

***FISCAL DECENTRALIZATION: THEORY AS REFORM***

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**Abstract**

*The last decade has seen a renewed interest in the concept of fiscal decentralization or fiscal federalism. This comes after a half-century of fiscal centralization in most developed and developing nations. This paper examines the theory behind fiscal decentralization and suggests the reasons for its renewed popularity. Two countries are examined in some detail: Brazil, which moved in this direction after their constitutional reform of 1988; and China, which is currently considering a policy change in this direction. Lessons from those two countries and comparisons with some other developed and developing nations are provided. The author concludes that fiscal decentralization provides promise for those nations wishing to encourage their subnational governments to assume additional responsibilities. However, special attention must be given to implementation issues, especially methods of dealing with fiscal inequities.*

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## **FISCAL DECENTRALIZATION:**

### **THEORY AS REFORM**

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*The federal system was created with the intention of combining the different advantages which result from the magnitude and the littleness of nations.*

Alexis de Tocqueville, *Democracy in America*

When Wallace Oates began his 1977 book on *The Political Economy of Fiscal Federalism*, the quote by de Tocqueville seemed an appropriate starting point (Oates, 1977). Indeed, the United States' founding fathers, in *The Federalist*, argued the advantages of a strong (but limited) federal government and independent state governments would provide the best opportunity for the protection of and responsiveness to the citizens in the fledgling nation (see especially Madison, No. 39).

During the period following World War II, and in particular the 1960s and 1970s, the United States, like many nations—both developed and developing—embarked upon a strong centralization of government policy and functions. Central government expenditures of 15 percent of GDP in 1960 doubled to 30 percent by 1985 (World Bank, 1997). However, in the United States, the 1980s and 1990s saw a resurgence of interest in strengthening state and local governments and restraining the growth of the national government. That pattern was repeated in other nations. By the mid-1990s, 62 of 75

developing nations with populations over 5 million were embarked on some form of fiscal decentralization (World Bank, 1997).

Fiscal Decentralization also has become part of a world-wide “reform” agenda, supported by the World Bank, USAID, the Asian Development Bank, and many others, and has become an integral part of economic development and governance strategies in developing and transitional economies (Bahl, 1999a). Along with “globalization,” fiscal decentralization and the desire for local discretion and devolution of power is seen by the World Bank as one of the most important forces shaping governance and development today (World Bank, 1999). My definition of fiscal decentralization is the following:

*Fiscal decentralization is the devolution by the central government to local governments (states, regions, municipalities) of specific functions with the administrative authority and fiscal revenue to perform those functions.*

This paper examines the underlying theory supporting and opposing fiscal decentralization; examines some specific issues concerning the implementation of fiscal decentralization; examines two nations, Brazil and China, that have been struggling with the issue of fiscal decentralization; and proposes a model for fiscal decentralization that attempts, as de Tocqueville argued, to take advantage of the strengths of strong national and local governments.

Why this renewed interest in fiscal decentralization as reform? There are three basic reasons:

1. Central governments increasingly are finding that it is impossible for them to meet all of the competing needs of their various constituencies, and are

attempting to build local capacity by delegating responsibilities downward to their regional governments.

2. Central governments are looking to local and regional governments to assist them on national economic development strategies.
3. Regional and local political leaders are demanding more autonomy and want the taxation powers that go along with their expenditure responsibility.

Fiscal decentralization is now seen as part of a reform agenda of many nations to strengthen their regional and local governments to meet the challenges of the 21<sup>st</sup> Century.

## **I. THE THEORETICAL FRAMEWORK FOR FISCAL DECENTRALIZATION**

The “proper” distribution of tax authority and expenditure responsibility is an extremely complex issue. Economists generally focus on issues of efficiency and equity, while public administration and political science scholars tend to focus on distribution of powers, responsiveness and accountability, and tax competition and coordination.

Economist Richard Musgrave’s framework for analyzing roles or functions is widely accepted (Musgrave, 1959, 1961; see also Oates, 1977).

The Stabilization Function involves the role of tax and spending policies and monetary policy in managing the overall level of economic activity. It is widely agreed that this macroeconomic function should be assigned to the national government. This suggests that the national government must have a broad-based tax suitable for this role. However, Oates’ (1993) analysis of 58 countries demonstrated a positive relationship

between economic growth and fiscal decentralization—suggesting some role for local governments, especially infrastructure development.

