



## Fiscal decentralisation and corruption A brief overview of the issues

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## FISCAL DECENTRALISATION AND CORRUPTION - A BRIEF OVERVIEW OF THE ISSUES

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A frequently used argument for fiscal decentralisation is that it increases accountability in the spending and raising of public funds, by moving government closer to the people. At the same time, there are concerns that fiscal decentralisation in practice may lead to a decentralisation of corruption.

This issue paper summarises available evidence on fiscal decentralisation and corruption. It starts off with a discussion of issues and proceeds to look at policy implications.

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## 1. INTRODUCTION

Fiscal decentralisation involves the transfer of taxing and spending powers to sub-national levels of government. Developing countries are in general more centralised than most industrialised countries were at a similar stage of development. As a consequence of much dissatisfaction with the results of centralised economic planning, reformers have turned to decentralisation to break the grip of central government and induce broader participation in democratic governance. Thus, fiscal decentralisation has become an important theme of governance in many developing countries over the past two decades. For developing countries on average, the share of public sector expenditures allocated at the sub-national level increased from less than 13% in 1980 to about 20% in the late 1990s. In the same period, there has been a modest increase in the share of local in total taxes.

## 2. DEFINITION, ADVANTAGES, AND DISADVANTAGES OF FISCAL DECENTRALISATION

### Definition

Fiscal decentralisation (FD) is the assignment of expenditure and revenue mobilisation functions to sub-national levels of government. The term thus encompasses two distinct public sector functions – spending and taxation – and FD reform can vary in the degree to which each of the two is shifted from the central to a local government level. Where local expenditure is higher than local taxes, the difference is financed by e.g. transfers from the central government, borrowing, and/or donor support. Inter-governmental transfers are indeed the dominant source of revenues for local governments in developing countries, although there are substantial differences between countries<sup>1</sup>. For instance, in Tanzania the lion's share of operational costs in district councils is financed by central government transfers. In 2002, these transfers funded on average 85-90% of the total operational costs in rural councils. When it comes to investments, most councils in Tanzania are almost completely dependent on transfers from the central level, including donor funding. In contrast, local authorities in South Africa generate, in aggregate, more than 90% of their own revenues (2000-data). The remaining revenues are transfers from the national and provincial governments. However, huge differences exist between municipalities. Metropolitan councils mobilise on average 97% of the revenues themselves, as opposed to some smaller municipalities which only raise 65% of their revenues from own sources.

Any fiscal decentralisation reform also has to take into account the impact on and efficiency of the system of transfers between government levels<sup>2</sup>.

### Advantages

The advantages to fiscal decentralisation are commonly thought to be three-fold:

- preference-matching,
- efficiency through competition, and
- increased accountability.

By being closer to its citizens and hence possibly better informed about local preferences, local government is in a better position to provide public goods and services which meet people's needs. Public services can also be made more efficient and perhaps innovative when territories compete with each other for the custom of mobile citizens. In addition, by reducing the distance between the government and the governed, fiscal decentralisation is expected to stimulate participation and improve accountability.

### Disadvantages

Decentralisation may lead to inefficient decisions and use of resources, if there are positive or negative externalities between regions, or if there are economies of scale or scope in fiscal functions. Shifting more fiscal decisions to local governments, may also increase national inequity, and leave the central government with fewer policy instruments to correct this<sup>3</sup>. Moreover, if the capacity of local institutions is constrained, fiscal decentralisation may transfer tasks to the local level which it is incapable of addressing

properly. While national efficiency and equity considerations entail questions of what type of functions to delegate to local levels, the problem of capacity constraints raises questions of whether local institutions are capable of taking on added functions, and whether and how to improve local capacity to enable them to do so. The answers will differ from country to country and between local authorities within countries, especially between rural and urban local government authorities.

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### 3. HOW DOES FISCAL DECENTRALISATION AFFECT CORRUPTION?

#### 3.1 The arguments

Everything else equal, discretion increases corruption. Fiscal decentralisation entails expanding the decision space of local government at the expense of the central government. Everything else equal, we would thus expect fiscal decentralisation to increase corruption at the local level, and reduce corruption at the central level of government.

