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New Rules for Implementation of Fiscal Decentralization

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ABSTRACT

This paper reviews the issue of how well fiscal decentralization has been implemented and how successful these projects have been in achieving a new level of local government financial capacity and service delivery. It reviews the most recent research literature that has assessed the success and failure rates of fiscal decentralization in a global and Central and Eastern European context. Overall, the levels of success have not been encouraging with fiscal decentralization having a positive impact. Professor Roy Bahl in a 1999 paper titled "Implementation Rules for Fiscal Decentralization" defined the basic approach to implementing fiscal decentralization and many of these rules have found been the guiding principles for implementing fiscal decentralization. This paper addresses the deficiencies in these rules based on the experiences over the past decades and formulates new rules for implementing fiscal decentralization. The paper concludes that new rules need to be formulated and encourages more dialogue and discussion among researchers and practitioners engaged in implementing fiscal decentralization.

Keywords: Decentralization, Fiscal Decentralization, Subnational Government, Central and Eastern Europe

INTRODUCTION

Professor Roy Bahl provided in his 1999 paper "Implementation Rules for Fiscal Decentralization" twelve rules for implementing fiscal decentralization (Bahl, 1999). These have been referenced and perhaps even followed by the practitioners in implementing fiscal decentralization technical assistance in the transition and developing countries over the past 15 years. The most common rule referenced is that "finance follows function"; yet this is more often violated in practice than probably any other of the rules and for many good reasons. Even Bahl in his paper indicates that this rule is rarely followed and cites reasons for this.

Since Professor Bahl formulated these rules over a 15 years ago there have been many fiscal decentralization programs implemented in both developed and developing/transition countries. So, by this time these rules should have been fully tested in the actual implementation of fiscal decentralization. Unfortunately, there seems to have been no testing, examination or assessment of these rules and how they have been employed in actual fiscal decentralization efforts based on literature searches.

So, what should we make of these rules and how should we assess their relevance or practicality over these years. In this brief paper I want to challenge all of these rules and offer a new set that conforms with my experience to the reality and practicality of implementing fiscal decentralization. I take them one-by-one with some critique and offer an alternative rule.

It is the contention of this paper that these rules where not based on the realities of the political, economic, and social situation in which they were applied and following them, to the extent possible, probably contributed to the unintended consequence of the failures that are evident today.

Because of this failure there is a need for a new formulation of what rules of fiscal decentralization implementation would provide a greater success rate and more beneficial impacts of fiscal decentralization in the future. The other alternative is to simply give up on fiscal decentralization as a good idea that could not be implemented.

A FAILING RATE OF SUCCESS

It seems fair to state that there have been few successes in implementing fiscal decentralization over this period, despite the millions and millions of funds spent by the donor community in these efforts. There are probably fewer objectively verifiable successes than the fingers on your hands. So, the question has to be why have they not succeeded. Is it from not following these rules or that these rules where not realistic or practical to begin with when they were tried.

While there is no comprehensive evaluation across all the countries or fiscal decentralization projects that have been implemented over the past decades, there is an extensive number of studies that have attempted more limited assessments and evaluations of the success rates of decentralization and its components.

There is no intent here to make a literature review of all of these. However, several significant studies are cited herein to illustrate the main contention of decentralization on a comprehensive basis has had a failing rate of success.

An OECD Working Paper published in 2004 gave an early indication that decentralization and it components did not provide a significant level of success in improving the levels of poverty reduction in 19 countries studied. Of the 19 countries studied, the results showed that only three countries (Bolivia, Philippines, and India (West Bengal) had positive results, four countries (China, South Africa, Mexico and Ghana) had somewhat positive results, nine countries (Paraguay, Brazil, Nepal, Vietnam, Egypt, Sri Lanka, Ethiopia, Burkina Faso, and Uganda) had somewhat negative results, and five countries (Guinea, Mozambique, Malawi, India (Andrah Pradesh) and India (Madhya Pradesh) had negative impacts of decentralization (Kauffman, McDonnell, Osterrieder, Pinaud and Wegner, 2004).

The World Bank has been one of the main proponents of decentralization and has provided probably the most significant level of funding through technical assistance programs. Consequently, some indication of the success rate of decentralization should be evident from the results of an evaluation of their programs. A 2008 report by the World Bank Independent Evaluation Group titled Decentralization in Client Countries: An Evaluation of World Bank Support 1990-2007 provided an assessment of the successes and success rate of the WB sponsored projects (World Bank, 2008). The evaluation examined 20 countries with the intent to determine what had worked and what had not in support of these decentralization efforts.

The report indicated that “the support for decentralization was of mixed quality, which nonetheless improved toward the end of the evaluation period, by which point it was rated high in about two-thirds of the focus countries. It was most successful in strengthening legal frameworks for decentralization and intergovernmental relations, improving public financial management at the local level, and helping central governments establish transparent fiscal transfer systems. It was much less successful in helping to enhance own-source revenue at the local levels, clarifying responsibilities of different levels of government, and strengthening citizen oversight.”

