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International Lessons in the Design and Practice of Fiscal Decentralization

Jorge Martinez-Vazquez

International Center for Public Policy

Andrew Young School of Policy Studies

Georgia State University

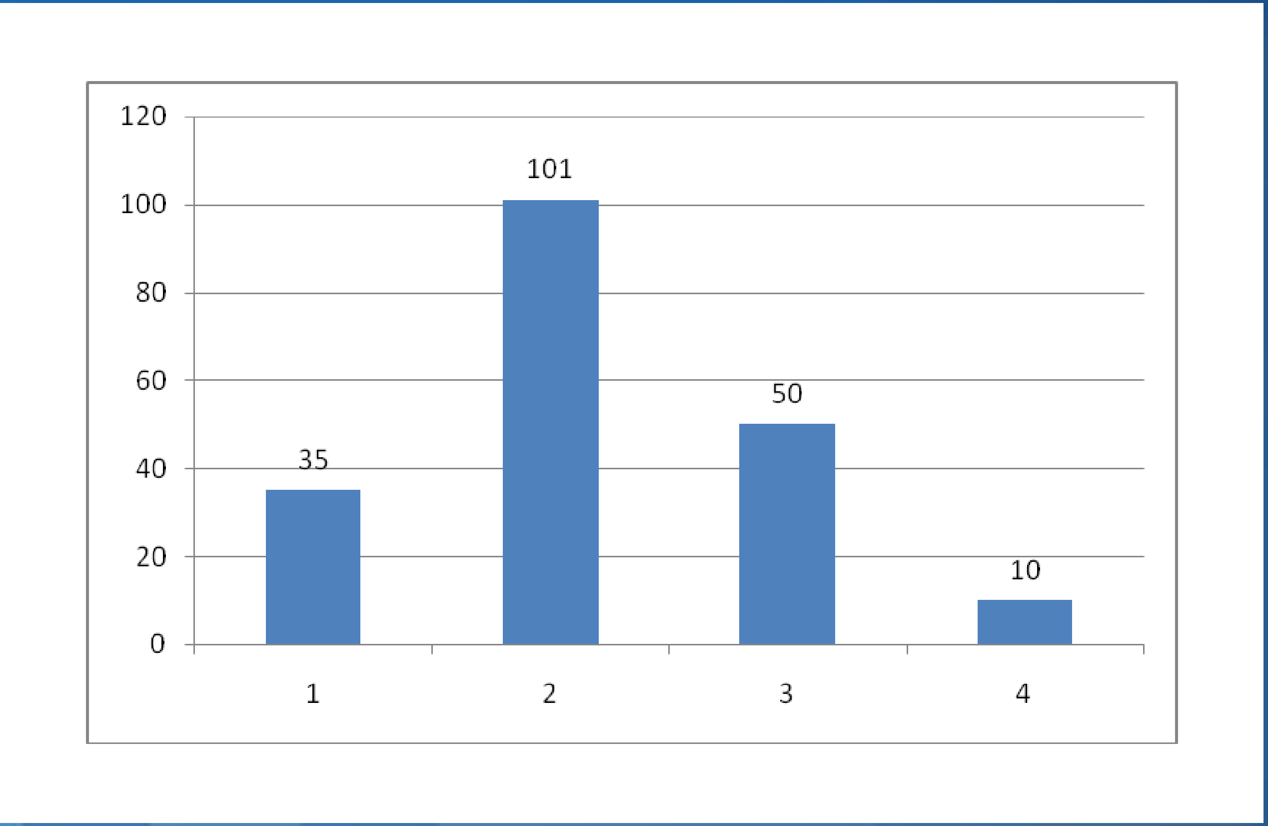
Outline of the presentation

- Vertical structure of government issues
- Expenditure assignments
- Revenue assignments
- Transfer design
- Borrowing issues
- Sequencing fiscal decentralization reform
- Obstacles to successful decentralization

Vertical Structure

- Sub-national government fragmentation: a commonly (perceived?) problem
- Several dimensions of fragmentation: multiple tiers (less well studied) and "excessive" number of units at any level
- As to be expected, the degree of jurisdictional fragmentation varies widely from country to country (sample of 197 countries)

Sub-national Government Tiers per Country



Best practice

- Balance two conflicting objectives in classical fiscal federalism:

  - Welfare gains from smaller governments because of the better matching of needs and preferences of residents, and

  - Economies of scale in the production and delivery of public services (many of these economies of scale achieved at 10,000 and above residents; but some exceptions exist)

- More recent insights to take into account:

  - Smaller governments bring closer accountability of public officials, and in the end accountability is paramount

  - But also higher friction/costs from complexity of multiple tiers and high fragmentation

EXPENDITURE ASSIGNMENTS

Multi-dimensional nature of expenditure assignments

- Who (what level of government) is responsible for the different public services?

