



Asia  
Research Centre

# Approaches to reform of intergovernmental relations

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# Issues

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- ▶ Inadequate outcomes of sub-national operations
  - ▶ Poor or cost-ineffective delivery of services including in OECD countries (Ahmad, Brosio, Tanzi 2008, see also Ahmad and Brosio 2009)
  - ▶ Inadequate autonomy or accountability (Bardhan 2009)
- ▶ Macro-economic difficulties (apportionment of deficits in EU countries)
- ▶ How to make constitutional reforms operational?
  - ▶ Political economy and institutional constraints
  - ▶ Attempts to disentangle spending assignments and revenue raising powers, and establish new transfer systems
    - Spain
    - Germany
    - Italy
  - ▶ Why is it so difficult to make progress with policy reforms?



# Disentangling spending responsibilities

# Enhanced service delivery?

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- ▶ Ostensible reason in the literature: better preference matching, more effective service provision
- ▶ Yardstick competition—modern equivalent, through political process
- ▶ But overlapping responsibilities—makes accountability difficult
- ▶ Complicated by
  - ▶ Differential power relationships/inequality
  - ▶ Incomplete information flows (typical in less developed countries, but also in many OECD countries)
- ▶ General absence of sub-national local/regional own-source revenues (most Latin American countries)—exceptions: Italian IRAP, Canada GST, Brazil ICMS, India state-level VAT.
- ▶ Competition for transfers; including conditional cash transfers

# Why do local services not improve?

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- ▶ **What responsibilities?**
  - ▶ Overlapping functional responsibilities
  - ▶ Too many levels of government? Links with own-source revenues
  - ▶ Excessive earmarks
- ▶ **Creating accountable governments with hard budget constraints?**
  - ▶ Access to own-source revenues, for hard-budget constraints (Ambrosiano and Bordignon, 2006)
  - ▶ How many levels of government?
  - ▶ Debt management: limits, bailout policies and coordination with the center
- ▶ **Standardized budgeting, accounting, reporting and information flows**

# Political responsibilities or capture?

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- ▶ **Could contradict effective service provision**
  - ▶ Avoiding accountability?
  - ▶ Local politicians might prefer to avoid being held responsible
  - ▶ Central government may prefer to use transfers as leverage
- ▶ **Theoretical solutions: asymmetry; contracts**
  - ▶ Contracts often suggested (Spahn, 2006)
    - ▶ Not necessarily conducive to greater transparency
    - ▶ Significant requirements on monitoring of outcomes, performance budgeting at all level of government
  - ▶ Asymmetry may be an excuse for ad hoc game-play/rent-seeking behavior, but often can provide solutions to intractable problems
    - ▶ China
    - ▶ Spain
    - ▶ Italy
- ▶ **Disentangle “functions” –such as basic education or health care (in UN COFOG terms, or GFS2001) rather than economic categories (wages, capital, etc...)**
  - ▶ Need for standardized information at all levels of government

# Constraints in implementation

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- ▶ **Incomplete decentralization**
- ▶ **Overlapping functions**
  - ▶ Spain and Germany
  - ▶ Italian constitutional reforms
- ▶ **Standardized information at all levels of government**
  - ▶ EU requirements where structural reforms are involved
  - ▶ Scope for additional work in Italy

# Case for own-source revenues

# Critical role of own-revenues

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## ▶ Critical for accountability

- ▶ Need to be able to adjust rates at the margin, even with centralized administration (Ambrosiano and Bordignon, 2006)
- ▶ Canadian options of multiple VATs may not be feasible in the EU legal context
- ▶ Italian IRAP being copied elsewhere as an appropriate handle at the intermediate level
- ▶ Pressures to remove IRAP and the removal of some property taxes (ICI) may be counterproductive

## ▶ Design:

- ▶ Consider exporting of taxes to other jurisdictions;
- ▶ Administrative considerations;
- ▶ Which level creates revenue space, given overall level of “desired taxation”?

