled.[35]

A common proposal (Artana et al., 1995) to deal with this problem is by instituting strict limits on the borrowing ability of sub-national governments. The rationales behind such recommendations appear to be two. The first rationale is simply that unchecked sub-national governments, particularly those highly dependent on national transfers, are inherently likely to behave irresponsibly -- by increasing current expenditures well above their capacity to finance them out of current revenues and then closing the gap through borrowing (especially if, as in Argentina, they control provincial banks), often pledging future transfer revenues to service the loans.

In counter, it might perhaps equally be argued that the sub-national deficits observed in some countries may to a considerable extent have been a transitory rather than systemic phenomenon, reflecting the inevitably lagged adjustment of fiscal institutions after the irresponsible budgeting practices that developed during the hyperinflation years (Burki et al., 1999). In Argentina, for example, the rapid and unexpected rise in provincial revenues in the early 1990s during the first phase of fiscal adjustment led to some unwise expenditure increases that could not be sustained when, so to speak, the 'boom' broke. Such asymmetric behavior is common. The solution is simple in principle, although seldom put into practice: mute the effects of the boom, and subsequent bust, by smoothing out its fiscal effects (for example, through a stabilization fund) – and, in addition, as always, try to improve public understanding of fiscal realities by such measures as increasing the transparency of financial reporting.

Principled solutions such as these are seldom found in practice, however. Their absence may be symptomatic of a more basic underlying problem -- the general inability of central governments to credibly commit to a 'no bailout' policy. So long as the budget constraint imposed on local

[35] Some provinces require provincial government approval before debt is issued; others require the specific approval of local electors. Sometimes the restrictions are different for different categories of municipalities or for short-term as opposed to long-term debt. But in no case are local governments allowed to borrow as they wish. For a detailed discussion of sub-national borrowing at both the provincial and local levels in Canada, see Bird and Tassonyi (1999).

governments is not completely hard, they will undoubtedly have some incentive to misbehave, and it may not be possible in the circumstances of many countries to make such constraints hard enough to prevent this outcome. Some sub-national governments may be too economically significant or too politically important to let them fail (Wildasin, 1997). In other instances, the effects of failure on local residents may be so undesirable that the central government feels impelled to interfere. Indeed, no matter how well the system of intergovernmental fiscal relations is designed in principle, serious short-term 'work-out' problems may remain with respect to those sub-national governments that fall into the deficit trap. Emergency central support may sometimes be needed to resolve such debt problems.[36] If so, however, any such support should carry with it the obligation to introduce and make effective any necessary reforms under the supervision of a review board. As noted below, a few more general restrictions on sub-national borrowing may also be advisable.

The second rationale for imposing special controls on sub-national borrowing is that, since macroeconomic stabilization is properly a central government task, it is important that the central government has full control over all the instruments of policy it needs to carry out this task properly. In particular, sub-national governments should be restrained from accentuating cyclical pressures by borrowing and especially from borrowing abroad and thus adding to the national obligation to service foreign debt. This argument suggests -- as also argued in Section 4 above -- that transfers should be pre-defined as basically fixed amounts within any particular fiscal year (Artana et al., 1995). In addition, in cases such as Argentina where provincial control of financial institutions facilitated both excessive borrowing and its concealment, privatizing provincial banks and making provincial fiscal behavior more transparent through improved accounting and reporting procedures is of course also desirable.

Sub-national governments may of course borrow for many reasons, some more defensible than others. In some cases, for example, local officials have reaped the political benefits of expenditure financed by borrowing, while leaving the political pain of debt service to their successors. Such practices obviously raise a major issue of accountability. A policy that might perhaps be considered to reduce such behavior would be to prohibit governments from raising their own salaries. Legislatures could of course vote salary increases for themselves and their officials -- but no such increases could take effect until after the next election. In other instances, sub-national governments have been almost forced to borrow (even illegally) because they are so constrained by central rules that borrowed resources are the only ones they can freely allocate at the margin in response to constituent demands. Is it surprising that some governments may choose this path if, after years of rapid increases, transfers level off? From the point of view of strict fiscal virtue they should of course bite the bullet and reduce expenditures at once. But even local politicians are human and tend to take the easy way out, if they can find one. And finally, borrowing may of course be the economically appropriate way to finance capital outlays. As every public finance textbook notes, in terms of both allocative efficiency and

