

# CHOICES IN FISCAL FEDERALISM

Mark Gallagher  
Chief Economist  
DevTech Systems, Inc.  
1629 K Street, NW, Suite 1000  
Washington, DC 20006 USA  
Tel: 202/296-8849  
Fax: 202/296-4884  
[www.devtechsys.com](http://www.devtechsys.com)

September 1998

© DevTech Systems, Inc. 1998

**CENTER FOR APPLIED STUDIES IN ECONOMICS**  
A Division of DevTech Systems, Inc.

*The purpose of the Center for Applied Studies in Economics is to analyze DevTech's applied international economic work and to disseminate the lessons learned from that work in ways that are most useful to policymakers, economists, policy analysts, and other development practitioners.*

# CHOICES IN FISCAL FEDERALISM<sup>1</sup>

## INTRODUCTION

This paper develops a comparative analytical framework for discussing the nature of fiscal federalism and decentralization. The framework will help those interested in defining their own preferences for fiscal federalism, which is absolutely essential in planning future institutional and legal changes as part of the decentralization process. The paper takes the approach that fiscal federalism is as much about the distribution of power among levels of government as it is about how public affairs are managed.

## AN AGNOSTIC'S APPROACH

Fiscal federalism refers to the structure of financial and broader relationships between central and subordinate levels of government. The process of altering the structure of fiscal federalism by devolving powers to lower levels of government is generally known as fiscal decentralization. Essentially, fiscal federalism is a state of affairs, whereas fiscal decentralization is a specific process meant to alter that state of affairs. Before we can think about the nature of decentralization we must consider the nature of the fiscal arrangements that are desired, i.e., before setting off on a path of decentralization it is important to have a clear picture of the target structure of fiscal arrangements.

The literature on fiscal decentralization is vast. Much of it has to do either with the economic returns from decentralization, although there seems to be little empirical evidence of a link between decentralization and economic growth, and decentralization as an important component in the process of democratization.<sup>2</sup> Despite the lack of empirical evidence regarding its presumed economic and political benefits, fiscal decentralization has many proponents.

For purposes of this exposition, we take an agnostic's approach. We are neither convinced about the usefulness of decentralization in promoting economic growth and democratization, nor interested in exploring these issues within the scope of this paper. The purpose of the paper is to provide a tool to help define and crystallize preferences with regard to the structure of fiscal federalism for a particular country, and then to consider the factors necessary for achieving that desired state. In World Bank (1995) the case is clearly made that decentralization is a matter of choice, or at least it should be. In conversations with government policymakers, mayors, parliamentarians, and others, I have found that almost all agree that there is a need to decentralize their governmental structure.<sup>3</sup> Indeed, almost all agree to the need for local governments to be "autonomous." The problem, however, is that autonomy, decentralization, and local self-government may all be desirable, yet their definitions and implications are merely starting points for debate.

The decision to decentralize the state — including how to decentralize — is one of public preference. The discussion of this paper is not on the public choice issues of how pressures, interests, and institutions come together to form the resulting revealed preferences, but rather how the "informed planner" might come to conclusions about the type of decentralized system he or she would prefer for the country.

Decentralization essentially is a matter of the devolution of power from the center to the periphery. More precisely, fiscal decentralization generally refers to the devolution of taxing and spending powers from the control of central government authorities to government authorities either at the regional or provincial and the municipal, county, or parish levels. Within a democratic system, we generally extend this model to include devolution of power to “the people,” which they can then exercise via locally elected government. In non-democratic states, power resides centrally with the dictator, the junta, or the party. In non-democratic states, decentralization is not an option, but deconcentration may be.

In our considerations of the distribution of power we generally mean the ability to mobilize resources and to make decisions about how those resources are mobilized and used. The structure of the state is not just *de jure* but also *de facto*. In a very decentralized system, local governments have considerable power to mobilize resources, through taxing authorities accompanied by strong tax bases. These legal authorities may be conferred by the constitution of the land or by way of secondary legislation, the first obviously having more durability than the second, *cet. par.* It is important that we realize that the form of the state in any country reflects, to some extent, decisions made at some time that reflected either prevailing circumstances or the preference of those designing and ratifying the constitution and basic laws.