It seems that while implementation improved over the course of the evaluation period covered, a two-thirds success rate is still of questionable value measured against the cost of providing the level of technical support and funding that went into these efforts.

In another well researched paper written by Jamie Boex titled Fiscal Decentralization and Intergovernmental Finance Reform as an International Development Strategy he states: “While there are some developing and transition countries where fiscal decentralization reforms have been relatively successful, it is indeed quite hard to come up with developing country examples where fiscal decentralization reforms have been an indisputable success story.” (Boex, 2009) Boex identifies only three countries, Poland, Indonesia and South Africa, as being relatively successful.

Martinez, Lago-Penas and Saachi (2015) provide the most recent and comprehensive assessment of the impact of fiscal decentralization across the economic and political spectrum. They provide a survey of the research literature on the (1) economic and fiscal consequences (service delivery, economic growth, macroeconomic stability and fiscal sustainability, income inequality and poverty, geographical and interregional disparities) and (2) the political and policy consequences (government size and public policies, governance, governments' accountability and corruption, social capital and tax morale, voter turnout and nationalization of party systems and national unity). In each of these areas the authors survey the research as to whether the positive or negative impact of fiscal decentralization can, first, be ascertained, and, secondly, if there is a reasonable causal link among these factors and the implementation of fiscal decentralization. They conclude that while the results are rather mixed across these areas the research tends to indicate that fiscal decentralization has positive impacts only where the process is "well designed and implemented." (Martinez-Vazquez, Santiago Lago-Penas and Saachi, 2015).

While the global impacts assessed above present a rather ambiguous or negative result of fiscal decentralization implementation, a region where fiscal decentralization efforts should have shown some significant impacts would be the transition countries of Central and Eastern Europe following the fall of the communist regimes. This region, perhaps more than any other, served as a very good pilot and test case for fiscal decentralization. However, even here the implementation of fiscal decentralization seems not to have achieved a satisfactory level of results.

Rodriguez-Pose and Kroijer, in a paper in 2009 examined the relationship between decentralization and economic growth. The findings indicated that the "expenditure assignments and dependence on transfers have negative implications for economic growth." (Rodriguez-Pose, Andres and Kroijer, 2009). The only positive correlation was when the own source revenue was a significant share of the overall fiscal resources at the local level.

In a 2012 paper by Aristovnik the trends of fiscal decentralization in Eastern Europe were analytically examined. A fiscal decentralization index was utilized to examine the overall levels of fiscal decentralization among the countries of the region. According to Aristovnik there was an "alarming downward trend of the fiscal decentralization index (FDI) in most countries of the region over the past two decades."(Aristovnik , 2015).

A report by the Network of Associations of Local Authorities of South East Europe (NALAS) in 2012 described "fiscal decentralization as a work in progress" and that the region was lagging behind in every aspect of revenue sources in comparison with the EU countries. The report cited the following critical features of the fiscal decentralization situation: (1) unconditional grants play a relatively small role in the financing of local governments, (2) revenue sources are largely based on real-estate transactions, new investment, and businesses, (3) the property tax collection is much less than 1% of GDP, which the EU average, and (4) local borrowing is not adequately utilized (Nalas, 2012).

If the above cited works represent a fair assessment of the impact of decentralization and, specifically, fiscal decentralization, then there is a need to examine and redefine how these programs have been and should be implemented. Therefore, to the extent the rules of implementation formulated by Bahl have been implemented, or not implemented, a new formulation seems to be in order.

NEW RULES OF FISCAL DECENTRALIZATION

In this section each of the rules promulgated by Professor Bahl are addressed with discussion of the problems with each of these and the formulation of a new rule for implementation.

Rule 1: Fiscal Decentralization Should be Viewed as a Comprehensive System

Professor Bahl begins his list of rules for implementing fiscal decentralization with the view that fiscal decentralization should be part of a comprehensive system that must complement and be coordinated across a broad spectrum of the political, administrative, and fiscal decentralization efforts. Bahl indicates “Implementation should begin with a design of the comprehensive system, and should lay out the plan for each element.” (Bahl, 1999: 5). This is a rather simplistic approach attempting to define a holistic strategy, which has been tried in other areas of development assistance with limited success.

This rule has largely been implemented through the development of some decentralization strategy that looks at the overall requirements of decentralized system and provides the objectives and approaches to meeting these objectives. Typically, a roadmap is provided providing a timeframe for the achievement of the specific steps.

In my own experience and having written a number of decentralization strategies I can say these tend to have a shelf life. That is they sit on the bookshelf for their whole life. There are a number of reasons for this, but chief among these can be reflected in the words of Machiavelli’s The Prince who cautioned: “It must be remembered that there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than a new system. For the initiator has the enmity of all who would profit by the preservation of the old institution and merely lukewarm defenders in those who gain by the new ones.”

