CONCEPT OF FISCAL DECENTRALIZATION AND WORLDWIDE OVERVIEW

by

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I. INTRODUCTION

In the last two decades there has been a worldwide interest in decentralization of government in all parts of the world. The pursuit of decentralization is widespread, as both developed and developing countries attempt to challenge central governments' monopoly of decision-making power. In the western world, decentralization is an effective tool for reorganization of the government in order to provide public services cost effectively in the "post-welfare state" era (Bennett, 1990; Wildasin, 1997). Developing countries are turning to decentralization to escape from the traps of ineffective and inefficient governance, macroeconomic instability, and inadequate economic growth (Bird and Vaillancourt, 1999). Throughout post-communist Central and Eastern Europe, decentralization of the state is the direct result of the transition from socialist system to market economy and democracy (Bird, Ebel, and Wallich, 1995). In Latin America, the origin of decentralization is the political pressure from the people for democratization (Rojas, 1999). In Africa, decentralization has served as a path to national unity (World Bank, 1999).

This diversity in the list of factors that have contributed the interest in decentralization reflects institutional differences across countries. Institutional factors, such as political, social, legal, and economic conditions, are generally important for the analysis of public finance issues, but they are especially important for the analysis of fiscal decentralization. The institutional context of fiscal decentralization entails the overall economic development, the nature of the legal system, ongoing process of economic and political reform, the organization of monetary and financial institutions, and tensions arising from ethnic, religious, or economic differences (Wildasin, 1997). This institutional background determines the design of intergovernmental financial system and ultimately affects the outcome of fiscal decentralization reform process.

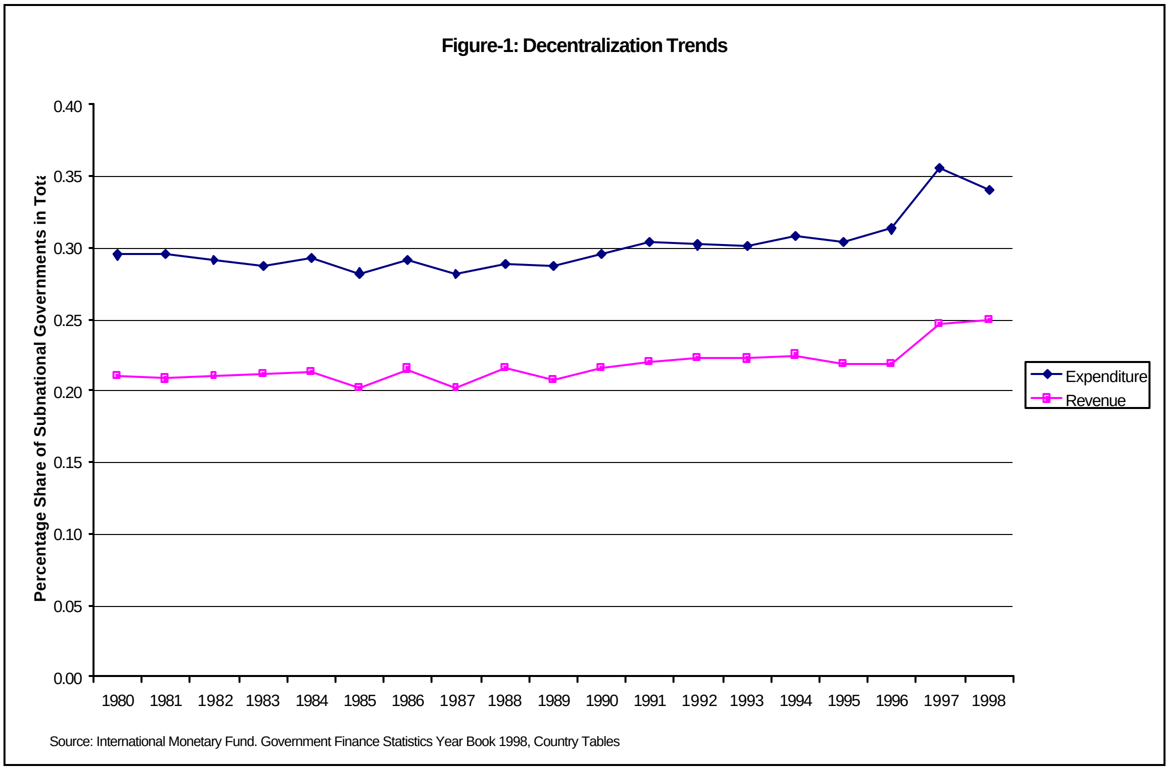
During the last two decades, the economic reforms in different parts of the world largely focused on the role of markets and understated the importance of the organization of the public sector in achieving broader objectives such as economic stability, sustainable growth, and provision of basic public services equitably across people and jurisdictions (World Bank, 1999). The key element underlying the interest in fiscal decentralization is to achieve these objectives by increasing efficiency, transparency, and accountability in the public sector.

In a fiscally decentralized system, the policies of subnational branches of governments are permitted to differ in order to reflect the preferences of their residents. Furthermore, fiscal decentralization brings government closer to the people and a representative government works best when it is closer to the people (Stigler, 1957). The theoretical argument for fiscal decentralization is formulated as "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision."[1] However, much of the established theoretical literature of fiscal federalism has been based on issues that arose within developed countries, particularly the US and Canada and the definition and implementation of fiscal decentralization differ greatly across developing countries due to differences in economic and political structures. This diversity creates challenges to measure and compare the degree of decentralization across countries and to make generalizations about it.

Existing Decentralization Indicators

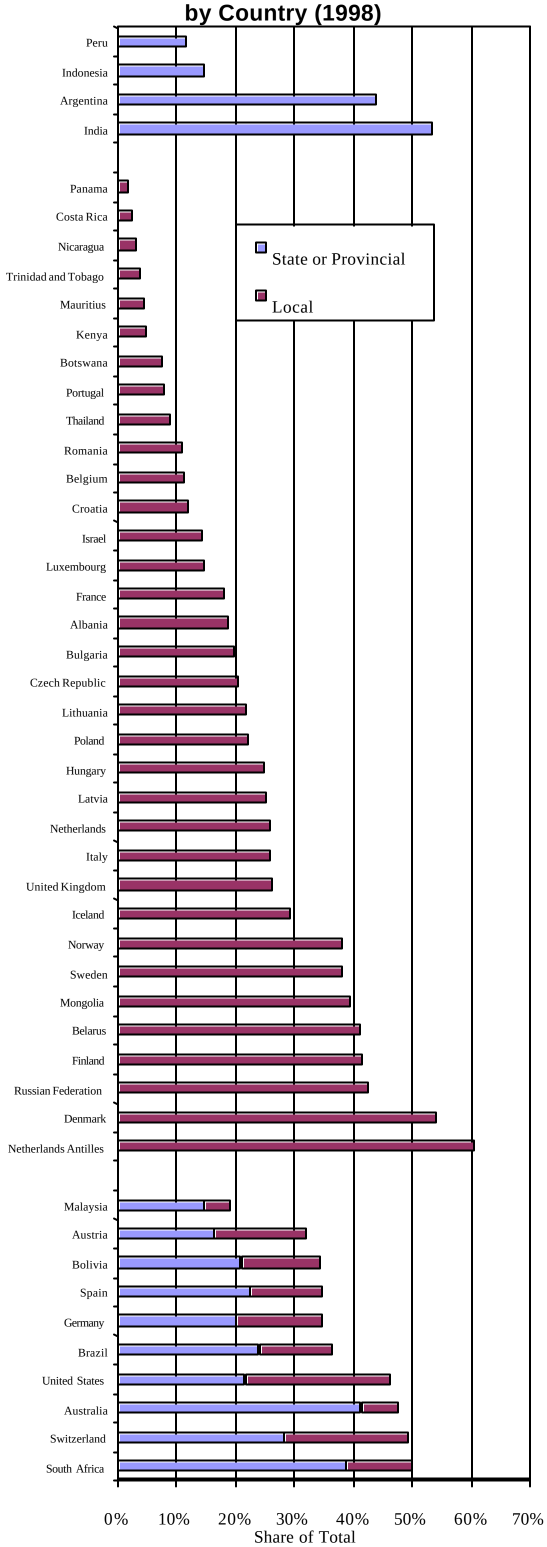
Figure 1 shows the population weighted average shares of subnational expenditure and revenue in total public sector for those 28 countries reported in the Government Finance Statistics of the International Monetary Fund (IMF) between 1980 and 1998[2]. The average expenditure and revenue shares of subnational governments in this group of countries has been increasing steadily over time since 1980.[3]

[1] Oates, 1972.
[2] Argentina, Austria, Bahrain, Belgium, Bolivia, Brazil, Canada, Costa Rica, Denmark, Dominican Republic, Finland, Hungary, Iceland, India, Indonesia, Ireland, Israel, Luxembourg, Mauritius, Mexico, Netherlands, Norway, Romania, South Africa, Spain, Sweden, Thailand, and United States.
[3] Revenue figures are for all revenues other than intergovernmental grants.



Although, the share of subnational governments in total government spending or revenue gives us an idea about the relative importance of subnational governments in total public sector and its change over time, neither of them is a perfect measure of fiscal decentralization. Fiscal decentralization is about empowering people to participate in and influence the decisions made within their close community (Inter-American development Bank, 1997). In a fiscally decentralized system, where citizens' participation in decision-making is encouraged, locally elected governments have the power to pursue the agenda mandated by voters.

Figure-2: Subnational Share of Expenditures by Country (1998)



Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

Thus, a measure of fiscal decentralization should reflect the key characteristics of a fiscally decentralized system, such as the existence of elected local council, locally approved budget, local governments' borrowing power, capacity of local governments to collect taxes (Bahl, 1999). In most countries, intergovernmental relations system does not have these characteristics. For example, in Annex-1 these characteristics of an effective decentralization are evaluated for 14 eastern European and central Asian countries and in 12 of them local governments don't have control over their revenues. Furthermore, in all of them they lack the expertise and technological capability to collect taxes.

Comparing the degree of fiscal decentralization across countries is a complex and multifaceted task that requires identification of subnational autonomy and discretion on expenditure and revenue affairs. Although there has been an effort by both multinational (OECD, 1999) and bilateral (Bird and Banta, 1999) organizations to develop a methodology for a comparable statistics on fiscal decentralization across countries, there is yet no standardized data set.[4]

The Government Finance Statistics (GFS), which has consistent definitions across some countries over time, is the only existing source of data for worldwide cross-country analysis of fiscal decentralization and public finance. Although, GFS is the most widely available internationally comparable data source on subnational finances, it is not an ideal data set for measuring fiscal decentralization. The need to standardize fiscal variables in GFS inevitably leads to a loss of details. For example, although GFS provides a breakdown of expenditures by function and economic type, it is silent about expenditure autonomy. Thus, expenditures that are mandated by the central government appear as subnational expenditure in the GFS. Similarly, on revenue side, the GFS contains information about tax and non-tax revenues, intergovernmental transfers, and other grants, but it does not distinguish whether taxes are collected through shared taxes, piggybacked taxes, and locally determined "own-source" taxes, or what proportion of intergovernmental transfers is conditional as opposed to general purpose transfers.

Although the expenditure share of subnational governments in total government spending is an imperfect measure of fiscal decentralization, in the absence of an appropriate indicator, economists commonly use the percentage share of subnational governments expenditure in total government expenditure as a representative of fiscal decentralization. Figure 2 shows the degree of fiscal decentralization, measured as the percentage share of subnational governments expenditure in total government spending, for those countries reported subnational statistics in 1998. In general, subnational governments (intermediate plus local) in federal countries have executed higher portion of total government spending than their counterparts in unitary countries. In 1998, the average subnational share of expenditures is 38% for federal countries and 22% for unitary countries.

[4] There are data sets available about subnational finances only for selected countries, such as Indian Subnational Database of the World Bank.

Generalizations About Decentralization

The government structure in any country is unique reflecting the historical, social, and cultural evolution of the society. The differences in the structure of government are a natural consequence of these factors. Despite such differences, the structure of intergovernmental financial system in many countries exhibits certain broad patterns, such as the existence of inadequate "own resources"[5] of subnational governments to finance the expenditure functions, the heterogeneity of subnational governments, and the lack of subnational autonomy to levy taxes that are capable of yielding enough revenue to meet local needs (Bird, 1995).

First, subnational governments don't have adequate level of "own resources." The revenues under direct control of local governments invariably less than their expenditures in most countries. Due to lack of data for own source of revenues, Table 1 presents local governments' revenues as a percentage of their expenditures reported in the GFS.[6] The revenues of subnational governments are less than their expenditures in both unitary and federal countries. The vertical imbalance is financed through intergovernmental transfers. However, in many countries, intergovernmental transfer system is not formula based and the central government decide on the amount of transfer on a discretionary basis. Therefore, intergovernmental transfer system in many countries is not transparent and subject to political manipulation, which lead to uncertainties on the part of subnational governments. Such uncertainties discourage fiscal planning and effective budgeting.

[5] Bird (2000) defines own revenues as taxes (i) that are assessed by subnational governments, (ii) for which subnational governments set the rate, and (iii) the revenues accrue to the local government. A revenue may be "own source" even if the tax base is centrally defined and the proceeds are centrally collected.

[6] Since these figures are from the GFS, they are subject to constraints discussed above. For example, the revenue figures include shared taxes and other taxes which their rate and base are determined by central government. However, regardless of local governments' control over revenue resources, Table 1 shows that subnational revenues are less than their expenditures.

Table-1: Local Government Revenues as Percent of Total Subnational Expenditures

Unitary Countries	1995	1996	1997	1998
Albania	5.64%	6.85%	3.69%	4.05%
Azerbaijan	73.97%	68.65%	66.78%	58.30%
Belarus	73.18%	70.63%	77.73%	81.69%
Bulgaria	57.27%	66.19%	65.35%	61.08%
Croatia	98.11%	93.62%	93.83%	89.18%
Czech Republic	72.26%	60.28%	72.74%	75.80%
Denmark	57.10%	57.50%	58.55%	59.25%
Estonia	65.95%	66.97%	73.10%	72.04%
Iceland	87.26%	84.64%	84.29%	85.31%
Kazakhstan	N/A	N/A	78.76%	71.68%
Latvia	75.53%	77.93%	73.82%	72.08%
Lithuania	73.82%	72.22%	71.71%	80.65%
Mauritius	39.51%	39.91%	40.68%	42.52%
Moldova	72.74%	60.50%	58.66%	62.49%
Mongolia	58.46%	56.92%	60.10%	57.32%
Norway	60.96%	62.10%	61.30%	59.71%
Poland	71.52%	66.49%	66.21%	64.83%
Slovak Republic	N/A	89.65%	79.75%	73.69%
Slovenia	77.31%	82.83%	81.88%	80.60%
United Kingdom	27.47%	27.31%	27.91%	29.33%
*Federal Countries**				
Australia	85.73%	83.28%	81.92%	81.80%
Austria	82.74%	85.31%	87.28%	83.89%
Bolivia	85.64%	85.93%	85.85%	85.76%
México	97.37%	97.72%	99.98%	N/A
Switzerland	81.35%	81.91%	81.96%	82.02%
United States	62.43%	63.51%	64.32%	64.51%

* In federal countries local government is the lowest tier of government.
Note: Intergovernmental transfers are not included in local government revenues.
Source: International Monetary Fund. 1998. Government Finance Statistics Year Book 1998, Country Tables.