The accountability argument for fiscal decentralisation suggests, however, that everything else is not equal. The idea is that by being closer to the people they serve, local governments are more accountable for their decisions and actions than the central government. If this is the case, we would expect fiscal decentralisation to produce a larger decrease in central level corruption than the increase in local level corruption, leading to less corruption for the country in question as a whole.

#### **Accountability and capacity of local governments**

The argument that local governments are more accountable for their decisions and actions, requires certain assumptions to be met. To be held responsible for a decision presupposes that you have some influence on the decision. For local authorities that face capacity constraints (in such areas as staffing, funding, etc.), the actual autonomy over fiscal decisions conferred on them may not be very large. If other agents are to hold a local authority responsible for misconduct, there must be some way in which they can detect misconduct. This requires a functioning and transparent system of accounting and reporting of local government activities, including a critical local press – often missing in a developing country context. It also requires that the decentralised structure is sufficiently clear for people to be able to attribute blame for failures and credit for successes. Moreover, for other agents to hold local government to account for their action, they have the power to effectively sanction or punish misbehaviour. Closeness to the people in itself is thus not sufficient for increased accountability. The people also have to have some leverage on local governments.

If local governments are more capacity constrained than central governments, or have a less adequate system of accounting and reporting, or contribute to a more opaque government structure, or face less critical or powerful opponents, fiscal decentralisation may lead to increased corruption. The increase at the local level can then be more substantial than the reduction at the central level. The capacity and quality of local institutions, and characteristics of the local political arena, are thus important variables that predict the effect of fiscal decentralisation on corruption.

#### **Taxes or transfers**

The type of fiscal decentralisation may also have an effect on the degree to which local governments are more accountable for their decisions. If decentralisation of expenditure is not accompanied by decentralisation of revenue generation, it is easier for local officials to ignore the financial implications of their spending. In other words, the soft budget constraint created by large transfers from central government, may be detrimental to local government performance. There is a tension here, because while generating revenue for local expenditure locally may increase accountability,

it may also lead to a more fragmented tax system, which creates national inefficiencies and inequities.

#### **Complementary or competitive fiscal functions**

In the previous section we noted that externalities between regions may lead to inefficiencies nationally. This is also relevant to the question of how fiscal decentralisation affects corruption. Consider a business or an individual who pays taxes to more than one local government. The bribes demanded by public officials (e.g. tax collectors) in one local government to facilitate tax evasion, will clearly affect the degree to which other local governments officers can demand bribes. In demanding bribes, however, each local government officer does not take into account the effect on other local governments, which means that bribes will be set higher than they would be if the decisions were coordinated. In contrast, if the business or individual were taxed by the central government, these externalities would be internalized, and bribes would be set at a lower level at which net total bribes are maximized.

By contrast, if the business or individual can choose which out of several regions to pay taxes to, we get competition between the regions for the common tax base. This would drive bribe levels down as local governments try to induce businesses and individuals to pay taxes to their region. This would reduce corruption relative to central government taxation, where the central government tax officer would act as a monopolist, and hence be able to demand higher bribes.

The implications for fiscal decentralisation can be summarised as follows: If local governments have complementary fiscal functions, fiscal decentralisation is likely to lead to an increase in corruption nationally. In other words, if businesses or individuals pay taxes to several local governments, or benefit from the expenditures of several local governments, fiscal decentralisation leads to a situation that is worse in terms of corruption. If, on the other hand, local governments compete fiscally, fiscal decentralisation is likely to lead to a decrease in corruption nationally. Put differently, if businesses or individuals are mobile across local government authorities (LGAs), or otherwise capable of shifting their revenues, costs, or activities between LGAs, fiscal decentralisation leads to a better situation. The extent to which local governments are complementary or in competition, will depend on the type of tax or expenditure, and is ultimately an empirical question.

#### 3.2 Cross-country evidence

There are two types of cross-country studies on the impact of fiscal decentralisation on corruption. One set of studies focuses on decentralisation of expenditure, and the other set on the way in which decentralised expenditure is financed (i.e. locally or by transfers and grants from higher levels of government).

