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Making Fiscal Decentralization Work: Cross-Country Experiences

Annalisa Fedelino and Teresa Ter-Minassian

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Preface

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

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

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

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

The provision of IMF advice on fiscal decentralization has taken different forms, including dedicated staff missions, the fielding of short- or long-term resident experts, seminars and other training events, and the preparation of a substantial number of research books and papers.[1] As evidenced by the case studies, the advice has spanned virtually all areas of intergovernmental fiscal relations. Regardless of the specific areas and forms of involvement, IMF advice has typically focused on the macrofiscal aspects of decentralization, with the primary goal of safeguarding macroeconomic stability and fiscal sustainability. This focus has reflected the core mandate of the institution and the comparative expertise of its staff. In the provision of its advice on fiscal decentralization, the IMF has frequently cooperated with other multilateral (notably the World Bank) and national institutions active in this area.

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

[1]The main examples are the IMF volume on *Fiscal Federalism in Theory and Practice* (Ter-Minassian, 1997); the proceedings of a 2000 international conference on managing fiscal decentralization (Ahmad and Tanzi, 2002); and the *Handbook of Fiscal Federalism* (Ahmad and Brosio, 2006).

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Abbreviations

CDF	County Development Fund (Liberia)
CSP	Comprehensive Settlement Proposal (Kosovo)
DAU	General Allocation Fund (Dana Alokasi Umum, Indonesia)
DAK	Special Allocation Grant (Indonesia)
DBH	Shared Revenue Fund (Indonesia)
DGI	Direction Générale des Impôts (Tax Collection Agency, Democratic Republic of the Congo)
EAD	Entités Administratives Décentralisées (Decentralized Administrative Entities, Democratic Republic of the Congo)
ETD	Entités Territoriales Décentralisées (Decentralized Divisional Entities, Democratic Republic of the Congo)
FAD	Fiscal Affairs Department
FYR	Former Yugoslav Republic (of Macedonia)
GDP	gross domestic product
GFMIS	Government Financial Management Information System
GFS	Government Finance Statistics
IDH	Direct Tax on Hydrocarbons (Bolivia)
IMF	International Monetary Fund
HIPC	Heavily Indebted Poor Countries
LFLSG	Law of Financing of Local Self Governments (FYR Macedonia)
LLGF	Law on Local Government Finance (Kosovo)
LLSG	Law of Local Self-Government (FYR Macedonia)
MoF	Ministry of Finance
MoHA	Ministry of Home Affairs (Indonesia)
OECD	Organization for Economic Cooperation and Development
PFM	public financial management
PIT	personal income tax
PPP	public-private partnership
SLG	state and local government
TA	technical assistance
TSA	treasury single account
VAT	value-added tax

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Pressures to decentralize—that is, transfer authority and responsibility for public functions from the central government to subnational entities—have become more evident over the years. Typically a political phenomenon, decentralization frequently takes on a fiscal dimension (hence the term "fiscal decentralization") when changes in a country's system of intergovernmental fiscal relations take place.[1]

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

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

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

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

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

[2]This publication looks at "downward" decentralization, that is, the arrangements between a sovereign or national state and its lower levels of governments. Because political and economic processes and activities are becoming global and require global action (Tanzi, 2008; Bordignon, 2006), examples of upward devolution of powers are increasing, raising issues of coordination, monitoring, and control of behavior of countries that are members of economic unions. The European Union, in its enlargement and the establishment of a monetary union, is one such example.

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Table 1. Comparative Indicators for Case-Study Countries

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

Sources: World Bank *World Development Indicators*; IMF *World Economic Outlook*; and administrative divisions of countries.
Note: … = data not available; n.a. = not applicable.
[1]Bolivia: Departmental prefectures. China: 22 provinces, 5 autonomous regions, and 4 municipalities. Colombia: 32 departments and 1 capital district. Congo, Dem. Rep. of: Regions (10 provinces and 1 capital city), expected to be expanded into 27 new provinces by 2009.
Indonesia: Provinces (30 provinces, the capital, and 2 special districts). Liberia: 15 counties. Mexico: 31 states and 1 federal district. Nigeria: 36 states and a federal territory.
[2]Nominal GDP per capita for Kosovo. Real GDP per capita for all other countries.

need to be coherently structured and managed so that subnational governments face credible "hard budget constraints" and respond to incentives to behave fiscally responsibly. The main lessons and future challenges for the IMF's role in the fiscal decentralization policy debate are outlined in Chapter 3. Part II (Chapters 4–13) provides more depth to the fiscal decentralization experience in each of the case-study countries, casting the IMF staff advice against a brief historical, institutional, and political context in each country as of the end of the first decade of the 2000s.