Second, striking variations appear in the size and capacity of subnational governments in all countries. There are big differences in terms of population, expenditure capacity, and revenue sources across subnational units in almost every country. These horizontal imbalances and fiscal disparities present challenges to fiscal decentralization reforms. Table 2 presents these striking variations across subnational governments' expenditure capacity in a selected group of countries. The coefficient of variation in the last row is an indicator of fast growing economic inequalities across subnational governments in these countries.

Table-2: Measures of Horizontal Imbalance: Per Capita Subnational Expenditures

	India (97) (rupee)	Russia (97) (ruble)	China (97) (yuan)	Argentina (94) (pesos)
Mean	1,946	3,762,600	6,857,226	1,410
Minimum	919	1,336,700	3,027,937	616
Maximum	3,407	30,543,500	27,413,257	4,665
Coefficient of Variation	0.39	1.17	0.77	0.62

Source: India: Author's calculations based on data from the Indian Subnational Database, The Statistical Information Management and Analysis System, World Bank; China: Author's calculations based data from Statistical Yearbook of China 1998; Russia: From Martinez-Vazquez and Boex (2001); Argentina: From Rezk (1999).

Third, subnational revenues are not adequately responsive to changing needs and subnational governments lack the legal authority to levy some taxes that yield enough revenue to meet their needs. The size and pattern of subnational government taxation varies greatly from country to country (see Table 3). In many countries, subnational governments are authorized to assess and collect taxes, but determining tax bases and rates is the responsibility of the central government. For example, income and property taxes are intended to be the most important sources of revenue for subnational governments. However, since there is no well developed real estate markets, the collection of property tax is problematic in most of the developing countries. In many countries, property values are not updated regularly and the inflationary environment is an important hindrance on subnational governments' ability to generate a substantial revenue from property tax. On the other hand, taxes that expand with economic activity and expenditure needs is exclusively collected by central governments in many countries. Exceptionally, in a number of Latin American countries and India, industry and commerce tax are important sources of revenues for subnational governments (Bird, 1995).

Table-3: Tax Revenue Attributable to Each Type of Government

	1997 INCOME TAX		1998 INCOME TAX		1997 PROPERTY TAX		1998 PROPERTY TAX		1997 CORPORATE TAX		1998 CORPORATE TAX	
	C	L	C	L	C	L	C	L	C	L	C	L
Albania	100.00%	0.00%	100.00%	0.00%	99.11%	0.89%	99.66%	0.34%	100.00%	0.00%	100.00%	0.00%
Belarus	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Bulgaria	50.01%	49.99%	50.29%	49.71%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Croatia	61.10%	38.90%	61.05%	38.95%	32.46%	67.54%	33.43%	66.57%	100.00%	0.00%	100.00%	0.00%
Czech Rep.	37.98%	62.02%	38.28%	61.72%	55.68%	44.32%	60.33%	39.67%	100.00%	0.00%	100.00%	0.00%
Denmark	44.88%	55.12%	42.35%	57.65%	39.38%	60.62%	44.53%	55.47%	100.00%	0.00%	100.00%	0.00%
Estonia	44.19%	55.81%	44.26%	55.74%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Hungary	81.27%	18.73%	79.50%	20.50%	49.84%	50.16%	50.00%	50.00%	100.00%	0.00%	100.00%	0.00%
Iceland	46.92%	53.08%	45.63%	54.37%	54.46%	45.54%	54.64%	45.36%	100.00%	0.00%	100.00%	0.00%
Kazakhstan	18.06%	81.94%	15.86%	84.14%	3.30%	96.70%	0.98%	99.02%	100.00%	0.00%	100.00%	0.00%
Latvia	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	0.23%	99.77%	100.00%	0.00%	100.00%	0.00%
Lithuania	21.79%	78.21%	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Mauritius	100.00%	0.00%	100.00%	0.00%	85.10%	14.90%	85.88%	14.12%	100.00%	0.00%	100.00%	0.00%
Moldova	N/A	N/A	0.00%	100.00%	N/A	N/A	1.55%	98.45%	N/A	N/A	100.00%	0.00%
Mongolia	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Norway	40.87%	59.13%	44.10%	55.90%	35.17%	64.83%	40.44%	59.56%	100.00%	0.00%	100.00%	0.00%
Poland	77.17%	22.83%	76.55%	23.45%	0.00%	100.00%	0.00%	100.00%	100.00%	0.00%	100.00%	0.00%
Slovak Rep.	82.91%	17.09%	84.33%	15.67%	24.50%	75.50%	28.68%	71.32%	100.00%	0.00%	100.00%	0.00%
Slovenia	100.00%	0.00%	100.00%	0.00%	0.00%	100.00%	15.53%	84.47%	100.00%	0.00%	100.00%	0.00%

Source: International Monetary Fund. 1998. Government Finance Statistics Year Book 1998, Country Tables.

II. WHY DECENTRALIZATION?

The best starting-point for a discussion about decentralization-centralization debate is the structural arrangement of government. In the centralist structure decision-making power concentrates in the hands of central government bureaucrats whereas in a decentralized system subnational governments have decision-making power on issues that effect their citizens' life. Although decentralization takes different forms, as discussed in the fourth section, political and economic dimensions of centralization-decentralization debate are inexorably linked to each other. In order to have economic gains to be realized from decentralization, it is necessary to have decentralization of political decision-making authority. This logic suggests that the greater the number of political units to which political authority is decentralized, economic gains are likely to be maximized. This is because large numbers of political units mean more choice to individuals to find a community that provides the level of outputs best suited their tastes (Tiebout, 1956).

Therefore, there are two dimensions of the decentralization of public management system: economic and political. The standard economic dimensions of a public finance policy are macroeconomic stability, equity and efficiency (Musgrave and Musgrave, 1984). The efficiency aspect of the economic dimension is the economists' *raison d'être* for fiscal decentralization. Since individual preferences for public goods differ, in a fiscally decentralized system individuals choose to live in a community that reflect their preference, which in return maximizes social welfare. The economic argument of efficiency stems from the fact that due to closeness to the citizens, local governments are able to meet different views and interests of people and allocate resources more efficiently than a central authority. However, efficiency aspect is not the only one in evaluating economic dimension of fiscal decentralization. Intergovernmental fiscal design has important implications on macroeconomic stability and equity. Before starting discussions on political dimension of fiscal decentralization, we discuss issues related to each aspect of the economic dimension of fiscal decentralization in turn.

Efficiency

The fiscal federalism literature argues that there are efficiency gains from decentralization. According to Stigler (1957) a representative government works best when it is closer to the people. In his seminal work on the theory of public finance, Musgrave (1959) separates the functions of government into three: macroeconomic stabilization, income redistribution, and resource allocation. With respect to resource allocation function, Musgrave (1959) argues that policies of subnational branches of governments should be permitted to differ in order to reflect the preferences of their residents. Carrying Stigler's and Musgrave's arguments further, Oates (1972) formulated the decentralization theorem as "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision."

The decentralization theorem is based on the assumption that central government can only provide goods and services uniformly across jurisdictions. Therefore, according to the argument, there are potential efficiency gains from fiscal decentralization. Efficiency gains from decentralization can be allocative and managerial:

(1) *Efficient Allocation of Resources*

Decentralization will increase efficiency because local governments have better information about their residents' needs than the central government. Decisions about public expenditure that are made by a level of government that is closer and more responsive to a local constituency are more likely to reflect people's choices than decisions made by a remote central government.

(2) *Competition Among Local Governments*

If public goods are financed by local taxes that reflect costs, people will shop around for the community that best fits their preferences (Tiebout, 1956). In doing so, they will "vote with their feet." Therefore fiscal decentralization will increase competition among the local governments for better use of public resources. Thus, by serving as a constraint on the behavior of the revenue-maximizing government, fiscal decentralization promotes interjurisdictional competition that limits excessive taxing power of the governments (Brennan and Buchanan, 1980).

While there are potential gains from decentralization, the primary reasons for decentralization in most countries have been political, not economic. For example, in Latin America, decentralization has been an integral part of programs to restore and deepen democracy (Rojas, 1999). In other countries, the poor performance of the central governments in achieving macroeconomic stability, sustainable growth, and adequate level of public services has fueled the interest in fiscal decentralization. Countries, such as India,[7] Philippines,[8] Columbia,[9] and Brazil,[10] have started assigning certain functions of public sector to subnational governments in order to offload the burden from central government's shoulder and rely more on lower level governments, which are often underutilized and have untapped revenue potential (Smoke, 1994).

In some developing countries, decentralization reforms are carried out without institutional and legal support mechanisms and appropriate intergovernmental fiscal

[7] Rao, 1999.
[8] Rood, 2000.
[9] Bird and Fiszbein, 1999.

arrangements to support decentralized system. In these countries, subnational governments fell short of meeting the expectations and decentralization has been blamed for macroeconomic instability, regional inequalities and inefficiencies in the public sector.[11]

Some macroeconomists argue that in a decentralized system, since policymaking becomes a responsibility shared by different levels of government, circumvention of central control over monetary and fiscal policies may have aggravated macroeconomic problems in these countries (Prud'homme, 1995; Tanzi, 1996). According to them, central governments are better equipped in dealing with spillover effects of local spending, inflationary pressures of monetization of local debt and cyclical shocks. To the extent that this line of argument highlights the potential problems arising from decentralization when checks and balances of intergovernmental relations system are not in place, decentralization can make matters worse. A good decentralization policy is not easy to design; clearly, it can be done well or badly (Bird and Vaillancourt, 1999).

Stability

Empirical research on decentralization and macroeconomic governance gives little a priori support to the concerns that decentralization is inherently destabilizing.[12] Recent studies on the relationship between fiscal federalism and macroeconomic governance find that "decentralized fiscal system offers a greater potential for improved macroeconomic governance than centralized fiscal systems."[13] In fact, highly decentralized federal countries, such as Switzerland, Germany, Austria, and USA, have very stable macroeconomic performance and low rates of inflation (Shah, 1997).

The concern over macroeconomic instability in a decentralized system stems from different factors:

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[10] Dillinger and Webb, 1999.

[11] According to Prud'homme (1995), "Argentina provides a good illustration of the 'fiscal perversity' of subnational governments" and constitutional reform of 1988 in Brazil "significantly reduced the central government's ability to conduct macroeconomic policies."

[12] Fiscal decentralization has an impact on different macro indicators, such stability, public sector size, and economic growth. This section discusses the impact of fiscal decentralization on macroeconomic stability, for discussions on public sector size and economic growth see Box 1 & 2.

[13] Huther and Shah (1998) examine statutory aspects of central bank operations, such as the terms of office for chief executive officer, the formal policymaking power, limitations on lending to the government and

(i) local pursuit of independent demand management policies will be largely ineffective in small, open, local economies;

(ii) uncoordinated local monetary policies will pose a severe inflation risk;

(iii) local debt will have national repercussions with an integrated capital market; and

(iv) economic shocks tend to be correlated across localities (Hemming and Spahn, 1997, p. 112).

In traditional Keynesian theory, fiscal policy is an important tool for manipulation of short-run demand, which affects prices and employment levels. Spahn (1998) argues that Keynesian demand management argument has overemphasized the need for centralized macroeconomic policies. According to him, any national fiscal stimulus would be offset by an exchange-rate change in an open economy. With regard to economic shocks, Gramlich (1977) has argued that may shocks are asymmetric and central policy instruments cannot be customized to address localized effects of economic shocks.

To the extent that local debt has national repercussions suggests time-inconsistency problem. In most countries, due to political concerns central governments cannot credibly commit to enforcing hard-budget constraint. Subnational governments may then overspend, expecting to get more resources from the common pool of national resources, either through additional discretionary transfers or bailouts. These can manifest themselves in the form of higher inflation if bailouts are financed through central bank borrowing.

Countries like Argentina and Brazil have had macroeconomic problems due to subnational debt reflects the fact that the old institutional arrangements no longer function under the decentralized regime (Spahn, 1998). In countries without institutional structures that support mature and stable decentralized system, subnational governments may use their fiscal power irresponsibly causing macroeconomic problems. Therefore, in

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other 13 criteria and show that there is a positive correlation between central bank independence and decentralization.

countries undergoing decentralization process, institutional reform is required for an effective mechanism of intergovernmental cooperation.

Institutional reforms that minimize adverse incentives and promote transparency, accountability, and predictability should be executed to have an effective fiscal decentralization (Wildasin, 1997; Bird, 2000). In the absence of these characteristics governments would settle their intergovernmental fiscal transactions on ad hoc basis, responding to the fiscal distress of lower-level units with a variety of special loans, grants, negotiated tax-sharing agreements, directed-credit programs, and other emergency bailouts, rather than establishing firm transparent rules which would govern the form and extent of fiscal flows between central and subnational fiscal and financial institutions.[14] Consequently, in order for the decentralization to be effective and successful, the transfer of fiscal power from the center to the localities must be supplemented by institutional arrangements that monitor the system. Such proper arrangements should enforce hard-budget constraints, motivate responsible behavior by the subnational governments, and reduce the possibility of macroeconomic instability.

It is therefore important to recognize that fiscal decentralization does not necessarily lead to macroeconomic instability. In fact, most countries choose to decentralize *because of* macroeconomic distress—that is in response to large central budget deficits central governments are increasingly relying on local governments for service provision. In some countries, decentralization is part of the fiscal adjustment strategy of the central government—pushing expenditure responsibilities downward without designing an intergovernmental financial system that allocates revenue sources to subnational governments. In the absence of appropriate rules that regulate intergovernmental relations, forcing local governments to provide adequate level of services and maintaining a sustainable decentralized system is a difficult task: when appropriate rules are not in place, the institutions of political control and accountability are not mature, and administrative professionalism and control mechanisms are not developed, fiscal decentralization aggravates macroeconomic problems.

[14] *Op. cit*. Wildasin (1998).

Box -1: Empirical Studies on the Impact of Fiscal Decentralization on Public Sector Size

If greater decentralization increases number of alternative fiscal jurisdictions, any attempt to increase tax rates in one jurisdiction would result in migration of its residents to another jurisdiction (Tiebout, 1956). In Tiebout's analysis, taxpayers migrate to alternative jurisdictions in order to avoid higher taxes and interjurisdictional competition limit excessive taxing power of the governments. Along with the lines of Tiebout, Brennan and Buchanan (1980) developed the “Leviathan” hypothesis, which argues that fiscal decentralization serves as a constraint on the behavior of the revenue-maximizing government. The "Leviathan" hypothesis predicts that the overall size of the public sector should vary inversely with fiscal decentralization; fiscal decentralization increases competition among local governments, which ultimately limits the size of the public sector. Empirical studies have tested the relationship between fiscal decentralization and public sector size and reported conflicting results.

Studies Testing “Leviathan” Hypothesis

Study	Unit of Analysis	Findings
Oates (1985)	Cross-country comparison	No significant relationship
Nelson (1986)	United States	No significant relationship
Marlow (1988)	United States	Strong negative correlation
Grossman (1989)	United States	Strong negative correlation
Joulfaian and Marlow (1990)	United States	Strong negative correlation
Grossman and West (1994)	Canada	Strong negative correlation
Ehdaie (1994)	Cross-country comparison	Strong negative correlation

Box -2: Empirical Studies on the Impact of Fiscal Decentralization on Economic Growth

Little research has been done on the impact of fiscal decentralization on economic growth. Until recently the debate over the merits of fiscal decentralization had been on theoretical grounds of efficiency gains and the empirical studies that have analyzed the impact of fiscal decentralization on economic growth have only appeared recently. Interestingly, these studies generally find that fiscal decentralization is associated with slower economic growth.