Krause-Junk and Müller (1993) pose a series of questions regarding the depth and nature of fiscal decentralization, which are of particular relevance to this paper. These are paraphrased and extended below.<sup>4</sup>

*Expenditures:*

1. Which level of government decides the nature of public intervention and expenditure? Where is the legislative competence (e.g., national parliament or local ordinance)?
2. Which level of government is competent or has the power to administer a function? Does local government administer central government programs?
3. Which level of government will budget and maintain financial control over the expenditure in question?

*Revenues:*

1. Who has legislative competence with respect to certain revenue laws? For instance, is local taxation authorized by national legislation or by local ordinance?
2. Which level of government will actually collect the specific tax?
3. Which level of government will budget these revenues? For instance, does shared revenue get budgeted by the central government?

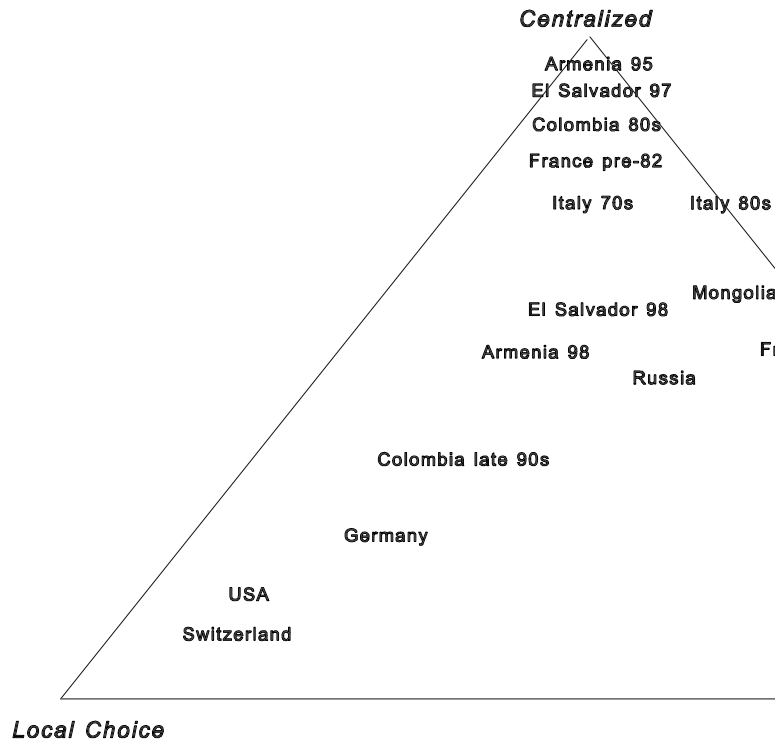
How these questions are answered — how power over fiscal resources is effectively distributed — actually defines the nature of fiscal federalism in a country.

## THE MODEL

In discussions with interested parties it is useful to consider these concepts of decentralization by making international comparisons. The gamut of structures can be represented in a triangular diagram, whose corners represent three distinct forms of state structure. The top corner represents a high degree of central-

## CASE STUDY No. 98/1

ization. The bottom-right corner reflects systems where local governments are mainly responsive to central government funding, legislation, and direction. The bottom-left corner represents those systems where local government is highly autonomous, with its own funding sources and responding to demands of local constituents.



In the upper corner we find countries where the state is totally centralized. All spending and taxing decisions not only take place at the central government level but are also implemented at this level. To the extent local government has taxing powers — and these are effectively limited — they are determined by national legislation rather than by local ordinance.

In the lower left-hand corner, states where considerable power resides with local or regional government are represented. We refer to this form of the state or power distribution as one of “local choice.” The bottom left corner represents a pure form of the local choice model of government, where local government is highly autonomous, its leadership is selected via local election, and it is accountable to the local electorate. In the local-choice model, most “normal” local public services are the responsibility of the local government, which has the legal ability to impose “normal” local taxation. Indeed, local legislation or ordinances authorize these local taxes, which nevertheless must be consistent with the national constitution. Residents elect the governments. There is an adequate local economic base and an institutional capacity to enable local governments to both mobilize resources and to use them to provide public goods and services desired by local constituencies. Local governments mobilize their own resources and decide how they will be used. They prepare budgets that are voted on either by local councils or by the broader local electorate.