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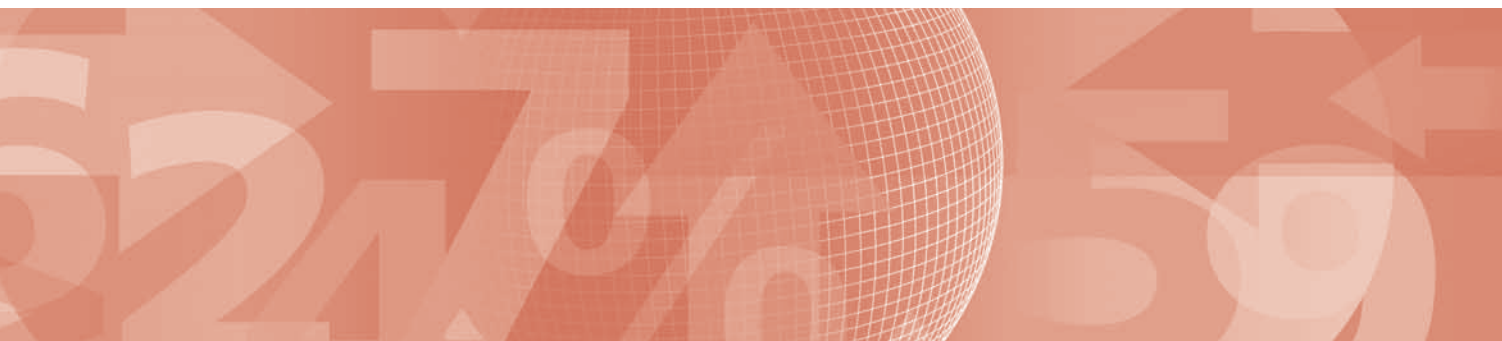
Part I: Lessons



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A Brief Literature Review

Fiscal decentralization involves a redefinition of the roles and responsibilities of the various levels of government in the conduct of fiscal policy. Traditional theories of public finance provide a normative framework for assigning the government's three fiscal functions—stabilization, redistribution, and resource allocation—across government levels (Musgrave, 1959; Tiebout, 1956; Oates, 1972).[1] While the center should be assigned the first two functions (Table 1.1 briefly reviews the main rationale), there is scope to improve resource allocation in the public sector through decentralization. The basic tenet of these theories is that governments and politicians behave like benevolent welfare maximizers; when preferences differ, welfare gains are possible through diversification of local public outputs.[2] Two reasons underpin the possibility of gains: first, local politicians know consumers' preferences in their jurisdictions better than does the central government, and therefore can better align the provision of local outputs to those preferences (allocative efficiency);[3] and second, consumers can move to jurisdictions that better satisfy their preferences (Tiebout's [1956] argument of "voting with one's feet"). Therefore, subnational governments face competitive pressures to attract consumers of their outputs, resulting in more efficient (and possibly more innovative) provision of public services (productive efficiency).[4] These issues are further developed in the next section of this chapter.

In practice, normative considerations seldom drive the assignment of functions. Experiences with fiscal decentralization lend little support to the welfare-maximizing predictions of these theories. In fact, fiscal decentralization is largely driven by political motives, and also reflects historical and cultural legacies. Fiscal decentralization has also shown a "dark side" in countries where subnational fiscal policies have played a large role in macroeconomic disruptions and debt crises—as, for example, in some Latin American countries during the 1980s. Fiscal decentralization can also enhance opportunities for corruption and abuse (Brennan and Buchanan, 1980; Prud'homme, 1995; Tanzi, 2001). The realization of the potential dangers of decentralization has called into question the relevance of traditional normative models, and has given way to a positive strand of literature, which attempts to understand the political and institutional conditions under which greater fiscal decentralization may enhance or undermine efficiency, when politicians behave as self-interested individuals with their own objective functions.[5]

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

[1]Oates (2005) provides a summary of these traditional theories, also called "first-generation theories" of fiscal decentralization.