There are many additional reasons for this failure to develop and implement a comprehensive decentralization system. These include:

1. <u>Resistance from the central level ministries to transfer of funds and personnel</u>. The central level ministries have the most to lose in the decentralization effort. Their interest is to maintain their personnel and funding position authority and not become relegated to a policy development or oversight function in the governmental scheme. The chief resistor is typically the Ministry of Finance that is uncomfortable with having their control over financial decisions limited. The other obstacle here is the perception that the local governments do not have the capacity

or skills to handle the financing of services and pose a financial risk to the central government, particularly in areas of local government borrowing.

2. Weak support or even resistance from the local levels leaders who in some cases would rather complain about the problems of delivering services than have to accept the responsibility for solving them. Some local leaders would rather be able to blame local service delivery problems on the lack of funds from the central level and their resistance to accept the responsibility for imposing local taxes and being accountable for the spending of these funds.
3. The election cycle is shorter than the time required to implement a comprehensive decentralization system and the whole process is viewed as a political ploy to win votes. Decentralization is too often utilized for political purposes and manipulation in the election cycle. Immediately preceding the elections, either at the national or local level, the central level politicians make a lot of promises on implementing decentralization. However, once the election is over the political will and the pressure to fulfil their promises fades very quickly.
4. External consultants too often develop these strategies without sufficient political or time commitment from the local stakeholders who view this as another donor community driven program. External consultants, hired largely by the donor organizations, are often used to write these decentralization strategies and these are often done without full commitment or interest of the local stakeholders. A working group will often be formed, but the work will largely done by the external consultant, who writes the document, holds a workshop, and then leaves.

New Rule 1: Define a few strategic entry points (two to four) of least resistance and moderate consensus for fiscal decentralization and build from this base for success.

A more nuanced approach targeted toward some win-win solutions in the early stages of the decentralization and fiscal decentralization process would increase the probability of achieving some successes that provide for further implementation of decentralization components. A large-scale comprehensive approach tends to only stiffen the resistance and opposition to implementing decentralization. The limitations of local capacity to accept and implement decentralization would be easily overcome through the more targeted technical assistance that could be provided. The success areas identified in the above cited WB report would provide some indication of these areas to target for more strategic entry points into the public finance system.

Some key entry points are likely to be in the revenue area, particularly in improving the collection of local taxes, providing for increased local authority to establish the base and rate of taxes, provide for local borrowing, and expanding the local own source revenues. Another area would be to make more transparent and objective is the infrastructure grants system that would incentive local governments to increase their own local revenue sources to match the grants from the central government. A performance based grant system would be a basis for implementing a new approach to decentralized delivery of services.

Rule 2: Finance Follows Function

Finance follows function is the mantra of the fiscal decentralization movement. It rests on some fairly simple assumptions that are conceptually appealing, but are nearly impossible of applying. Bahl indicates this important rule requires: (1) the cost of the expenditures must be determined before (2) the appropriate mix of revenues can be assigned to the local governments. (Bahl, 1999: 11)

In practice this has failed on both counts. First, costing public services is impractical as there is rarely a unit cost that can be applied to the diverse service requirements of a local government. The level of services across the whole country, especially if it is a large country will vary greatly, and the local costs could vary greatly from rural to urban areas. Finally, economy of scale is not applicable to most local public services, particularly health, education, welfare, etc. Fox and Gurley (2006) have provided a comprehensive review of the issue of economy of scale in the delivery of public services and its relationship to the size of local governments (Fox, William and Gurley, 2006).

The other practical problem is that it seems finance never follows the functional assignments. The unintended consequence of this approach is a lot of unfunded mandates that the local governments have neither the funding nor the capacity to deliver. The central government simply off-loaded functions they didn't or couldn't finance and fiscal decentralization is a good cover for doing that.

Professor Bahl in his paper admits that most countries do not follow this rule, as the practicalities of doing this are too difficult. So, a rule that isn't applied can hardly be a rule worth following.

New Rule 2: Function evolves from Finance

Since most central governments find the route of assigning revenues easier to implement, the rule should follow this more practical approach. There is no need to assign functions as a bulk transfer of functions in a law on local government. The increase in local government revenues or additional intergovernmental transfers to the local governments could be accompanied by specific functional assignments that could be directed to those functions. Over time the number of functions assigned could be increased along with the capacity of the local governments to assume these services.

The asymmetrical approach to functional assignments could also be applied and only those local governments with the capacities and willingness to assume these functions should be given the functions. The approach of Croatia in giving additional share of the income tax to local government units, which assume additional decentralized functions, such as elementary and secondary education, health care, fire protection and welfare, is one example of how this approach could be applied.

The use of earmarked transfers for certain functions, rather than just general unconditional grants, would provide some control and accountability in the use of funds. Rwanda is one example where the use of earmarked funds has been effectively utilized to ensure that the local units apply the funds properly. This also needs to be accompanied with an appropriate level of auditing of the use of these funds as well.