The Distribution Function involves the role of government in changing the distribution of income, wealth or other indicators of economic well being to make them more equitable than would otherwise be the case. The case for assigning this function to the national government rests on two assumptions: 1) that the national government's broad taxing powers can more easily redistribute income; and 2) that the ability of taxpayers to move from one jurisdiction to another to take advantage of more attractive spending and taxation policies weakens local government's ability to "soak the rich and redistribute to the poor." The case for regional and local redistributive policies rests on the fact that subnational levels of government provide the services most used by low-income families. However, most economists view the national role as primary.

The Allocation Function is government's role in deciding the mix of public and private goods that are provided by the economy or by government. Each level of government may be more efficient in delivering certain governmental goods and services. The superiority of the national government in delivering national defense or national health research is obvious as is the likelihood that certain services such as fire and police protection are more suitable for local government. In attempting to match local revenues and expenditures in the allocation process, economists are concerned about efficiency, vertical imbalances (mismatches between revenues and expenditures), horizontal equity (fiscal capacity among regions), externalities (spillovers), and tax exportation. Additional

public management concerns have to do with overlapping of taxes and roles, and responsiveness and accountability for service delivery.

This framework is most helpful in thinking about which taxes are levied at each level of government and the total tax authority of each level. A commonly cited public finance principal is “finance should follow function.” If certain expenditure roles are assigned to a level of government, that level must have the resources to meet those responsibilities. Taxes are the principal source of “own-source” revenue for governments at all levels. If tax collections or fiscal capacity falls short expenditure responsibilities, then that level of government must have additional taxing authority, develop user fees, or rely on intergovernmental transfers (such as grants and shared taxes) to support its expenditures.

## **II. ARGUMENTS FOR FISCAL DECENTRALIZATION**

The theoretical case for fiscal decentralization dates from 17<sup>th</sup> and 18<sup>th</sup> Century philosophers, including Rousseau, Mill, de Tocqueville, Montesquieu and Madison. Central governments were distrusted and small, democratic governments were seen as the principal hope to preserve the liberties of free men (Faquet, 1997). The modern case for decentralized government was articulated by Wolman (in Bennet, 1990). Wolman divided the proponents’ arguments under two headings: Efficiency Values and Governance Values.

### **Efficiency Values**

Efficiency is an economic value seen as the “maximization” of social welfare. The public sector does not contain the same price signals as the private sector, to regulate

supply and demand. Public sector allocation of goods and services are inherently political; however, as nearly as possible tax and service packages should reflect “the aggregate preferences of community members.” (Wolman 1997, p. 27). However, within any political jurisdiction, some people will prefer more, some less, public services. As a result there is a “divergence between the preferences of individual community members and the tax and service packages reflecting the aggregate community preferences” (Ibid). Since such divergence reduces social welfare, it is desirable to hold those to a minimum and they will be less in smaller communities (e.g., municipalities) than in larger, more heterogeneous areas (the nation).

### **Governance Values**

Governance values include responsiveness and accountability, diversity, and political participation (Wolman, 1997). Decentralization places allocational decision making closer to the people. This fosters greater responsiveness of local officials and greater accountability to citizens. This is because we expect local decision makers to be more knowledgeable about the problems and needs of their local area than centralized decision makers. Further, to the extent that there is accountability through local elections, those elections are more likely driven by issues of local allocation, whereas national elections are seldom focused on local service delivery.

Diversity in public policy is a second governance argument for fiscal decentralization. It is valued because it offers citizens a greater choice in public service and tax options when they are deciding where to reside (Tiebout, 1956). In addition, it helps to create “laboratories” for innovation and experimentation, which sometimes serve

as models for later implementation by the central government or by example to other local governments. While there is no theoretical reason why a central government could not be diverse in its solutions, there is great pressure on the central government towards uniform policies and procedures.

Finally, fiscal decentralization is thought to enhance political participation at the local level. This has the potential to enhance democratic values and political stability at the local level. It provides a forum for local debate about local priorities, and can be a proving ground for future political leaders. For example, 4 of the last 5 U.S. presidents were state governors.