Studies on The Impact of Fiscal Decentralization on Economic Growth

Study	Unit of Analysis	Findings
Davoodi and Zou (1998)	Cross-country comparison	Significant negative
Xie, Zou and Davoodi (1999)	United States	Significant negative
Zhang and Zou (1998)	China	Significant negative

Serious methodological issues confront efforts such empirical studies. First, there is no consensus about specification of an empirical model for growth studies. The literature on economic growth suggests that growth is a complex phenomenon with multi-dimensions (Levine and Renelt, 1992). Growth studies are usually criticized on the grounds of a possible model misspecification (Martinez-Vazquez and McNab, 1997). Second, the fiscal decentralization variable used in these studies does not represent the multidimensionality of the issue. Without controlling for subnational governments' autonomy over expenditure and revenue decisions and whether subnational officials are democratically elected, the expenditure share of subnational governments as a fiscal decentralization variable means very little in representing the level of decentralization. Third, regression coefficients may very well be the product of spurious correlation. In regression analysis models, the cause-and-effect relationship runs directly from explanatory variables to the dependent variable. However, if both dependent and independent variables are determined simultaneously, the distinction between dependent and explanatory variables becomes dubious. If there is no unidirectional cause-and-effect relationship, the dependent variable is determined by explanatory variables, and some of the explanatory variables are, in turn, determined by output. Given that there has been extensive research on the role of economic on growth on fiscal decentralization (Oates, 1985; Pommerehne, 1977; Kee, 1977; Bahl and Nath, 1986) and very little research on the causation line from fiscal decentralization to economic growth, it is highly suspected that the regression coefficients reported on these studies is a mere reflection of spurious correlation. Therefore, the theoretical underpinnings of the relationship between fiscal decentralization and economic growth still need to be further developed.

Equity

Equity aspect of a public finance policy concerns with the redistribution of income to achieve a socially just outcome. In its classical definition, redistribution typically implies a transfer of funds to low-income households to achieve more equal distribution of income. In decentralization context, the issue of redistribution has two dimensions: horizontal and within-locality equity. Horizontal equity refers to the extent which subnational governments have the capacity to deliver an equivalent level of services. There are two major factors contributing horizontal inequalities: taxes bases vary significantly from region to region and regional characteristics affect the cost of service provision. In addressing horizontal inequalities redistribution policies are designed to provide more resources to poorer regions. Equalization grant, discussed in the fifth section, is the commonly used tool to correct for horizontal inequalities in most fiscally decentralized systems.

However, providing more resources to poor regions addresses only one aspect of the equity problem. Success in redistribution policies requires special attention to within-locality equity. In designing redistributive policies subnational governments need to be supported by the central government. Otherwise, subnational governments cannot effectively carry out redistributive policies. The potential mobility of households places real constraints on the capacity of decentralized governments to employ redistributive policies. If a local government were to undertake an aggressive program to redistribute income, it would create compelling incentives for low-income people to immigrate into the jurisdiction and for high-income people to move elsewhere. Nevertheless, there is certainly scope for local governments in engaging fight against poverty. In fact, some even argue that local governments are more concerned with poverty and by the nature of their business their actions have redistributive impacts. For example, Pauley (1973) makes the point about greater concern for poverty in a locality than the poor in other places. Furthermore, Sewell (1996) argues that the regulatory power of subnational governments, such as land use, rent controls, user charges, has profound distributional implications.

Political Dimension of Fiscal Decentralization

Institutions of accountability and participation are the key to the success of decentralized decision making. In decentralized systems, local governments' proximity to their constituents will enable them to respond better to local needs and efficiently match public spending to private needs. This entails establishing institutions and mechanisms for citizens voice and exit. Regular elections, local referendums, permanent councils and other institutional structures are some of the easily identifiable and effective tools that may improve the ability of local governments to identify and act on citizen preferences in a decentralized setting.

Issue and project-specific mechanisms for enhancing the flow of information between decision-makers and the public can often be implemented more quickly and easily locally than centrally. It should be recognized that in many countries local governments use a wide variety of techniques in determining people's preferences and having them involved in decision-making and application process. For example, a survey of water supply users in Baku, Azerbaijan revealed that users are willing to pay more for better quality of services (World Bank, 1995). In Bangalore and several other Indian districts, local governments use report cards to evaluate effectiveness of service delivery. In Colombia, municipalities have formed public-private councils to obtain technical assistance from the private sector.

Together with shortening the distance between people and elected representatives and widening the scope for greater transparency about how and where money is spent locally, decentralization makes accountability a more tangible issue. Therefore, the debate about decentralization of government should not be limited only to considerations of economic factors and efficiency. Political accountability of elected officials to voters ensures that government services are responsive to people's needs. If officials are not responsive, the citizen has the choice of either voting out the offending officials and/or migrating to other jurisdictions (to "vote with one's feet").

In democratic societies, public servants are responsible to elected officials and the latter are in turn responsible to the public that elected them in the first place. In this process, political accountability should increase the pressure for more transparent local governance that is more responsive to people's needs. The democratic local governance initiatives currently under way in many countries hold much promise for developing effective systems of public accountability that will ensure that public resources are used efficiently and services are delivered effectively. Studies have shown that citizens' participation and control over government's actions can increase the quality of public management system and that participation of citizens in decision-making process can lead to some identifiable improvements in the allocation of resources (Putnam, 1993; Fiszbein, 1997; Huther and Shah, 1998; Inter-American Development Bank, 1997).

III. DIFFERENCES IN THE DEGREE OF DECENTRALIZATION

It is likely that the average divergence of individual preferences from the tax and service package adopted by the community through its government will be less in small communities of relatively like-minded individuals than it will be in larger, more heterogeneous areas. Therefore, the differences in the degree of decentralization across nations are in part explained by different size variables, such as population (Oates, 1972; Pommerehne, 1977; Bahl and Nath, 1986), land area (Oates, 1972), and GDP (Pommerehne, 1977). Figures 3 and 4 present the variation in expenditure and revenue shares of subnational governments across regions. As presented in figures 3 and 4, high-income countries are relatively more decentralized than others. Subnational governments in sub-Saharan African countries have the lowest level of expenditure and revenue shares compared to other regions of the world. As shown in figures 3 and 4, high income OECD countries have the highest degree of decentralization.

Figure-3: Sub-national Share of Expenditures by Region

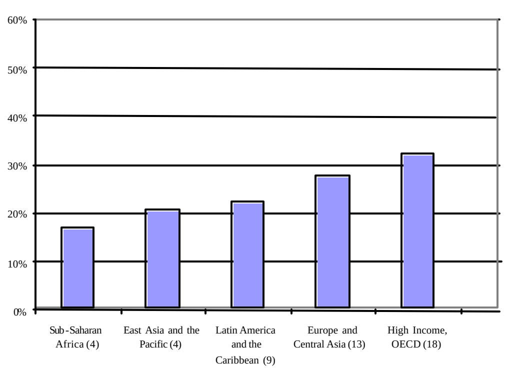
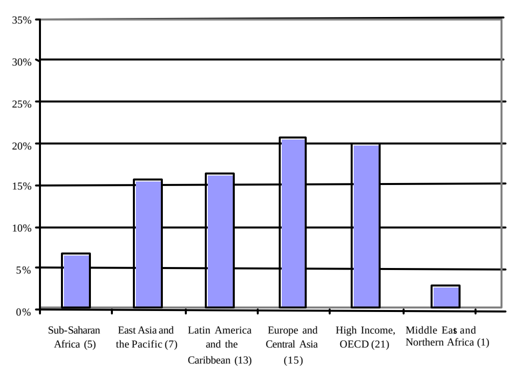


Figure-4: Sub-national Share of Revenues by Region



Note: Simple average of most recent observations in available countries. Numbers in parenthesis indicate number of countries represented.
Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

Figures 5, 6, and 7 present the association between country size and decentralization for federal and unitary countries separately.[15] The regression line in Figure 5 suggests that GDP per capita is positively associated with higher decentralization in both groups. The positive association is stronger for unitary countries. The steeper regression line for unitary countries implies that the increase in income levels has a stronger effect on subnational governments' expenditure levels in unitary countries than it has in federal countries. Also, the higher value of R^2 for this group of countries indicates that regression analysis has a stronger explanatory power than federal countries. Overall, the positive association of decentralization and GDP per capita suggests that an increase in income increases expenditure levels for subnational governments in both groups.

Figure 6 presents the association between population and fiscal decentralization for the same group of countries. It appears that population is positively associated with higher level of subnational governments spending in both groups also. Unlike GDP per capita, the positive association of population and decentralization is stronger for federal countries than unitary countries. The stronger association of population with fiscal decentralization in federal countries is consistent with the argument that as country size gets bigger, subnational governments are expected to play an important role in delivering public services.

Figure 7 shows the relationship between the third size variable and decentralization. The positive slope of regression line suggests that land area is positively associated with higher decentralization. The magnitude of the impact of land area on fiscal decentralization is stronger for unitary countries than federal countries.

The estimation results suggest that size variables have a reasonable level of explanatory power in analyzing the differences in the degree of decentralization across countries. Among the size variables, GDP per capita and population have the strongest effect on the level of decentralization in unitary and federal countries, respectively.

[15] The figures for subnational governments' expenditure share are from GFS used in Figure 1 and the size variables are from World Development Indicators of the World Bank.

Figure-5 A: Decentralization and GDP (Federal Countries)

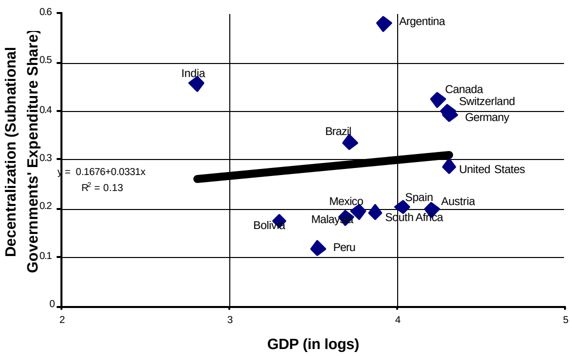


Figure-5 B: Decentralization and GDP (Unitary Countries)

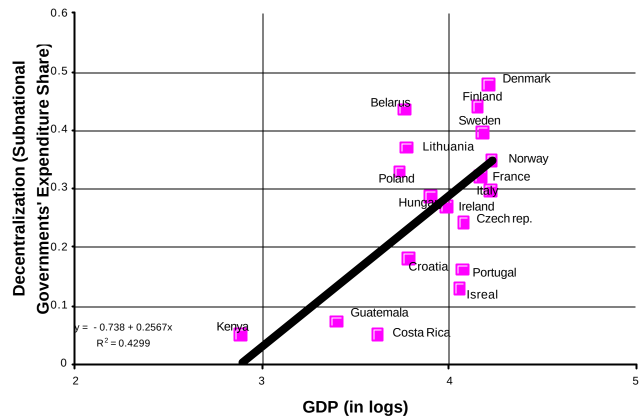


Figure-6 A: Decentralization and Population (Federal Countries)

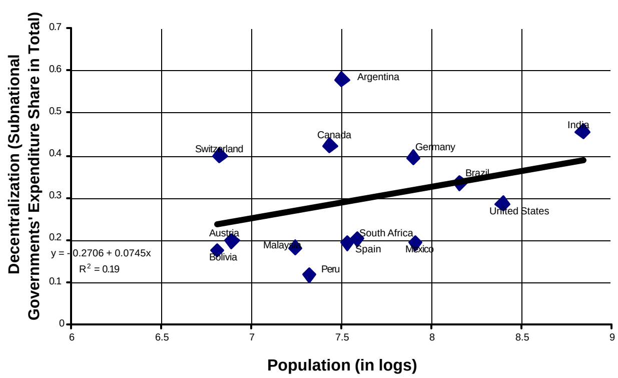


Figure-6 B: Decentralization and Population (Unitary Countries)

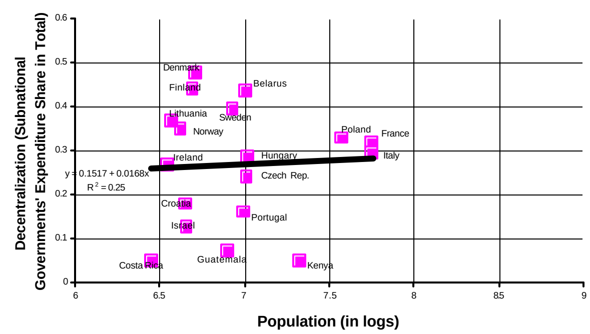


Figure-7 A: Decentralization and Land Area (Federal Countries)

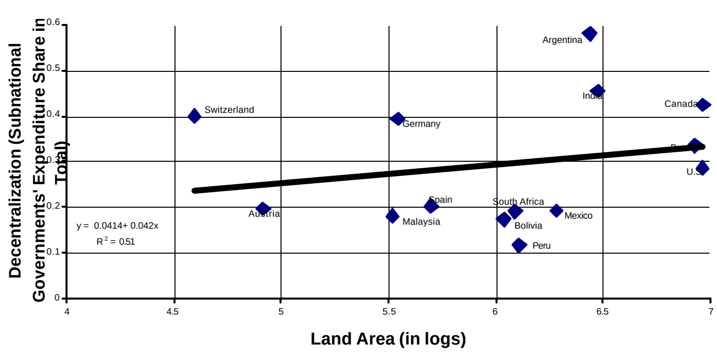
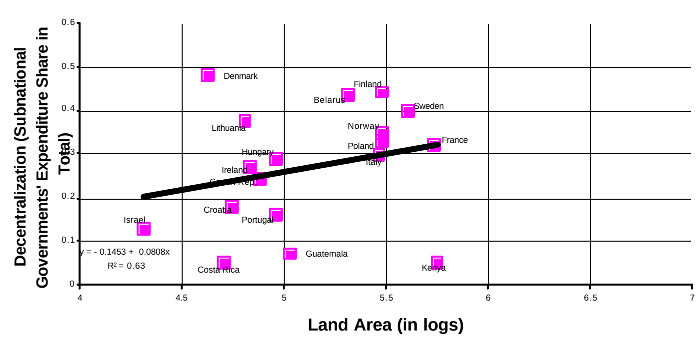


Figure-7 B: Decentralization and Land Area (Unitary Countries)



IV. HOW TO DECENTRALIZE?

The transfer of authority and responsibility over public functions from the central government to subordinate or quasi-independent government organizations covers a broad range of topics (World Bank, 1999). There is no prescribed set of rules governing the decentralization process that apply to all countries. Decentralization takes different forms in different countries, depending on the objectives driving the change in structure of government.

In general, decentralization of public policy making power is transfer of legal and political authority for planning projects, making decisions and management of public functions from the central government and its agencies to subnational governments. Taking advantage of their capacity to tailor services to the needs and preferences of communities, subnational governments are in a good position to provide public services whose benefits are localized. Devolution of resources and decision-making power is expected to result in improvement in the life quality of the population. Power can be transferred on three fronts: political, administrative, and fiscal. Although each type of decentralization has different characteristics, system outcomes, and policy implications, the expected impact in each of them is an improvement in the life quality of the population (see Figure 8). Ideally, this is the case for a good decentralization practice that is people oriented.

While distinguishing among different types of decentralization is useful for highlighting its many dimensions, it is impossible to disentangle the inter-linkages between these three concepts. Political decentralization aims to give citizens and their elected representatives more power in public decision-making. The concept implies transfer of policy and legislative power to citizens and their democratically elected representatives at the local level. Political decentralization is often associated with pluralistic politics and representative government. If necessary, it requires constitutional or statutory reforms, development of pluralistic political parties, strengthening of legislatures, and creation of local political units and encouragement of effective public interest groups.[16]

Administrative decentralization seeks to redistribute authority, responsibility, and financial resources among different levels of government (Rondinelli, 1999). Administrative decentralization can be done in two different ways: functional and areal distribution of power (Rondinelli, 1981). Functional distribution is the transfer of authority to specialized organizations that operate across jurisdictions. An example of functional distribution is creation of field offices within national ministries dealing with health care, education, and transportation issues. Areal distribution of power aims to transfer of responsibility for public functions to institutions within specified geographical and political boundaries. Usually, areal distribution of power is to a subnational government - a province, district, or municipality.