This approach would eliminate one of the main failures that have been identified in the development of fiscal decentralization efforts. It could overcome the tendency to dump functions on the local government without the necessary funding by a more stringent approach in assigning functions that can be more appropriately financed on the local governments without placing an excessive burden on them.

Rule 3: There Must Be Strong Central Ability to Monitor and Evaluate Decentralization

Bahl in this rule is referring to monitoring the progress of decentralization through the changes in the financial condition of the local governments. He proposes that the solution is to (1) create a Fiscal Analysis Unit in the Ministry of Finance and (2) create an extensive financial reporting system that will provide the data for the monitoring and evaluation. Interestingly, Bahl goes on to indicate that neither of these is practical in the context of the developing and transition economies.

There have been some attempts to create these fiscal units within Ministries of Finance, but those that are known to this author have not really succeeded due to low level of expertise and competence available, the drain of talented to positions outside of government once they achieve some level of skill and knowledge, and the low level of salaries for retention.

The requirements for a large-scale implementation of a financial accounting system with the low level of availability of the technology and financing that is available make this particularly difficult. While this rule would provide for increased probability of decentralization succeeding, it actually needs to be developed prior to the introduction of the decentralization process.

New Rule 3: Establish External Institutional Monitoring and Evaluation Mechanism not influenced by governmental stakeholders

Given these problems, the donor community would be more effective if they supported the development of external monitoring and evaluation mechanisms through non-governmental organizations that focus on analyzing governmental fiscal decentralization efforts and gathering the financial data to support the analysis. This would provide an opportunity for holding the government more accountable for the implementation of fiscal decentralization effort.

PEFA assessments, which are being adapted to the subnational level in some countries, could provide one source of independent monitoring and evaluation of the fiscal decentralization progress. These also provide a basis for assessing the full scope of the governmental financial system, without the financial data, that would serve to indicate the progress of achieving the requirements of a fiscally decentralized project.

Further support could be given to providing Parliamentary bodies with more analytical ability to examine the progress of fiscal decentralization. A Parliamentary Budget Office, appropriately staffed, could also support this monitoring and evaluation effort. Recently, there has been greater interest in establishing Parliamentary Budget Offices and these have been developed in such developing countries as Benin, Ghana, Kenya, Liberia, Morocco, Nigeria, the Philippines, and Uganda according to a World Bank Institute training module on Parliamentary Budget Offices[1]. However, these would be most effective in the situations where the Parliament has a budget making, rather than a budget-approving role.

The State Audit Offices might also be another possibility, but their independence from the government would need to be established and with appropriate means to sanction the government for its financial management failures.

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[1] World Bank Institute, Module 02: Fiscal Councils and Parliamentary Budget Offices.

On the international level, the International Budget Partnership has initiated the Open Budget Initiative that works with non-governmental and civil society organizations in many countries to provide an index of the transparency and impact of the national level budget process on improving the services to the people. These efforts can provide more opportunity to hold governments accountable for implementing decentralization.

Rule 4: One Intergovernmental System Does Not Fit the Urban and Rural Sector

This is quite an appropriate rule for beginning the development of the intergovernmental transfer system and Bahl indicates when he writes: “Subnational governments have very different capabilities to deliver and finance services, and certainly different capabilities to borrow. It may be necessary to set up a system where these differences are explicitly recognized, i.e., where different local governments are given different financing powers and expenditures responsibilities.” (Bahl, 1999: 14) The rule states that the differences between urban and rural areas should be recognized, but Bahl’s discussion is more general and does directly relate to what the differences are between urban and rural areas. Bahl focuses on recognizing the asymmetric nature of the problem, but a fuller discussion of the differences between urban and rural, and within urban and rural areas is not further defined as elements of the intergovernmental transfer system.

New Rule 4: Treat Equals Equally and Unequal’s Unequally

If the intergovernmental transfer system is to really support the objective of equalization then it needs to identify more explicitly the characteristics and gradations among the subnational units. These can obviously be populations, population density, fiscal capacity, and assigned functions as basic characteristics. These can then be segmented in various gradations and appropriate formulas developed that would take into account these differences. The final result should be that those with equal character are treated equally and those that are unequal among these characteristics are treated in a different manner.

It should be cautioned that identifying too many characteristics or specifying too fine a gradation of characteristics can be carried too far and make the whole process overly complex and difficult to understand. There tends to be a clustering of the characteristics across the whole ranges of local government units, so these clusters of population, density, and other factors many lead to a grouping of 3-5 gradations that would make a reasonable level of transfer factors.

One particular problem arises when there is an outlier among the characteristics, particularly with regard to population size. The normal pattern is that there are many subnational units with small populations and then a decreasing number of large population units. The outlier among all of these tends to be the capital city of the country with a disproportionate amount of the population, sometimes as much as 25% of the total population and a very high density. This issue has been highlighted in a 2012 report by NALAS, which indicated that this high proportion of population concentrated in the capital city is a substantial political and economic obstacle to furthering decentralization (Nalas, 2016). What should be done when you have this situation?