### **III. ARGUMENTS AGAINST FISCAL DECENTRALIZATION**

While the international political movement towards fiscal decentralization is strong, there have been some recent cautionary notes that need to be considered (Hommes, 1996; Tanzi, 1995, Prud'homme, 1995). Tanzi summarizes this critique by raising a number of situations or conditions, especially in developing countries, where fiscal decentralization may lead to less than an optimal result:

1. Taxpayers may have insufficient information or no political power to pressure local policymakers to make resource-efficient decisions.
2. Local politicians may be more corrupt than national politicians or at least find themselves in more corrupting situations.
3. The quality of national bureaucracies is likely to be better than local bureaucracies.
4. Technological change and increased mobility may reduce the number of services that are truly "local" in nature.

5. Local governments often lack good public expenditure management systems to assist them in their tax and budget choices.
6. Fiscal decentralization may exacerbate a central government's ability to deal with structural fiscal imbalances.

Prud'homme (1995) finds other potential flaws in the theory of fiscal decentralization. The economic efficiency argument, he suggests, requires roughly even regional fiscal capacities—a condition not existing in developing countries. Fiscal inequities may actually increase with decentralization. In addition, localities might engage in destructive competition to attract industry. He also argues that the rationale for decentralization of revenues is not the same as expenditures: and “in many cases the problem is not so much whether a certain service should be provided by a central, regional, or local government, but rather how to organize the joint production of the service by the various levels”(201). Finally, to the extent that local governments are viewed as agents of the central government, fiscal decentralization may limit the ability of the principal (the central government) to influence policy at the local level.

Hommes (1995) sees decentralization as “essentially a political problem” representing, in Latin America for example, a stark departure from centuries of centralism. The success of decentralization may depend upon the existence at the local level of a civic cultural tradition—informal civic institutions, such as solidarity, cooperatives, etc. With a lack of local governmental experience and riddled with patronage, local governments in Latin America tend to be captive of the elites and

political barons. Thus, for Hommes, an irony of fiscal decentralization may be the need for more central government controls to protect against this danger.

*Rejoinder*

The concerns raised have been partially addressed by other scholars (McClure, 1995; Oates, 1995). McClure argues that Prud'homme sets up a straw man—pure decentralization of fiscal federalism—and easily details its flaws. Decentralization done badly says McClure, will cause problems. However, no one proposes full decentralization; rather, what is proposed is decentralization of some functions. Clearly, the central government must retain sufficient revenues (and discretion) to be effective in both their stabilization and distribution roles. Furthermore, a national role in establishing uniform financial reporting requirements and in clarifying roles and responsibilities is also an important aspect of effective fiscal decentralization.

Perhaps the most important issue raised by opponents is the “local capacity” issue. However, it is not self-evident that national politicians and bureaucracies are superior to or less corrupt than their local counterparts. Political and bureaucratic skills may well flow to “the action.” If political decision making is decentralized to the local level, you may see an increase in the capacities of local governments. One of the major objectives of reform *is* building the capacity of local government and local citizens to actively participate in their governmental decisions. Both Brazil and China have experienced corruption and failures at both the central government and local government level. Local corruption may be easier to uncover through central government oversight,

whereas central governments may lack sufficient internal checks to monitor their own performance.

Prud'homme and Hommes are correct that a simple division of responsibilities is seldom appropriate. A good illustration of this issue is environmental protection, where national standards are appropriate, and regional or local governments may enforce, regulate, and produce (e.g., water quality). Financing could easily be a shared responsibility. Hommes would provide grants with strings attached to enforce local accountability.

Hommes notes the seeming paradox of decentralization is that it demands of the central government more sophisticated political control. Ultimately, however, effective decentralization requires the relinquishing of some central control. Oates (1977) notes that as John Stuart Mill pointed out more than a century ago, “decentralized political institutions play an important role in developing skilled public administrators by allowing more widespread and direct participation in the affairs of government” (351). The United States experience in decentralization was (and is) not always an “ideal success.” However, even failures provide learning opportunities for local citizens and their political representatives. Local control over own-source revenues and spending decisions is at the heart of effective decentralization.

#### **IV. ILLUSTRATIONS**

The following table provides a comparison of macro-tax revenue allocations in Brazil and China in comparison to some other nations. Four of the other nations (Germany, India, Russia, and the United States) are federal nations, like Brazil; the other

two (Japan and Korea) are unitary nations like China. The percentage shares of tax revenues include any formal tax sharing provisions but do not include other transfers (such as grants) made by the central government. Also excluded are social insurance revenues and non-tax revenues such as fees and charges (because of the lack of comparable data among the nations).