In administrative distribution of power, an essential distinction with important implications on intergovernmental relations system is the form of decentralization: deconcentration, delegation, and devolution.

1. *Deconcentration* involves the shifting of responsibilities from central government agencies located in the capital city to regional offices. Rondinelli (1981) defines deconcentration as local administrations in which all subordinate levels of government within a country are agents of the central authority either appointed by or are responsible directly to central government. This is the least extensive type of administrative decentralization.
2. *Delegation* refers to the transfer of public policy making and administrative authority and/or responsibility for carefully spelled out tasks to institutions and organizations that are either independent or under central government's indirect control. Typically, delegation of functions is by the central ministries to semi-autonomous organizations not wholly controlled by the central government but legally accountable to it, such as state owned enterprises, public utilities, and regional planning and economic development authorities.

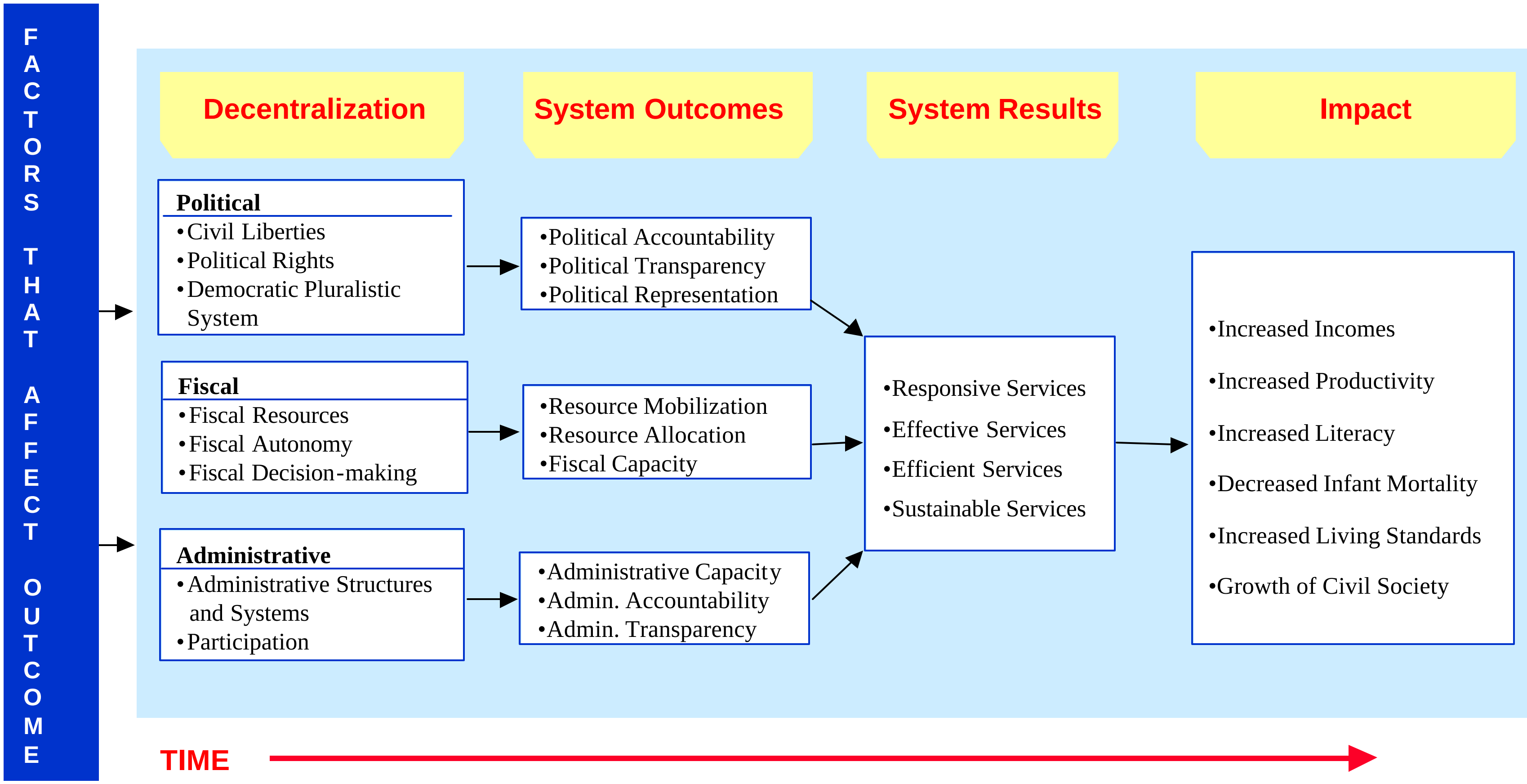
[16] *Op. cit.* Rondinelli (1999).

3. *Devolution* is the most extreme form of decentralization where independently established subnational governments are given the responsibility for delivery of a set of public services along with the authority to impose taxes and fees to finance services. In a devolved system, subnational governments have independent authority to raise their own revenues and to make investment decisions. It is devolution of administrative power that underlies decentralization of power on political fronts.

Devolution is usually synonymous to fiscal decentralization where subnational governments have clear expenditure assignments, substantial budget autonomy, and legally recognized geographical boundaries within which they perform public functions. Although the varieties of fiscal decentralization may exist, corresponding to the degree of independent decision making exercised at the subnational level, the general description of the term fiscal decentralization encompasses the political, economic, and institutional underpinnings of intergovernmental fiscal relations, and ranges from examining the efficiency of public institutions and developing sustainable infrastructure finance, to rationalizing fiscal transfer mechanisms and supporting the social safety net (Ebel and Hotra, 1997).

Therefore, a carefully designed fiscal decentralization policy should not only enhance local autonomy where subnational governments are allowed to act independently within their own sphere of competence in designing revenue and expenditure policies but also promote political accountability, economic efficiency and transparency.

Figure- 8: Decentralization on Three Fronts



Source : Adapted from Parker, Andrew N. 1995,*"Decentralization: The Way Forward for Rural Development?"* Policy Research Working Paper 1475. The World Bank, Washington, D.C.

There is no easy answer to the question of how to design a decentralization strategy to promote transparency, accountability, and efficiency in intergovernmental financial system. Ideally the intergovernmental fiscal system should function leaving little room for ambiguity and negotiations among different levels of government. Therefore, an important component of a decentralization strategy is designing a legal and regulatory framework that would provide guidance to different levels of government in sorting out the roles and responsibilities.

In the process of decentralization, the constitution should enshrine the broad principles on which decentralization is to operate, including rights and responsibilities of all levels of government, the description, and role of key institutions at central and local levels, and the basis on which detailed rules may be established or changed (Ford, 1999). The specific parameters of the intergovernmental fiscal system and the institutional details of the local government structure must be defined in the laws governing relations across governments. Ford (1999) lists the issues that the legal framework of reform efforts should address as:

- Classification of local governments within tiers established under the constitution;
- Broad organization structures and their roles and responsibilities;
- Terms of office, operating powers, procedures, and limitations of the political leadership, as distinct from the civil service;
- The degree of autonomy of personnel policies and administration of local governments;
- The taxing and fiscal administration authority of local governments;
- The borrowing authority and capacities of local governments;
- The distribution of budgeting, expenditure management, accounting, auditing, and reporting requirements;
- Service provision and delivery authority;
- The mechanisms for citizen participation and voice.

V. FOUR PILLARS OF INTERGOVERNMENTAL FISCAL SYSTEM

The design of a decentralized system requires "sorting-out" of public sector responsibilities among different types of governments and the process of sorting out entails transfer of some decision-making powers from central to subnational governments (Ebel, Varfalavi and Varga, 2000). Ideally, to achieve the relevant policy objectives, intergovernmental fiscal system should be designed based on each country's specific circumstances. The policy objectives should include not only the public finance goals of efficiency, transparency, and accountability but also should aim at maintaining national integrity and political stability and being equitable to different people and places. Such a design is based on four pillars: expenditure assignment, revenue assignment, intergovernmental transfers/grants, and subnational debt/borrowing (Bird, 2000).

Expenditures

Expenditure assignment is the first step in designing an intergovernmental fiscal system. Designing revenue and transfer components of a decentralized intergovernmental fiscal system in the absence of concrete expenditure responsibilities would weaken decentralization process (Martinez-Vazquez, 1998). In Latin America and Eastern Europe, many countries have focused only on the revenue side of decentralization and neglected a clear assignment of expenditure responsibilities, which led to weak decentralized systems and fiscally overburdened central governments.

The lack of clarity in the definition of subnational responsibilities has a negative impact on three important respects. First, if the responsibilities are imprecise, the necessary corresponding revenues will remain poorly defined. Second, without clear responsibilities, subnational government officials might prefer to invest in populist projects which benefit them in the short run rather than in projects with long term impact on the region's economy (such as infrastructure, education, etc.). Third, there will be a confusion whether subnational expenditures represent local priorities or centrally determined programs.

The "assignment problem" is the most fundamental issue in designing an intergovernmental fiscal system. The theory provides broad guidance in delineating expenditure responsibilities among various levels of governments. However, the key to the success of a decentralized system is matching expenditure responsibilities with the objectives of service assignment.

A report prepared by the US Advisory Commission on Intergovernmental Relations (ACIR) on Governmental Functions and Processes (1974) lists four principles in regards to setting the right incentives for efficient and equitable delivery of public services. As presented in figure 9, these principles are economic efficiency, fiscal equity, political accountability, and administrative effectiveness. They suggest that expenditure assignments should be made to governmental units that can

> ...(1) supply a service at the lowest possible cost; (2) finance a function with the greatest possible fiscal equalization; (3) provide a service with adequate popular political control; and (4) administer a function in an authoritative, technically proficient, and cooperative fashion.[17]

The principles of expenditure assignment provide a framework to determine whether each function could be best performed by central government or any other level of governmental unit. In more specific terms they relate economic, political, and administrative considerations to the geographic and population size considerations:[18]

1. *Economic Efficiency:* Functions should be assigned to jurisdictions

   (a) that are large enough to realize economies of scale and small enough not to incur diseconomies of scale; [economies of scale]

   (b) that are willing to provide alternative service offerings to their citizens and specific services within a price range and level of effectiveness acceptable to local citizenry; [public sector competition]

   (c) that adopt pricing policies for their functions whenever possible. [public sector pricing]

2. *Fiscal Equity:* Appropriate functions should be assigned to jurisdictions

   (a) that are large enough to encompass the cost and benefits of a function or that are willing to compensate other jurisdictions for the service costs imposed or for benefits received by them ; [economic externalities]

[17] ACIR (1974), p. 7.

(b) that have adequate fiscal capacity to finance their public service responsibilities and that are willing to implement measures that insure inter-personal inter-jurisdictional fiscal equity in the performance of a function. [fiscal equalization]

3. *Political Accountability:* Functions should be assigned to jurisdictions

   (a) that are controllable by, accessible to, and accountable to their residents in the performance of their public service responsibilities; [access and control]

   (b) that maximize the conditions and opportunities for active and productive citizen participation in the performance of a function. [citizen participation]

4. *Administrative Effectiveness:* Functions should be assigned to jurisdictions

   (a) that are responsible for a wide variety of functions and that can balance competing functional interests; [general-purpose character]

   (b) that encompass a geographic area adequate for effective performance of a function; [geographic adequacy];

   (c) that explicitly determine the goals of and means of discharging public service responsibilities and that periodically reassess program goals in light of performance standards; [management capability]

   (d) that are willing to pursue intergovernmental policies for promoting inter-local functional cooperation and reducing inter-local functional conflict; [intergovernmental flexibility] and

   (e) that have adequate legal authority to perform a function and rely on it in administering the function. [legal adequacy]

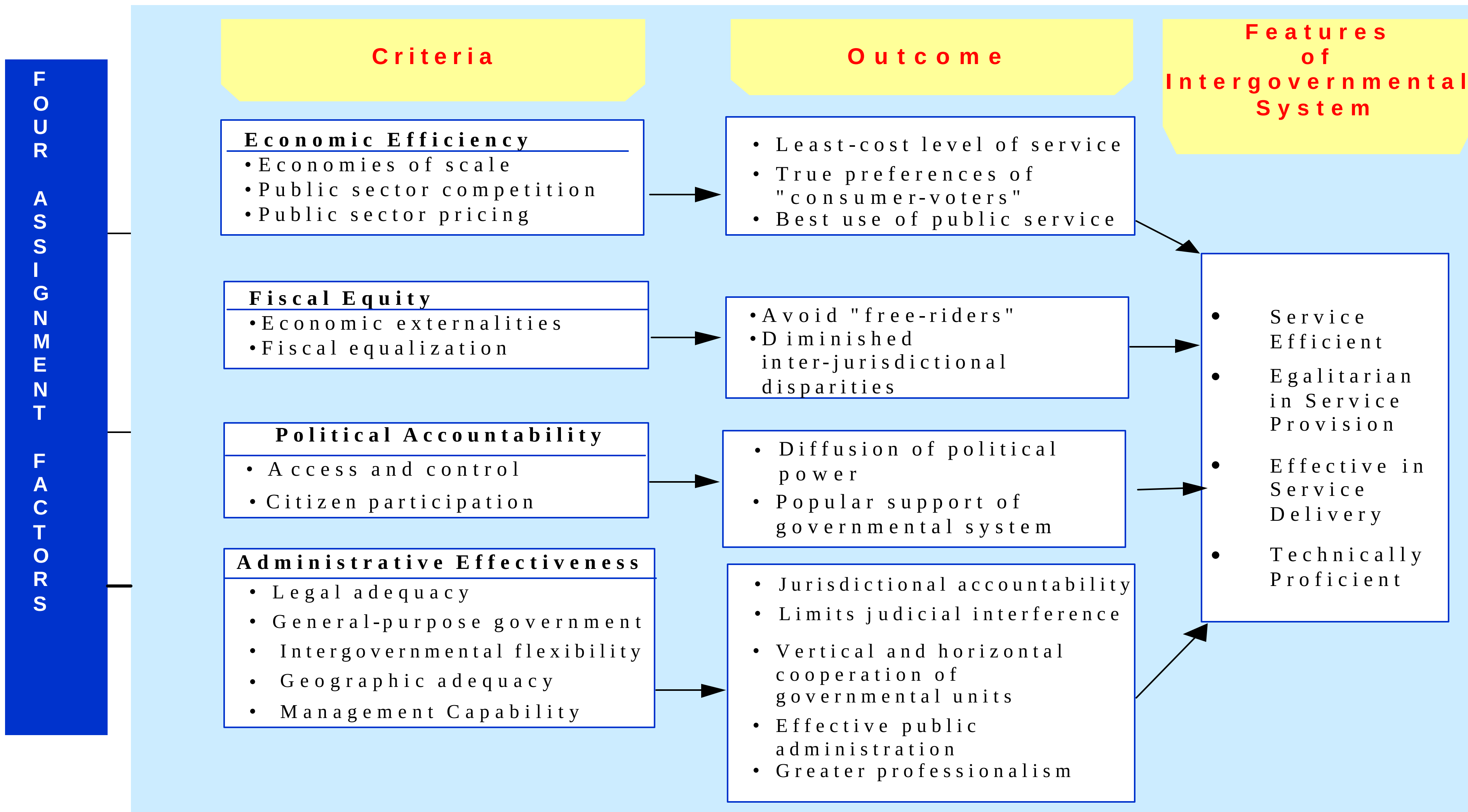
Application of these assignment criteria is not an easy task. These principles might yield conflicting recommendations for expenditure assignment therefore each must be weighted against others in assigning functional responsibilities. For example, political accountability suggests that subnational governments should administer local services, such as education, which require continuous political control. However, if education services are assigned to subnational governments, wealthier jurisdictions will have more financial resources than poor jurisdictions to allocate for this function. Therefore,

[18] ACIR (1974), p. 7.

assigning this function to subnational governments will contradict to fiscal equalization criteria. On the other hand, assigning it to the central government means loss of political control for local residents.