[36] Note that this does not necessarily imply subsidization. In Canada, for example, as a rule the full cost of any needed financial restructuring of local government is in principle supposed to be borne locally in the form of reduced services for a period of years until the debt is cleared. The rule is clear: "your mistake, you pay." The central (provincial) government supervises the review and adjustment process, but it does not subsidize it except very occasionally when the default was clearly beyond the control of the locality (for example, a forest fire that destroys the resource base of a rural community) so that the problem is clearly one of solvency not liquidity.

intergenerational equity it often makes sense to finance long-lived investment projects by borrowing rather than relying solely upon either current public savings or manna from above (transfers).

There is thus good borrowing as well as bad. In principle, it is as important to facilitate the former as to block the latter. Indeed, in a sense it may even be more important since, in the right conditions, the market may impose any discipline needed. From this perspective, imposing too strict and arbitrary central limits to sub-national borrowing may have a perverse result. Like deposit insurance, debt limits and similar controls raise moral hazard problems precisely because they prevent market discipline from being applied. Potential lenders to sub-national governments should reasonably be expected to be sufficiently capable and motivated to find out what risks they are running with their money. If such loans have received a seal of approval from above, they are not only relieved of this task but also in effect provided with a stronger implicit guarantee that the central government will back up its judgement than would otherwise exist. The result may be more risky lending.

For a hard budget constraint to be effectively imposed by capital markets, there must not only be a credible no-bailout rule, but in addition there must also be full transparency so that lenders have full information on borrowers and local residents have both full information on the consequences for them of local borrowing and the ability to influence local decision-makers. To the extent that democracy and markets work together in bringing about responsible fiscal behavior, the process is likely to take time. Perhaps, as has been argued with respect to some developed countries, the hardest budget constraints are those forged in the fires of experience (Bird and Tassonyi, 1999). If countries have learned through experience that careful attention needs to be paid to sub-national borrowing to avoid serious problems, then such problems are more likely to be avoided -- whether by redesigning intergovernmental fiscal relations to reduce the temptation to borrow irresponsibly or by establishing a set of rules or signals constraining such borrowing. In the end, what may matter more than the specific solution adopted is the clear recognition of the problem and of the consequences if it is not dealt with properly. Most mature democracies went through decades, even centuries, of difficulty before working out the ways in which they presently cope with the problems that may potentially arise from the actions of relatively autonomous sub-national governments.[37] Perhaps countries can shorten the process by learning from the experience of others, but in the end each country is likely to follow its own path to a considerable extent with some having an easier time of it than others.

To some extent, the oft-expressed concern about irresponsible sub-national governments getting themselves into trouble looks like yet another instance of inappropriate and misconceived paternalism -- the 'father knows best' attitude so common with central governments facing the uncomfortable prospect of losing control as a result of decentralization. Just as children seldom learn to save unless they suffer the consequences of not having done so, sub-national governments seem unlikely to be well managed as might otherwise be the case if they know they will be saved from the possibility of making mistakes by the imposition of arbitrary limits and, if necessary, bail-out by the central government. There may thus be a case for imposing some clear rules and limits on sub-national borrowing -- not so much to save the children as it were as to save the parent from the consequences of its own inability to refrain from saving the children. In other words, one reason for imposing restraints on sub-national borrowing may be to save the central government from the consequences of its own weakness (Elster, 1984). If central

[37] See, for example, the discussions of various developed countries in Ter-Minassian (1997); see also Inman (1999) and Bird and Tassonyi (1999).

governments are all too likely to bail out defaulters, they have good reason to try to limit the extent to which this weakness can be exploited by limiting the possibility of default.

Although allowing sub-national access to capital markets should in the long run strengthen rather than weaken fiscal discipline, the 'long run' may be quite long. In the interim, it may be sensible to limit such access to some extent, for example, by introducing something like the Colombian system of 'traffic lights,' under which sub-national governments can borrow freely (green light) when debt is below a specified threshold, but require central approval (yellow light) when debt levels are higher (Dillinger and Webb, 1998). Given the impossibility of formal bankruptcy proceedings in the public sector, reducing the moral hazard that will remain in any case requires in addition the institution of a credible review/control system for debt work-outs, perhaps along the lines suggested recently for Argentina (World Bank, 1996b).