**Table 1**  
**Tax Allocations Among Levels of Government**  
(Percent of Total Taxes Collected)

Country	Federal	Region/State	Local
Brazil	45.6	47.4	7.0
China	52.1	47.9 *	
Germany	50.2	37.4	12.4
India	46.6	53.4 *	
Japan	60.0	40.0*	
Korea	79.0	21.0*	
Russia	46.3	53.7 *	
United States	59.5	25.3	15.2

\* Local tax revenues are included in the state totals

*Source:* Financial documents from the various countries for FY 1997 or 1998; see references.

While Table 1 does not reveal which taxes are levied by each country, it does provide an overview of policy regarding the *amount* of total taxes allocated to each level. With the exception of Korea, all of the central governments' shares of revenue are within a fairly narrow range, with a high of 60 percent for Japan and a low of 45.6 percent for Brazil. Somewhat surprising, the U.S. appears more centralized than any of the other federal nations studied. This first glance, however, is somewhat deceptive. State and local tax revenue in the U.S. is all "own-source" revenue; that is, state and local governments rely on their own taxing powers to raise their tax revenue. For the other countries, a substantial percentage of the regional/state share of taxes is the result of constitutional or legislative decisions to allow regional governments to *share* national tax revenues.

From a fiscal decentralization perspective it is not just the amount of taxes allocated to each sector, but also the composition of those taxes and the extent that regional and local governments control their own taxes. The former is important in assessing whether the specific taxes match the policy responsibilities at each level. The latter is critical in establishing accountability for local spending. Thus, at least at the margin, subnational governments should control their own-source revenues sufficient to allow some discretion in matching the needs of citizens and the taxes paid (Tiebout 1956). A closer examination of China and Brazil reveals strikingly different revenue compositions, which are summarized in Table 2

**Table 2****Percent Composition of Tax Revenue: China and Brazil****By levels of government, FY 1997, 1998**

<b>Tax</b>	<b>China Central</b>	<b>China Province/Local</b>	<b>Brazil Union</b>	<b>Brazil State/Local</b>
Personal Income Tax		19.9	15.8	10.5
Business IT	8.2	3.1		
Other Business	4.9	41.1	2.1	
Consumption: VAT	56.2	20.8	11.5	76.5
Cons: Sales	16.9			
Cons: Services				1.6
Customs/Duties	8.9		3.9	
Prop/Land/Agr		9.8	.1	1.6
Social Contributions			52.9	6.8
Miscellaneous	5.0	5.3	13.7	3.0

*Sources:* Finance Ministries of China and Brazil and calculations by the author.

## **Brazil**

Brazil is the largest of the Latin American countries and the sixth largest country in the world after China, the United States, Canada, Russia and Indonesia. The Constitution of the Federative Republic of Brazil establishes three government tiers: the Federal Union or central government; 26 states and the Federal District of Brasilia (which has the powers of both a state and a municipality), and 5,507 municipalities. The central government determines the boundaries of states, and the states determine the process for establishing municipalities within their borders; both require approval of the population in the proposed new jurisdiction. Industrial activity is concentrated in the southeastern region of Brazil, with approximately fifty percent of industrial production located in the state of Sao Paulo, the most populous state.

The current tax system in Brazil dates from the constitutional and tax reform of 1966 and the new Federal Constitution of 1988. A major purpose of the 1988 Constitution was to decentralize tax revenue so as to provide greater tax resources to subnational governments, Brazilian states and municipalities. While the Union continues to collect more than two-thirds of total revenue, the constitutional fiscal decentralization has resulted in the federal government's using for national purposes (after tax sharing) less than one-half of total national taxes. In FY 1997, the Federal share was 12.7 percent of GDP, state share was 13.3 percent and municipalities about 2 percent.

Overall, direct taxes (such as income taxes) account for only 30 percent of all tax revenues, while indirect taxes (such as value-added taxes) account for the remaining 70 percent. For Brazilian governments, taxes can be broken down into two categories: own-

source (collected and spent by the same level of government) and shared (collected by one level of government and distributed to lower levels). The major sources of revenue for the federal government are the Personal Income Tax and the Industrialized Products Tax (a limited value-added tax). The federal government keeps 56 percent of the revenue from those two taxes and distributes 21.5 percent to the states and 22.5 percent to municipalities, with part of the distribution providing greater funding to poorer states and municipalities.