[2]Local public outputs are goods and services whose consumption patterns are less than national in scope.

[3]Oates (2005) notes that even in cases in which the central government is not affected by an asymmetry of information vis-à-vis subnationals, diversified provision of public services by the center may not be politically sustainable because the center cannot be seen as favoring some jurisdictions over others. This would still justify decentralized provision of some public services.

[4]Even without the mobility assumption, subnational governments may engage in "yardstick competition" as citizens observe what neighboring jurisdictions offer and demand comparable treatment from their politicians (Besley and Case, 1995).

[5]These are also called "second-generation theories" of fiscal decentralization (Qian and Weingast, 1997; Oates, 2005; Weingast, 2009). Ahmad and Brosio (2006) provide an extensive review of political economy theories.

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Table 1.1. The Policy Rationale for Fiscal Decentralization

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

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

problem arises when the central government cannot credibly commit to enforcing budget constraints for subnational governments consistently over time.[6] A crucial issue is how to design and manage policies and institutions to mitigate the distortions created by the common pool and soft budget constraint problems. This issue will be covered in more detail in the following sections.

Macrofiscal Implications of Decentralization

Empirical evidence on the impact of fiscal decentralization on macroeconomic performance is mixed. Empirical studies seeking to quantify the relationship between measures of fiscal decentralization and macroeconomic variables, such as growth and inflation, have yielded contradictory results. This situation can be attributed to difficulties in compiling comparable measures of fiscal decentralization across countries because available data suffer from a number of shortcomings (Box 1.1), and difficulties in controlling for other possible factors (beyond decentralization) affecting macroeconomic performance. Finally, the design of intergovernmental fiscal relations, more than the degree of decentralization, affects efficiency and growth, as well as macroeconomic stabilization.[7] As discussed in the previous section, decentralization can enhance or reduce efficiency, depending on the ability of subnational governments to carry out their increased responsibilities effectively. Similarly, decentralization can, in certain circumstances, negatively affect the conduct of short-term fiscal stabilization, or medium-term fiscal sustainability. This section

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

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

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Box 1.1. Measures of Fiscal Decentralization

Measures of fiscal decentralization abound in the literature. Empirical studies on various dimensions of fiscal decentralization use both quantitative (typically, subnational shares in total spending and revenue as well as measures of reliance on transfers) and qualitative indicators (capturing aspects of the institutional and regulatory framework for subnational government finances). For example, the World Bank identifies 18 indicators of fiscal decentralization. However, despite the seeming abundance of indicators, "measuring decentralization is both difficult and controversial" (Treisman, 2006a, p. 2).

Data availability is relatively, sometimes severely, limited. The IMF's Government Finance Statistics (GFS) database remains the best source of internationally comparable data on fiscal variables by government level. As of June 2009, the GFS database contained data for 152 countries, including local government data for 87 countries (see box table). The database includes a statement of government operations and detailed tables on revenue, expenses, and transactions in assets and liabilities. However, a general absence of standardized recording and reporting across government levels and even among jurisdictions at the same level hampers the collection of subnational fiscal statistics. Such limited coverage can lead to sample selection bias: countries reporting GFS data are more likely to have well-developed subnational governments with better-defined responsibilities, and may not be representative of the majority of decentralized countries.

Available data tend to overestimate the true degree of decentralization. Usually no distinction is made between autonomous versus mandated revenue and spending. For example, a large amount of expenditure undertaken by subnationals under mandate from the central government would not necessarily indicate that subnational governments are decentralized—they could merely operate as deconcentrated agents of the center. Similarly, subnational revenue would not adequately distinguish between own-source revenue (where subnationals have some degree of discretion over tax rates and tax bases) and shared revenue (with little or no subnational taxing autonomy). These are well-known limitations of GFS data.