#### **Correlations between fiscal decentralisation and corruption?**

Taken as a whole, the studies of expenditure decentralisation do not prove conclusively that there is an effect of decentralisation on the level of corruption. Two studies from 2001 and 2002<sup>4</sup> find that the share of sub-national expenditure to total government expenditure is negatively and significantly correlated with corruption. These studies thus conclude that countries with more

fiscal decentralisation have lower levels of corruption. However, a later study from 2004<sup>5</sup> finds that a negative relationship between the share of sub-national expenditure and corruption is sensitive to the inclusion of school enrolment as an explanatory variable. When enrolment is included, the relationship is insignificant. Since schooling is not included as an explanatory variable in either of the two earlier studies, this casts the robustness of their findings into doubt.

Cross-country studies of fiscal decentralisation and corruption commonly use perception indices of corruption as their dependent variable, which may create additional complications. As argued above, fiscal decentralisation can be expected to reduce corruption at the central government level, and increase corruption at the local level, everything else equal. If perceptions of corruption in a country are to a large extent shaped by cases of abuse detected at the central level, due to for instance greater visibility, then any negative correlation between decentralisation and the corruption indices used, does not mean that decentralisation reduces total corruption in a country.

### **Transfers and corruption**

A closer match between local expenditures and local revenues appears to lead to less corruption, with some possible caveats. A study using data from a cross-section of US states<sup>6</sup> finds that larger federal transfers are associated with higher rates of conviction for abuse of public office, which supports the theory that soft-budget constraints created by federal transfers are potentially problematic. However, an IMF study<sup>7</sup> finds that the effect of increasing local revenue generation reduces corruption only in cases where the share of local to national expenditure is relatively low. The implications are that for developing countries – many of which have small sub-national governments – increased local revenue generation improves governance. The latter study is, however, vulnerable to the objection that it omits the variable of school enrolment, raising questions as to the robustness of the results.

## **3.3 Case study evidence**

### **Local level revenue corruption in Tanzania**

A series of studies covering the period 1996-2003, explore local authorities in Tanzania. Fiscal administrations in many local authorities in this period were found to be highly corrupt, partly due to the high degree of discretionary fiscal power held by local officials, and poor (or non-existent) monitoring from above. Coercion was an integral part of the effort to raise local government taxes. Furthermore, the involvement of donors through arrangements which supply development aid on the basis of matching funds from the local government induced increased tax effort, but at the expense of accountability, responsibility and democratic development<sup>8</sup>. Increased tax effort was achieved through oppressive collection methods, often characterised by violent and extortive forms of enforcement. Coercive tax collection has important consequences for citizens' rights and for the democratisation process. If taxpayers' rights are unclear for both taxpayers and tax authorities, tax compliance and accountability will be affected. Moreover, as long as coercion is accepted as an integral part of tax collection it is unlikely that state-society relations can become more accountable and democratic.

Fiscal corruption in Tanzania takes many forms and varies by types of taxes, methods of tax collection and location. It cuts across all levels of the local government, from the villages to the councils' headquarters. Corruption in local authorities is particularly prevalent in procurement of goods and services, in revenue collection and financial management, in human resources management, and in land allocation and control. The magnitudes in terms of the amounts of money involved seem to rise in step with the administrative level of the council. Although many cases of collusion between taxpayers and collectors are reported, the findings show that the most common type of corruption is embezzlement of revenues by tax collectors and administrators.

Three factors may have led to widespread theft of tax revenues within the local authorities in Tanzania in the period covered (1996-2003)<sup>9</sup>:

- **The low level of wages paid to staff:**

The average civil servant's pay package covered only about 40% of the expenses of a typical household. As administrators and tax collectors did manage to make a living, it meant that they have other sources of income in addition to their salaries. These other sources may include income from farms or from a second or third job in the private sector, as well as embezzled funds. In a survey on fiscal decentralisation and corruption in Tanzania, 78% of the respondents mentioned low salaries of public service workers as a major incentive for seeking and accepting bribes. One respondent stated: 'You may find someone having not received salary for at least three or four months. What do you think he will eat? He will eat us!'

- **The complex nature of the tax structure:**

The local revenue structure was extremely complicated and non-transparent. A large number of tax bases, sub-bases and rates existed for any given local government. Furthermore, the revenue target for tax collection did not necessarily refer to fulfilling the budget, but rather to amassing sufficient revenues to cover the wage bill of the council. When this was achieved, the central government would usually not interfere into the affairs of the local authority. Since both revenue estimates and reports on revenue collection were based on information from the same staff, there was room for manipulating numbers and results. Thus, tax collectors could report enough revenues to cover the wage bill and pocket whatever was left.