- Multi-dimensional nature of expenditure assignments :
  - Responsibility for <u>policy and regulation</u>
  - Responsibility for <u>financing</u>
  - Responsibility for <u>provision/administration</u> (personnel vs. other charges; recurrent vs. capital responsibilities)
  - Provision vs. <u>production (delivery</u>) of the service.

Market Failures and the Role of Government

- Markets may lead to an:
- Inequitable distribution of income
- Unstable economic environment
- Inefficient allocation of resources.
  (Monopoly, imperfect information, public goods, externalities)

- So market failures call for government intervention in these three areas:
- Income redistribution (mostly central)
- Macroeconomic stabilization (mostly central)
- Allocation of resources (subnational & central).

- Efficiency and the "Subsidiarity Principle" (exceptions-externalities, scale economies etc.):

Elements of a sound expenditure assignment

- Importance of a clear and stable assignment
- There is no single "best" assignment
- The efficiency criterion plays a critical role in expenditure assignment
- Responsive and accountable local government is a precondition for expenditure decentralization
- Recognizing the multi-dimensional nature of expenditures

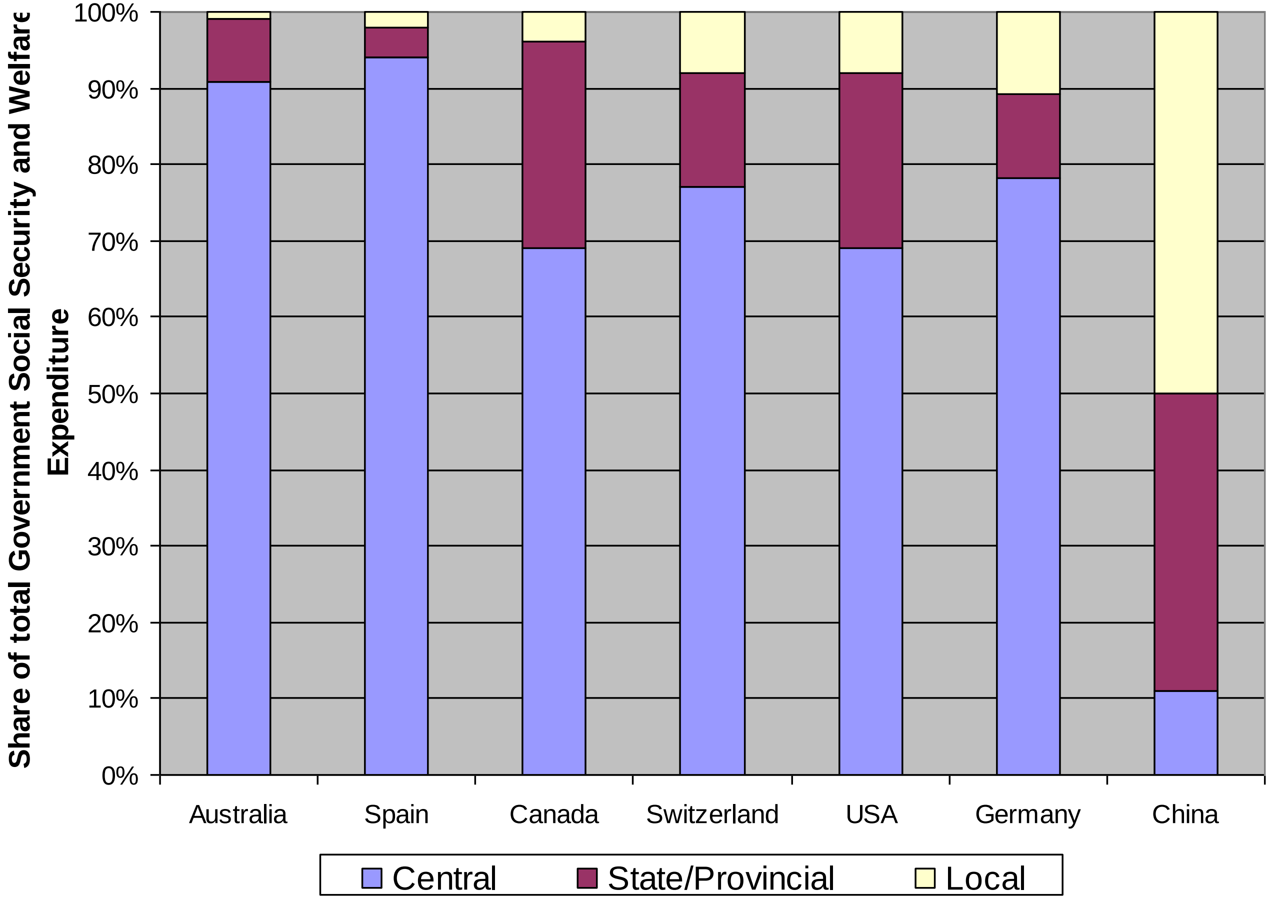
Sample Expenditure Assignments

Box 1
A Representative Assignment of Expenditure Responsibility

Function	Regulation	Financing	Provision / Administr.	Production
International affairs	N	N	N	N
Defense	N	N	N	N
Public order and safety	N,R,L	N,R,L	N,R,L	N,R,L
Primary and secondary education	N,R,L	N,R,L	R,L	R,L,P
Higher education	N,R	N,R	N,R	N,R,P
Health care	N,R,L	N,R,L	R,L	R,L,P
Social security and welfare	N,R	N,R	R,L	R,L
Community services (water, sewer, refuse, fire protection)	N,L	L	L	L,P
Highways, roads and streets	N,R,L	N,R,L	N,R,L	N,R,L,P
Parks, recreation and culture	N,R,L	N,R,L	N,R,L	N,R,L,P
National transportation / communication networks	N	N,R	N,R,L	N,R,L,P
Regional/local public transportation	R,L	R,L	R,L	R,L,P

Note: N demotes National Government; R denoted Regional Government; L denotes Local Government, and P denotes the private, non-government sector / civil society.

The division of expenditure assignments can be approximated in practice by expenditure shares at different levels: An example with **social security and welfare** expenditures



Common Problems With Expenditure Assignments