Including this high population and high-density capital city will greatly distort the equalization formula and calculations that result. The recommended solution in this case to treat these outliers as special category and not be included in the general equalization pool with all the other subnational units. These capital cities can be treated as a special category in the transfer system and include more specific conditions on their revenue capacity and expenditure assignments.

Rule 5: Fiscal Decentralization Requires Significant Local Government Taxing Power

This would be an excellent rule to follow if it were not so difficult to apply. The main problem with this rule is that the local tax base from which subnational governments could derive taxes is very limited. Also, the administrative and collection charges are often very high and negate the benefit of collecting the tax.

Bahl goes through a list of various taxes and whether they would be appropriate for subnational governments. He indicates that the VAT, corporate income tax and retail sales taxes are not appropriate or practical at the subnational level for mainly collection problems.

The individual income tax, excise taxes, motor vehicle taxes, property taxes and user charges are considered the best possibilities for the local governments to apply. But even this faces some formidable obstacles in being applied at the subnational level. Overall, none of these provide a significant level of local taxing base or rates that could be applied.

Another significant constraint for the subnational units is the restrictions or limits placed by the national level on the tax rates for any of these taxes. The central level provides upper limits to the tax rates or parameters for the tax rates, which constrain local governments from exploiting any particular tax base.

Finally, local government officials would rather complain that the central government is not giving them enough money than to take the political heat associated with raising local government taxes. As long as they can place the blame for their limited resources on the central level without any incentive to increase their own revenues they will play this game.

New Rule 5: Allow Local Governments Authority to Piggyback on National Level Taxes Applied by the Local Governments as Additions to the Taxpayers Bill

The intermediate term solution to the problem until such time as local governments have more economic base for their revenues sources is to allow for the local governments to apply surtax or to piggyback on the national level taxes, particularly the personal income tax and the corporate income tax. While there are some problems with attributing the income to the place of residence/business these could be overcome with clearer rules on where the tax base will be applied. Two countries in the Central and Eastern Europe region, Croatia and Montenegro, allow for this surtax application on the personal income tax (PIT). In both countries, the PIT has become a substantial source of their own source revenue (Nalas, 2016).[2] While this is an encouraging development it needs further acceptance in the region.

A distinction between small businesses largely serving one local area as opposed to businesses with multiple locations and headquartered in the capital city could be made and the tax directed to a specific local government unit. Both of these could be applied on a derivation basis with some percentage being put into a national equalization pool for distribution across the local governments or at regional government level.

Shared taxes can be utilized, but since they are really a form of grant/transfer to the local governments and entirely under the control of the central level, these are not considered to be within the purview of local government taxing authority. However, the shared taxes are good candidates for a surtax or piggyback approach to enhancing local government revenues.

The property tax has the greatest potential as a local tax source and has not been fully exploited in the developing and transition countries. According to the NALAS 2016 report, only four countries (Montenegro, Slovakia,

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[2] According to NALAS report (2016), in Montenegro the PIT surcharge has been between 12-14% of own source revenues since 2011 and in Croatia the PIT surcharge accounts for over 10% of the total PIT revenue and the total PIT revenues account for more than 50% of the local own source revenues since 2006.

Romania, and Slovenia) of the South East European region had property taxes yielding more than 30% of their own source revenues. However, there are substantial differences in how property taxes are applied and how they are accounted for in the own source revenues that may distort these figures (Nalas, 2016).

The land registration, assessment and administrative problems, while formidable, can be overcome with the latest technology and innovations. This is a tax that would produce a more equitable and fairer tax system as it relates to the delivery of many of the services that are provide by the local governments. A comprehensive assessment of how to improve the property tax to be substantial own source revenue has been addressed by Kelly (2013).

An interesting conclusion about property taxes as an incentive for greater fiscal discipline at the subnational level is referenced in the work of Presbitero, et. al., in the above cited paper by Martinez-Vazquez. The greater the use of the property tax the more fiscal discipline was evident at the subnational level (Presbitero, Saachi, and Zazzaro, 2014).

Rule 6: Central Governments Must Keep the Fiscal Decentralization Rules That They Made

This rule recognizes that many of the features of a decentralization strategy are not keep when the central government embarks on a fiscal decentralization process. Examples of these are (1) the promise by the central government to provide the funds sufficient to finance the functions assigned to the local governments, (2) providing for borrowing authority to local governments, but then issuing restrictions that effectively preclude local governments from borrowing, (3) maintaining control over the tax base and rates of the local governments, and (4) altering the transfer formulas and the shared taxes each fiscal year creating greater uncertainty in the local government budgets.