Table 4 provides an overview of expenditures patterns across countries reported in the Government Finance Statistics Yearbook 1998. As seen in the table, functions with high degree of spillover externalities (such as defense and welfare) are exclusively performed by central governments and functions which require high degree of political accountability (such as education) are performed by subnational governments in both federal and unitary countries.

Figure-9: Expenditure Assignment Process



Source: Adapted from ACIR. (1974). Governmental Functions and Process: Local and Areawide. Advisory Commission on Intergovernmental Relations, A-45. Washington, DC.

Tables-4 A & B: Expenditure Shares of Central and Subnational Governments in Unitary and Federal Countries

Table- 4A	Defense		Education		Health		Housing		Police		Recreation		Welfare		Subsidies		Other	
	C	L	C	L	C	L	C	L	C	L	C	L	C	L	C	L	C	L
Albania	100%	0%	20%	80%	70%	30%	68%	32%	100%	0%	65%	35%	81%	19%	63%	37%	75%	25%
Azerbaijan	100%	0%	17%	83%	16%	84%	2%	98%	100%	0%	55%	45%	99%	1%	100%	0%	84%	16%
Belarus	98%	2%	18%	82%	21%	79%	0%	100%	81%	19%	42%	58%	97%	3%	92%	8%	74%	26%
Bulgaria	100%	0%	39%	61%	44%	56%	32%	68%	98%	2%	65%	35%	94%	6%	90%	10%	82%	18%
Croatia	100%	0%	81%	19%	99%	1%	63%	37%	99%	1%	31%	69%	99%	1%	54%	46%	64%	36%
Czech Republic	98%	2%	82%	18%	95%	5%	23%	77%	83%	17%	35%	65%	93%	7%	98%	2%	41%	59%
Denmark	100%	0%	53%	47%	5%	95%	69%	31%	88%	12%	43%	57%	46%	54%	65%	35%	73%	27%
Estonia	100%	0%	45%	55%	97%	3%	1%	99%	99%	1%	61%	39%	91%	9%	56%	44%	62%	38%
Iceland	100%	0%	47%	53%	99%	1%	31%	69%	92%	8%	45%	55%	78%	22%	82%	18%	78%	22%
Kazakhstan	86%	14%	22%	78%	57%	43%	0%	100%	75%	25%	55%	45%	73%	27%	66%	34%	79%	21%
Latvia	99%	1%	28%	72%	95%	5%	20%	80%	93%	7%	53%	47%	94%	6%	91%	9%	66%	34%
Lithuania	100%	0%	30%	70%	98%	2%	0%	100%	97%	3%	61%	39%	91%	9%	99%	1%	78%	22%
Mauritius	100%	0%	100%	0%	100%	0%	77%	23%	99%	1%	79%	21%	99%	1%	100%	0%	91%	9%
Moldova	100%	0%	32%	68%	40%	60%	23%	77%	85%	15%	64%	36%	95%	5%	93%	7%	57%	43%
Mongolia	100%	0%	28%	72%	13%	87%	38%	62%	51%	49%	61%	39%	99%	1%	31%	69%	56%	44%
Norway	100%	0%	37%	63%	23%	77%	13%	87%	83%	17%	35%	65%	81%	19%	85%	15%	66%	34%
Poland	100%	0%	43%	57%	88%	12%	18%	82%	96%	4%	45%	55%	95%	5%	88%	12%	62%	38%
Slovak Republic	100%	0%	100%	0%	100%	0%	40%	60%	95%	5%	72%	28%	99%	1%	96%	4%	73%	27%
Slovenia	99%	1%	76%	24%	99%	1%	22%	78%	94%	6%	55%	45%	99%	1%	77%	23%	81%	19%
United Kingdom	100%	0%	33%	67%	100%	0%	59%	41%	48%	52%	35%	65%	80%	20%	91%	9%	78%	22%

Table- 4B	Defense			Education			Health			Housing			Police			Recreation			Welfare			Subsidies			Other		
	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L
Australia	100%	0%	0%	28%	72%	0%	52%	47%	1%	23%	44%	33%	13%	83%	3%	20%	46%	34%	90%	8%	1%	58%	33%	9%	46%	46%	8%
Bolivia	100%	0%	0%	57%	37%	6%	38%	47%	15%	23%	31%	46%	100%	0%	0%	24%	14%	62%	93%	6%	2%	30%	39%	30%	78%	5%	17%
Switzerland	90%	5%	5%	10%	55%	36%	57%	25%	19%	14%	23%	63%	7%	67%	26%	13%	31%	56%	78%	14%	8%	33%	44%	23%	39%	28%	33%
United States	100%	0%	0%	5%	43%	52%	57%	32%	11%	72%	9%	20%	18%	28%	55%	24%	11%	65%	69%	22%	8%	64%	26%	9%	69%	13%	19%
Russian Fed.	100%	0%	0%	14%	NA	86%	15%	NA	85%	7%	NA	93%	73%	NA	27%	15%	NA	85%	90%	NA	10%	89%	NA	11%	64%	NA	36%
Indonesia	100%	0%	0%	93%	NA	7%	91%	NA	9%	98%	NA	2%	99%	NA	1%	100%	NA	0%	100%	NA	0%	14%	NA	86%	100%	NA	0%

C= Central Government, S= State or Provincial Government, L= Local Government

Source: International Monetary Fund, 1998. Government Finance Statistics Yearbook 1998.

Revenues

The essence of decentralization is that subnational governments have the authority and responsibility to own-finance local services at the margin. Complete fiscal autonomy over revenues requires that in principle local governments can change tax rates and set tax bases. Box 3 illustrates varying levels of local revenue autonomy in different tax designs. The general principles of revenue assignment to different levels of government are listed in fiscal federalism and local government finance literature as (Oates, 1972; Bird, 2000):

1. *The tax base assigned to subnational governments should be immobile in order to allow local authorities some freedom to vary rates without the base vanishing.* Inter-jurisdictional mobility of tax base makes taxation of mobile factors difficult to subnational governments.
2. *Redistributive taxes should be assigned to the central government. Taxes imposed on mobile factors for redistribution purposes might result in inefficient jurisdictional allocation of the factors of production.* Uniform redistributive taxes minimize locational distortions of economic activities.
3. *Services provided by subnational governments should to the extent possible be financed through user charges and other local fees and taxes that are related to benefits.* Efficient allocation of resources requires subnational governments recover their expenses from the beneficiaries of their services. Examples of benefit related revenues include taxes levied on motor vehicles and fuels and construction fees.
4. *Taxes that are subject to important economies of scale in collection efforts should be centralized.*
5. *Taxes subject to cyclical fluctuations need to be protected by a system of counter-cyclical rate adjustments in order to avoid subnational governments exploitation of fiscal power.*
6. *Taxes levied on tax bases that are unevenly distributed should be centralized. Uneven distribution of tax bases among subnational governments forces the residents of one subnational area bear the economic burden of taxes imposed by another jurisdiction.* Taxation of natural resource is the best example of this type of taxation practice.
7. *The revenue yield should be stable and predictable over time.*

8. *The revenue system should be easy to administer efficiently and effectively.*
9. *Subnational taxes should be visible to encourage subnational government liability.*

Box- 3: Fiscal Autonomy in Subcentral Governments

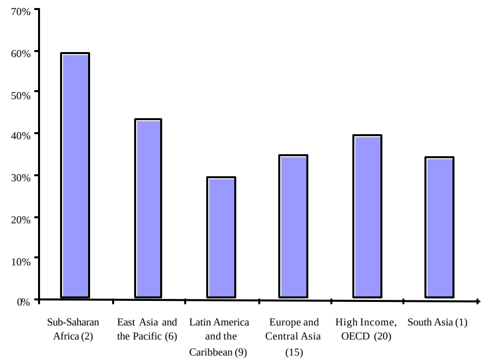
Own taxes	Base and rate under local control.
Overlapping taxes	Nationwide tax base, but rates under local control
Nontax revenues	Fees and charges. Generally, the central government specifies where such charges can be levied and the provisions that govern their calculation.
Shared taxes	Nationwide base and rates, but with a fixed proportion of the tax revenue (on a tax-by-tax basis or on the basis of a "pool" of different tax sources) being allocated to the subcentral government in question, based on (1) the revenue accruing within each jurisdiction (also called the derivation principle) or (2) other criteria, typically population, expenditure needs, and/or tax capacity.
General purpose grant	Subcentral government share is fixed by central government (usually with a redistributive element), but the former is free to determine how the grant should be spent; the amounts received by individual authorities may depend on their efforts.
Specific grants	The absolute amount of the grant may be determined by central government or it may be "open-ended" (that is, depend on the expenditure levels decided by lower levels of government), but in either case central government specifies the expenditure programs for which the funds should be spent.

Source: Anwar Shah, *The Reform of Intergovernmental Fiscal Relations In Developing & Emerging Countries*, Policy and Research Series #23, World Bank 1994.

Intergovernmental Transfers

The revenue and expenditure assignments give rise to vertical and horizontal imbalances within a nation's intergovernmental finances. In fact, every intergovernmental transfer system has two dimensions: (i) *the vertical dimension*, concerned with the distribution of revenues between central and local governments; and (ii) *the horizontal dimension*, concerned with the allocation of financial resources among the recipient units.

Figure-10: Vertical Imbalance by Region



Note: Measured as transfers to sub-national governments as a share of sub-national expenditures. Simple average of most recent observations in available countries. Numbers in parenthesis indicate number of countries represented.

Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

A vertical imbalance occurs when the expenditure responsibilities of subnational governments do not match with their revenue raising power; the issue of vertical imbalance is widespread in all regions (see Figure 10). At least 30 percent of the subnational governments' revenues come from intergovernmental transfers in all regions. A horizontal imbalance occurs when own fiscal capacities to carry out the same functions differ across subnational governments. In all countries, these imbalances are handled trough a variety of transfer mechanism in order to allow subnational governments to perform their assigned functions. Figures 11 through 15 present the importance of intergovernmental transfers in the composition of subnational governments' revenue structure across regions.

There are different forms of transfer mechanism: sharing revenues and tax bases, establishing conditional or unconditional grant systems. Central government and subnational governments can share revenues based on a formula or share a tax base by one of them applying a surcharge on other’s tax. In the case of establishing grant system, conditional grants require matching elements by recipient government but unconditional grants are given to recipient government with full discretion to spend. The choice of transfer mechanism depends on the objectives of the intergovernmental policies. If the only concern of the intergovernmental system is to address vertical fiscal gap, this could be achieved either by revenue sharing or by “gap-filling” unconditional grants. The horizontal imbalances can be alleviated with equalization transfers from the central government to subnational government. However, in practice, measuring the horizontal imbalance and relative fiscal capacities of subnational governments is a very difficult task and only very few countries review them. The countries that undertake a comprehensive review of horizontal balances are Australia, Canada, and Germany (Ahmad and Craig, 1997).

The intergovernmental transfer system of a country usually has diverse objectives to meet and in most cases, these objectives may need to be met through a combination of policy tools. According to Ahmad and Craig (1997), there are three different policy responses to establishing the link between vertical and horizontal balances:

1. Correct each imbalance by separate policy measures: The vertical imbalance at each level is resolved by tax-sharing or grant arrangements. Horizontal imbalances are then resolved by payments from regions with higher fiscal capacity to poorer regions. This is the approach used in Germany.
2. Implement an integrated system of equalization grants: The vertical and horizontal imbalances are dealt with simultaneously through a system of grants, including equalization payments and special purpose grants. This is the Australian and Canadian approach.
3. Correct only the vertical imbalance and ignore horizontal balance: As under the first option, vertical balances are resolved by tax sharing and grants, but no action is taken to correct horizontal imbalances. Capital and labor migration then responds, not only to earned income differentials, but also to the regional net fiscal benefits (net benefit received from government expenditure and of taxes paid). There may be, however, special purpose grants servicing central government objectives, which may also reduce horizontal imbalances at least in some functional areas. This is broadly the approach in the United States.

Figure- 11: Composition of Subnational Revenues and Grants in Europe and Central Asia

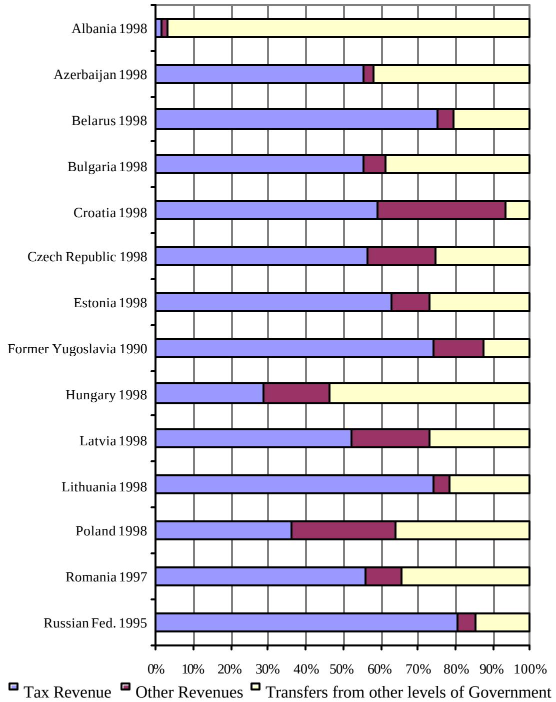


Figure- 13: Composition of Subnational Revenues and Grants in OECD Countries

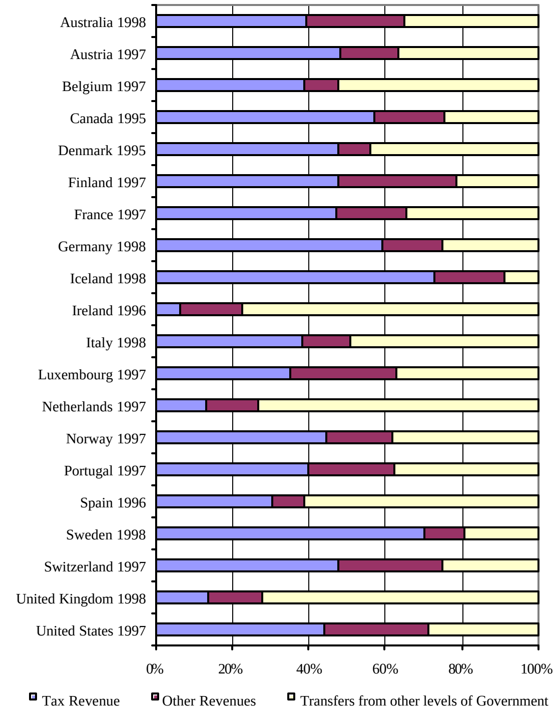


Figure- 12: Composition of Subnational Revenues and Grants in East Asia and the Pacific