Special problems may arise from foreign borrowing by sub-national governments. A sensible precaution might therefore be to require explicit prior approval from the central government before any such loans may be contracted. More generally, to ensure accountability, all sub-national borrowing should report immediately and in a transparent fashion both so that no government can shift hidden debts onto the next administration and so that both local voters and the central government can understand more clearly what is going on. The problems in Argentina, for example, arose under a clearly inadequate set of rules with respect to accounting, reporting, and transparency. Such problems can, and should, be corrected. Moreover, since the only good case for local borrowing is to finance capital investment, no borrowing should be permitted for other purposes, no matter how worthy.[38]

To sum up, as a rule inappropriate borrowing by sub-national governments should be viewed not so much as a problem of decentralization but rather as a symptom of more basic underlying inadequacies with the intergovernmental fiscal system in general. Once that system is cleaned up by such measures as, for instance, reassignment of revenues (and perhaps also of expenditures), a revised transfer system, the introduction of transparent, timely, and reliable reporting systems, and the establishment of a stable, accepted periodic review process (see Section 6), the institutional problems that may give rise to unsustainable sub-national borrowing should largely be solved in principle -- although, as noted above, it may take considerable learning before practice reaches the same level as principle, and in the interim certain specific rules and limits may need to be put into place to reduce the likelihood of undesirable outcomes.

Two distinct problems now face some countries. The first is to restructure the finances of a few sub-national governments that have, for whatever reason, gotten into a debt bind. The second is to restructure the system of intergovernmental finance in such a way as to ensure that the delivery of those services provided by the sub-national level should be as equitable, efficient, effective, and stable as

[38] Of course, some arrangements may have to be made to permit 'in-period' borrowing to smooth out cash flows over the budgetary year. Although some have expressed concern about the ability of local governments to borrow on the basis of the increased cash flow as a result of transfers (or, for that matter, royalties), it is not clear why this should be a problem -- provided, of course, that such borrowing is not subsidized. To the extent that transfers constitute revenues that local governments can spend as they wish, if private agents are willing to lend money based on this security they should be free to do so, provided, of course that they also bear the consequences if the loan goes bad.

possible. These are essentially unrelated problems, and need to be dealt with separately. If the long-term problem is properly solved, however, the short-term problem should not arise again.

In the end, only two basic ex ante limits on sub-national borrowing seem needed. First, borrowing should be permitted only for investment purposes -- a restriction that may not always be easy to enforce (especially in the absence of strictly segregated capital budgets). Second, explicit national approval should be required for borrowing abroad. At a deeper level, however, given the extreme current dependence of sub-national governments on central transfers (as well as political realities), somewhat stronger restrictions on borrowing may be warranted in many countries at present. Unless sub-national governments are able to save themselves from fiscal crises by drawing on their taxing powers, their only options are bankruptcy or bailouts. The *fiscal* root of this problem is the limited taxing power available to sub-national governments that are expected and required to carry out a much wider range of functions than they can finance on their own without extensive reliance on central support -- either directly through transfers or, less desirably, indirectly through bailouts (Eichengreen and von Hagen, 1995). The *political* root of the problem, however, lies in the continuing expectation by all players -- citizens, sub-national and national politicians, and lenders -- that in the end the central government will come to the rescue. So long as central actions, ex post, reinforce this expectation, such common ex ante administrative controls on borrowing as requiring prior central approval or limiting debt service to a certain proportion of current revenues may have to remain in place.[39]

6. Institutional Aspects

Another concern about the possible dangers of decentralization arises from the poor quality of local administration in most developing countries (Prud'homme, 1995). While there is often good reason for such concern, to a considerable extent countries get the local governments they want, and deserve. Sub-national politicians and officials, like those at the central government level, respond to the incentives with which they are faced. If those incentives discourage initiative and reward inefficiency and even corruption, it should not be surprising to find corrupt and inefficient local governments. The appropriate response is to adjust the formal and latent incentive structures affecting local (and central) decision-makers to make it possible and attractive for honest, well-trained people to make a career in local government. Given appropriate incentives -- in terms of heightened expectations of improved services from their constituents and access to resources for which they are politically responsible -- even very small local governments have demonstrated significant improvements in administrative capacity within a relatively short time (Fiszbein, 1997).