- **Inadequate controls:**

In principle, financial control in local authorities in Tanzania was exercised through internal and external audits. However, both functions were weak. In some councils, no internal audit units were in place, and the audit of the local treasury was conducted by the treasury staff themselves. Regarding external audits, the Auditor General's office was, in general, understaffed and had limited capacity to undertake comprehensive audits in all councils because of severe shortage of qualified and trained staff, especially at the senior professional levels. The Auditor General's Office was hindered by financial constraints and its inability to attract, train or keep suitable staff since the private sector offered more rewarding employment to professionals.

### **Citizen survey on local government authorities, Tanzania**

In a more recent citizen survey covering six local government authorities in Tanzania, including 42 villages and wards, corruption was perceived to be prevalent in all councils<sup>10</sup>. On average 60% of the respondents saw corruption as a serious problem. However, there were large differences across local authorities with regard to the extent of corruption. When asked at which level tax revenue was least likely to be misused, respondents favoured village authorities over ward, council, and parliamentarians to truthfully allocate tax revenues. Moreover, the Tanzania Revenue Authority (TRA), a central level institution, was reported as less likely to misuse tax revenues than ward, council, and parliamentarians. On measures to improve the use of tax revenues, most respondents pointed to stronger punishment of government employees and politicians. More information to the public on the allocation of tax revenues was also perceived to be a potentially important measure to improve the use of revenues.

### **Decentralisation and corruption in Uganda**

Many of the corruption related problems in decentralisation reform found in Tanzania, seem to be shared by Uganda. The proceedings from a consultative workshop held in 2002<sup>11</sup>, argues that there are “numerous reports from oversight and other governmental and non-governmental institutions indicating that corruption has accompanied the decentralisation of power and authority from the central to local government levels”. Local financial management is highly flawed, and there are several cases of misappropriation and diversion of funds. In relation to the above discussion, the following shortcomings are particularly relevant:

- There are capacity constraints in local government, in particular in terms of qualified staff, and resource levels which do not correspond to legal and operational requirements
- Local government autonomy is compromised by political interference
- Reporting and accounting is inadequate, false and/or not timely
- Internal and external audits are inadequate, and some auditors are corrupt
- Public awareness is inadequate “at all levels”, and large sections of the populations – particularly the poor – are unaware of their rights, and lack the ability to influence government

As in Tanzania, there are indications that the corruption varies with levels of local government. In local integrity surveys, sub-counties and districts are seen as the most corrupt, whereas lower level local government like village wards are seen as less corrupt, though not clean either. The type of government activity most characterised by corruption is – not surprisingly – procurement.

### **Information dissemination against corruption, Uganda**

A public expenditure tracking study<sup>12</sup> (PETS) addressing the education sector in Uganda, offers further insight into problems of local corruption. Of education grants from the central government channelled through district government, only 13% reached schools in the mid-1990s, implying that the bulk of funds were redirected at the district level. There may be several reasons for this leakage of funds, and corruption is one possible explanation. Interestingly, in an attempt to reduce the leakage of funds, the Ugandan gov-

ernment initiated a campaign, where grants to schools were published in newspapers<sup>13</sup>. Leakage was reduced substantially after the campaign was introduced, and schools in physical proximity of newspaper outlets were able to claim larger portions of their entitlements. The case suggests that information dissemination can be a powerful agent against local corruption.

The idea behind the newspaper campaign was to provide community members with information on allocations to public sector programmes and thereby facilitate local-level monitoring. The assumption behind the grass-roots approach is that since community members are the people who benefit from a successful programme, they have better incentives to monitor the disinterested government bureaucrats. Thus, by enabling grass-roots or community members to monitor and discipline service providers, it is expected that this will amplify their voice in policymaking, and thereby the incentives for service providers to serve the poor will be strengthened.