1. Lack of a Clear Delineation Between the Public and Private Sectors
2. Lack of a Formal Assignment
3. Assignment of Responsibilities to More Than One Level of Government
4. Lack of a Mechanism for Coordination and Conflict Resolution
5. Inefficient Assignments

REVENUE ASSIGNMENTS

The relevance of revenue assignments

- Accountability and effectiveness requires meaningful revenue autonomy: the perils of transfer dependency – “raiding the commons”; fiscal irresponsibility.

- Which taxes should be allocated at the subnational levels? How much revenue autonomy is needed? This is what is known as the “tax assignment problem”.

- Basic objective is to provide adequate financing to subnational governments. However, revenue adequacy per se is not a guide for tax assignments.

Theory of Revenue Assignments

- Guidance by the "Benefit Principle" but limitations due to identifying users or excluding non-payers; externalities, equity issues
- Finding substitute arrangements we need to address two sets of issues: (1) how to assure the efficient level of service provision; and (ii) how to use alternative tax sources.
- Two fairly unconnected strands in the literature:

(i) optimal expenditure decisions--tax autonomy brings accountability (tax autonomy *at the margin;* "hard" budget constraint; etc.

(ii) optimal taxation theory: marginal cost of funds

What form of tax autonomy? What is the best practice

- Open or closed list of subnational taxes? good reasons to limit choice--a closed list approach is preferable .
- Exclusivity versus cohabitation of bases? Cohabitation offers more choices and meaningful sources of revenue …vertical tax externalities are manageable.
- Autonomy over the structure of the tax bases and tax rate levels? Autonomy only to set tax rates is preferable for simplicity—compliance costs, and accountability.
- Responsibility for administration /enforcement: Subnational administration can enhance accountability but can be less cost effective. Administration responsibilities are context specific.
- Tax autonomy does not need decentralized tax administration

A long list of desirable properties for subnational taxes

- Besides revenue potential, general desirable properties for all taxes: (i) buoyancy/elasticity; (ii) fair burden distribution; (iii) be relatively efficient/ low distortions; (iv) low administration and compliance costs; and (v) be politically acceptable.