In the lower right-hand corner, labeled “principal-agent,” local government operates at the pleasure of the central government.<sup>5</sup> Essentially, the central government can be considered the “principal,” deciding what

## CASE STUDY No. 98/1

resources will be allocated to the provision of services at the local level. In the “principal-agent” model, local government serves at the central government’s behest or at its instruction. Sometimes local government may be elected, but it has so few powers or authorities as to make it incapable of providing services other than those mandated and funded by the central government. If these local governments prepare a budget, this is much the same as any central-government budget entity preparing its annual budget request. A local council or constituency need not review this request. Its approval or alteration is in the hands of a central government entity, such as the Ministry of Territorial Administration.

## COUNTRY EXAMPLES

The states of the world are structured in many different ways. In many cases the structure of the state is the result of historic happenstance rather than design. For instance, the United States of America and Germany were born as federations of individual states. Smaller countries usually, but certainly not always, have tended toward the unitary form of government, where the central government is of primary importance and local government plays a small role. In these small-country, unitary states, where there is regional government, it is often just an agent of the central government, as in Armenia or El Salvador.

The traditional federal republics often fall closer to the “local-choice” model of the state. The desires for governance are expressed at the local or regional level. A large share of resources is generally collected at the regional level, and a high proportion of spending is made at the regional or local levels. In the **United States**, almost all important public education is funded at the local and state levels (the country has 50 states), a third of the country’s tax revenues are collected at these levels, and law enforcement and the administration of justice are overwhelmingly provided at these levels. The House of Representatives and the Senate have much greater power to establish national law, but the states have particular powers reserved to them.

In **Germany** (as of 1989) two-thirds of total government spending takes place at the federal level, with outlays dominated by social welfare and defense. As in the United States, education spending is predominantly the domain of sub-national governments and is dominated by the states (Länder). In Germany the federal government has almost total legislative competence over taxation. Local governments have almost no power to create new taxes or to raise rates. However, local governments are able to impose a surcharge on some federal taxes, in particular the property tax, resulting in differing total rates from location to location. The Länder have almost no tax-creating authorities.

On the chart, **Switzerland** is found deep in the local-choice region, along with the United States. Both countries were formed initially as federations of political units. In the case of the United States, the 13 colonies formed the original union. In the case of Switzerland, three cantons seeking autonomy from Hapsburg rule eventually joined together and later formed the Swiss Federation. Switzerland is even more decentralized than is the United States; in Switzerland, just about every measure of national import is decided upon by cantonal ratification based on local referenda.<sup>6</sup>

It is interesting to note that despite vast regional differences and its history as an amalgam of city-states, **Italy** is a unitary state. Not only is Italy highly centralized, but it has been moving further from its once-limited degree of local autonomy toward the principal-agent model of fiscal federalism. Before the tax reform of the early 1970s, local governments were collecting about 15 percent of total government tax revenues. By the late 1980s this share had dropped to only about 5 percent. Increased transfers from the

central government matched the decline in local government revenues. These transfers, in general, have been tied to the prior distribution of local tax collections. Hence, this change has neither encouraged local tax effort — indeed, local tax effort was explicitly thwarted as part of this reform — nor compensated for regional economic and social disparities. According to Fraschine and Osculati (1991), this switch to dependence on the central government for revenue transfers has led to a great increase in the importance of government spending by central-government agencies.

Local administration in **France** is organized around 22 administrative regions and 96 metropolitan departments, and was highly centralized until the Mitterrand government implemented, in 1982, a devolution plan giving considerably more authority to regions and departments. Today, an elected departmental council administers each department. In addition, each department is composed of *communes*, which total about 36,400 in the country. An elected mayor heads each commune. In France the central government is responsible for almost 90 percent of all government spending, compared to two-thirds in Germany and the United States and only one-third in Switzerland. Despite efforts to reform the state in 1982 and 1986, the central government in France is still quite dominant. The central government establishes the levels and rates of taxation for sub-national levels of government on an annual basis. The role of unconditional grants is rather small compared to Germany and the United States.