If expenditures, taxes, and transfers are set up properly along the lines sketched earlier, decentralized provision of services seems in principle at least as likely as centralization to prove fiscally responsible. Moreover, it should both more efficient and more accountable. Nonetheless, many are dubious of such assertions, not least because of experience in countries in which decentralization has not been well structured. Central politicians and officials are generally among the first to deplore the inevitable examples of corruption, malfeasance, and general incompetence that are likely to emerge in countries in which -- often for the first time in their history -- local people are being asked, encouraged,

[39] For an example of a phased (and asymmetric) approach to liberalizing sub-national access to capital markets, see Ahmad (1999).

and required to make decisions for themselves and to bear the consequences of their own decisions. Some of those who so complain may lose if it turns out that their jobs can be done more efficiently and accountably in a decentralized system. More generally, like all major institutional changes, decentralization is a complex and lengthy process. Dillinger, Perry, and Webb (1999) recently noted that many of the alleged macroeconomic problems arising from decentralization reflected transitional problems. Much the same may perhaps be said of some of the implementation problems often experienced at the local level.

Local Capacity

Those who emphasize the local capacity problem often suggest one of two solutions. If they support decentralization, they usually propose increased central support of local training and upgrading. If they are less supportive, they often in effect take back the allegedly devolved power through means such as earmarking and mandating local expenditures. While there is little to be said for the latter approach, even the former may sometimes be slightly poisoned since there is no reason why the best or only source of technical support and training for newly-decentralized activities should come from the central government.

As an example, over the last decade or so Colombia has moved in a major way towards decentralizing responsibilities and resources to its two levels of sub-national government (*departamentos* and *municipios*). Considerable doubts have been expressed as to the effects of the newly decentralized system, particularly with respect to social spending, on the poor. Both the willingness and the capacity of local governments to deliver effective poverty-alleviation assistance have been questioned (World Bank, 1994). Although partial and preliminary, the evidence with respect to the development and use of local capacity in Colombia is surprisingly encouraging. A study of 16 municipalities across the country found numerous beneficial results of decentralization in terms of enhancing local capacity (World Bank, 1995).[40] Some municipalities, for example, improved the skills of local officials through means such as competitive hiring, sharing the services of professionals among municipalities, training municipal employees, and rotating personnel across different departments in the same municipality. Capacity in terms of capital was also increased. One municipality totally privatized road maintenance; another put private developers in charge of the construction of urban roads. Computers have been introduced to monitor water and sanitation services in other localities. Some municipalities have started to share certain equipment. Some have also improved their technological capability in terms of internal organization, planning, and monitoring to ensure better management of municipal projects.

Underlying these improvements is a more basic change. In effect, some Colombian municipalities have moved to a 'demand-driven' approach to public services as opposed to the previous 'supply-driven' approach. Increasingly, reflecting both the liveliness of local politics and -- with substantial variations from area to area -- more extensive community participation, people are getting what they want, rather than what someone in the capital thinks they should want. Most municipalities have emphasized roads, education, and water works. These priorities may not always coincide with what the central officials previously in charge of these areas think is most important, but since these are the needs

[40] As Maldonado (1999) emphasizes, however, this study sample was non-representative, since it was deliberately chosen to reflect largely positive experiences.

people perceive, these are the needs that the newly empowered and responsive local governments are attempting to satisfy. Opinion surveys suggest that the resulting sectoral allocation of resources is consistent with community preferences, with most respondents indicating that they trust the local government more than the national government to deliver goods and services (World Bank, 1995).