- Several other—somewhat overlapping-- desirable properties make them more adaptable to the benefit principle (McLure (1998), others): (i) geographic neutrality-- not distorting location, not interfering with commerce, and not exportable; (ii) evenly distributed, relatively immobile, and stable bases; (iii) high visibility and transparency; and (vi) administrative feasibility at the subnational level

Selecting revenue instruments for subnational governments

- Best choice: Ample consensus that **user charges and fees** are the most appropriate source. However, it is not generally feasible to finance all local services with user charges

- Better choices :

  -Property taxes and betterment levies

  -Vehicle and transportation taxes

  -Flat-rate piggyback income taxes

  -Local business taxes

  -Some excise taxes

- Worse choices:

  - VAT and CIT

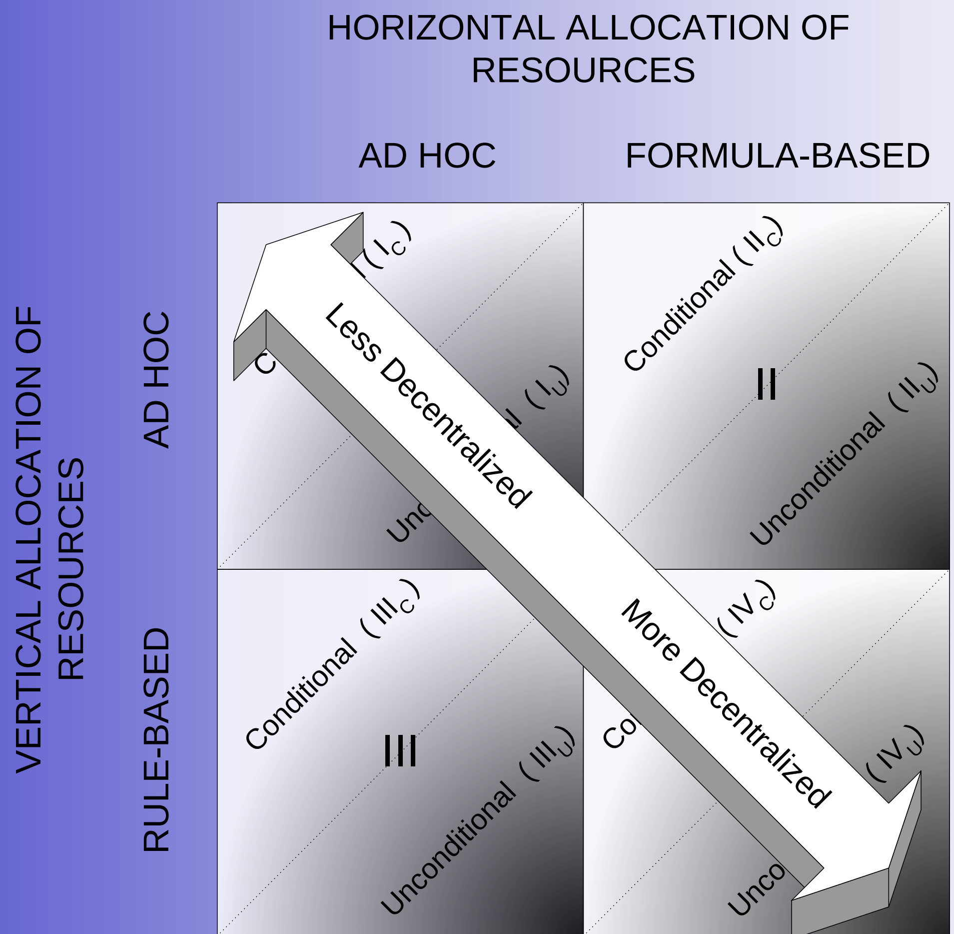
TRANSFERS DESIGN

- EQUALIZATION GRANTS
- CONDITIONAL TRANSFERS
- CAPITAL TRANSFERS

Dimensions of Intergovernmental Transfer Schemes

- Purpose: closing vertical and horizontal fiscal gaps and encouraging expenditures in particular areas including infrastructure
- Determination of transfer pool
  - Ad hoc, share of revenues, full or partial reimbursement, need-driven
- Open-ended or closed-ended
- Allocation of transfers between government units
  - Derivation-based revenue sharing, formula-based, ad hoc, matching grant, full reimbursement
- Conditional *versus* unconditional
- Nature of grant: matching grant or lump sum

A taxonomy of intergovernmental grant systems



Design of **Equalization Grants**

- Determine the goal of equalization: What is to be equalized and by how much
- Determine the pool of funds necessary for equalization and funding mechanism
- Determine where the funds are to come from (from central government versus other sub-national governments—Robin Hood or fraternal systems)
- Establish a distribution formula
- Determine institutions for implementation (Clarify transition ("cold turkey" vs. "hold harmless") and monitoring

Distribution Formula

The most general equalization grant formula equalizes horizontal fiscal disparities across jurisdictions measured by the "Fiscal Gap," which is defined for jurisdiction *i* as

- *Fiscal Gap = Expenditure Needs – Fiscal Capacity*
- For those jurisdictions with a negative fiscal gap (FG) or one that is zero, the system will set it equal to zero (FG=0.)