Local government in **El Salvador** takes place in municipalities.<sup>7</sup> A mayor as well as a council lead each municipality. The population directly elects the mayor, but only one party wins the council. Basically, whichever party wins the most votes takes the council. In El Salvador, not including the capital city San Salvador, self-generated revenues by local government have been almost insignificant. Until 1998, rather meager transfers from the central government had supplemented these insignificant revenues. In 1995 these central-government transfers to local government came to less than 1 percent (about 0.25 percent) of the central government's total expenditures. There is also departmental government in El Salvador. Each department has a governor who is appointed by the president. The departmental governor has almost no role, other than to rally local political forces and serve as a liaison between mayors, deputies of the National Assembly, and the executive branch of government.

The capital city, San Salvador, being quite large and more advanced than the other parts of the country, can generate more revenues than can other municipalities. The capital has its own police force, although it is small and subordinated to the national police. Some other highly industrialized municipalities have similar police forces, mainly to protect municipal property.

A recent reform in El Salvador moves that country's placement downward from the extreme case of centralized system toward a bit greater real autonomy of local government. In December 1997, the Legislative Assembly passed a law decreeing that 6 percent of the national budget be transferred to municipalities and that the transfers be made according to specified criteria. This method of transfers provides the municipalities with a great amount of resources compared to what they had, and also provides them with the freedom to access these resources without having to jump through political hoops. Prior to this reform, municipalities had little authority to impose taxation, and their effective power was almost negligible. Although their mayors were freely elected, they were dependent upon the largesse of central-government agencies for much of their resources. While this new transfer mechanism goes far in providing Salvadoran municipalities with financial wherewithal, the relative importance of municipalities in El Salvador is still rather small. Services beyond the most basic municipal services are still provided by the central government. The ability to fund investment projects, raise capital, or even generate current tax revenues is restricted.

**Colombia** had been a very centralized state. However, with political liberalization and the free election of mayors in the second half of the 1980s, the country has been moving headlong toward decentralization.<sup>8</sup> Prior to the reform, the president named mayors, and local governments implemented central-government programs with central government funding. Local government was part of the central-government budget system. The Colombians are moving toward the “local choice” model for municipal governments, while the regions and territories have also been decentralized, but toward the “principal-agent” model. Central government’s budget is shared with local and regional governments, which receive transfers and shared revenues amounting to almost 50 percent of the total budget. These revenues are transferred to local and regional governments for specific as well as non-specified uses. In part, these revenues are based upon the size of the population, the degree of poverty, and the schooling needs (schooling is provided by local government, but is mostly centrally funded).

The “principal-agent” model characterizes **Chile**, where the central government is the principal, deciding what should be done at the regional or local level and providing financing for these activities. The subsidiary levels of government serve as the agents of the central government, carrying out the funder’s mandates.<sup>9</sup> Chile, during the 1980s, began an intense battle against poverty. It decided, in part, to combat poverty by both reducing the role of the state and better focusing its resources. These resources were targeted on the needy rather than on providing assistance to the general public. The Chileans focused their battle on improving the basic education and health services provided to its people. Under the principal-agent model it chose to adopt, provincial and local governments provided these basic services under the regulation of, and with funds from, the central government. At this time, neither local nor national government was elected; the Pinochet government, which came to power through a coup d’etat in 1973, was still in office. Today, Chile’s president and congressional representatives are elected, but provincial government remains under central control.

**Armenia**, after gaining independence from the USSR, formed a unitary state, with most executive powers residing in the central government, especially with the president. In the 1995 constitution, considerable mention was made of local government autonomy and the right to elect local officials. The June 1996 Local Self-Government Law established the taxation powers, revenue-sharing, and service-provision mandates that the parliament established for local government. Local councils and mayors are now elected and are to respond to their local electorates if they are to keep their positions.

The diagram shows both the former **USSR** and **Russia**. Under the Soviet system, all local-government officials were Communist Party members. This ensured that party decisions would be smoothly implemented. Not only were the local councils and executive committees subordinate, lower-level institutions of the state, indeed they were subordinate to the party. Now the system of local governance is in flux. The new system is based more on control by individuals beholden to the Federation president but in conflict with local councils that participate in multi-party elections.<sup>10</sup>

## GENERAL RECOMMENDATIONS FOR FISCAL DECENTRALIZATION

In most countries of the world, the structure of fiscal federalism resulted from historical events rather than as a result of design. Yet, in the case of the countries of the Former Soviet Union, there is a conscious need to restructure the state. Rejection of the Soviet system and its replacement with a more liberal constitution, coupled with the newly found independence, requires that the New Independent States, as with many

## CASE STUDY No. 98/1

of the ex-colonial countries of the post WWII era, give serious consideration to the state structure that most suits their own desires and aspirations. Many Latin American countries, too, are actively pursuing decentralization programs. We have already pointed out that some Western European countries — specifically France and Italy — in recent decades have greatly altered their structures of fiscal federalism.