As always, people are central to success, and the key to successful decentralization in any area is to provide the right incentives and institutional structure to induce and permit the right people to be in the right places. This is not always easy, and more attention should be paid to this critical "human" dimension of decentralization. Since newly empowered local governments are unlikely to deliver services efficiently or to maintain (or meet) high quality standards, one way to deal with potential capacity problems has sometimes been to reassign central government workers to local governments. In the Philippines, for example, central government employees who were transferred to newly-decentralized local services in 1991 received on average around US$ 142 a month (at the official exchange rate) compared to only US$ 88 for local employees (Bird and Rodriguez, 1999). In these circumstances, local salary bills seem likely to have to rise if decentralization is expected to improve quality and delivery of services. Indeed, more generally as Campbell, Peterson, and Brakarz (1991) have argued with respect to Latin America, if service levels are to be maintained, decentralization may well increase rather than reduce government outlays, at least initially, through such a "leveling-up" effect on salaries and service levels.[41] Over time, of course, cost-saving incentives may come into play and offset this initial effect.

Accountability and Information

As has been emphasized throughout this paper, if decentralization is to work properly, those charged with providing local infrastructure and services must be accountable *both* to those who pay for such services *and* to those who benefit from them -- two groups that are seldom identical. Enforcing accountability at the local level is not easy. It requires not only the establishment of an intergovernmental fiscal system that provides clear and correct incentives to all relevant decision-makers but also the provision of adequate information to local constituents, as well as the opportunity for them to exercise some real influence or control over the service delivery system. ‘Informal’ organizations almost by definition must be structured like this or they are seldom sustainable (de Soto, 1989). In the political and social circumstances of many developing countries, however, it can be a considerable challenge to introduce a similar degree of responsiveness into formal governmental organizations.

In any case, improved accountability is the key to improved public sector performance, and, as noted earlier, improved information is often the key to accountability. The systematic collection, analysis, and reporting of information that can be used to verify compliance with goals and to assist future decisions is critical to successful decentralization. Such information is essential both to informed public participation through the political process and to the monitoring of local activity by central agencies responsible for supervising and (usually) financing such activity. Unless local ‘publics’ are aware of what is done, how well it is done, how much it cost, and who paid for it, no local constituency for effective government can be created. Unless central agencies monitor and evaluate local

[41] Stein (1998) found that decentralization had indeed led to larger government outlays in Latin America, although the main reason appeared to be inappropriately designed intergovernmental fiscal relations which resulted in sub-national governments not being subject to hard budget constraints.

performance, there can be no assurance that functions of national importance will be adequately performed once they have been decentralized, although care must be taken to avoid the use of such information for inappropriate control purposes.

An important accompaniment of any successful decentralization program is thus an improvement in national evaluation capacity (Wiesner, 1993). Decentralization and improved central evaluation and assessment of local activities are not substitutes; they are complements. An essential element of the hard budget constraint needed to induce efficient local decisions is adequate central enforcement capacity in the shape of credible information gathering and evaluation. The 'carrot' of central financial support of local efforts must in the end be accompanied by the 'stick' of some degree of withdrawn support if performance is inadequate, and a credible stick requires both some standard of adequacy and some way of knowing how performance measures up.

Unfortunately, the lack of an appropriate structure to monitor and support local governments is a common problem. Central governments should, for example, in principle be responsible for monitoring and assessing the finances of sub-national governments, both in total and individually. Often, central authorities do not have a very good understanding of either the existing situation of their local governments or of the likely effects of any proposed changes in local finance. Most need much more regular and detailed financial data on local governments than they usually possess. Ideally, uniform financial reporting and budgeting systems should be established, perhaps with different degrees of complexity for different categories of local governments. As discussed below, an appropriate agency -- perhaps preferably one with a certain degree of political separation from the central government -- should be made responsible for collecting and processing these data in a timely fashion.

Central government support may be needed not only to develop and maintain an appropriate reporting system, but also to train and support local government officials. As noted above, if decentralization is to be effective, support is often needed to upgrade the technical capacity of local governments to carry out efficiently and effectively the expenditure functions for which they are responsible. In some instances (education?) the necessary support might come from the relevant central ministry, while in other instances (roads?) it may come from the ministry, regional agencies, universities, private sources, or some mixture of these bodies. Each functional area has different requirements, problems, and possibilities and needs be treated differently.

Different countries may of course have different cultural understandings and political conditions with respect to the desirable level and nature of accountability. Whatever standards and practices of accountability may be considered desirable, however, formal reporting and evaluation systems inevitably constitute essential components of any workable accountability system -- whether to users, to local taxpayers, or to the central government, depending upon the source of financing. In all cases, an adequate system of collecting and assessing information is required not just for accountability but also, more importantly, to help establish a "public" to whom to be accountable.