The states' chief source of own-source revenue is the tax on Circulation of Goods and Services (a value-added tax at the state level), of which they retain 75 percent and distribute 25 percent to municipalities. States, as indicated, also share the federal government's Personal Income Tax (PIT) and the Industrial Products Tax revenue. Municipalities, in addition to sharing the federal PIT and Industrial Products taxes and the state value-added tax, levy own-source taxes on certain services and urban property. They also are increasingly relying on fees and charges to fund municipal operations.

## **China**

With an area of 9.6 million sq. km. (3.8 million sq. mi.) and a population of about 1.3 billion, China is the fourth largest country in area and the most populous in the world. The Constitution establishes three government tiers: the central government; 32 provincial authorities consisting of 23 provinces, 5 autonomous regions, and 4 metropolitan cities—Beijing, Shanghai, Tianjin, and Chongqing—and numerous municipalities and counties. Industry is concentrated in northeastern and southeastern

provinces, whereas natural resources are primarily located in the northwest. Regional disparities in the level of income are large.

The current tax system in China dates from fiscal reforms in the 1980s and the 1990s (especially the 1994 tax reform). Fiscal reform has been an important part of China's macroeconomic reforms. The prior revenue remittance system, under which government was financed by the profits of state-owned enterprises, is being converted into a tax system that is generally modeled on Western systems. One purpose of fiscal reform is to decentralize fiscal management by granting the provinces and localities greater flexibility in collecting revenues and making expenditure decisions. The central government's transfers (both tax sharing and grants) to provinces are extensive (Rmb 332.2 billion in 1998), constituting more than two-thirds of provincial/local revenue.

China's taxes are divided into three categories: central government taxes; provincial taxes; and local taxes. The major sources of revenue for the central government are the VAT, Consumption Tax (both on domestic and on imported goods), Business Tax (on railroads and financial institutions), Income Tax on state-owned enterprises, and Customs Duties. Since the tax reform in 1994, the central government keeps approximately 75 percent of the revenue from VAT, which is the primary source of revenue for the central government budget, providing more than 50 percent of all central government tax revenue in 1998. Provincial governments' own-source revenues are the Income Tax on provincially and privately owned enterprises, Personal Income Tax, Business Tax (excluding railroads and financial institutions), Urban & Town Land Use Tax, and Stamp Duties. Provinces also receive from the central government

approximately 25 percent of the VAT, all of the urban maintenance and construction tax, and the natural resource tax (except on offshore oil, which is retained by the central government). Local governments, in addition to sharing some tax revenue from provincial governments, may collect taxes on locally owned enterprises, agricultural products, animal slaughtering, and certain agricultural contracts.

China's system of taxation and the assignment of tax revenues are specified by its central government statutes, not by the Constitution. The National People's Congress (NPC) alone has the power to make tax laws, and the State Council is responsible for enacting provisional regulations specifying the details of taxation. In 1998, the State Council issued a circular requiring subnational governments and departments to strengthen tax administration. The circular reiterates that legislative power over taxation (tax bases, taxpayers, and tax rates), including all central, provincial and local taxes, is the sole domain of the central government

One of the major current concerns in Chinese tax policy is the growth of user fees and charges at the provincial and local government level. Virtually all of these are *extrabudgetary* (off budget) and nearly half are considered non-sanctioned by the central government. While provincial and local taxes represent only 5-6 percent of GDP, authorized user fees and charges boast total revenue to approximately 10 percent of GDP; and when the non-sanctioned revenue is included, the estimated local spending is nearly 14 percent of GDP—more than double the central government's general revenue (6.1 percent of GDP in 1998). Many of these charges and fees are quasi-taxes in nature and do not reflect payments for benefits received.

## **V. MAJOR IMPLEMENTATION ISSUES IN FISCAL DECENTRALIZATION**

Both Brazil and China seem committed to their current course of fiscal decentralization. However, issues in both countries raise questions regarding some of the elements of their current tax policy. Bahl (1999b) notes that while there has been significant analysis of fiscal decentralization as a policy strategy (e.g., Gramlich, 1993), far less attention has been given to implementation strategies. In fiscal decentralization, the details do matter.

### **1. How much fiscal decentralization?**

Policymakers in Brazil and China (and elsewhere) are asking whether the revenues available at the national level, after current decentralization efforts, are sufficient to meet the needs of the central government. In both countries, available revenues, including taxes and fees, at the regional and local levels now exceed the central government's revenues. This allocation may make it harder for these countries to eliminate their structural fiscal deficits and effectively perform other stabilization functions (Tanzi, 1995; Prud'homme, 1995).