New Rule 6: Central Government Fiscal Decentralization Rules Must be Kept to Minimum of Restriction on Local Government Authorities in areas of revenue sources and borrowing capacities

The central government should keep to an absolute minimum the restrictions on the local governments relating to revenues and borrowing capacities to ensure that the local governments can have the maximum flexibility to utilize these financial resources. Any restrictions should be provided for in a law on local government finance with only implementing instructions provided later to the local governments. Where the central government establishes such restrictions they should provide for a wide range of options available to the local governments and not narrow restrictions on the tax rates, tax base, and debt sources.

Rule 7: Keep It Simple

There is no doubt that devising a simple formula based grant system would have substantial benefits. Bahl rightly points out four circumstances where a complicated allocation formula and applying restrictions on grants that distort the purpose of the transfer of funds are quite common problems within the intergovernmental transfer system. Interestingly, Bahl points out that these complicated formulas are the product of “well meaning policy analysts.” (Bahl, 1999: 16) It could be added that they are often the result of well meaning international consultants from developed countries who attempt to transplant their experiences and preferences into countries without any of the capabilities to implement them.

The most common problem with the transfer formulas is the inclusion of a multitude of factors with coefficients that require an advanced degree in mathematics to fully understand. In addition, the accuracy of the data is often questionable and the determination of the coefficients is manipulated to satisfy the funding constraints.

Just as there is a need to segment the transfer system based on the differences in the characteristics of the local governments, there is also a need to simplify the allocation formulas with more basic data that reflects the population and economic differentials among these subnational units. There may be an impression that the more factors that are included in the formula the more fair or equitable the transfer system will be. So, there is a trade-off to be made between complexity and simplicity. However, the complexity can be reduced by further segmenting the subnational units based on basic data, rather than make a more complex formula based system that cannot be supported or maintained by the adequacy or accuracy of the data.

So, while keeping the transfer system simple is a laudable goal, in reality to make the transfer system more equitable and objective, there is a level of complexity that cannot be avoided.

New Rule 7: Keep It Transparent

A more appropriate rule would be to place transparency of the transfer system as a higher priority than simplicity. In many cases, the subnational units do not understand how the formula is derived and how the data is gathered that is included in the formula. They often see that other local government units with similar size and character often receive greater amounts of funds and this leads to suspicion that the formula is manipulated based on political affiliations. This is particularly true for infrastructure grants where there is considerable latitude in making the allocations among local governments.

Where the allocations are based on more simple formulas and the process is more transparent and the differences among the allocations can be more readily understood, the confidence the subnational units will have in the process will be greater and more politically acceptable.

Rule 8: The Design of the Intergovernmental Transfer System Should Match the Objectives of the Decentralization Reform

Bahl provides another rule that on its face should be evident and applied. But at the end of his discussion on this he states: "As simple a rule as this seems, it is all too often violated." (Bahl, 1999: 21)

This discussion is rather complicated by Bahl through an examination of the different forms that the intergovernmental transfer system can take, but without relating these to any stated objectives of the decentralization reform. The objectives of the decentralization program are multiple and varied if you consider that it must address political, administrative, and fiscal decentralization within a very complicated political process and stakeholder resistance to any comprehensive change. Consequently, the objectives are generally too many and in practice often conflict across the decentralization reform effort.

New Rule 8: The Design of the Intergovernmental Transfer System should be based on a minimum of objective and verifiable criteria and apply both carrot and sticks to the transfers to the local governments

This new rule recognizes the difficulty of formulating specific objectives of a broad based and comprehensive decentralization reform, and instead focuses on the narrower identification of what each element of the transfer system should achieve. Specific objectives of the intergovernmental transfer system should be the following or some variation of these:

1. The transfer should achieve an equalization of the overall financial resources within a lower limit of 75% across levels of government based on defining objective and accurate data reflecting the differences among the subnational units.
2. The transfer system should be based on incentivizing the local governments to increase their own revenue sources to within 75% of the

national level average of local governments within the same characteristics.

3. Conditional grants for infrastructure should be based on subnational units achieving a performance level of own source revenues at the 75% national average level and performance factor of 80% of citizen satisfaction with local service delivery.

The main point here is that the design of the intergovernmental transfers cannot address the overall requirements of the decentralization reform, but a more limited and narrow focus on equalization and incentives for improving their financial situation.

Rule 9: Fiscal Decentralization Should Consider All Three Levels of Government

This rule is rather impractical as most countries governmental systems are based on a unitary form of government, rather than a federal system, which Bahl refers to in the discussion of this rule. He mainly refers to large countries and assumes that the provincial level has some role to play in the system of government. In most of the developing and transition countries, the middle level of government is largely just an extension of the central government and, generally, has little assigned role in delivery of services. There has been some debate over the years as to whether an intermediate level of government is needed in such small countries with a unitary structure of government.