## ▶ Revenue-sharing inadequate in providing own-tax handles

# Administration

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- ▶ **Subnational administrations for major taxes**
  - ▶ Often found in federal countries: Germany, Canada, India, Brazil
  - ▶ Can be quite complex (dual VATs; separate income tax arrangements)
- ▶ **Single administration often much more efficient**
  - ▶ Canada: piggy-backed arrangements in the past
  - ▶ Italian IRAP for the regions with own-source revenues at the margin better than arrangements that allow no flexibility in rates

# Policy interactions: Taxes and transfers:

The political-economy of sequencing major reforms

# VAT –related reforms

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- ▶ **Centralization of administration, revenue-sharing alternatives (not an effective “local” tax)**
  - ▶ China (1993, stop-loss provisions plus equalization system)
  - ▶ Australia (2001, linked to the equalization system)
  - ▶ Mexico (1978-81 complex sharing arrangements, with central pool)
- ▶ **Decentralization of administration, centralized policy; complex sharing**
  - ▶ Germany: inefficiencies as absence of Laender own-source revenues leads to “administration” game play
  - ▶ Inefficiencies as administration used to proxy policy
- ▶ **Inertia: hard to implement additional reforms**

# Australian VAT

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- ▶ Sub-national VATs not an option as goods cannot be subject to s/n tax; and services cannot be subject to federal tax
- ▶ VAT opposed by the states as it would cut across their taxes and autonomy
- ▶ Political economy compromise:
  - ▶ 1. Decision on federal administration—with tax policy determined by center in consultation with states
  - ▶ 2. All VAT revenues returned to the states through the existing equalization framework
- ▶ Simple and transparent solution
  - ▶ and in recent years, a simplification of the factors used to calculate the needs and revenue capacities

# Conclusions on Tax reforms and incentives

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- ▶ **Desirability of control over rates at the margin**
  - ▶ IRAP Italian style?
  - ▶ Canadian joint-occupation of bases (HST); or Quebec administration
  - ▶ Piggy backed options on income taxes
- ▶ **Scope for stop-loss provisions**
- ▶ **Action on transfers helpful to address gainers and losers**

# What to do about transfer design?

Equalization and special purpose transfers

# Design of transfers: key issues

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- ▶ Does an equalization system help?
- ▶ Can a conditional cash transfer (CCT) system work with imperfect information?
  - ▶ Categorical tests (disability, work test, clinics and schools) versus asset and income tests
  - ▶ Costs of administration? Poverty traps and kinks in the effective tax schedule?
  - ▶ Makes game play more attractive?

# Transfer design and Institutions

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- ▶ Poorly designed transfers/aid could affect incentives—gap-filling transfers problematic (Rao, in Ahmad, *Financing decentralized expenditures*, 1998)
  - ▶ sap incentives to provide services effectively and for accountable behavior
- ▶ Design issues
  - ▶ Equalization frameworks?
  - ▶ Need for simplification—recent reforms in Australia to simplify factors and information and standardized information
  - ▶ How to address special purpose transfers? CCTs?
- ▶ Institutional framework for agreements
  - ▶ Grants/Finance Commissions

## Some Institutional Comparisons for Untied Grant Distribution

	Is there a separate agency to advise on grants distribution	What Ministry does untied grant distribution work	Is local govt involved in grant decisions	Are academics involved in a formal way	Where a separate agency operates			
					Is the agency permanent	Does it operate under the Constitution or a law	What is its range of functions	What is the size of the agency
Australia	Yes		Yes		Yes	Law	Narrow	Small
Canada		MoF	Yes					
China		MoF						
Denmark		MoF	Yes					
Ghana	Yes		No		Yes	Constitution	Narrow	Very small
Ethiopia		House of Federation and MoF	Yes	No				
India	Yes		Yes		No	Constitution	Narrow	Small
Italy		MoF and MoLG	Yes	Yes				
Japan		MoLG	Yes					
Philippines		MoF	Yes					
Sierra Leone	Yes		Yes	No	Yes	Law	Wide	Small
South Africa	Yes	MoF and MoLG	Yes		Yes	Constitution	Wide	Large
South Korea		MoLG	Yes					
Sudan	Yes	(MoF)	Yes	Yes	Yes	Constitution	Wide	Large
Uganda	Yes		Yes		Yes	Constitution	Wide	Small

Source: Bob Searle, 2010, "Revenue sharing and Intergovernmental Transfer Design," in E. Ahmad and A. Al-Faris, *Fiscal Reforms in the Middle East*, Elgar.