Data are typically aggregated by government level, possibly masking important differences within a level. Aggregation in GFS data masks information that could be useful in assessing differences and variation among subnational entities' fiscal operations and capacities.

Quantitative data also omit important institutional dimensions. There is much more to fiscal decentralization than quantitative measures suggest. Qualitative information is also relevant, although not always available. The World Bank and the Organization for Economic Cooperation and Development (OECD; the latter under the Fiscal Federalism Network) have promoted efforts to collect information relating to the design and management of expenditure and revenue assignments, transfers, and borrowing arrangements. Coverage of indicators remains limited (for example, information on revenue assignment is available for 31 countries, of which 20 are OECD countries).

Sources: GFS database; and Ebel and Yilmaz, 2002.

Country Coverage of GFS Data

Total IMF members	**185**
Countries reporting GFS statistics	152
Reporting countries with published central government data	87
Reporting countries with published data on all government levels	60

Source: GFS database.

Note: The exercise tallies countries with published data during the period 2002–06, with data for at least one year.

briefly discusses interactions between various aspects of intergovernmental fiscal arrangements and macroeconomic management.

When subnational governments hold the key to a large share of spending, the center is less able to conduct stabilization through fiscal policy. The center has limited room to carry out any needed fiscal adjustment when it only controls a small share of spending. Many countries, for instance, in Latin America, have experienced such difficul-

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ties. Even when the overall level of subnational spending is constrained by taxation and borrowing arrangements, a budget-neutral shift in the composition of such spending can in principle affect aggregate demand counter to the center's stabilization policies. This contrary result may happen, for example, when the share of subnational spending with relatively larger multiplier effects increases. At the opposite end of the spectrum, central governments' efforts to inject stimulus into the economy may be partly offset by subnational procyclical fiscal retrenchment during downturns—as happened in a number of countries during the 2008–09 financial crisis.

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

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

In such settings, nationally binding rules, or effective intergovernmental cooperation mechanisms, are needed to promote both short-term fiscal stabilization and medium-term fiscal sustainability.[8] Some countries (e.g., Austria, Germany, Switzerland, and some Northern European countries) have used cooperative arrangements between the center and the subnational governments to formulate shared economic and fiscal objectives. In such cases, the incentive problem is addressed through moral suasion and peer pressure; although forging an agreement may be complex and time-consuming, greater ownership and flexibility often result from the process. In other countries, fiscal rules for subnational governments are being used; for example, in some European countries, Domestic Stability Pacts—the subnational counterpart to the Growth and Stability Pact for central governments—are increasingly being applied (Belgium, Italy, Spain).[9] Fiscal rules offer the advantage of direct and immediate applicability; still, they may give rise to creative accounting and may not be politically sustainable if too rigid. Overall, fiscal rules may be a useful device to address coordination problems, but not necessarily to solve them. Box 1.2 reviews issues with regard to subnational fiscal rules.[10]

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

[8]For a review of these issues, see also Pisauro (2001).

[9]The United States provides another example where fiscal rules are applied to the subnational (state) level; virtually all states apply some sort of balanced budget rule. However, these rules have been self-imposed by the states, and not by the federal government. It could still be said that their credibility is enhanced by an effective no-bailout policy on the part of the federal government.

[10]These issues are further explored in "Identifying Mechanisms to Control Borrowing" in Chapter 2. In practice, solutions are not as clear cut as described here, and eclectic approaches are applied; for example, fiscal rules may be formulated in a cooperative framework (Franco and Zotteri, 2008).

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Box 1.2. Fiscal Rules for Subnational Governments

Fiscal rules at the subnational level act to modify the incentives faced by these governments. They offer a number of desirable features, such as transparency, reducing the level of uncertainty in the economic environment by increasing the predictability of governments' behavior, and evenhandedness in promoting fiscal responsibility; to be effective, fiscal rules must be credible (that is, not set unrealistic targets) and be consistently enforced (to avoid expectations of bailouts from the central government).