The assignment in China of the Personal Income Tax to local government seems particularly problematic. While not a significant revenue source to date in China's transitional economy (largely due to poor enforcement and tax evasion), it likely will become a greater potential source of future revenue. Because of its revenue significance and its potential ability to act as an important macroeconomic tool, most nations assign this tax to the central government. However, Bahl (1999b) argues that personal income taxes—primarily a wage tax in developing countries—could be a good local tax.

Alternatively, regional and local governments might be allowed to “piggyback” a regional/local rate on top of the national rate, while leaving the central government in control of structure—even if the tax is collected at the local level.

**2. How much discretion should the central government provide regional and local governments?**

There are a variety of methods of assignment of taxation authority. Regional and local governments can be given authority to levy a range of taxes—perhaps with modest discretion as to methods and rates. This is the current case to a large extent in Brazil and in India and Germany. This approach might also include the “piggybacking” of sub-national rates on top of the national tax. The advantage of limited discretion is more central control and uniformity across a nation; however, the limited discretion may result in reliance by regional and local governments on the central government

A second approach is to specifically assign taxes to each level of government. This is the current case in China, where the central government has reasserted itself as the determiner of tax policy, rates, bases and administrative procedures. Russia also has followed this model, as have most centralized systems of government, including Japan and Korea.

A third approach is to have overlapping authority, where both the central government and regional governments have plenary power to institute a broad range of taxes. This is the case in the United States and (to some extent) Brazil with respect to consumption taxes.

Finally, taxes can be shared in some fashion with one government (usually the central government) taking the lead, imposing and collecting the tax and sharing it under some constitutionally or legislatively mandated formula. Many countries use this approach to some extent, including Germany and Japan, as well as China and Brazil. While this provides the revenues to localities, it keeps the control at the central government level.

Bahl (1999b) argues that in some cases it may be wise to differentiate among local governments, with those of a certain size or maturity having more discretion. In addition, it may be necessary to handle decentralization differently in urban and rural areas. However, to achieve its theoretical gains, fiscal decentralization requires significant local taxing power and discretion to hold local officials accountable for local services.

### **3. How much central control should the central government exercise over regional and local governments?**

There are inherent tradeoffs between central government control and local flexibility. Controlling the tax base ensures standard treatment for all taxpayers but may not fully account for local conditions. Controlling tax rates ensures uniformity but doesn't provide local flexibility to meet specific local needs. Controlling tax exemptions prevents unhealthy local competition but may limit local economic development incentives and options. On a continuum of maximum control to maximum flexibility, the United States and India are two countries toward the "liberal" end of the flexibility scale;

China is toward the control end; and Brazil, somewhat in the middle. One approach is to authorize a limited range of tax rates for localities.

Whatever the level of control, Bahl (1999b) argues that the central government must maintain an ability to monitor and evaluate decentralization. This may require the imposition of a uniform system of accounts and the provision of technical assistance to local governments.

#### **4. To what extent and in what manner will a nation deal with vertical imbalances and horizontal inequities?**

Some type of revenue sharing, from the central government to regional (and possibly local governments) is necessary if central policymakers are concerned about vertical imbalances and horizontal inequities. Vertical imbalances arise when regional and local governments have more expenditure responsibilities than the revenues to fund them. Horizontal inequities refer to the differing fiscal capacities of regions. Both of these issues must be dealt with at the central government level; although regional governments could play a mediating role with local governments.

Both China and Brazil deal with the vertical problem by explicit tax sharing arrangements. Brazil's (like Germany's) arrangement is anchored in its constitution. China's is through central government policy. Both China and Brazil rely on the VAT as their principal sharing tax. Brazil, in addition, shares the Personal Income Tax and certain minor taxes. China also shares certain natural resource taxes. Both nations also provide some of that tax sharing in a fashion to address horizontal fiscal inequities.

There are three challenges in designing an effective tax sharing system. First it is necessary to develop a formula that deals with the problems without eliminating incentives for regional and local governments to develop their own tax resources. For example, Russia uses taxes per capita as a measure of fiscal capacity; but this formula has the effect of penalizing those regions that are developing their tax base. Second, the formula should allow the central government to raise revenues for stabilization purposes without also increasing subnational revenue. Thus, a rate “piggybacking” approach may be superior to the tax sharing approach in use in both China and Brazil. Finally, the tax sharing needs to be fixed, providing a hard budget constraint for local governments. Otherwise, local governments will feel they can negotiate additional funding from the central government, thereby reducing local accountability—a major rationale for fiscal decentralization.