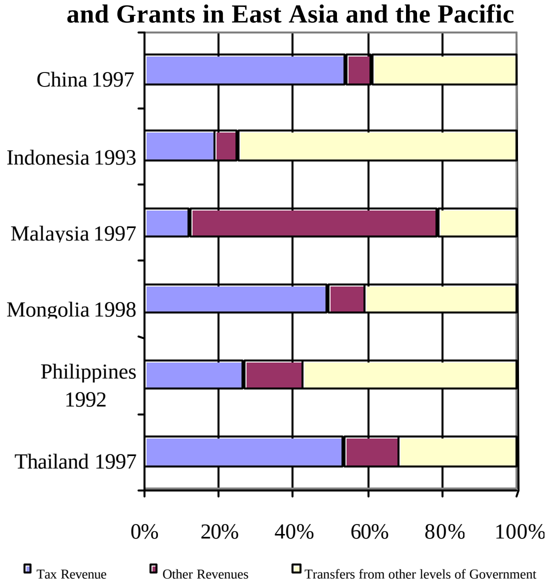
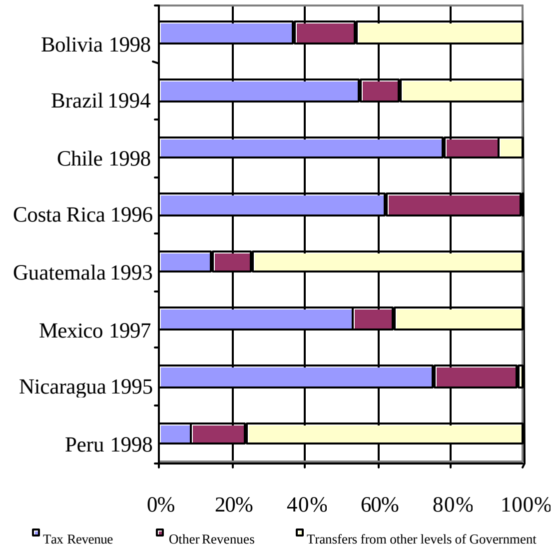


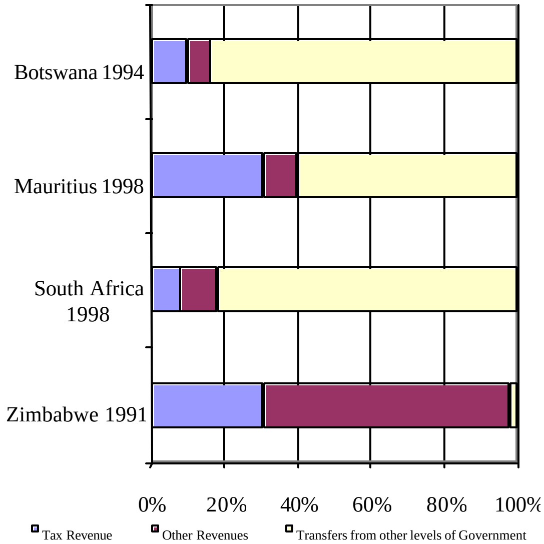
Figure- 14: Composition of Subnational Revenues and Grants in Latin America and the Caribbean



Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

There are three key factors in the design of intergovernmental fiscal transfers: the size of distributable pool, the basis for distributing transfers, and conditionality (Bird, 2000). Determining the distributable pool has an important impact on the stability of the intergovernmental fiscal relations system. Sharing a fixed percentage of all central taxes is a better way of establishing transfer system rather than sharing on an ad hoc basis. Sharing must be based on the basis of a formula. Discretionary or negotiated transfers are unstable and unpredictable in nature. The formula for revenue sharing should take needs and capacity into consideration. Once the first two factors have been sorted out, the last question is whether the transfer should be made conditional on a measure. Expenditure conditionality ensures that the transfer amount is spent on a specified service. On the other hand, performance conditionality links transfers to a performance criteria.

Figure- 15: Composition of Subnational Revenues and Grants in Sub Saharan Africa



Source: International Monetary Fund. Government Finance Statistics Year Book 1998, Country Tables.

Subnational Borrowing/Debt

There are three primary reasons why subnational borrowing can be considered as an appropriate tool for subnational public finance:

1. *Intergenerational equity*: The benefits of certain investment projects, such as infrastructure and education, are spread over time, which means that not only present residents of a locality, but also future residents will consume the services provided by the projects. Therefore, the benefit principle of taxation suggests that future residents should also contribute the cost of investment. For this purpose borrowing is an appropriate tool that offers a means through which payments for capital projects can be spread over the life of the project so as to coincide more closely with the stream of future benefits (Oates, 1972).
2. *Economic Development*: Delaying infrastructure investments might have a negative impact on subnational economic performance. Such a negative impact will have a direct effect on residents' life in terms of less employment opportunities and decline of earning levels. Therefore, borrowing is an

appropriate tool for subnational governments in investing on infrastructure projects to stimulate regional economy.

3. *Synchronization of Expenditure and Revenue Flows*: Access to financial tools offers an opportunity to subnational governments to synchronize expenditures incurred and revenue collection. For a variety of reasons expenditure incurred and tax intake may not be fully synchronized for a particular year. In such a situation, borrowing provides subnational governments to smooth out the mismatch and provide services without disruption.

There are at least two different channels through which subnational governments can borrow: through a public intermediary such as infrastructure bank or direct borrowing from private capital markets. The international experience suggests that lending through a public entity, either central government lending or public financial intermediary, suffers from political favoritism (World Bank, 1990). Direct access to private markets entails development of market-based relationship between lenders and subnational governments, which requires the use of private credit rating and bond insurance agencies to monitor subnational borrowing. Establishing these institutions offers a potential for improving transparency and political accountability in local government management. As capital markets emerge, residents of local governments would learn more about the financial health of their governments.

Subnational borrowing is an important component of the devolution of fiscal powers to local authorities. However, a well-designed regulatory framework for subnational borrowing is necessary to ensure that subnational borrowing does not provide perverse incentives to lending institutions and subnational governments for excessive lending and borrowing. Such a framework includes standardized accounting procedures for subnational governments, disclosure of subnational governments' liabilities and repayment capacity (see Figure 16). However, these measures by themselves will not be sufficient to curb moral hazard problem. The macro concern of moral hazard occurs when subnational governments are backed by the central government by providing guarantees to their borrowing. In these circumstances, the incentive structure is set for excessive borrowing of subnational governments, which would ultimately lead subnational governments to default on loans.

Figure 16: Regulatory Framework for Subnational Borrowing in Transition Countries

Country	Are local governments allowed to borrow?		Is there a regulatory framework for borrowing?	Are there any limitations on borrowing?	Are the purpose for which money can be borrowed limited?	Is there regulation for municipal bankruptcy?
	At Home	Abroad				
Albania	Yes		Yes			
Armenia	Yes	No	Yes	Yes	No	No
Bulgaria	Yes	Yes	Yes	Yes	Yes	No
Croatia	Yes	Yes	Yes	Yes	Yes	No
Czech Rep.	Yes	No	Yes	No	No	No
Estonia	Yes	Yes	Yes	Yes	Yes	No
Hungary	Yes	Yes	Yes	Yes	No	Yes
Kazakhstan	Yes	No	Yes	Yes	Yes	No
Kyrgyz Rep.	Yes		No			No
Latvia	Yes	Yes	Yes	Yes	Yes	No
Lithuania	Yes		Yes	Yes	Yes	No
Poland	Yes		Yes	Yes	Yes	No
Romania	Yes	Yes	Yes	Yes		No
Russia	Yes	No	Yes	Yes	Yes	No
Slovakia	Yes	Yes	No	No	No	No
Slovenia	Yes		Yes	Yes	Yes	No
Ukraine	Yes	Yes	No		Yes	No

Source: Deborah Wetzel, 2001. "Decentralization in the Transition Economies: Challenges and the Road Ahead" PREM, World Bank.

A common proposal to deal with subnational governments' default on loans is to institute limits on the borrowing ability of subnational governments (Ter-Minassian and Craig, 1997). There are two reasons limiting subnational governments' borrowing ability (Bird, 2000). First, if there is no constraint on subnational governments borrowing, the propensity to behave in a fiscally irresponsible way is very high. In the absence of the checks and balances of the subnational debt issuance mechanism, subnational governments may increase their current expenditures well above their capacity to finance them and close the gap through borrowing, especially in countries where general inability of central governments to impose hard-budget constraints exist. The second reason for imposing restrictions on subnational borrowing is macroeconomic stabilization. Since central government has the responsibility for stabilization policies, it is important that it has full control over public debt.

VI. CONCLUDING REMARKS

This module has stressed that fiscal decentralization is a multifaceted complex issue. Legal and constitutional framework, as well as institutional structure of the public administration system in each country has a bearing on the outcome of fiscal decentralization application. The success of fiscal decentralization reforms is inextricably tied to the question of "sorting-out" public sector responsibilities among different levels of government. There is no prescribed set of rules for "sorting-out" that apply to all countries.

Although specific aspects of fiscal decentralization process can be worked out in the context of each individual country, the common components of designing a decentralized system of intergovernmental fiscal relations in all countries are assignment of responsibilities for governmental functions, assignment of the power among levels of government to tax people and collect revenues, the nature of intergovernmental transfers system and ability of subnational governments to borrow.

The failure to design these interrelated components in a consistent way may lead to undesirable results. However, the issue of designing an effective intergovernmental structure is not limited to these components. It involves electing local government officials, having approved budget locally, absence of mandates on local governments as regards to employment and salaries, keeping adequate books of account and monitoring, and monitoring progress towards an effective fiscal decentralization (see Annex 1).[19]

[19] Annex 1 provides a comparative assessment of fiscal decentralization in a selected group of countries.

Annex 1-A: Comparative Assessment Requirements for Effective Decentralization

Benchmark	Estonia	Latvia	Lithuania
Elected Local Officials and Councils	YES Estonian local governments are all part of a two-tier system. Local governments consist of councils, rural municipalities, boroughs and towns. Both the representative bodies (councils) and executive officials are elected. Municipal council representatives are elected directly, whereas, mayors are elected by the councils. At the regional level the countries represent the central government. The county level operations are financed by from the central budget. Regional councils are also elected. The city of Talin has a special status.	YES In 1990-1997 both municipal and regional councils in Latvia were elected. In 1997, the regional set up changed - the chairs of municipal councils became members of the district council. The results of this experiment have revealed that such indirect representation at the regional level cannot ensure its impartial functioning. There was a trend supporting a return to the direct election of regional councils by 2001 but the arrangements remained unchanged. Executive power rests with Local boards, which serve both executive and decision-making functions. The chair of the council is simultaneously the chair of the board. The city of Riga has a special status.	YES In Lithuania the system of local government is two tiered: the county and the municipalities, villages, etc. The county is a territorial unit of state administration. Only the municipal government has autonomous power, enjoys the right of self-government and forms elected bodies. Members of local government councils are elected for three-year terms. The municipal council members nominate the executive officials at the municipal level. The city of Vilnius has a special status where the council is elected but the mayor is appointed.
Locally Appointed Chief Officials	YES Under the Government of the Republic Act, a county governor is appointed by the central government on proposal by the prime minister and in agreement with the regional union of local authorities. Other central government institutions at the regional level are tax offices, immigration and citizenship departments, statistics bureaus, forestry offices, et cetera. The heads of these departments are appointed by the county governor in consultations with the central government officials.	YES Central government representatives at the regional level execute functions that are nationwide and require uniformity and central regulation. A law on regional government (districts) was introduced on 15 February 1992. In accordance with the law the central government established regional local boards that serve executive functions. The chair of the council is simultaneously the member of the board. The boards are responsible for nominating and appointing heads of departments and other chief officials at the regional level.	YES The county governor is appointed and dismissed by the government on proposal by the prime minister. County administration is a part of the state administration and the boundaries of counties are approved or changed by the councils based on the proposals of the central government. The national government has direct control over the appointment of chief executives and heads of the departments but the appointments of these chief executives need to be approved by the council.
Locally Approved Budget	YES Local councils are responsible for developing (in collaboration with executive branch) and approving local budgets. Budgetary independence in Estonia is quite high; for example local authorities have the right to establish their own salary rates. Draft budgets, approved budgets, amendments and reports are published as public information. Municipal budgets are drafted taking into consideration the local development plans.	YES According to the law “On Local Government Budgets” (29 March 1995) local councils have the right to approve the local budget and its amendments and report on budget expenditures. The share of total budget revenue that is allocated to small municipalities is relatively bigger than that of large municipalities. Hence, in reality, the budgetary independence in large municipalities is much higher than in smaller municipalities.	YES The constitution gives local governments the right to draft and approve their own budgets, to establish local dues and to levy taxes and duties. According to the Law on Methodology for the Establishment of Local Government Budgetary Revenues (1997) personal income tax is ascribed to the local government budget upon the deduction of mandatory social insurance. The primary source of county revenues is the state budget.

	Estonia	Latvia	Lithuania
Absence of Mandates on Local Governments as Regards to Employment and Salaries	NO Employment and salaries are regulated by the Public Service Act. Municipal administrative agencies, in which employment is considered to be public service, are: (1) the office of a municipal council, (2) municipal governments together with their structural units, (3) municipal district governments of local authorities, (4) town government executive agencies and (5) bureaus of local authority associations. The municipal councils approve the structure, staff and salary rates of public servants of local administrative agencies. Local government associations have an important role in negotiating local government mandates with the central government.	NO There are no restrictions on the formation of administrative structure for Latvian local governments in the law "On Local Governments". The set up is mostly determined using local government statutes. However, the law "On Public Civil Service" regulates basic employment arrangements for both the central and the local governments. Since local government employees are considered to be public servants they are obliged to take the qualification examination or participate in the training program for civil servants.	NO All public employees are employed by the labor code of the central government. Local governments can hire new staff but they can not create new positions and give different wages and other compensation allowance. Local government association has an important role in negotiating local government mandates with the central government.
Local Governments' Control on Revenues	NO Most of local authorities in Estonia are heavily dependent on shared revenues and central transfers. The main sources of municipal revenue are as follows: shares of centrally established taxes; allocations/subsidies from the state budget; municipal taxes; loans; rental of municipal property; revenue from municipal property sales. Currently, the following proportions are allocated to municipal budgets: fifty-six percent of personal income tax; one hundred percent of land tax; twenty percent of oil shale utilization tax, seventy percent of tax on construction materials and twenty percent of water utilization tax.	NO More than half of total local government revenues consists of tax revenues, with the exception of district governments; 91.1 percent of their total revenues are grants. But on average for all types of local government the share of grants is about one-third of total revenue. The main source of tax revenue in local governments is personal income tax—41.2 percent. The other largest sources of tax revenue are from property (7.2 percent) and real estate and land (4.8 percent). Formally, only state taxes are collected in Latvia. In 1995 and 1996 there were three levels of taxation—personal income, property and land—that were fully delegated to local government budgets. From 1997, however, only land taxes and property taxes are exclusively local; a proportion of personal income taxes now remains in the state budget.	NO Local government revenues consist of tax revenues (which includes personal income tax, after mandatory health insurance is deducted– by far the biggest sources of municipal revenues), non-tax revenues, grants (that are either general or earmarked), and loans from central government. Law regulates all taxation; municipalities may not introduce their own taxes. According to the Law on Local Self-government, the council establishes local duties in accordance with procedures established by the Law on Local Duties. The existing budgetary system is unsatisfactory; it finances numerous events on behalf of the state. Because of the equalization system, the redistribution of revenues among municipalities leaves major cities with a very small portion of tax revenues collected in that city. The primary source of county revenues is the state budget. Interests of central, regional and local authorities often differ. Conflicts arise particularly on the distribution of authority and revenues. This depends on which political parties prevail at the central and local levels.