New Rule 9: Fiscal Decentralization Should be Based on the Principle of Subsidiarity regardless of the levels of government

Whether there are two or three levels of government is rather inconsequential if the objective of the decentralization is to provide the services at the lowest level capable of delivering that service. The principle of subsidiarity, which is basic to determining the assignment of a function, is largely made without regard to whether a country has two or three or even four levels. The local level, if it properly receives the expenditure assignments and financial resources, could provide the basic services at this level. The intermediate levels would have the main function of coordinating some functional areas, such as some road networks, regional hospitals and universities whose services cross the local boundaries.

In some cases, the provincial, district or county levels, where they have been responsible for allocation of funds received from the central government, have imposed different allocations formulas and greatly distorted the equalization of funds across this intermediate level. Without some intervention or standardization of the allocation formula by the central government level, there could be greater inequality and levels of service per citizen due to the differences across this intermediate level of government.

Rule 10: Impose a Hard Budget Constraint

This is a necessary rule for the long-term financial solvency of the local governments as well as the central governments. The national bankruptcy of some countries, such as occurred in Argentina, has been attributed to the level of debt that subnational units accrued over some years. Recently, the level of debt of the local governments in China that financed the infrastructure is causing considerable concern.

However, the reality is that for a good many reasons local governments in the transition and developing countries do run deficits, whether planned or not. Some of the reasons for this are due to the lack of economic base to provide sufficient revenues (which may be a result of the central government not giving them sufficient taxing authority), the unfunded mandates imposed on the local governments, the inability to borrow for cash flow purposes, and the delays in receiving their transfers from the central government as scheduled. While the local government may have complied with constitutional or legal requirements for a balanced budget at the beginning of the fiscal year, the deficits are realized during the year by constant changes to the local government budget by unforeseen circumstances.

New Rule 10: Local Governments should be allowed to have budget deficits to be financed within limits of their future intergovernmental transfers

Rather than try to impose a hard budget constraint that only proves to be impractical, the local governments should be allowed to budget for deficits by carry over of the deficit into the next year against a certain percentage of their transfer funds, such as 50% of the next year transfers. This deficit carryover can be budgeted for in the current local government budget. There is no doubt that there should be strict limits and justification for such an action or request by the local governments and have the approval of the Ministry of Finance.

Local governments could also be allowed to borrow from the central government a certain amount of the next year transfer and receive these in the current budget year to cover any deficits. This could be allowed in instances where local governments have a need to finance particular infrastructure projects, need funds for unexpected shortfalls or perhaps for emergencies, such as local natural disasters.

There should be strict limits on this deficit carrying capacity of the local governments to guard against financial bankruptcy. For example, once a local government has breached the deficit rules, they would be subject to bankruptcy procedures where the local council would be removed, the central government would appoint a financial administrator with the power to increase local taxes or other means to draw down the deficit within the limits.

Rule 11: Recognize that Intergovernmental Systems Are Always in Transition and Plan for This

This rule is axiomatic in the world of governance. Governments, even the most authoritarian, are always saying they are in a state of transition. It is not difficult to say governments are in transition, but the problem here is to plan for this. The balance between stability and flexibility is difficult to manage.

The central governments are always making some changes in their budget allocations from year to year as they rely basically on taxes that are driven by economic factors. They central level will transfer this uncertainty in their revenue sources to the local governments by either transferring functions they don't want to finance or changing the levels of shared taxes that finance many of the local government functions.

The more difficult problem for the local governments in the transition is that constitution or the laws or not changed or easily changed as their circumstances change. The restrictions that are imposed on the local government authorities last longer than they should and no longer serve the purpose of improving the conditions of the local governments. So, the greater problem in planning for the transition of the intergovernmental system is to avoid the situation where changes cannot easily be made.

NEW RULE 11: NO LAW, FISCAL RULE, EXPENDITURE ASSIGNMENT, REVENUE SOURCE, OR BORROWING LIMITS SHOULD BE ALLOWED TO EXIST LONGER THAN FIVE YEARS INTO THE FUTURE WITHOUT BEING RENEWED BY NATIONAL LEVEL POLICY AND LEGISLATION

This new rule reflects the need to impose time limits on the decentralization policies and the local government system. These are generally referred to as "sunset laws or provisions" in that at the time they are enacted they have a time limit in which they are in effect. At the time of the expiration, the government must renew the law or authority.

Regulations issued by the central government ministries should have even shorter time frames, such as not beyond the present fiscal year without renewal by the central government.

Recently, Albania amended their local government law and included a provision that the regulations issued by the Ministry of Finance, which had effectively prevented local governments from borrowing over the past several years, could not extend beyond the fiscal year without approval by the Parliament.

> *Any and all regulations or restrictions imposed by central government on local borrowing that limit local governments' access to borrowing shall be provisional and shall not extend their effect beyond the fiscal year in which they were imposed, except for cases where these restrictions are adopted by the Parliament.* (Article 39, paragraph 3 of the Law 8652 on Organization and Functioning of Local Governance, Republic of Albania, January 1, 2016).