### **Grass-roots monitoring in Indonesia**

However, as a recent study<sup>14</sup> from Indonesia, measuring missing expenditures in over 600 village road projects, shows, grass-roots monitoring may be prone to capture by local elites. Moreover, since monitoring public projects is a public good, there may be serious free-rider problems: If my neighbour keeps a beady eye on public spending, I can benefit from his vigilance without making an effort myself, so why should I bother? But by the same logic, why should the neighbour? The study estimates that on average 28% of the reported spending to village roads went missing, mostly because road builders skimmed on materials. Increasing grass-roots participation (bottom-up) in monitoring the road projects affected only missing labour expenditures, with no impacts on materials. Since materials accounted for about three-quarters of total expenditures, the overall impact of grass-roots monitoring was nonetheless small and statistically insignificant. In contrast, by increasing the probability of external audits (top-down) substantially reduced missing funds in the projects.

These results suggest that grass-roots monitoring may be effective for government programmes which provide private goods, such as subsidised food, education, or medical care, as long as individual community members have a personal stake in ensuring that the public goods are delivered and that theft is minimised. For public goods where incentives are much weaker, such as village roads or similar infrastructure projects, the use of professional auditors may be more effective.

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#### 4. DOES CORRUPTION REDUCE THE DEGREE OF FISCAL DECENTRALISATION?

If we expect fiscal decentralisation to reduce corruption at the central government level, corrupt officials at the central level will be opposed to decentralisation, since it impairs their ability to extract rents. This means that there may be reverse causality at work here, where corruption decreases the likelihood of fiscal decentralisation in a country. Even in cases where decentralisation is being pursued, central officials may attempt to keep the types of spending with high rent extraction potential, such as defence, under central control, while decentralising spending in other areas, such as health or education.

The cross-country studies mentioned in the previous section do not find evidence that more corrupt countries pursue fiscal decentralisation to any lesser degree. These studies do not, however, explore whether there is a link between corruption and the types of expenditure and revenue generation that are decentralised. Hence, the studies do not tell us whether central government, in pursuing decentralisation reform, have attempted to slant reform in a way that keeps activities with high rent extraction potential at the central level. There is a need for further studies in this area, using a variety of methodological approaches.

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#### 5. DOES CORRUPTION DECREASE THE IMPACT OF FISCAL DECENTRALISATION?

##### *Corruption and preference-matching*

Fiscal decentralisation is partly justified by appeal to Tiebout's classic argument that decentralised provision of public goods allows better fulfilment of diverse individual preferences<sup>15</sup>. This would happen since local governments would choose different levels of public goods provision, and people would move to a jurisdiction whose level fits their preferences. Many observers, however, have expressed concern that the conditions justifying Tiebout's argument are not present in many developing countries. In the presence of local corruption and tax evasion, which exist in many developing countries, the benefits of fiscal decentralisation are limited. By raising public-good costs, corruption cancels out some of the gains from better demand fulfilment. Tax evasion may obstruct the preference-matching mechanism, creating communities where preferences are diverse rather than homogeneous. Hence, the gains from fiscal decentralisation are eliminated.

A recent study from Tanzania addresses this point<sup>16</sup>. It reports that taxpayers' unwillingness to pay taxes and fees are reported as a major obstacle to enhancing local government revenues. Taxes are widely perceived to be unfair. The respondents see few tangible benefits in return for the taxes they pay. In a survey, only 9% of all respondents agree to that most of the tax revenues collected in an area is used for reciprocal services. The majority of respondents hold the view that people should deny paying taxes until services improve. 73% of respondents agree to increased taxation in exchange of improved services. About two-third of all respondents want more citizen participation to improve government services, though there are large variations across councils.

##### *Elite capture*

Elite capture of local governments may exacerbate these problems. With local tax financing, there is a risk that the captured local government may resort to a regressive financing pattern, where the non-elite bear the tax burden of providing services to the elite. Hence, restrictions on the ability of local governments to levy taxes may be desirable, even if the result is to reduce the flexibility of service provision for local needs<sup>17</sup>. User charges may be a useful compromise between the need for matching provision to local needs and avoiding an unduly heavy burden on the local poor. But user charges are, in general, inappropriate for financing anti-poverty programmes such as the targeted public distribution of food, education, or health services. Such programmes are, by their very nature, targeted at groups that do not have the ability to pay for the service – or to pay the bribes to the bureaucrats. As far as central government grants are concerned, these may encourage local governments to claim higher local needs or costs, leading to a restriction of the level of service delivery.