The concept of “subsidiarity” prescribes that the “modern state” should cede its direct role to the organization or level of government closest to the beneficiaries, to the greatest financial and technical extent possible. At the same time, it is generally recognized that certain things can be better done by local government and others by the central government. We refer to this as “comparative advantage,” and we can give general guidance as to its distribution between central and local governments.

For instance, certain traditionally municipal services can usually be provided better at the local level, including:

- Trash collection,
- Street lighting,
- Street paving (local streets),
- Traffic lighting and monitoring, and
- Municipal policing (controversial, especially in smaller countries).

Other functions usually can be provided better at the central government level, such as:

- National defense,
- Border controls,
- International affairs, and
- Education standards.

Certain taxes are usually, and for good reason, collected mainly by local governments, including:

- Property taxes,
- Commercial or business licenses,
- Industrial cess, and
- Local retail sales tax.

At the same time, the following taxes are usually reserved for the central government:

- Import duties,
- Value-added taxes, and
- Corporate income taxes.

In general, policies or taxes that by their very nature affect a variety of jurisdictions should normally be left to central government, or at least super-municipal government. At the same time, policies or taxes that can be limited to specific areas, where the benefits can be limited to single jurisdictions, should usually be left to local government or agencies. Oates (1991) discusses this literature.

## USING THE MODEL TO DEFINE PREFERENCES

Now that we have discussed the “should” of the fiscal-decentralization literature, we can discuss how practitioners can use the triangular model. It can be helpful to policymakers, politicians, mayors, and others to form and express their preferences about the shape they would like for their own country’s system of fiscal federalism.

This model has been applied in conversations with stakeholders in Nicaragua, Mongolia, Armenia, and El Salvador. The process followed, more or less, went along the following lines:

- The issues of comparative advantage were discussed.
- A discussion was held on how fiscal federalism works in other countries, usually countries with which the particular stakeholders were familiar. In El Salvador and Nicaragua, for example, stakeholders were usually interested in how fiscal federalism works in the United States. Armenian stakeholders were interested in Germany and France.
- Stakeholders were asked to indicate where they felt their country should be located on the triangle. Most of the Armenian stakeholders placed their country firmly within the camp of centralized states. Salvadorans, prior to December 1997, also placed their country in this camp. Mongolians generally placed their country somewhat toward the center of the triangle, i.e., indicating a mix of centralism, local choice, and principal-agent.
- Based on the discussion of fiscal federalism in other countries, stakeholders indicated the direction on the triangle map in which they would like their country to move. The Salvadorans and Nicaraguans who were interviewed tended to indicate a desire to move slightly toward the lower left-hand corner, i.e., toward greater local choice but not overwhelmingly so. Colombians in the 1980s clearly expressed their desire to move their country firmly toward the local choice corner. Armenians, who originally were designing a system where local government would be dominated by the central government, greatly adjusted the tenor of reforms and redrafted their law on local self-government toward increased local choice, once the triangle was discussed in detail.

## IMPLEMENTATION

Once some semblance of consensus is formed about the nature of the desired fiscal decentralization, a number of items must be placed on the work agenda. The nature of these items will be determined, in part, by the revealed preferences as demonstrated in the use of the triangle.

Depending on the nature of the preferences and the structure of the national constitution, a *constitutional* reform may be called for. This was perceived as necessary in Colombia and, given the radical nature of fiscal decentralization in that country, it seems that constitutional reform was absolutely necessary. Armenia reformed its constitution in 1995 to specifically include clauses referring to local self-government, yet constitutional reform in Armenia was already taking place, given the need to move from being a Soviet Republic to an independent, multi-party, democratic nation. A similar situation prevailed in Nicaragua, where constitutional reform in 1995 included extending greater financial autonomy to local government. Stakeholders in other countries generally have indicated that the desired fiscal decentralization can be implemented in their country without the need for constitutional reform.