## **VI. CONCLUSION: TOWARD A MODEL ALLOCATION?**

After examining the theory of fiscal decentralization and the practices of nations such as Brazil and China, it might seem impossible to find any common elements that could lead to a “desired” allocation of taxing powers. In addition, differing political aims may suggest alternative revenue strategies. However, there are widely agreed to principles that suggest a particular direction in fiscal decentralization reform, even if falling short of a “model” allocation system.

**First:** For stabilization and fiscal equalization/redistribution purposes, the central government should collect 50 percent or more of total taxes, and those taxes should be from a broad-based elastic tax bases (such as income or value added). The three

developed nations whose central share exceeds 50 percent, Germany, Japan and the U.S., arguably have the strongest macroeconomic programs. In contrast, Brazil, China, India and Russia have all experienced problems with having insufficient national revenues.

**Second:** For allocational efficiency and accountability, regional and local governments should have sufficient discretion on “own-source” taxes. If regional and local governments rely on sharing national revenues, there is less incentive to develop their own tax resources and more incentive to overspend with money other than their own. This discretion should be broad enough to allow local officials to develop their own-source taxes (including some discretion on rates) to fund discretionary local expenditures.

**Third:** For horizontal equity (among regions and states) and vertical balance (matching revenues and expenditures), the national government should have at least one tax that is shared with subnational governments on a formula basis which takes into account fiscal capacity and tax effort. While the degree of fiscal equalization is a political question, attempts at 100 percent equalization are probably not desirable. In Germany and Russia, there is little incentive for states and local governments to develop their own-source revenues because it simply results in less revenue sharing from the national government. The lack of any equalization program is often regarded as one of the defects in the US federal system. Some combination of tax sharing and rate sharing (or piggybacking) could deal with the equity issues while not crippling national stabilization functions.

**Fourth:** Regional or state governments could play a useful intermediary role, allowing the national government to deal with national disparities and the regions to deal with local disparities and individual allocational needs. Regional oversight over local taxes

may be important to ensure integrity and uniformity, especially if the local tax base is used in a formula determining fiscal capacity (e.g., assessed real property values).

**A Tax Allocation Model of Fiscal Decentralization**

What does this all mean for a specific allocation of taxing powers? Table 3 provides for a type of model tax system, which would achieve the four objectives, outlined above.

**Table 3**  
**Model Tax Allocation System**

<b>Central Government</b>	<b>Regional/Local Government</b>
--Income Taxes	--Property Taxes
--Import and Export Duties	--Business Taxes
	--Charges and Fees
<b>Shared/Joint Taxes</b>	--Gaming/lottery
--Natural Resource Taxes	--Income or VAT (piggybacked on national tax)
--VAT	--Excise Taxes

While the case for national import and export duties is obvious from an interstate/international perspective, the case for national income taxes is less obvious. Income taxes, both personal and corporate, are highly elastic and therefore excellent macroeconomic tools. In addition, issues such as tax coordination and compliance and reducing tax evasion argues that income taxes are more appropriate for the national

government. However, Bahl (1999b) argues that in developing countries personal income taxes are primarily wage taxes that can be monitored and enforced at the local level. A compromise model would have the central government be the principal actor with local governments piggybacking a local rate and possibly collecting the tax.

The VAT makes a good shared tax. It can be collected at either the national or regional level. It is more stable than the income tax and thus provides a more assured revenue stream for regions and/or local governments. Sharing natural resource taxes is appropriate because in one sense oil, gas and coal reserves are a national resource; yet, in another sense, the exploitation of those resources imposes costs on local governments. What does not seem appropriate is windfall profits to one region at the expense of other regions.

The property tax is a good local tax. Real property is immobile and local assessment of valuation is appropriate (perhaps, as in the U.S., under state or regional supervision). Business taxes, charges and fees are often closely related to specific services provided by state or local government and thus are good from a standpoint of allocational efficiency. Some would argue against allowing state or local gaming taxes because it leads to exportation of local taxes (and hence lowers the real price for local services); however, there are governmental costs associated with this revenue source.

Regional governments might rely on a piggybacked source of revenue, such as on a national income tax or VAT, or on excise taxes (gasoline, alcohol and tobacco, for example).