The role of the central government in ensuring and monitoring effective decentralization is especially critical when, as is often the case in practice, a major concern is to enhance service delivery, perhaps particularly with respect to services such as health and education that are important not only for national development but for poverty alleviation and welfare in general. An unfortunate side effect of decentralization in some countries has been the virtual disappearance of reliable information on the provision of such services. Decentralization of a function does not mean that the central government no longer has any responsibility in the area. What it means is rather that the nature of central responsibility has changed from direct service delivery to regulating and monitoring the efficiency and equity of services delivered by local governments. The essential tool needed for this task is an adequate and up-to-date information base -- generated, for example, by requiring local governments to file uniform and informative budgets and financial and other reports. Unfortunately, this need for extended and reliable information has been sadly neglected in most decentralizing countries, in which those making the decisions often understandably wish to hide the real reasons for (and the results of) their actions and to live the quiet life of the unaccountable.

An incentive to comply with demands for such information may be created by making timely submission of such reports a condition of receiving fiscal transfers. Implementing this requirement may in turn imply significant initial set-up costs in the form of system design, training, and implementation. As mentioned earlier, to spend money wisely in a decentralized system may sometimes require some initial investment. While of course such concerns are less important when full responsibility for the efficiency and equity of services is devolved (as in a formal federal structure) rather than simply delegated to sub-national governments, the need for an adequate information system remains critical to effective macroeconomic management (see Section 5), given the importance of such services as education and health in total public expenditure. Regardless of the form of decentralization, an important institutional problem is thus how to ensure *both* that the relevant central government agencies have adequate incentives to monitor sub-national activity *and* that sub-national governments have sufficient incentives to provide the necessary information.

Institutionalizing Decentralization

Decentralization is a dynamic process. No country ever gets it right on its first try. Circumstances change, and the nature and design of intergovernmental fiscal relations should change also. An important aspect of establishing an adequate institutional framework for decentralization is to build in some "error-correction" mechanism, that is, to permit and encourage the adaptive development and evolution of the system in response to changes in needs and capacities. As Bahl (1999) emphasizes, countries seem unlikely to be successful in implementing significant decentralization programs unless decentralization has a powerful 'champion.' Even if such policies are successfully implemented, however, they are unlikely to produce good results or to prove sustainable unless considerable attention is paid to ensuring that the institutional environment is propitious.

Several possible mechanisms along these lines are suggested by experience around the world:

*One approach, for example, might be to build in "sunset" provisions into any transfer program. That is, to provide that transfers to local institutions are subject to renewal in a specified number of years, provided they pass some kind of independent evaluation of their performance. In principle, India's Finance Commissions should play this role. Another example is the Colombian decentralization law discussed in World Bank (1996a).

*Another approach might be to use the likely need for some centrally supported access to capital markets for infrastructure finance not only as a screening device to reject obviously flawed projects but also as the foundation of an evaluation system to build up 'ratings' of local capacity and effort.

*Yet another approach, emphasized in this section, might be to assemble and publicize reliable comparative information on local government performance. This approach is discussed further in Bird (forthcoming).

*Finally, as discussed further below, most democratic federal countries have developed specialized institutions that serve on the one hand to integrate to some extent the fiscal decisions of governments at different levels and on the other to provide the informed public with some useful and trustworthy (non-partisan) information on what both levels of government are doing, separately and together (Watts, 1999).

Whatever approach is taken, developing such institutional 'infrastructure' is neither a quick nor a cheap undertaking. Nonetheless, it is essential if countries wish to decentralize important public sector activities without losing touch with what is going on in these important parts of the public sector.

Much more informed and open discussion of decentralization policies and outcomes than now prevails in most countries is needed. Regular publication of relevant data would of course help, but one cannot rely solely on an interested party -- the central government -- to carry out, let alone publish, all the information needed for informed public discussion. In countries in which intergovernmental fiscal issues are important, consideration might therefore be given to establishing one or more non-governmental research institutes focusing on sub-national governments.