There are a number of reasons for ushering in a thoroughgoing reform by enshrining it in the constitution. Constitutional reform, once implemented, by its very nature is generally more stable than mere legal changes. Thus, it introduces greater stability into fiscal relations and the division of powers. Constitutional reform is a sign of broad consensus since it usually requires much more political support than does ordinary legal reform.

Constitutional reform may not always be desired, however. To move a country closer to the principal-agent model, it is often neither necessary nor desirable. In the case of improving transfers systems, central governments may prefer not to enshrine reform in a constitutional amendment since this will cause budget rigidities, removing discretionary control over resources on the part of both the executive and legislative branches of government.

Whether there is constitutional reform or not, there is a need to clearly specify rules of *governance*. Laws specifying the composition of local government — which, how, and how often local officials and councils will be elected — are basic, and due attention must be paid to them. Rules of governance must be consistent with the national constitution but must be more precise in detailing the exact implementation of the constitution's requirements. Usually a general *local-government code* is developed, either by a central-government entity in unitary systems or by a state or regional entity in federal systems. The respective superior level of legislature then passes these codes into law.

The *institutional capacity* of local government in many cases is very limited. World Bank (1995) points out that local capacities are often not immediately up to the tasks that would be imposed by fiscal decentralization. In great part this is because local government has had little authority or capability to mobilize resources as well as few specific responsibilities to provide services. Weak institutional capacity is often cited by central-government stakeholders in their arguments against fiscal decentralization.<sup>11</sup> At the same time, admitted weakness is cited by mayors and advocates of greater fiscal decentralization as a matter to be resolved with technical assistance, training, and other assistance. At any rate, where fiscal decentralization does take place, it almost always is accompanied by efforts, often funded by international donors, to strengthen institutional capacity at local levels.<sup>12</sup>

Local government *revenue legislation* will be necessary to clearly define the limits to which local governments will be able to tax and collect other fees. In some countries, say, where there is less local choice, all local revenue plans must be approved by the central government's ministry of finance and by the legislature. In other countries a single local-revenue law specifies taxing and fee powers for all local government. In still other countries, enabling legislation provides broad parameters within which local governments may act. In the United States, local taxation is generally only restricted by the national constitution, which does not permit taxation of international trade or interstate trade, nor does it allow local and state governments to impose taxes upon federal properties. Also, state constitutions may limit how county, city, and municipal authorities raise revenues.

Related to the local-government revenues or tax code is the issue of *revenue sharing*. Revenue sharing has a number of advantages and disadvantages. One of the major concerns, however, is how a system of revenue sharing would fit in with the style of the desired system of intergovernmental relations, i.e., with the very topic of this paper. In some countries property taxes are imposed and collected by central government but are wholly or partly transferred to local government.<sup>13</sup> Revenue sharing also takes place with regard to the value-added tax (VAT), such as in Brazil, where state governments implement the tax, although rates and regulations are fixed by the federal government. Bahl and Linn (1992) point out that

revenue sharing of property tax often takes place between central and local governments, while the VAT is often shared with state or regional governments.<sup>14</sup>

Legislation with regard to the *borrowing powers* of local government must also be reviewed. In many countries, local governments are only allowed to borrow from the central government. In other countries, local governments are not specifically allowed to borrow at all. In still others, local governments, states, regions, and municipalities all have the authority to borrow from private lenders, usually through issuing tradable bonds. In some countries, state or regional governments impose borrowing restrictions on local governments, restricting them only to borrowing for “revenue anticipation” needs or to specific capital infrastructure needs.

The central government, as the unit of government most responsible for developing and enforcing macro-economic stabilization policy, has considerable concern about the extent to which borrowing by subordinate levels of government takes place. Regardless of the degree of local fiscal autonomy in a country, central governments will always need to carefully monitor and project local-government finances.

Because of the imbalance of revenue-generating advantages at the central-government level and certain spending advantages at the local-government level, fiscal decentralization usually includes the *transfer* of financial resources from central to local government. These transfers can take many forms, and the degree of control that the central government places on the use of these resources sometimes is prescribed in the constitution or some secondary law. Winkler (1994) discusses the rationale for transfers and their design. In general, transfer laws in countries where the preference is toward local choice will seek to impose few restrictions on municipalities regarding how they use these resources. In addition, transfer laws in these countries will usually be based on strict formulae, including targeting transfers to specified criteria, such as poverty levels, local fiscal effort, and population size. Indeed, these criteria were specified in the recently passed transfers law in El Salvador.