Of course, no country starts from scratch. There are existing structures of taxation and political commitments. However, change is in the air. Brazil, China, India, and Russia are all in discussions—in one degree or other—about the appropriate allocation of revenues among the central and subnational governments. Sound political and economic principles should be applied in the discussion.

### **Fiscal Decentralization as Reform**

The theoretical case for continuing the efforts to find the right mix of tax and revenue sharing for subnational governments is the following. When regional and local governments are involved in financing their own expenditures, at least at the margin, they will be more accountable to their citizens (and the central government) for the efficient delivery of public services. In contrast, when the bulk of financing of local services comes from revenues transferred from a higher level of government, local governments are less likely to be parsimonious with those expenditures. Thus, tax sharing formulas need to be constructed in a fashion that encourages (or at least does not discourage) local governments from developing their own-source revenues.

The case for local tax administration and at least some local discretion on tax rates is to place greater responsibility on local government to collect taxes owed and to use discretion as to tax rates to provide discretionary services or to use for economic development purposes. The goal is to provide the greatest stake in the success of local governments with the local officials and to take away the excuse that they are “bound” and therefore unfairly limited by national legislation.

Both Brazil and China have moved strongly in the direction of fiscal decentralization reform and they both share some common problems typical of developing nations:

1. There is overlapping and confusion over expenditure responsibility in both countries. This confusion leads to ad hoc bargaining over central government grants and creates a disincentive for local governments to develop their own-source revenues. This is especially true if local governments are “punished” by a reduction in central government transfers.
2. There is a need—in both countries—to develop a comprehensive VAT, applying to all products uniformly, that can be shared with regional and local governments. This will eliminate any problem of “cascading” tax increases on the product. The central government can either share revenue on a percentage basis or could allow their states/provinces to apply a regional tax as a surcharge on the national tax. This latter option has some advantages because the central government can vary its VAT rates, for macroeconomic purposes, without affecting revenue raised by the state VAT portion.
3. Both countries need to develop a long-run strategy for development of a comprehensive real property tax for their localities. States and provinces might be given the task of assisting localities in this effort and ensuring common assessment practices. While developing such a system is time consuming and resource intensive, it can, over time, provide a steady source of revenue for local governments.

4. There needs to be more discussion and national agreement on the degree of fiscal equalization desired among the regions. Neither country may desire (or have the fiscal capacity) to equalize to the extent that Germany does. And total equalization, as in Germany, also may be a disincentive for localities to develop their own-source revenues. What is important is for the national government to provide a steady stream of transfers that local governments can rely on for budget purposes. The revenue-sharing formula should be transparent and create some incentives for the development of own-source revenue at the regional and local level.

There also are issues that are specific to each country. China's assignment of its personal income and certain enterprise taxes to its provinces runs counter to the common wisdom that such taxes should be national taxes—for both stabilization and redistributive purposes. Provinces could impose a surcharge and “piggyback” their tax on the national tax. National collection and enforcement is critical to long-run growth of this revenue source.

China needs to get better budgetary control over fees and charges levied at the provincial and local level. The central government should create a framework for appropriate user fees and charges, both to the type of allowable fees and charges and to the method of pricing. Fees for services that could be provided by the private sector and are not considered “essential” should be prohibited and/or privatized. All fees and charges should be part of the budgetary review process and not “off-budget.” Finally,

fees and charges that have a characteristic of a tax should be converted to taxes (for example, various transportation fees might be converted into a broad-based fuel tax).

China's recent reforms on tax administration, creating the State Administration of Taxation (SAT), are a move in the right direction. However, dual loyalty problems (created by local funding of regional SAT offices) need to be resolved by full funding by the central government and by thorough training by the headquarters.

The Constitution of Brazil contains far too much tax detail to allow the central government to make changes necessary for effective fiscal policy. It does, however, provide considerable protection for state and local government. While a major overhaul of the tax provisions in the Constitution is unlikely and unnecessary, Brazil policymakers should consider creating some more flexibility in the Constitution so as to relieve the necessity of passing "emergency" legislation to deal with macroeconomic problems.

Brazil and China have taken the path of fiscal decentralization reform yet are struggling with implementation issues. However, if reform follows theory, greater fiscal decentralization and discretion should lead to stronger regional and local governments and greater accountability to for local taxes and expenditures. In the final analysis, fiscal decentralization is a political question and requires a combination of political will, local development and sound implementation strategies to succeed.

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