Fiscal rules can be either procedural or numerical. Procedural rules aim to enhance transparency, accountability, and fiscal management. They typically require the government to commit up front to a monitorable fiscal policy strategy, usually for a multiyear period, and to routinely report and publish fiscal outcomes and strategy changes. New Zealand pioneered this approach, and applied procedural rules within the 1994 Fiscal Responsibility Act. Cross-country evidence suggests that, in countries with weak records of policy implementation, procedural rules may work better than numerical rules. At the same time, the successful implementation of procedural rules requires modern budget systems and a high degree of fiscal transparency, as well as a substantial constituency for fiscal discipline and responsibility.

Numerical fiscal rules refer to specific quantitative targets, and are intended to impose permanent constraints on fiscal policy, typically defined by an indicator of overall fiscal performance (such as the budget balance or the public debt). Examples of numerical rules abound at the central or general government level. For instance, in the European Union, ceilings are specified for deficit and debt ratios. The United States implemented an expenditure cap mechanism (the Budget Enforcement Act) from 1991 to 2002. Canada resorted to both legislated spending caps (the Federal Spending Control Act, 1991–96) and unlegislated policy rules.

Numerical rules can help contain a deficit or expenditure bias, and address time-inconsistency problems. However, such rules also introduce policy inflexibility and may create incentives to resort to low-quality measures to meet numerical targets. For example, in some countries the application of numerical rules has led to creative accounting practices aimed at circumventing the rules, including reclassification of expenditures, accumulation of arrears, and the use of public entities off-budget to perform government operations. The existence of an effective public financial management system is a necessary condition for proper implementation of numerical fiscal rules.

Fiscal rules need to allow for flexibility over the cycle. A possible solution would be to define numerical fiscal rules in cyclically adjusted terms, although "local" cycles for subnational governments are difficult to assess. In the United States, "rainy day" funds have been used to introduce flexibility into fiscal policy implementation, as part of the fiscal rules in almost all states (Franco, Balassone, and Zotteri, 2007). In combination with rules calling for balanced budgets (exclusive of accumulation, or drawdown of the funds), rainy day funds have provided a transparent mechanism to save during good times, and have proved useful in smoothing the impact of cyclical revenue fluctuations on state expenditures. Experience indicates that rainy day funds cannot be relied upon for prolonged fiscal crises, as confirmed by financial difficulties of the U.S. states in the 2008–09 financial crisis.

Sources: Franco, Balassone, and Franzese, 2003; Ter-Minassian, 2005; Franco and Zotteri, 2008.

American debt crises in the 1980s, and by Argentina's crisis in the late 1990s. Subnational governments are generally less exposed to the financial repercussions of excessive public debt accumulation, such as higher expected inflation and interest rates, and therefore, again, may be less concerned about it.

For these reasons, IMF conditionality has focused on the general government fiscal balance. The IMF has advised countries to seek mechanisms, appropriate to their political and legal environments, to promote adherence by the subnational governments to national fiscal objectives (e.g., through the enact-

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ment of national or subnational fiscal responsibility laws). In some cases, however, the lack of timely and reliable data on subnational fiscal outturns has made the use of central government balances unavoidable as quantitative conditionality in IMF-supported programs.

Evidence also suggests that subnational fiscal policies tend to be procyclical, for various reasons (Wibbels and Rodden, 2006). First, subnationals may be heavily dependent on income-sensitive revenues. Second, the central government may play a limited role in stabilizing subnational fiscal positions through transfers over the cycle.[11] In a normative world, a welfare-maximizing central government would strive to mitigate the procyclicality of subnational finances—as highlighted in Table 1.1, central or federal governments are typically better placed to conduct countercyclical policies and withstand the impact of cyclical shocks, relative to subnational governments, given their broader access to resources (larger tax base and better borrowing conditions) and their privileged role in policy coordination.[12] However, the central government may face little incentive to do so; in fact, opportunistic central governments have an incentive to push the costs of adjustment onto subnationals, by cutting transfers in downturns—thus exacerbating procyclicality—or shifting spending (the so-called unfunded mandates). Indeed, in most federations, transfers are found to be procyclical, or at best acyclical.[13] Finally, lack of access to borrowing may add to procyclicality, when subnationals cannot smooth spending through access to credit to offset lower revenue during downturns (and have not accumulated buffers as insurance for rainy days, as highlighted in Box 1.2).