# Sub-national governance, information flows and reporting

Incentives and Public Financial Management Systems

# Perspectives

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- ▶ **Local governance has to be seen in context**
  - ▶ Information and incentives matter
  - ▶ The mechanics are important, and represent “necessary” conditions, not “sufficient” ones...
- ▶ **Public financial reforms need to be grounded on**
  - ▶ well designed incentive structures
  - ▶ Accurate and timely information flows; and
  - ▶ Sanctions and enforcement mechanisms

# Transparency/PFM Objectives

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- ▶ Who spends what?
- ▶ When?
- ▶ What happens to the moneys?
  - ▶ Need timely and verified information
  - ▶ Deluge of “unverified” information is not necessarily better
- ▶ Standardized information important for enhancing local incentive structures, and
- ▶ Making equalization transfer systems operational

# PFM Reforms

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- ▶ Moves towards performance budgeting at the central level
- ▶ Need to firm up basic “building blocks” of public financial management
  - ▶ Focus on “minimum requirements”
    - ▶ Weaknesses in budget classifications and accounting frameworks
    - ▶ Need to align information systems
  - ▶ Need to report on general government operations
  - ▶ Importance of common standards across levels of government
    - ▶ Either EU requirements for Maastricht or other international standards

# Central government PFM reforms incomplete in Italy

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- ▶ Program classification introduced for 2008 budget, refined for 2009, in preparation for performance budgeting
  - ▶ 34 high level missions, 168 programs
  - ▶ But budget voted on 700 line items (*unita provvisoriale di base; UPB*)
  - ▶ UPB basic accounting and control unit
- ▶ **Limited flexibility for managers**
  - ▶ expenditure chapters encumbered by other legislation
  - ▶ Need for spending review exercises
    - ▶ 2007 review on Ministry lines, rather than programs

# Central government PFM

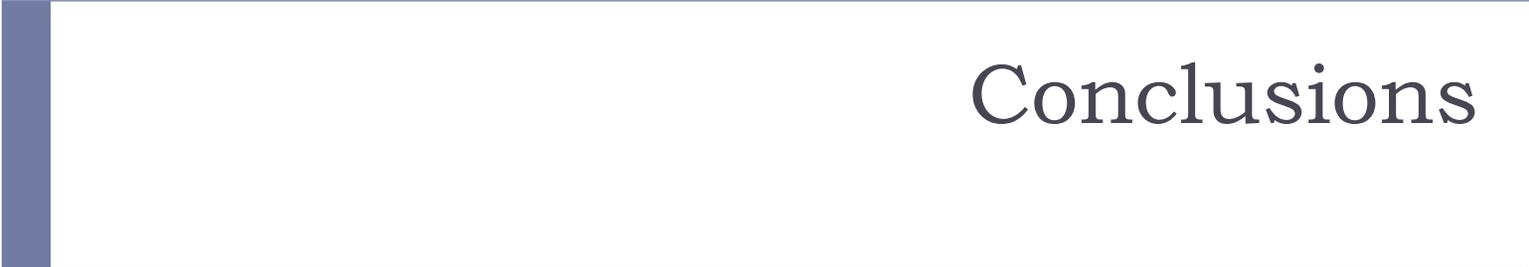
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- ▶ Information base on budget execution
  - ▶ SIOPE only for *cash* transactions
  - ▶ Does not contain commitment controls, not quite a GFMIS
- ▶ Need for standardized and comparable information across jurisdictions
  - ▶ Similar or improved information systems needed at all levels of government
  - ▶ Consistent budget and accounting frameworks, particularly budget classification
- ▶ Needed for effective operations of transfer mechanisms as well as apportionment of debt limits

# Preconditions for SN borrowing

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- ▶ Address greater clarity of responsibilities and accountability;
- ▶ Sub-national access to own-revenues at margin necessary for enforcement and credibility of hard-budget constraints
- ▶ Enhanced CG monitoring; prepare consolidated statements of debt and sustainability
- ▶ Effective SN government financial management and administration: greater transparency
- ▶ Standardized information essential
- ▶ Establish credible credit ratings for sub-national governments



# Conclusions

Does the economic crisis make matters worse?

# Way forward

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- ▶ **Attempts to clarify responsibilities** are steps in the right direction
- ▶ Italy has already made progress with regional own-source taxation—same may be needed for local taxation
- ▶ **Non-distortive set of equalization transfers** needed to provide similar levels of service at similar levels of tax effort
- ▶ Clearly defined earmarked transfers for central objectives
- ▶ **Standardized information flows** will remain a critical precondition for
  - ▶ better sub-national governance,
  - ▶ overall macroeconomic management, and
  - ▶ the operation of an equalization system
- ▶ Any major reforms will need careful sequencing to indemnify losers, and to consolidate political support