	Estonia	Latvia	Lithuania
Borrowing Power of Local Governments	NO Borrowing by both central and local governments in Estonia is strongly regulated by the law. The state and local government guarantees on loans must not exceed fifteen percent of state and local budget revenues. Local authorities cannot grant or secure loans, with the exception of student loans. If the borrowing takes place at the state level it is from large international organizations such as WB, EBRD, European Investment Bank and Nordic Investment Bank at much lower than market rates. The funds are later redistributed to local authorities.	YES/NO Since 1995 the central government has gradually reduced access to private capital markets by local governments. Today local governments borrow mainly from the treasury but also from the environmental investment fund and the local government credit fund and, in special cases, with the permission of the minister of finance, from commercial banks. Such restrictions contradict the demands of the European Charter of Local Self-government on free access to national capital markets. For the most part, local governments are unable to undertake many large-scale projects because the proportion of their budgets allocated for investment is only a small percent of total financial resources. Local governments also have the right to take short- and long-term loans and to make loan guarantees as determined by the laws "On Budget and Finance Management" and "On Local Government Budgets." In accordance with the latter, local governments may take loans in the amount and according to procedures determined by the Cabinet of Ministers, which may be used only as appropriated. Local governments are not allowed to guarantee loans by properties that are necessary for the fulfillment of their responsibilities.	YES/NO According to the Law on Local Self-government, the local authority has the right to use bank credits and borrow and grant loans. No explicit limits are placed on the level of borrowing; however, there are also no provisions for bankruptcy and defaults, collateral provisions or using municipal assets to guarantee the repayment of loans. However, other than short-term loans from central government (that mostly resemble grants rather than loans), municipalities have rarely engaged in borrowing; commercial bank loans have been used on a small scale. Municipal credit limitations were established in 1998. Annual debt cannot exceed ten percent of the annual budget, and general debt, twenty percent. These limitations and the equalization system in fact prevent the introduction of an independent capital investment policy.

	Estonia	Latvia	Lithuania
Transparent Intergovernmental Transfer System	NO Regulations specifying procedures for transferring appropriations and subsidies from the state budget to municipal budgets have constantly changed during the recent years. Therefore, it has been very difficult for local authorities to plan their budgets with a long-term perspective. The system of transfers in itself can be considered as transparent since this information is available to public, but the problem lies in its instability. Currently the appropriation of the subsidy fund is determined by the distribution equation: $T_n = (m \times ak - an) \times 0,9 \times en$ where $\boldsymbol{T_n}$ = subsidy allocated to local authority; ***m*** = subsidy level coefficient; ***ak*** = average level of appropriations and receipts in Estonia allotted from state taxes to the municipal budgets in the fiscal year in EEK per capita; ***an*** = average level of appropriations and receipts allocated from state taxes to municipal budgets in the fiscal year in EEK per capita; ***en*** = population of the local authority.	NO The Union of Local and Regional Government of Latvia (ULRGL) represents local governments in negotiations with the state. A protocol is formulated annually based on negotiations between working groups formed by ULRGL and representatives of all ministries. The main area of conflict between the central and local governments is related to budget allocations. Local authorities receive special grants from the state in order to carry out projects such as investment in territorial planning. General grants from the state may be distributed as the local authorities see fit. Many local governments receive general grants in addition to those from the state from more wealthy districts through the local government financial equalization fund.	NO Transfers from the central government amounted to almost one-fifth of total municipal revenues for 1996. Since 1996 the proportion of transfers from central government has only increased (up to a third of total municipal revenue), whereas the share of local own revenues has actually decreased. This was primarily due to the transfer of corporate profit tax revenues to central government and the decrease in the local share of personal income tax. Central government transfers are usually earmarked. Earmarked transfers include grants for the creation of reserves for unforeseen expenses during the planned budgetary year, for the equalization of tax-related revenues and for the equalization of structural differences in expenditures.
Clear Expenditure Assignment	YES The assignment of expenditures is clear, but the structure of local expenditure varies significantly among local authorities. There is very little regulation concerning, for example, the size of the municipality. Majority of funds are allocated for the traditional areas of expenditure: education (thirty-seven percent of local revenue); public transport, housing, et cetera (twenty-one percent); and administration (eleven percent).	YES The assignment of expenditures based on the transferred responsibilities is quite clear. However, there is a provision in the law that states that the Cabinet of Ministers or individual ministries may delegate specific tasks to local governments. In delegating such tasks the Cabinet of Ministers or the relevant ministry must accordingly transfer financial means to the local government, or the local government may voluntarily support the task through its own resources.	YES Assignment of expenditure and responsibilities is clear. The problem lies in local government revenue collection capacity and thus local expenditure keep on decreasing due to the shortage of own source revenues. As a reference point, municipal expenditures in Lithuania in 1996 exceeded all central government expenditures on the economy and social affairs combined. However, since then real municipal expenditures have started to fall. This trend continues to the present day. The reduction in the local government share of the national budget reflects a realignment of national expenditure priorities (the reverse process of fiscal decentralization).

	Estonia	Latvia	Lithuania
Capacity of Local Governments to Collect Taxes and Deliver Services	NO Local government revenue assignments are relatively clear but these assignments are not implemented to the full. Local governments are afraid to impose high taxes that may lead to the migration of businesses and labor force. The total revenue generated by taxes constituted only 1.6 percent of Tallinn's total gross revenue in 1998. In other cities the ration is much smaller. The allocation of financial resources for the tasks assigned to local authorities still remains to be a problem. Today there is no reliable information on the cost of such tasks; thus, there is no guarantee that all local authorities have the capacity to fulfill them. Service delivery remains to be a problem at the local level.	NO/YES The list of taxes that the local government can collect is clearly defined and the responsibility for local tax collection clearly lies with the local government. However, in practice only major cities with special status and district authorities are capable of collecting sufficient level of revenues from taxes. Local capacity in tax collection is low. The execution of services that are assigned by the law "On Local Govern ments" is fully financed from the budget of the corresponding local government. When additional functions are delegated, new sources of income are identified accordingly. The execution of additional functions may be legally delegated to local governments for a specified period of time if the sources of additional financing are simultaneously identified to provide for any increase in expenditures. Local governments have the right to establish institutions and enterprises, to cooperate with public and private companies, to contract the private sector to manage projects, to cooperate with other local governments and to privatize local government property in order to perform municipal services. As a result of privatization, the share of local government ownership in public services has been greatly reduced and in fact is currently less than the share of the private sector, with the exception of preschool establishments.	NO According to the law, the local governments may not introduce their own taxes, just the duties. Their tax collection capacity is even more constrained both by the legal provisions and the existing capacity constraints. Local governments are charged with providing services in the fields of education, social security, health care, culture and leisure and communal economy. County administrations are also involved in service delivery, though to a much lesser extent. They primarily address services that bear a regional dimension, such as the administration of certain educational and cultural institutions, maintenance of regional roads, et cetera. The only functions that are specifically ascribed to county administrations are agricultural issues and construction inspection. Both county and municipal governments are heavily dependent on state transfers to deliver assigned services. All municipal enterprises that provide public services are registered as joint limited liability enterprises. Some of them are classified as special enterprises, which can privatize up to thirty percent of their shares to the year 2001. Funding for special tasks is allocated through open tenders for both public and private companies.
Adequate Books of Account	YES State and regional audit offices are responsible for ensuring adequate bookkeeping and accounting practices. The government has been working hard to bring the bookkeeping and accounting standards in conformity with EU regulations. In most of the local governments these initiatives have proved to be successful.	YES The audit commission in each district monitors adequate bookkeeping and accounting standards. The auditing commission monitors internal control of local government; it is elected by the council of the administrative territory for a four-year term. Its membership is proportionate to the number of deputies from each political organization or voters association elected to the council.	YES The system of international accounting standards has not yet been implemented in Lithuanian local governments. However, the control over bookkeeping and accounting is carried out by the office of the controller, which is accountable to the council and not the executive power. Lithuania is equally trying to bring its accounting and bookkeeping standards in accordance with EU regulations.

	Estonia	Latvia	Lithuania
Central Government's Ability to Monitor Progress of Effective Fiscal Decentralization	NO	NO	NO

Annex 1-B: Comparative Assessment Requirements for Effective Decentralization

Benchmark	Turkey	Czech Rep.	Poland	Hungary
Elected Local Officials and Councils	YES There are 79 provinces and 3216 municipalities. Provinces are headed by governors, appointed by the central government. Municipalities are headed by mayors, popularly elected every five years. The members of Provincial General Assemblies (headed by the governor) are elected by vote for five years. The members of Municipal Council (headed by the mayor) are elected by popular vote for five years.	YES Municipal Councils are elected for four years. The municipal council elects the mayor, deputy mayors and executive committee. The municipal council is a representative body elected directly by citizens of the municipality and it is the highest authority of the local government. The municipal board is the executive board responsible to the council.	YES Municipal Councils are elected for four years. The municipal council appoints the mayor and the chief administrative officer.	YES The basic rights and powers of local governments are exercised by an elected council and mayor. The mayor is the head of the office. The basic rights and powers of local government are exercised by the body of elected representatives.
Locally Appointed Chief Officials	NO All provincial chief officials are appointed by central government. Mayors' appointment of chief officials is subject to an approval process by the Governor and the Ministry of the Interior.	YES The municipal board appoints the Chief Administrative Officer (CAO). The CAO is responsible to the council and the mayor.	YES The municipal council appoints the chief administrative officer upon recommendation of the mayor.	YES The mayor is the political and administrative head of the local government and is responsible for local policy implementation and exercises employer's rights over the vice-mayor, chief executive and heads of local government institutions.
Locally Approved Budget	NO Provincial General Assemblies prepare the budget for the approval of governor and the budget must be sent to the Ministry of the Interior for ratification within 30 days.	YES The preparation of the municipal budget is a long process. The budget proposal is completed in cooperation with other departments of the municipal office and then is discussed by the council and by the public. Finally, it is approved by the municipal council.		YES The annual local government budgeting procedures, their content, and the forms of presentation and reporting are strictly regulated by the law and government decrees.

Benchmark	Turkey	Czech Rep.	Poland	Hungary
Absence of Mandates on Local Governments as Regards to Employment and Salaries	NO The State Personnel Directorate is responsible for defining the principles governing the legal and financial status of public officers and processing their applications.	NO All public employees are employed under the Labor Code of central government. The discretion of municipalities in their personnel policy is limited by a national wage policy.		
Local Governments' Control on Revenues	NO Local government officials have control over only small number of taxes and fees.	NO Municipalities have limited power on controlling revenues, especially on tax rate and tax base.	YES Local governments have control over their revenues.	YES Local governments are fairly free to determine their own revenue. However, with few exceptions, local governments have failed to take full advantage of the taxing powers given to them by law due to either the lack of political will, insufficient institutional incentives or weak tax administration capabilities to increase local taxes.
Borrowing Power of Local Governments	NO Local governments do not have borrowing power. Borrowing from international sources are subject to lengthy central government approval process.	YES Municipalities have wide discretion to borrow. They can get bank credits, loans, or issue bond. Prague and five others were able to borrow on international capital markets.	YES Local governments can issue bonds. Municipalities also have line of credit from commercial banks.	YES Local governments have power to borrow independently. However, local governments are subject to insolvency and bankruptcy regulations.
Transparent Intergovernmental Transfer System	YES The main source of local governments is intergovernmental transfers. Local governments get a share of the national tax revenues collected.			NO The overall pool of resources available to local governments is determined by annual decisions by Parliament over the state budget for which there are no basic rules. The grant structure is overly complicated.

Benchmark	Turkey	Czech Rep.	Poland	Hungary
Clear Expenditure Assignment	YES Assignment of responsibilities is clear. Municipalities are responsible for roads and drainage, public transportation, fire protection, water supply and sanitation, solid waste collection and disposal, parks and other recreational facilities, veterinary services, wholesale markets, and slaughterhouses.	YES Local Government Act of 1990 defines responsibilities of municipalities.		YES The 1990 Local Government Act defines responsibilities of municipalities in general terms. The relevant requirements of the Act are not clear and can be interpreted in different ways.
Capacity of Local Governments to Collect Taxes and Deliver Services	NO Municipalities have no taxing powers and limited collection capabilities (real estate tax) and limited capacity to deliver services.			NO The major constraints on local tax administrations are the shortage of qualified staff, weak computer capabilities, and tax collection expertise, which reduce the effectiveness of tax collections.
Adequate Books of Account	YES Local governments keep accurate accounting records; government audits are done periodically.			YES Local governments' books of accounts are audited by internal as well as external organizations. Financial committee of the body of representatives monitors budgetary activities and the State Audit Office exercises control over the management of assets of local governments.
Central Government's Ability to Monitor Progress of Effective Fiscal Decentralization	YES	YES	YES	YES

Annex 1-C: Comparative Assessment Requirements for Effective Decentralization

Benchmark	Kazakhstan	Kyrgyz Rep.	Tajikistan	Georgia	Armenia
Elected Local Officials and Councils	YES Members of local representative bodies (Maslikhat) at all three levels of local government (region, district, city) are elected by local population.	YES/NO Local government reform in the country has been implemented on ad hoc basis. There are different levels of local government (province-7, region-44, city-21, municipality). Members of local representative bodies (Kenesh), where such bodies exist are elected. But in some local units such bodies do not exist. For exa mple out of 21 cities only 12 have the local government status. The rest of the bodies at the city and the above level are under direct control of the central government. At the highest level of local governance (province) the president appoints Governors. The only form of complete local governance is at the village level.	YES Municipal Representative bodies (Madjlis) are elected at regional (3), district (62) and city (22) levels. There are 77 Madjlises in the country.	YES Representative bodies of local government (Sakrebulos) exist at the municipal and district level and are elected by the public. At the highest regional level there are no elected officials. The Regional division of the country is not defined in the constitution.	YES Local government in Armenia exists on the regional (marzer) and community level (hamainkner). Elections take place only at the community level. Representative body (community elders) and the head of the executive body (the head of the community) are both elected by local population for a three-year period.
Locally Appointed Chief Officials	NO Heads of executive administration (Akimam) at regional and district level are appointed by the President Although the 1999 revision to the law allows for municipal elections of the city administrators. In practice no such elections have taken place. Akimams appoint the deputies and head of departments with the approval of Maslikhat.	NO President appoints Head of the Executive office at the Province level (Governor) in consultation with Provincial Kenesh. The Governor appoints the Head of the Executive office at the regional level in consultation with regional Kenesh. City executive officers are appointed by the regional officers in consultation with the city Kensh (where Kensh exists).	NO Heads of the executive office (Khukumata) at all levels of local governance (region, district, city) are appointed by the President of the country and are at the same time the representative of the President. The candidates presented by the President are approved by Madjlis.	YES Locally appointed officials exist at the lowest municipal level. Mayors and Gamgebelis at the municipal level are elected by the public. Executive branches also exist at the other two levels, but the district Gamgebeli is appointed by the Governor, and the regional Governor is appointed by the President.	YES Although the heads of the communities are elected by the local population, the central government appoints and dismisses the heads of the regional government (marzpetner). Marzpetner manages local government with the help of territ orial administrative bodies (marzpetaran). The Regional Council is a consultative body formed under the marzpet. It is composed of all the heads of the communities of that marz and the marzpet.