Thus, not only the degree of fiscal decentralization, but also its design matter for macroeconomic management. The impact of subnational fiscal operations on fiscal discipline and procyclicality does not simply depend on the share of these operations in overall spending and revenue, but also on how they are financed. The discussion above has underlined the role that central transfers play in shaping incentives at the subnational level. This issue is relevant because in practically all countries, subnational spending shares are larger than revenue shares; thus, varying degrees of central transfers are required to cover the resulting vertical fiscal gaps (in Figure 1.1, all countries are located below the 45 degree line). In addition, these gaps appear to have been increasing over time, further highlighting the importance of establishing appropriate policies to deal with these issues (Figure 1.2).[14]

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

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

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

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

[14]Treisman (2006a) finds a strong positive relationship between economic development (measured as increases in GNP per capita) and expenditure decentralization, while the relationship with revenue decentralization does not appear to be significant. This could further explain why vertical fiscal gaps tend to widen over time.

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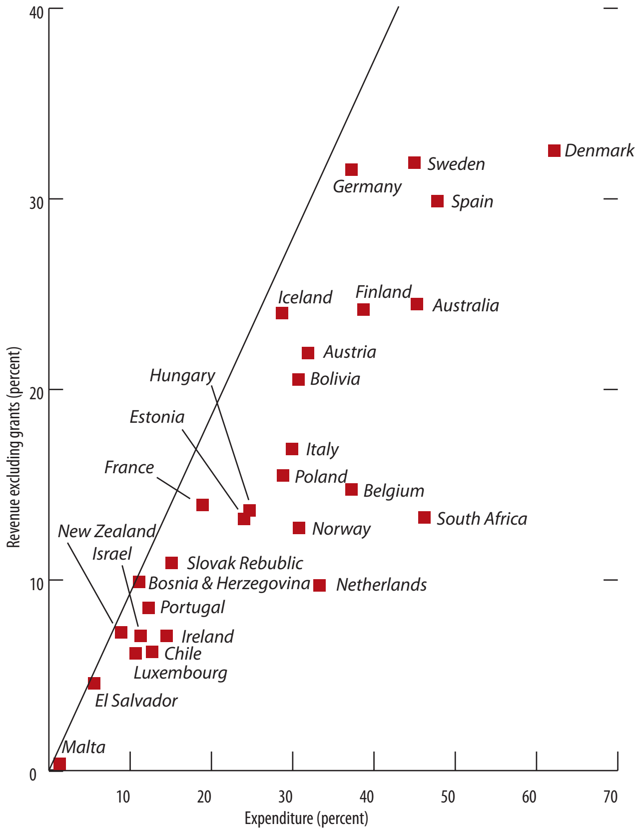
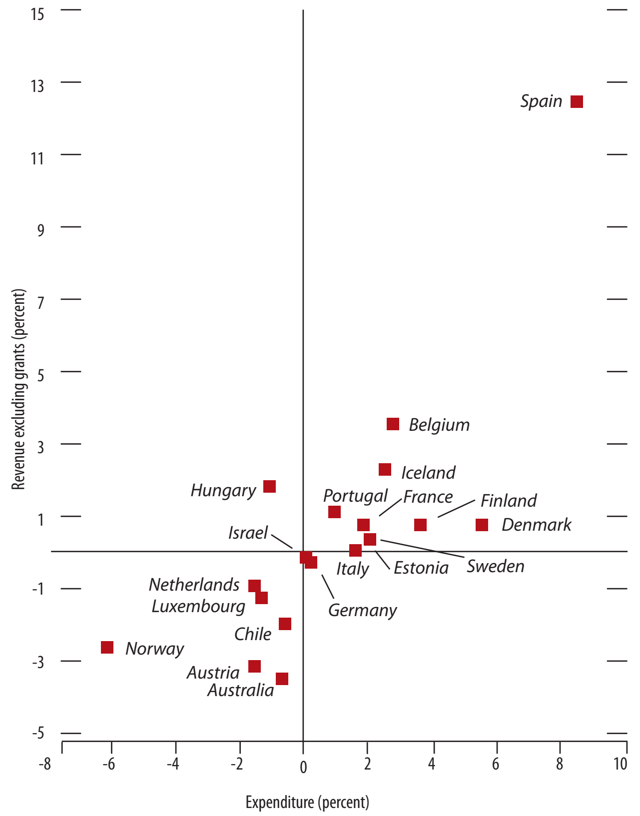
Figure 1.1. Subnational Revenues and Expenditures as Shares of General Government, 2006



Source: GFS data.