Basic Architecture		Country examples
Equalize only expenditure needs (e.g., enable similar levels of service affordability)		**India, Italy, Nigeria, South Africa, and Spain**
Equalize only fiscal capacity (e.g., enable similar levels of fiscal resource availability)		**Canada**
Equalize both (e.g., enable similar service at similar levels of taxation)		**Australia, Germany, Indonesia, India, Japan, Korea, Latvia, Russia, Uganda, United Kingdom**

Approaches to Measuring Expenditure Needs

- Lagged expenditure values;
- Equality or equal per capita expenditure norm;
- Weighted indexes of expenditure needs;
- Per-client (top-down) financial expenditure norms;
- Traditional (bottom-up) physical expenditure norms; and
- Regression-based Representative Expenditure Systems (RES).

Approaches to measuring fiscal capacity

- Lagged own revenue collections
- Basic proxies for the local ability to tax/ability to pay (such as personal income or Gross Regional Product)
- More sophisticated measures of fiscal capacity, such as the Representative Revenue System

Issues in the design of conditional grants

Uses of conditional grants

- **Influence (control with positive incentives)** the standard of services being provided by subnational governments; ensure national priorities and standards; address externalities; protect vulnerable groups etc.
- Leveraging resources through **matching** arrangements for conditional grants
- **Block grants** - more general conditionality and therefore respect for subnational autonomy –e,g., spend on education– versus **Specific conditional grant**s with more micro conditionality –e.g., spend on textbooks
- **Access and alloation**: Formula versus discretion

Different forms of conditionality

- Ex ante (Conventional)-- 'how the funds need to be spent.' It implies some forms of micro-management of subnational governments, limits local autonomy, and focuses on inputs
- Ex post (New trend)-- performance-based– 'what is accomplished with the funds.' It implies more local autonomy, and focuses on outputs and possibly outcomes... (but difficulty with measuring performance…)

BORROWING AND DEBT

Advantages of Local Borrowing

- Finance long-lived assets efficiently and equitably
  - Overcome liquidity problems of “lumpy investments”
  - “Pay-as-you-use” financing among different generations of users
- Improve selection of investments
- Increase local revenue mobilization

Local Borrowing Risks

- “Soft” budget constraints
  - Weak fiscal discipline
  - Opportunistic behavior by subnational governments (“deficit shifting”)
  - Moral hazard
- Macro-instability

Improving public financial management

- Monitoring of local debt service and financial ratios at provincial or national levels
  - With weak reporting of "*above-the-line*" information, focus on coverage, budget classification and accounting issues
  - Monitor "*below-the-line*" operations, arrears and contingent liabilities
  - Implement a nationally maintained debt register, including contingent liabilities

Administrative Controls

- Controls include *ex ante* authorization and *ex post* monitoring
- No "bail-out" provisions: National government does not guarantee subnational debt
- Local borrowing rules

Local Borrowing Rules

Type of Restriction	Description	Countries
Affordability Formulae	Ceilings on (i) debt service / local revenues; (ii) debt service / local current saving	Argentina, Brazil, Italy, Japan, Spain, Lithuania, Romania, Poland, Colombia
Indebtedness Formulae	Limit on total outstanding debt / net revenues	Brazil, Colombia, Italy EU
"Golden Rule" Provision	Borrowing for capital expenditures	Brazil, Canada, USA, Austria, South Africa, Switzerland, India
Balanced Budget	Local councils are required to pass balanced budgets	Brazil, Canada, Germany, Netherlands, USA
Local Approval	Local councils are required to approve borrowing for individual projects	Canada, Switzerland, USA

Market-Based Systems

- *Credit quality* determines market acceptance and debt pricing
- Credit ratings
- Supervision and disclosure
- Bankruptcy/work out procedures (including creditor remedies)

Lending to Creditworthy Local Governments

- Specialized Municipal Banks
- Municipal Development Funds
- Bond Market

Thank you