	Kazakhstan	Kyrgyz Rep.	Tajikistan	Georgia	Armenia
Locally Approved Budget	YES Local representative bodies (Maslikhat) approve local budgets at all levels of local governance (region, district, city). The appointed local officials prepare the budgets and present it to Maslikhats for approval. Executives are also responsible for the implementation of the budget and monthly reporting to the Meslikhats.	NO Budget preparation and implementation is a hierarchical process – Province – Region - City. Budgets are prepared and approved at the local level only in villages.	YES Local budgets in Tajikistan are developed and approved by Medjlis. After the identification of own source revenues, shared revenues and transfers from central government (if needed) the central budget is approved. After the approval of the central budget the Medjlis can review and approve the local budgets.	YES Local budgets at the municipal and district level in Georgia are developed in collaboration with and approved by the Sakrebulo. Local executive officials are responsible for budget implementation. There are no budgets at the regional level, since the regional administration is factual.	YES The head of a community submits the draft decision on the community budget for the consideration of the community elders within a one-month period after the approval of the national budget or prior to the approval of the national budget.
Absence of Mandates on Local Governments as Regards to Employment and Salaries	NO All local government employees are hired under the Labor Code of the country. Although special arrangements may be made (for foreign residents) in agreement with the central authorities if the need for such arrangements occurs.	NO All public employees are employed under the Labor Code of central government. The discretion of municipalities in their personnel policy is limited by a national wage policy.	NO All public employees are employed under the labor code and are treated in accordance with the Law on Public Servants.	NO All public employees are employed by the labor code of the central government. Local governments can hire new staff but they can not create new positions and give different wages and other compensation allowance. All people working for local government are public servants.	YES All public employees are employed by the labor code of the central government. Local governments can hire new staff but they can not create new positions and give different wages and other compensation allowance.

	Kazakhstan	Kyrgyz Rep.	Tajikistan	Georgia	Armenia
Local Governments' Control on Revenues	NO Local governments receive very little in own source revenues. Moreover, they have very little control over how shared revenues are distributed among the different tiers of government. The shares keep on changing on regular basis.	NO Local governments' control over revenues is being implemented only at the village level. At all other levels (province-region-city) revenue identification and collection is a hierarchical process.	NO Local governments have control over their revenues. But the revenue generation and utilization process is implemented by the executive office of the locality which is the representative office of the central government. The final approval and management of local revenues is the responsibility of the Madjlis. Shared revenues comprise a large part of local revenues.	NO Local governments have the right to levy local taxes, but the sources of local tax and non tax revenues are very small. Most of the easily collectable and high income sources of revenues are shared with the central government. In order to change these ratios the local government needs to get the approval from the parliament of the country.	NO Communities have the right to levy and collect local taxes. However, these comprise a small portion of annual income. In over 70% of communities the share of official transfers makes up more than 50% of the budget revenues.
Borrowing Power of Local Governments	YES Local governments have the power to borrow from both, higher local government and central government agencies and private banks. Although the law does no describe the arrangements for bail out in case of default.	NO There is no law that regulates local borrowing. Most of the funds are disbursed by the central government through specifically targeted grants.	NO There is no law that regulates local borrowing. Nevertheless, the law on bankruptcy is being applying to local government units.	YES The Law allows local governments to generate revenue through credits from both private and state sources but the decentralized borrowing has been constrained solely to the state loans or loans from international organization with the guarantees provided by the central government.	YES The law allows the communities to use reserve fund for capital expenditures. The reserve fund is represented in the administrative part of the budget**.** The total amount of debt service expenditures made from the reserve fund for credits and other borrowings drawn mustn't exceed 20 % of the reserve fund of the budget for the given year.

	Kazakhstan	Kyrgyz Rep.	Tajikistan	Georgia	Armenia
Transparent Intergovernmental Transfer System	NO The overall pool of transfers available to local governments is determined by annual decisions of the ministry of finance.	NO Funds are disbursed by the central government and disbursement is hierarchical: Province – Region – City – Village.	NO Local governments receive grants and transfers from central government. Most of the transfers and grants are approved as part of the annual national budget before the local budgets are approved by Madjlis. However, the transfer and grant system is based on negotiations between the central and local government.	NO The amounts of central government transfers and grants are identified as a result of negotiations between local government officials and the central government. Transfers to mountainous regions are quite transparent since these regions are in constant need for state subsidies but in the rest of the country transfer system is very disorganized.	NO Armenian communities are heavily dependent on state transfers, but the government has not been able to come up with a functioning transfer system. The system is very complicated and is constantly being amended based on government negotiations.
Clear Expenditure Assignment	YES Assignment of expenditures is clear but the implementation is ad hoc. Local government incomes and expenditures are mainly dependent on their resource extraction and export capacity and thus very across local governments. The expenditure assignments are decided by the central government.	YES Assignment of expenditures and responsibilities is clear. Local government units have extensive responsibilities but they are constrained in their revenue generation capacity.	YES Assignment of expenditure and responsibilities is clear. The problem lies in local government revenue collection capacity and thus local expenditure keep on decreasing due to the shortage of own source revenues.	YES Both national and local governments take on various duties. The responsibilities for service delivery are being delegated to local authorities at an increasing rate. Unfortunately, slow decentralization of revenue collection authority and the great number of tasks of local governments create their dependence on the funding by intergovernmental transfers from the central government.	YES Assignment of expenditures is clear but, the communities have more responsibilities that they can manage and thus the central government is forced to cover some part of expenditures using the transfers and grants system.

Annex 1-D: Comparative Assessment Requirements for Effective Decentralization

Benchmark	Slovakia	Croatia	Romania	Bulgaria	Macedonia
Elected Local Officials and Councils	YES Municipalities in Slovakia have an independent local government with the elected representative bodies and elected mayors. Counties and regions are the second and third levels of public administration. The regional and district offices form the basis of state administration.	YES Local government in Croatia exists at three levels: the municipality, the county and the territorial entity. The assemblies (in counties) and the councils (in municipalities) are elected by the population. County governors, municipal mayors and members of the executive boards (heads of departments) are elected by the representative bodies – the assemblies and the councils.	YES Romania is divided into counties, towns and communes. Local authorities at the communal or municipal level are the local councils and mayors. Both are elected in accordance with the Law on Local Elections.	YES There are two main levels of local government: the municipality and the region. Local elections of representative bodies and heads of the executive branch take place in municipalities. State authority is distributed at the regional level.	YES There are two different types of administrative-territorial divisions in Macedonia. The first consists of central governmental bodies and their local agencies. The second consists of the system of municipal governments. Local elections take place at the municipal level. Both mayors and local council members are elected by a popular vote.
Locally Appointed Chief Officials	YES Heads of large municipal offices are appointed by the municipal council on recommendation of the mayor. Each municipality has a chief auditor who is elected by the municipal council on recommendation of the mayor.	YES All municipal chief officials and heads of departments are appointed by the county governors and mayors and approved by the councils.	YES The implementation of central government's policy towards the municipalities is the responsibility of the Prefect. The prefect is an appointed by the central government in each county and in the municipality of Bucharest. Appointments at the municipal level are done by the chief executive with the approval of local councils.	YES Locally appointed officials exist at the regional level. Regional Governors are appointed by the Council of Ministers. The Deputy Regional Governors are appointed by the Prime Minister. There are appointed officials at the municipal level as well. For example, the land commissioners are state authorities on land ownership at the municipal council and are appointed by the Minister of Agriculture.	YES The mayor of the municipality appoints all executive officers and deputies with the approval of the municipal council.

Benchmark	Slovakia	Croatia	Romania	Bulgaria	Macedonia
Locally Approved Budget	YES Local governments manage their own budgets and assets. Budgets are prepared by the chief executive and approved by the council. Regional and district offices are financed by the state budget of the Slovak Republic.	YES Budgets are approved at the local level. Budget preparation is a long process and involves many players including interest groups and public. Municipal councils approve the final draft of the budget presented by the executive officer.	YES The mayors are responsible for formulating a draft budget and submitting them for approval to the local council. The local council of a commune or town is responsible for approving the formulation and execution of the local budget, credit transfers, use of budgetary reserves, loans and closing accounts.	YES Municipal budgets are developed by the mayors and approved by municipal councils in accordance with the Municipal Budget Act (1998). Regional authorities are funded from state funds.	NO Locally elected executive and representative bodies are responsible for approving the budget, but the central authorities determine the size of local government budgets, taking into consideration the level of development, the size of the population, etc.
Absence of Mandates on Local Governments as Regards to Employment and Salaries	NO Currently there are no special laws defining the system of public service and labor relations at the local level (though a draft bill was considered by parliament in November 1997). Labor relations for state administrative staff are governed by the Labor Code. Salaries of civil servants are regulated by an act on salary and compensation for work in budgetary organizations and certain other organizations and bodies.	NO In the absence of a new law, an old Law on Public administration regulates the employment and salaries of public administration officials.	NO The state law regulates local government mandates on employment and salaries. For example, the public administration salary law establishes salary limits and labor code regulates employment arrangements.	NO Local employees are considered to be public employees and are employed in accordance with the labor code of the central government. The mayors fix the individual salaries of each employee within the funds allocated by the municipal council and in conformity with the salary rates set by the Council of Ministers.	NO All public employees are employed by the labor code of the central government. Central government and respective ministries have the final say in determining the staff benefits and salaries.

Benchmark	Slovakia	Croatia	Romania	Bulgaria	Macedonia
Local Governments' Control on Revenues	NO Municipalities own source revenues are quite small. Independent budgetary revenues are limited to shared taxes, but this element also has not been stabilized; the structure, base, areas and percentage of the municipal share of taxes change frequently.	NO Local governments have very little control over shared revenues which account to over 50% of the local budget. Municipalities have the power to collect own source revenues but these revenues are insignificant. The local portion of the shared revenues is decided by the central government.	YES Local governments have full control of own source revenues, but the structure of own source revenues varies among areas of the country. Local authorities have the power to use special taxes, tariffs and dues for public services, but they do not have the power to establish new categories of taxation. Local authorities have little competency concerning tax rates, but the proportion of taxes allocated locally by the state may be negotiated, and duties may be adjusted for inflation.	NO Local governments have a full control of own source revenues, but such resources are quite limited. Central transfers and shared revenues are the lion share of municipal funds (over 60%). None of these sources are under the control of local governments.	NO Municipalities have very little control over their own revenues. Although legal possibilities exist for municipalities to control and increase revenues, the current status of the law makes it impossible for them to be utilized.
Borrowing Power of Local Governments	YES Municipalities are allowed by law to borrow both from the state and from private banks. However, the law states that the government will not bail out local governments. Scarcity of funds is resolved in some cities by issuing municipal bonds (Bratislava). Most of the municipalities take loans from local banks.	NO In spite of the fact that the municipalities are allowed to borrow the system of loans has not proven to be particularly useful. In most countries, the central government controls the volume of loan taking at the local level.	NO Romanian municipalities are allowed to borrow, but such loans are not the responsibility of the central government, and they must be paid from the incomes with which they were guaranteed by local administrative authorities. Due to legislation that made it difficult to secure loans, local administrations rarely uses this option. Those that were granted are covered by external credits guaranteed by the central government.	NO The Law allows loca governments to generate revenue through credits from both private and state sources. Local defici can be financed through the issue of securities, municipal bonds and loans from financial institutions. Nevertheless, in reality borrowing by the municipal administration is limited due to the unstable financial standing of the banking system in th recent years prior to the introduction of th Currency Board.	NO Municipal borrowing is allowed, but not widespread at the moment, as many municipalities have unsettled property claims, revenues are poor, and the loan capacities of Macedonian banks are very limited.

Benchmark	Slovakia	Croatia	Romania	Bulgaria	Macedonia
Transparent Intergovernmental Transfer System	NO In spite of the presence of horizontal equalization system among the municipalities, the grant and transfer system is complicated and is not reacting to different revenue bases and expenditure patterns. Direct instruments of equalization are transfers for self-governmental municipal functions to support basic management and administrative tasks in small municipalities.	NO Transfers are not an important part of local government revenues and therefore there is no clear mechanism that regulates grants and transfers. The decision is made by the central government based on the request from the local government. Most of the money transferred to local government is in the form of the portion of the shared tax.	YES The share of intergovernmental transfers in local budgets has been decreasing over the last few years. Equalization grants were introduced in 1999 as a subset of national transfers to local governments.	YES Bulgarian municipalities are heavily dependent on transfers. Transfers of state revenue are specified by law. Grants and subventions allocated from the executive budget comprise of block grants, ad hoc grants, and subventions.	YES Municipalities are heavily dependent on state transfers and grants. There are no shared revenues so transfer system is very much organized and is divided into funds such as Fund for Economically Underdeveloped Areas, Fund for Communal Activities and Roads, Fund for Water Pipes and Sewerage. Budget transfers are also common.
Clear Expenditure Assignment	YES Slovakia ranks among countries with a relatively low proportion of municipal expenditures to total public expenditures (twelve percent of state budget expenditures and less than ten percent of total public expenditures in 1997). One of the most important reasons for this is its specific system of division of responsibilities and clearly assigned expenditures.	YES Assignment of expenditures in Croatia is clear. Public service delivery responsibilities in communes and counties are provided for and enumerated by law. Provision of basic services like health, education and welfare is strongly controlled by the central authorities, but local governments have more independence in the provision of local services such as local utilities, cultural services, etc.	YES The most important public tasks in Rumania are still financed by the central government by means of specific departments (health, higher education, public security). Other public services are financed with local administration participation (education, buildings, transportation), and some are supported entirely by the local administration (culture). Nevertheless, the division of responsibilities is clear.	YES The assignment of expenditures and responsibilities in Bulgaria is regulated by the Law on Municipal Budgets. The responsibilities are clearly identified and delegated to the municipal government.	NO In the past major expenditure were assigned to large municipal entities With the new division of the country and newly established local governments there is a need to clearly define their responsibilities, but the existing Law on local budgets fails to take this into consideration.

Benchmark	Slovakia	Croatia	Romania	Bulgaria	Macedonia
Capacity of Local Governments to Collect Taxes and Deliver Services	YES Local governments in Slovakia have the right to levy local taxes and fees, but a huge portion of their independent revenue is not tax related by municipal property related. Although, local taxes are collected on regular basis. Services are delivered but many times loans are needed to finance current expenditures.	NO Local taxes and tariffs comprise a small portion of the income. Income from shared taxes is used to cover current expenditures. Provision of basic services like health, education and welfare is strongly controlled by the central authorities, but local governments have more independence in the provision of local services such as local utilities, cultural services, etc	YES Local governments have increased their own tax collection rates significantly. Currently local governments provide the majority of services to local population.	NO Local governments have very little capacity to collect taxes and finance the services that are transferred to them from central governments. The government is currently implementing a program aimed at improving municipal capacity to provide basic public and communal services.	NO Local governments in Macedonia do not have the capacity to collect the taxes and finance public services. There are no legal grounds that would allow them to establish new local taxes and fees and collect them. Service provision is primarily funded from the funds disbursed by the central government through the support funds.
Adequate Books of Account	YES Every municipality is subject to independent audit by a member of the Slovak Board of Auditors. The audit is approved by the municipal council, and its results are publicized. Audits by international accounting firms are not common but do take place in the capital.	YES The State Audit Office is a body directly responsible to the House of Representatives of the Croatian Parliament. It has the authority to audit financial reports and financial transactions of local units and of legal persons that are financed entirely or partially from local budgets. Due to the existing strict requirements the books are kept in good order.	YES The Court of Accounts provides financial control of local government activity and of each specific department. International accounting standards have been introduced in several large municipalities.	YES International accounting standards are slowly being introduced. Nevertheless, local governments are audited by the central and regional government on regular basis.	NO New accounting standards have not been introduced in Macedonian municipalities. Since the central government is the main provider supervisor of local revenues and expenditures the books are kept in accordance with old government standards.
Central Government's Ability to Monitor Progress of Effective Fiscal Decentralization	YES	YES	YES	YES	NO

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