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



Source: GFS data.

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2 The IMF's Advice on Designing and Managing Fiscal Decentralization

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

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

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

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

Institutional and political arrangements at the subnational level—although not immediately related to the IMF mandate—have also been taken into account in IMF advice on fiscal decentralization. In countries where there are too many subnational entities (or they are too small to be viable), issues of spending and tax assignments cannot be properly addressed in the absence of some form of territorial reorganization, whereby subnational governments are streamlined and their roles refocused. This situation has been noted in Liberia and the former Yugoslav Republic of Macedonia (FYR Macedonia), for example. Similarly, merit may be found in increasing local participation in economic decision

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making outside of formal channels, for example, by seeking increased consultation with local communities. Although not a substitute for devolution of actual fiscal powers, these and similar steps might mitigate the political imperative driving fiscal decentralization, allowing more time to prepare properly for its design and implementation. Finally, sound and viable political mechanisms must be in place to identify and express local preferences—this is the channel through which fiscal decentralization can deliver its promise of better services. In this respect, political mechanisms such as local elections should be in place to help local preferences to be revealed and accountability to subnational constituents to be established. As the background information in Chapter 6 notes, introducing the local election of mayors contributed to the success of fiscal decentralization in Colombia.

Defining Spending Responsibilities

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

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

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

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

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

[2]In practice decentralization often does not involve a clean transfer of new responsibilities, but an adding of new layers of responsibility for local governments.

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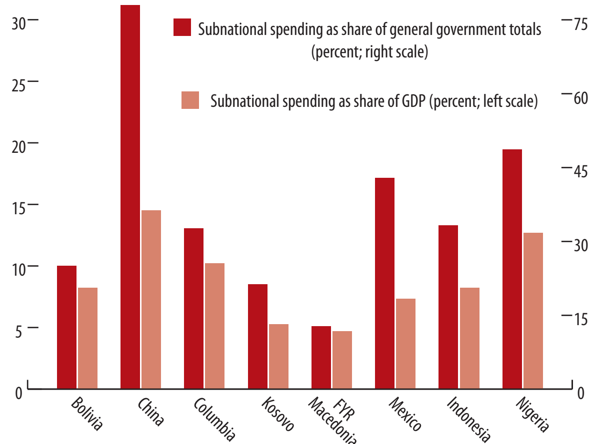
Figure 2.1. Subnational Spending in Case-Study Countries



Source: Case studies in Part II of this occasional paper.
Note: Data for the Democratic Republic of the Congo and Liberia are not available.

definition and execution is lacking. Lack of clarity may be related to a number of factors. First, existing constitutional and legal provisions on the role and authority of the different government levels may be unclear or inadequate. Second, there may be duplication of tasks and weak coordination between the different tiers in implementing their responsibilities, possibly resulting in excessive spending and waste. Third, lower levels of government may display insufficient involvement and ownership, and when providing politically sensitive social programs, may opt for suboptimally low levels of services, relying on the center to become the natural "financier of last resort."

Lack of clarity in spending assignments is, therefore, a root cause of soft budget constraint problems. One immediate implication of unclear spending assignments is that accountability is weakened: if voters do not know which level of government to hold responsible for possible shortcomings in service provision, politicians can play a blame game and avoid taking responsibility and corrective action. The difficult situation of health care in Italy is a case in point: while the center sets standards and largely provides financing, the regions are mainly responsible for administering service provision. Repeated episodes of "ex post" bailouts have occurred, as regional financing needs for health have exceeded the center's allocations (Bordignon, 2006).[3]

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

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

[3]These issues were also covered in IMF (2000).

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