There are quite a few empirical studies of the effect of fiscal decentralisation on fiscal discipline, economic growth, inflation, government size, and more. These studies commonly do not test the extent to which corruption changes the impact of decentralisation of expenditure or revenues. A recent cross-country study which explores the impact of revenue decentralisation on inflation, does, however, take local accountability into account<sup>18</sup>. It finds that although decentralisation of taxation is inflationary, it is less inflationary in countries where there is local accountability in terms of local elections. There is a need for more studies of this kind, focusing explicitly on the issue of corruption.

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## 6. HOW TO DEAL WITH THE PROBLEM OF CORRUPTION IN FISCAL DECENTRALISATION REFORM

Fiscal decentralisation reform essentially consists of two questions: Which expenditures and revenues to decentralise? How to design and implement decentralisation reform?

### 6.1 Which expenditures and revenues to decentralise?

Fiscal decentralisation should attempt to balance national efficiency and equity concerns with the benefits of devolving expenditure and revenue responsibilities to local levels. This implies that types of expenditure and taxation where there are substantial externalities between regions – or that are important in preventing inequity nationally – should be kept at a central level, while other functions can be decentralised. Based on this type of reasoning, a World Bank economist suggests a so-called representative assignment of expenditure and tax responsibilities<sup>19</sup>: (see Table 1 and 2 below)

The two tables can be taken to represent a stylised situation. In practice, the appropriate level of fiscal decentralisation will depend on country-specific factors, such as the level of economic and institutional development, geographical and population size, ethnic fractionalisation, etc.

The presence or possibility of corruption raises additional complications. As the previous sections argue, there is less of a rationale for fiscal decentralisation if:

- there are capacity constraints at the local level,
- there is a lack of transparency or inadequate reporting of local government activities,
- the local level is a hotbed for corruption or captured by elites, and
- no agent has the power to effectively criticise and sanction the local government for inefficiencies or abuse of office

Moreover, decentralisation can increase corruption if the activities of local governments are complementary. This implies that for types of taxation or expenditure where individuals or businesses relate to several local governments, decentralisation can make matters worse. Where there is competition between local governments for the custom of agents, however, corruption can be expected to decrease. It is important to note that the degree of complementarity versus competition can also be a policy lever in certain cases. Typical examples are fees for driving licences, where competition can be created by allowing citizens to choose which region to obtain a licence in.

The respective degrees of expenditure and revenue decentralisation are also linked. Studies suggest that a mismatch between local expenditures and revenues generated at the local level, is associated with more corruption. Where a gap between expenditures and revenues is desirable for other reasons, it is important that the system of transfers between government levels is properly designed.

Table 1. Representative assignment of expenditure responsibilities

Function	Policy, standards oversight	Provision/administration	Production/distribution	Comments
Interregional and International conflicts resolution	U	U	N, P	Benefits & costs international in scope
External trade	U	U, N, S	P	“ “
Telecommunications	U, N	P	P	National regulation not feasible
Financial Transactions	U, N	P	P	“ “
Environment	U, N, S, L	U, N, S, L	N, S, L, P	Externalities of global, national, state, and local scope
Foreign Direct Investment	N, L	L	P	Local infrastructure is critical
Defense	N	N	N, P	Benefits & costs national in scope
Foreign Affairs	N	N	N	“ “
Monetary policy, currency, banking	U, ICB	ICB	ICB, P	Independence from all levels essential. Some international role for common discipline
Interstate commerce	Constitution, N	N	P	Constitutional safeguards important for factors and goods mobility
Immigration	U, N	N	N	U due to forced exit
Transfer payments	N	N	N	Redistribution
Criminal and civil law	N	N	N	Rule of law, a national concern
Industrial policy	N	N	P	To avoid beggar-thy-neighbour policies
Regulation	N	N, S, L	N, S, L, P	Internal common market
Fiscal policy	N	N, S, L	N, S, L, P	Coordination is possible
Natural resources	N	N, S, L	N, S, L, P	Promotes regional equity and internal common market
Education, Health & Social Welfare	N, S, L	S, L	S, L, P	Transfers in kind
Highways	N, S, L	N, S, L	S, L, P	Benefits & costs of various roads vary in scope
Parks & Recreation	N, S, L	N, S, L	N, S, L, P	“ “
Police	S, L	S, L	S, L	Primary local benefits
Water, sewer, refuse, fire protection	L	L	L, P	“ “

Note: U is supranational responsibility, ICB is independent central bank, N is national government, S is state/provincial government, L is local government, and P is non-government sectors/civil society. Source: Shah (1994).