In other countries, where the revealed preference is toward the principal-agent model, transfers are designed with specific central-government objectives clearly stated. In such cases, local governments may be seen as having certain advantages in implementing specific programs, such as road construction, but the central government funds the program and “hires” local government as an implementing agent.

Regardless of preferences, some transfer systems are just not efficient. For instance, “gap-filling” systems, such as in Mongolia and Bulgaria, provide incentive to meddling by ministry of finance staff, lying by municipal governments, and politicking by all.<sup>15</sup> Whatever the system of fiscal federalism chosen, the rules of transfer systems should be clear and transparent and should encourage behavior consistent with good management practices.

As part of the decentralization process, the central government will often need to amend the current *budget process law* or even write a new one in order to appropriately regulate the budget process at the local level. Where local governments are to be given greater autonomy, greater accountability is often a prerequisite. Budget laws can prescribe transparent procedures for budget formulation and discussion at the local level. Posting budgets, voting on or public debate of budgets, and periodic budget reviews at the local level are usually important aspects of this type of law. Where the principal-agent model is dominant, the budget law may prescribe how, within central-government regulations, local budgets will be developed, presented to central-government authorities, and included in the central-government budget submitted to the legislative branch for approval. The structure of the budget law needs to be consistent with the preferred structure of fiscal federalism in the country.

## CASE STUDY No. 98/1

Most countries have a *treasury law*, which regulates how fiscal funds are to be managed, who will manage those funds, how public debt will be issued, and how cash balances will be managed. In federal systems, or systems of extreme local choice, central-government treasury systems are irrelevant to local-government treasury operations, although these are usually regulated by regional (state or provincial) legislation. In some countries, even where local choice is strong or considered desirable, treasury operations for local governments are managed by the central government. This has been the trend of late in International Monetary Fund-supported technical assistance programs in Central Asia and the Caucasus.

It is very important that treasury regulations not discourage effective management by local officials. If local governments that are efficient in collecting and remitting tax receipts are made to subsidize less well-managed municipalities or even the central government without receiving adequate compensation, there will be undesired consequences. These efficient local governments will likely loosen their management and the entire fiscal system may deteriorate. Receipts will be collected slowly, expenditures will be made as rapidly as possible, and either government borrowing will become rampant or expenditures will be rationed by treasury officials.

## CONCLUDING REMARKS

Despite all the reasons for or against fiscal decentralization, the decision to decentralize is basically preference-driven. How preferences are discussed, formed, and articulated is an important step in the process. It is hoped that the analytical model presented in this paper can serve as a useful tool for those seeking to clarify preferences in fiscal decentralization and for defining an appropriate work plan for initiating the decentralization process.

Once preferences have been clearly articulated we can begin the arduous tasks of legal drafting, program design, capacity development, public education, and general institutional reform that will lead in a coherent and consistent manner to the desired structure of fiscal federalism.

## REFERENCES

Bahl, R., and J. Linn (1992) *Urban Public Finance in Developing Countries*, published for the World Bank, Oxford University Press.

Bidus, Mark (1995) *Desarrollo Municipal y Democracia en Centro América*, USAID, Central American Programs, Guatemala, August.

Bogetic, Zeljko, and Arye L. Hillman (1995) *Financing Government in the Transition*, World Bank, Washington, DC.

Campbell, Tim, George Peterson, and Jose Brakarz (1991) *Decentralization to Local Government in LAC: National Strategies and Local Response in Planning, Spending and Management*, World Bank, Washington, DC.

Casteñeda, Tarsicio (1990) *Para Combatir la Pobreza*, Centro de Estudios Públicos, Santiago, Chile.

**CASE STUDY No. 98/1**

Council of Europe (1994) *Local and Regional Self-Government Structures in Central and Eastern European Countries*, informal meeting, Warsaw, Poland.

Espinoza, José, and Mario Marcel (1994) *Descentralización Fiscal: El Caso de Chile*, Comisión Económica para América Latina y el Caribe, Naciones Unidas, Santiago de Chile.