Rule 12: There Must be a Champion for Fiscal Decentralization

Bahl presents a very comprehensive analysis of the main stakeholders in the decentralization reform and their potential to be the driving force behind decentralization. There is no question that there must be some political energy behind this effort because as previously stated for the criticism of Rule 1; there will be many who will oppose and very few who will support such a change.

Unfortunately, the support for fiscal decentralization tends to coincide with the political election process. Promising the people that more authority and resources will be given to them makes an attractive vote-gathering platform. However, once the election is over, as with most political promises, these are forgotten or other more pressing issues get the attention of the political leadership.

The external donors are identified as a potentially strong champion for decentralization, but perform more often the function of a cheerleader at a sporting event. They cheer the team on, but have no real influence on the outcome of the game. To the extent they get the crowd cheering for their teams and this cheering energizes the team to perform to a higher level; they can serve a useful purpose. This has been the main failure of the external donors. If they had energized the grassroots organizations, instead of focusing on technical assistance to the very institutions that have the most to lose from decentralization, the success of fiscal decentralization might be different that what the research shows cited earlier in this paper.

While Bahl identifies a number of what he terms potentially strong supporters, potentially weak supporters and ambivalent supporters, none of these have proven to be consistently champions of decentralization. The central level supporters are captives of the government policies and have little incentives to pursue decentralization. A natural champion would be the Ministry of Local Government, or its equivalent, in the central administration. But this ministry too often sees its role to be more of controlling the local governments than being an effective lobbyist for the local governments.

One potentially strong supporter not identified by Bahl is the local government association. Unfortunately, these have proven to be disappointing for several reasons. First, these associations are often very divided along political lines, with associations formed by the local governments and mayors pledged to support a particular political party of the national level.

Secondly, there are often multiple associations reflecting the different characteristics of the local governments. The rural communes will have their own association, while the larger urban cities will form their own association. Their interests greatly differ and finding common ground within a very politicized local government system limits their possibility to be effective champions of decentralization.

The champion of decentralization needs to be at the very senior level of the government structure and have the full support of the head of government, such as the prime minister or president. One example of where decentralization has found an effective champion is in Somaliland where the Vice President has been designated the champion of decentralization by the President and has proven to be capable of pushing the process forward against the bureaucratic inertia. The Vice President appointed an Inter-Ministerial Committee on Local Government composed of seven ministers representing the main sector ministries, particularly health, education, planning, etc. With the support of the international donor community supporting the decentralization program, this approach has worked much better than might be expected under the difficult circumstances.

New Rule 12: There must be organized a broad-based grass roots political and civic organizational support for fiscal decentralization

An organized and broad-based grass roots effort by local political and civic organizations that can be sustained through non-governmental financing holds the potential to keep the pressure on the central government and other reluctant stakeholders to implement decentralization. An external monitoring and evaluation of the progress of the government should accompany it to implementing decentralization and holding them accountable for the progress or lack of progress. (New Rule 3)

The donor community can play a more decisive role as a champion by supporting these political and civic organizations as well as requiring specific decentralization reforms as conditions for their financial support.

This can be greatly enhanced where there are competitive political parties at the central and local level that must deliver on their promises or be swept from office in the next election cycle.

New Rule 13: If at least 8 of the above 12 rules cannot be applied, do not undertake fiscal decentralization.

This is a conditional rule that hopefully would prevent the undertaking of fiscal decentralization projects that have little chance of success.

What is most unfortunate and probably leads to the low success rate of fiscal decentralization initiatives is that there is not sufficient attention given in the early formulation stage of the defining the prerequisites for improving the chances for success. There are risk assessments done, although they always indicate that the risks are minimal or can be mitigated in the process, which never happens. There are too many stakeholders, particularly donors and the consultants, that have an interest in undertaking the work rather than making a realistic assessment of the costs/benefits for the funds expended.

The application of this rule should provide a basis for assessing the probability, not the possibility, of succeeding in implementing fiscal decentralization. The risk assessment should examine what is available, required, and can be implemented in some strategic intervention approach based on an identified sequence of actions and broad based consensus to achieve these actions.

CONCLUSION

Professor Bahl's contribution to the thinking and research in the field of fiscal decentralization is unquestionable and inestimable over the past decades. His formulation of the rules provided a starting point for improving the quality of the thinking on the difficult path to implementing fiscal decentralization.

The level of knowledge and experience has greatly increased in the intervening 15 plus years since Professor Bahl formulated these rules. In this interim period much should and could have been done to improve the successful implementation of fiscal decentralization. Fiscal decentralization was a pivotal feature of the reforms in the transition and developing countries over these years; but, unfortunately, the impact is still difficult to ascertain in most cases.

Therefore, it seems time to incorporate this increased level of knowledge and experience and develop some new rules for implementation of fiscal decentralization. While the rules formulated here rely greatly on the experience of this author in supporting fiscal decentralization in several countries, others with equal or greater experience are welcomed and encouraged to contribute their own experience to the improvement of these rules.

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