Table 2. Representative assignment of taxing powers

Types of Tax	Determination of Base	Collection and Rate	Administration	Comments
Customs	F	F	F	International trade taxes
Corporate income	F, U	F, U	F, U	Mobile factor, stabilization tool
Resource taxes				
Resource rent (profits/income) tax	F	F	F	Highly unequally distributed tax bases
Royalties, fees, charges; severance taxes; production output, and property taxes	S, L	S, L	S, L	Benefit taxes/charges for state-local services
Conservation charges	S, L	S, L	S, L	To preserve local environment
Personal income	F	F, S, L	F	Redistributive, mobile factor, stabilization tool
Wealth taxes (on capital, wealth, wealth transfers, inheritances, and bequests)	F	F, S	F	Redistributive
Payroll	F, S	F, S	F, S	Benefit charge, e.g. social security coverage
Multi-stage sales taxes (value-added tax, [VAT])	F	F	F	Border tax adjustments possible under federal assignment; potential stabilization tool
Single stage sales taxes (manufacturer/wholesale/retail)				
Option A	S	S, L	S, L	Higher compliance cost
Option B	F	S	F	Harmonized, lower compliance cost
"Sin" taxes				
Excises on alcohol and tobacco	F, S	F, S	F, S	Health care a shared responsibility
Betting, gambling	S, L	S, L	S, L	State and local responsibility
Lotteries	S, L	S, L	S, L	State and local responsibility
Race tracks	S, L	S, L	S, L	State and local responsibility
Taxation of "Bads"				
Carbon	F	F	F	To combat global/national pollution
BTU taxes	F, S, L	F, S, L	F, S, L	Pollution impact may be national, regional, or local
Motor fuels	F, S, L	F, S, L	F, S, L	Tolls on federal/provincial roads
Effluent charges	F, S, L	F, S, L	F, S, L	Inter-state-/municipal, or local pollution issues
Congestion tolls	F, S, L	F, S, L	F, S, L	Tolls on federal/provincial/local roads
Parking fees	L	L	L	To control local congestion
Motor vehicles				State responsibility
Registration, transfer taxes, and annual fees	S	S	S	State responsibility
Driver's licenses and fees	S	S	S	Benefit tax
Business taxes	S	S	S	Residence-based taxes
Excises	S, L	S, L	S, L	Completely immobile factor, benefit tax
Property	S	L	L	Completely immobile factor, benefit tax
Land	S	L	L	Cost recovery
Frontage, betterment	S, L	L	L	Payment for local services
Poll	F, S, L	F, S, L	F, S, L	Payment for services received
User charges	F, S, L	F, S, L	F, S, L	

Note: U is supranational agency, F is federal, S is state or province, L is municipal or local. Source: Shah (1994)

## 6.2 How to design and implement decentralisation reform?

An IMF study of fiscal decentralisation in transition countries, suggests that decentralisation reform should rest of the following three pillars<sup>20</sup>.

### Box 1. Pillars of fiscal decentralisation reform

- **THE NEED FOR CLARITY OF ROLES AND RESPONSIBILITIES** between different levels of government. Clarity, transparency, stability and well-defined rules of the game are paramount for achieving accountability that efficient and sound decentralization requires. Given the interdependence among the various components of the system of intergovernmental relation, this requires a clear and effective delegation of functions by central government, with revenue assignments that are transparent, unambiguous, and commensurate with subnational governments' expenditure responsibilities. It also requires transfers that are based on stable principles and specified by legal formulas that support hard budget constraints.
- **A MEASURE OF AUTONOMY** for subnational governments on the expenditure and revenue side is crucial for realizing the efficiency gains of decentralized government and supporting macroeconomic stability.
  - On the expenditure side, this requires subnational budget flexibility to decide – within limits – expenditure priorities and the choice of both the output mix and techniques of production.
  - On the revenue side, this requires that subnational governments have the authority to own-finance locally provided services at the margin. More complete revenue autonomy requires a minimum of authority to set tax rates and assignment of at least one significant tax source.
  - Sustainable autonomy and economic efficiency, however, also requires a reduction of vertical imbalances and some equalization of opportunity to allow subnational governments to perform their assignment functions. This points to the crucial importance of intergovernmental transfers in fiscal decentralization design.
  - While autonomy should be explicit and well-defined, it must also be circumscribed with respect to the access to borrowing by subnational governments in order to support hard budget constraints and reduce moral hazard.
- **INSTITUTION BUILDING** is the last of the three pillars. A prerequisite for successful decentralization is that subnational governments possess the administrative and technical capacity required to effectively carry out their assignment responsibilities. Supporting institutions, including democratic representation, sound budget processes, local government revenue collection capacity, and mechanisms to ensure coordination and cooperation between different levels of government – both at the political and the technical level – are crucial for the functioning of a multi-tier system of government.