Fraschine, A., and F. Osculati (1991) "Controlling Local Government: The Italian Experience," in J. Owens and G. Panella, eds., *Local Government: An Institutional Perspective*, Organization for Economic Cooperation and Development, North Holland, Amsterdam.

Gallagher, Mark (1996) *Fiscal Policy Making, Planning and Operations*, report to the Minister of Finance, Mongolia, June.

Gallagher, Mark, and Oscar Melhado (1995) "Federalismo Fiscal," in Mark Gallagher, ed., *Bases Fiscales para el Estado Moderno*, Escuela Superior de Economía y Negocios, San Salvador, El Salvador.

Guess, G., W. Loehr, and J. Martinez (1996) *Fiscal Decentralization, Economic Growth and Democracy: Literature Review and Methodology for Case Studies*, draft proposal submitted to the U.S. Agency for International Development for funding under its CAER II project.

Krause-Junk, Gerold, and Regina Müller (1993) *Fiscal Decentralization in Selected Industrial Countries*, UN Economic Commission for Latin America and the Caribbean, Santiago, Chile.

Martínez-Vázquez, Jorge (1995) "Central and Local Government Tax Relations," in Zeljko Bogetic and Arye L. Hillman, eds., *Financing Government in the Transition*, World Bank, Washington, DC.

Oates, Wallace (1991) *Principals of Fiscal Federalism: A Survey of Recent Theoretical and Empirical Research*, Center for Institutional Reform and the Informal Sector, University of Maryland, Working Paper No. 21.

Owens, J., and G. Panella (1991) eds., *Local Government: An Institutional Perspective*, Organization for Economic Cooperation and Development, North Holland, Amsterdam.

Wiesner Duran, Eduardo (1992) *Colombia: Descentralización y Federalismo Fiscal*, The Presidency, Government of Colombia.

Winkler, Donald (1994) *The Design and Administration of Intergovernmental Transfers*, World Bank.

World Bank (1995) *Decentralization: Good Results Aren't Automatic*, Development Brief No. 60, August.

## NOTES

<sup>1</sup> In preparing this paper, I have benefitted from comments made by colleagues attending a CASE Technical Seminar held August 28, 1998, and from specific comments made by Jorge Sanguinetti, Tom Miller, Michael Shea, Clarence Zuvekas, and Casey Delhotal. Of course, all errors and omissions are attributable only to me.

<sup>2</sup> See Guess, Loehr, and Martinez (1996). See also Oates (1991).

<sup>3</sup> My own field work has led me to talk about these issues with central government, local government and civil society groups in the following countries: Colombia, Ecuador, El Salvador, Mongolia, and Nicaragua.

<sup>4</sup> Krause-Junk and Müller (1993) discuss fiscal federalism in Canada, France, Italy, Germany, Switzerland, and the United States, and are relied upon to some extent in this paper.

<sup>5</sup> Campbell, Peterson, and Brakarz (1991) develop the concepts of principal-agent and local choice as two opposing poles.

<sup>6</sup> Advocates of decentralization who tout the positive impact on democratization are a bit frustrated by the fact that women only gained complete suffrage in Switzerland in 1972.

<sup>7</sup> See Gallagher and Melhado (1995).

<sup>8</sup> For an in-depth treatment of the decentralization process in Colombia, see Wiesner Duran (1992).

<sup>9</sup> See the description of the Chilean decentralization process in Espinoza and Marcel (1994).

<sup>10</sup> Council of Europe (1994).

<sup>11</sup> Proponents of decentralization often claim that this “justification” for not decentralizing is in fact a ruse by those who wish to keep power centralized at the national government level. Others point out that central governments get the local governments they deserve by specifically hamstringing local government’s ability to pursue legitimate actions.

<sup>12</sup> For a discussion of assistance provided in this area, see Bidus (1995). Also, Campbell, Peterson, and Brakarz (1991) review how international assistance has been provided and make recommendations for its improvement.

<sup>13</sup> Guatemala did this until recently. The property tax has now been entirely devolved to local government. Armenia initiated this system in 1996.

<sup>14</sup> See Bahl and Linn (1992), p. 435.

<sup>15</sup> See Gallagher (1996) for a discussion of transfers from the central to local government in Mongolia. For discussion of a very similar situation in Bulgaria, see Martínez-Vázquez (1995).