Some central governments are learning through experience to carry out this essential information and monitoring activity more adequately in their own interests -- for example, to avoid excessive sub-national borrowing and hence potentially undesirable macroeconomic pressure. In no country, however, has any central government yet admitted that full disclosure (transparent accountability) should apply also to its own actions as they affect intergovernmental fiscal relations. Decentralization is a two-sided street, and the central role of central governments in determining the outcome of this complex process needs more attention than it seems so far to have received. As Breton (1996) has demonstrated, for the potential benefits of increased governmental competition to be realized, governments at *all* levels must become more transparently comparable and hence accountable for their actions.

Without a public better informed of the real alternatives and choices facing them in their collective capacity as members of society, the long-run sustainability and outcome of decentralization is questionable in many countries. As the world now turns, the decentralized governments now existing in most countries seem unlikely to be particularly efficient. But they can, and may, become more so over time if sufficient attention is paid to developing the institutional infrastructure needed to produce such a favorable outcome.

Achieving Fiscal Transparency

Fiscal transparency is fundamental to sound public policy. Such transparency is needed not only to improve the working of the executive and legislative branches of government but also to improve the level of public discussion and understanding of policy issues. The capacity to accept and absorb policy change in the public at large needs to be strengthened in countries in which all too often people have on the one hand already suffered much from change while on the other hand they have not yet absorbed such basic lessons of economics as that one cannot get something for nothing and that life is not solely a zero-sum game. In general, the more open and transparent the public policy process is, the more likely are policy decisions to be grounded in fact rather than fantasy, and the more policy outcomes should coincide with stated policy intentions. Such arguments are of course now well accepted in theory, and to some extent supported by empirical studies and experience in a variety of countries (Kopits and Craig, 1998).

Nonetheless, fiscal transparency is inherently a difficult concept for many politicians and officials to accept. For them, there are often overwhelming incentives to hide taxes and liabilities, to exaggerate benefits, and generally to present fiscal realities in as complex and confusing a way as possible in order to present a more acceptable public face. In this way, they can then live the quiet life available to those who exert monopoly control over information that might be used to make them accountable for their actions (or lack of action).

The need for transparency, and more informed public input, is nowhere greater than when the responsibility for governance is divided between two (or more) tiers or levels of government. Not only do citizens in such countries need to know exactly who is responsible for precisely what if they are to hold governments accountable through the electoral process (or in other ways), but it is also critically important that each level of government be well informed of the intentions, actions, and outcomes of the other levels. Although most apparent in formal federations similar pressures, and needs, arise in all countries with some degree of fiscal decentralization.

As stressed earlier, the key to effective accountability, and hence to good governance, is to make relevant information publicly available in a comprehensive and comparable form. Uncomfortable though the lives of politicians and officials may be when their actions are open to public scrutiny, the more that is known, and the more publicly it is known, the better policy outcomes are likely to be over the long run. To achieve efficiency in a decentralized setting, not only must the rules of the game be clear but also all players must have access to broadly the same information base.

Perhaps the main conclusion one can draw from international experience with specialized 'decentralization institutions' intended to improve the nature and understanding of the process is that each country deals with these matters in its own way. Nonetheless, experience around the world suggests that several different roles might be envisaged for a body concerned with intergovernmental finance issues. Depending upon what is politically desired and feasible, some of these roles may, or may not, be incompatible and may or may not be combined in the same institution.

One of the most important institutional requirements for effective decentralization is a cadre of fiscal and policy analysts at all levels of government. These persons need to be trained not only in the mechanics of analysis but in working together, from their different perspectives, towards the common goal of making the complex political and administrative system work. A possible role for a special intergovernmental commission or agency, for example, might be to serve as a link between the political and executive branches in the center and the regional (and perhaps local) governments. A special institution might achieve this aim --

(1) by providing a non-partisan forum within which various relevant actors may get to know one another in a non-confrontational setting; or

(2) by providing a common informational basis to all parties that is (one may hope) trusted by all parties; or, finally,

(3) by training both formally and informally a cadre of expertise in fiscal and financial areas that may, over time, spread over the country.

Whether the 'forum' role -- which would appear to require that members be selected largely on political criteria -- is really compatible with the other two attributes mentioned is by no means clear, however.