Most of these points are relevant to the question of avoiding corruption. Capacity at the local level, clarity of responsibilities and transparency, and democratic representation, are all important for avoiding substantial corruption problems at the local level. It is important, however, to look beyond the technical aspects of a decentralisation reform, and also focus on political and cultural factors. In particular, the characteristics of the local political arena, such as the degree to which a local government is vulnerable to capture and sanctions by other agents, is essential to the ability of the local government to use increased autonomy as a means of self-enrichment.

### **Risk of increased corruption, Tanzania and Uganda**

Tanzania and Uganda are two countries that have most of the characteristics which imply that decentralisation may increase corruption problems – at least at the local level – and produce fewer benefits than intended. Local corruption is high in both countries, and there are many cases of funds being misappropriated. There is a lack of qualified staff in local government, and inadequate controls in terms of internal and external audits. Reporting and accounting are flawed, false, or not conducted on time. Taxes are complex, the rights and obligations of taxpayers are vague, and coercion and perceived unfairness of the tax system suggest that large sections of society – and the poor in particular – have little influence on local government.

### **Key considerations when facing corruption**

The two case countries – Tanzania and Uganda – also offer some insight into how fiscal decentralisation reform can be shaped to have a more beneficial impact. It is apparent that the level of corruption varies between levels of local government, and that lower levels appear to have smaller problems of corruption. This would suggest that there may be advantages to devolving responsibilities to lower levels of local government, such as village authorities. Not all types of spending or tax authority can be meaningfully decentralised to such a low level, however, so the potential for this type of reform may be limited. In addition, limited corruption at these levels may reflect a limited amount of current discretion, with the possibility that corruption may increase with increased spending and taxation powers.

Where corruption is an issue, one should also be careful in terms of what types of taxes and spending powers to decentralise, and to what localities. The most suitable types of powers to decentralise are those that are the most simple and transparent, where individuals and groups can easily determine who is responsible for action and inaction, and where the outcome of government action is easily observable. In addition, in areas where there are powerful and vocal groups that hold a local government accountable for spending and tax decisions, decentralisation is a useful option. The latter also implies that asymmetric reform may be appropriate, where the degree of decentralisation may vary across regions according to their institutional and political situation.

### **Complementary actions**

Finally, in the event that decentralisation is implemented in the face of corruption related problems, a range of complementary actions should be taken to counteract increases in corruption or negative effects of local capture. As the evidence from Uganda shows<sup>21</sup>, publication of transfers from central government can ensure that

funds are used as intended. Similarly, transparency requirements in the collection and spending of local revenue would reduce the possibility of coercion and misappropriation. Local level capacity in financial management is also an important area to bolster, in order to improve decision making, implementation, and oversight of the collection and use of public funds at the local level. Improved information to the public on budgets and accounts may improve the opportunities for citizens to voice their views and demand accountability from local authorities. It is, however, important to stress that encouraging citizens and civil society to engage in fiscal and financial monitoring at the local level does not imply that such measures should replace formal auditing and accounting mechanisms. Recent evidence from Indonesia suggests that grass-roots monitoring may be effective for government programmes that provide private goods, such as subsidised food, education, or medical care, where individual community members have a personal stake in ensuring that the public goods are delivered and that theft is minimised<sup>22</sup>. For public goods where incentives are much weaker, such as village roads or similar infrastructure projects, the use of professional auditors may be more effective.

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