Fiscal Decentralization: Objectives, Principles & Challenges

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Outline of Presentation

- Why decentralize expenditure and revenue responsibilities?
- Fiscal decentralization in practice
- What challenges arise from fiscal decentralization?
- Principles of fiscal decentralization
- Components of successful fiscal decentralization
Why decentralize expenditure and revenue responsibilities?
Fiscal decentralisation is a transfer of responsibility for fiscal policies from the national level to the region, sub-region, or local levels. It should be assessed according to the degree of autonomy in designing, delivering and financing spending programs. The share of expenditure undertaken or revenue collected by sub-national governments is not always sufficient to determine this.
Decentralizing on grounds of efficiency

- Decisions taken by a level of government closer and more responsive to a local constituency, are more likely to reflect the demand for local services.

- Decentralisation could increase accountability of sub-national governments to their citizens and also encourage competition between sub-national governments.

- However, in practice, political motives are often a driving force behind decentralisation.
What spending programs to decentralize?

- The public service provided by the local government should primarily benefit local citizens.
- National public good – such as national defense, foreign affairs, macroeconomic stabilization, and redistribution – should be centrally provided.
- However, a majority of the local public services have unclear benefit territories, generate externalities, and some nationwide distributional implications.
- Weak governance and/or limited capacity at the sub-national level.
- Some degree of centralized coordination of policies could be desirable (regulations and minimum standards).
What revenues bases to decentralize?

- Highly mobile, progressive, volatile and pro-cyclical tax bases should remain at the central level
  - Corporate and personal income taxes, value-added taxes, customs duties
- Immobile, easy to administer and transparent tax bases can be decentralized to encourage local accountability
  - Property tax, retail sales taxes
- Revenue-sharing and transfers to fill the financing gap, as the central level usually has more revenue than its expenditure assignments (vertical imbalance)
  - The funding gap for SNGs is typically filled by revenue-sharing (formula-based) and transfers from the central government
  - General-purpose transfers (formula-based), block grants (sectors, formula-based), earmarked grants (specific projects or programs)
Fiscal decentralization in practice
Fiscal decentralization has been increasing

- Devolution of functions has accelerated over the last two decades, driven by:
  - Empowering of local communities
  - Maintaining political stability
  - Improving service delivery and make it more relevant to local needs
  - Encouraging local tax revenue collection

- Share of decentralized spending varies widely, from >50 percent (China, Canada, Denmark, Switzerland, Sweden) to <10 percent (Cyprus, Greece, Jordan, Honduras, Netherlands)
  - Two and three tiers, although lower levels generally have fewer financial responsibilities
Extent of expenditure decentralization varies across sectors

- **Healthcare**: Extent of decentralization differs significantly across countries, policies are often substantially harmonized by national standards.

- **Education**: Highly decentralized. Primary and secondary education normally administered by local (municipal) governments, university education is more centralized for economies of scale. Also national standards often apply.

- **Social protection**: Public pension and unemployment insurance is typically centralized for risk pooling of such social insurances. Local provision of social and family assistance (e.g. disability) tends to be more effective in identifying the appropriate recipient due to the lower costs of local information.

- **Infrastructure**: SNGs are generally responsible for local projects (e.g. local roads), while the central government for national infrastructure networks (e.g. inter-state highways).
Fiscal decentralization challenges
Macro-fiscal challenges

• Risk of multiple public financial management systems across levels of government
  – Many levels of government make allocation decisions more complex
  – Spending containment and fiscal adjustment more difficult

• Limited PFM capacity at the local level: poor monitoring and information flows of subnational activities reduces accountability and transparency

• Expenditure arrears when resources are insufficient to finance entitlement spending

• Local borrowing can generate debt unsustainability
Efficiency challenges

- Decentralization is not a substitute for failed policies
- Subnational governments do not have real choices in allocating their budget to specific services.
- Lack of clarity in spending assignment, when overlap of responsibilities across levels of government
- Local governments do not internalize the full costs of spending when they are financed with central transfers and/or when they expect central bailout
- Fragmentation can reduce efficiency when fixed costs of public services are substantial.
- The existence of economies of scale and externalities may warrant more centralized control and provision.
Principles for fiscal decentralization
Clarity of responsibility

- **Clarity of spending assignment**: Expenditure responsibilities given to subnational governments should be clearly specified, and differentiated from shared responsibilities with central government.

- **Exclusivity**: They should generally be exclusive to ensure accountability for financing and delivering the related public services.

- **Accountability**: Local governments should be given full range of powers to fulfill their responsibilities.
Financial viability

- **Adequacy**: Local governments should have sufficient resources to meet their responsibilities, and these resources should be sufficiently buoyant to meet rising demand for services.

- **Vertical fiscal balance**: Local governments’ own revenues should cover their basic expenditure responsibilities and dependence on central government’s grants should be minimized.

- **Fiscal sustainability**: Local governments should not place an undue burden on the central government budget and jeopardize overall fiscal sustainability.
Local accountability

- **Tax localization**: Subnational taxes should be raised and spent for the benefit of local residents.

- **Equity**: All citizens should be entitled to a basic level of public services, with redistribution of resources where necessary.

- **Transparency, integrity, and accountability**: Local governments should publish timely in-year and year-end financial reports which should be subject to regular internal and external audit.
Hard budget constraints for overall fiscal sustainability

- **Comprehensive fiscal coverage**, including extra and off-budget activities carried by local governments

- **Medium-term and aggregated** view of local finances

- **Fiscal rules at the subnational level**: Balanced operating budget; borrowing only for investment and within prudent limits
Components for a successful fiscal decentralization
Key fiscal components I

- **Consistent budgeting and execution**
  - Same budget classification to appropriate, execute and track spending
  - Treasury single accounts to minimize borrowing needs
  - Consistent tracking of commitments and arrears, to limit fiscal risks

- **Transparency**
  - Standardized reporting, to ensure comparison across regions and consolidation
  - Clear and uniform government accounting standards
  - Internal and external audits, program evaluations
Key fiscal components II

- **Strengthening PFM capacity at local levels**

- **Evaluation of outcomes**
  - Governance and budget outputs: where does the money go? How is it accounted and reported?
  - Additional information to budget data: Access to public services, distributional impact
  - Inform subnational governments about the costs of public services, even if they are financed by the central government budget