An intergovernmental fiscal agency might in particular support and develop sub-national administrative capabilities in financial and fiscal areas, working with local institutions to develop and offer appropriate training and even helping to implement uniform statistical information systems. Such an agency might help develop the needed pool of professional financial analysts committed to public sector work in a variety of ways, through, for example, offering short training programs, affording promising young graduates internship positions and so on. Experience with such training programs in a variety of circumstances suggests that one of their major intangible benefits is the facilitation of frequent (and productive) interchanges not just between federal and regional actors but also between regional actors themselves.

Other ways in which an intergovernmental agency might, if desired, serve a formal political role might be:

(1) by making annual or periodic reports on 'The State of the Federation;'[42]

(2) by determining, or reporting on, the appropriate basis for grants;

(3) by providing 'federalism impact statements' indicating clearly the impact on sub-national governments of central actions;[43]

(4) by working with central banks and departments of finance in developing comparable public finance data (for example, on borrowing); or

(5) by going further and, like the Australian Loan Council, serving as a formal coordinating mechanism for public sector borrowing.

The substantive content of such tasks might perhaps best be achieved by a body whose main formal role was educational rather than political. For example, a common accounting framework could be developed and utilized for monitoring the fiscal performance of all levels of sub-national government. Such reports might be more credible if the agency did not have a formal "reporting" role to the central government, and its output was accepted as the work of competent and politically neutral analysts.[44] An intergovernmental fiscal body might also play a useful role from the point of view of the sub-national governments by monitoring and reporting on the possibly intrusive impact of central government policies on sub-national governments. Such work might again be more credible if it were not seen as one of the players in the political game but rather as an outside, but well-informed and trustworthy, referee.

In the hurly-burly of emerging democratic politics in many countries, such suggestions may seem either naive or hopelessly idealistic. Nonetheless, for a decentralized system to work well in a democratic setting, people need to understand not only what is going on but also the real possibilities and constraints facing governments at all levels. If an appropriate agency can be established along the lines sketched above, it might serve as a central analytical focus, both supplying trustworthy information

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[42] Examples are the annual reports published by the Institute of Intergovernmental Relations at Queen's University in Canada.

[43] This idea is developed in detail in Inman and Rubenfeld (1997).

[44] On the other hand, such an agency might have more public impact if legislative bodies were legally required to receive and discuss its reports.

to all actors and also helping to create the informed public that is needed for the political system to cope with the great strains and challenges facing it. How 'politically-institutionalized' such a body should be -- like the details of its appropriate structure and functions -- can only be determined in the context of each country.

Experience in developed federal countries suggests (1) that transparency is needed for good fiscal management, (2) that good fiscal management is needed for a successful decentralized structure, and (3) that an agency performing at least some of the functions sketched above may play a vital role in this process. Good, relevant, timely analysis of intergovernmental fiscal relations, training good analysts, facilitating and encouraging productive technical exchange between and within governments, and providing neutral, competent input to the public discussion of intergovernmental fiscal and financial policy -- such intangible but critical institutional factors in the end play a vitally important role in making decentralization work in any country. If the current wave of decentralization measures is to prove sustainable and beneficial in the long run, much more needs to be done to foster the development of such an institutional framework.

7. Conclusion

This paper has covered a very wide range of topics. One of its principal arguments is that many aspects of intergovernmental fiscal relations can be worked out specifically only in the context of each individual country. The extent to which the 'ideal' structure of intergovernmental fiscal relations sketched here may be approximated in the case of any particular country inevitably depends upon constitutional restrictions, political realities and an array of specific contextual factors. Allowing for differing degrees of democracy or differing levels of competence would of course introduce still more variations, as would allowing for different sizes and capabilities of sub-national governments. While such universal principles as establishing a transparent and accounting system should in principle apply to all countries, many subjects discussed here – for example, different patterns of sub-national revenues and transfers – may be appropriate for different stylized types of countries as (a) a large federal country in which important social services are provided by sub-national governments, (b) a decentralized unitary country in which again social services are provided at the sub-national level but where the central government has more control over sub-national spending, and, finally, (c) a small unitary country in which local governments provide only 'local' services. More generally, as emphasized at the beginning of the paper, in the final analysis the real science and art of designing and implementing better intergovernmental fiscal systems inevitably lies mainly in the hands of those who must apply these (or other) principles locally. Good principles are easy to expound; applying them in practice is much more difficult.

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