The Conceptual Framework for Fiscal Decentralization

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Intro - In

I. Background Issues

Decentralization in its broad sense refers to the division of political, economic and administrative power/responsibility between the centre and subnational levels of government. The degree of responsibility that is transferred by the center may vary from simply adjusting workloads among different units of government to diverting all government responsibilities for performing a set of what were previously considered to be central government functions.

Decentralization of one form or another, i.e., **deconcentration, delegation, devolution**, is called forth as a means for solving political and/or economic problems. As such, its extraordinary scope is revealed by the many objectives it supposedly serves.

- It is often expected that decentralization will reduce overload and congestion in the channels of administration and communication. Decentralization is thought to improve government's responsiveness to the public and increase the quantity and quality of the services it provides.

- More effective or efficient management of economic development can also be achieved through decentralization, by allowing greater discretion to local managers in decision making that would enable them to cut through 'red tape'.

- Decentralization is further considered as a way of mobilizing support for national development policies by making them better known at the local level. Greater participation in development planning and management supposedly promotes national unity by giving groups in different regions in a country a greater ability to participate in planning and decision making, and thus increases their stake in maintaining political stability. Greater equity in the allocation of government resources for investment is presumed more likely when representatives of a wide variety of political, religious, ethnic, and social groups participate in development decision making.

- Largely, however, decentralization is pursued to achieve broad political objectives such as self-reliance, self-determination, democratic decision making, popular participation in government and accountability of public officials to citizens[1] (Rondinelli, et al 1984: pp 5-9).

[1] The political decentralization measure in Ethiopia seems to draw its argument from this premise [TGE, 1992a].

So, although many countries, particularly developing ones, often embark on a course of decentralization primarily for political reasons, it is also the case that decentralization could be undertaken primarily for economic causes. It is in light of this general concept of decentralization that this paper reviews the literature on fiscal decentralization.

II. Fiscal Decentralization

Today, fiscal decentralization, that is the proper location by level of government of various taxes, spending programs, grants and regulations, is becoming an important issue not only in the literature but also in the real world. Many developing countries are experimenting with it as a means of improving their governance and economic growth. For instance, in Canada fiscal decentralization is tied up with the Quebec issue that threatens the national unity; Eastern Europe is looking into fiscal decentralization as one of the means with which to come out of their political and economic mess; in Germany a review of the earlier fiscal decentralization system is becoming a focal point to deal with the unification issue; and in the European Union, the United States and many other countries, fiscal decentralization is acquiring greater importance.

Fiscal decentralization covers the whole spectrum of intergovernmental fiscal relations coming under the literature of **fiscal federalism.**[2] Fiscal federalism encompasses principles of fiscal relations between central and subnational levels of government, that is the command over resources by the various levels of government and the direction and size of inter-governmental fiscal flows. This includes the division of tax powers and the means through which resources are adjusted to match expenditure responsibilities for central and subnational levels of government. What types of spending should be conducted by what level of government? Which level of government should levy what types of taxes? How should grants-in-aid be allocated? How should financial regulations be harmonized? These are the major issues of fiscal decentralization.

Searching for the optimal level of decentralization is a complex matter. At one extreme, so limited is decentralization that the role of subnational levels of government is nominal because of the all too pervasive role of the central government; at the other extreme decentralization goes too far, so much so that the role of the central government becomes highly constrained to the extent of threatening the national cause. The principle of fiscal decentralization attempts to search for the optimal pattern of inter-governmental fiscal relations,

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[2] Bird (1993) prefers to assess fiscal decentralization in two perspectives: federal finance and fiscal federalism. He defined the former as constitutionally fixed in all respects, i.e., boundaries as well as assignment of functions and finances, while the latter is more in line with the traditional definition as set by Oates (1972).

i.e., expenditure and tax assignment, and inter-governmental transfers, that promotes economic development.[3]

A. Expenditure Assignment

On the spending side, decentralization draws its argument largely on efficiency grounds, though it is also argued that lower level governments have some degree of distributional and stabilization roles (see below).

The basic rule of efficient expenditure assignment is to assign each function to the lowest level of government consistent with its efficient performance. So long as there are variations across jurisdictions in tastes and costs, there are clearly efficiency gains from carrying out public services in a decentralized manner. Oates (1972) shows how jurisdiction size can be determined by the balance between competing forces - the welfare loss from taste differences, which argues for small jurisdictions, and the welfare gain from burden sharing, which argues for large jurisdictions. According to his decentralization theorem *each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision* (Oates 1972: 55). A corollary of this is that efficiency can be further promoted by having central government grant or inter-jurisdiction arrangements to ensure that those living outside the jurisdiction pay their appropriate marginal share of the benefits of public services (more on this under "Inter-governmental Transfers").

The rationale for decentralized expenditure assignment, apart from allocative efficiency, is also based on other economic and political arguments such as accountability, autonomy and manageability. Accordingly, decentralization

- ensures consistency between the level and mix of public services with local preferences, tastes and needs;

- induces more responsiveness to local issues and creates fiscal responsibility since decision making is vested in relevant local bodies;

- eliminates multiple layers of jurisdiction; and

- enhances inter-jurisdiction competition and innovation in the provision of public services (Shah 1991: 3).

Using this logic of the benefit principle, public services that are sensitive to regional or local conditions, such as schools, roads, police, fire service, etc. (Table 1) would be

[3] The argument whether fiscal decentralization is largely a product of economic development or vice versa is of little importance in this discussion. For details on this issue, see Oates (1993).

provided by local governments covering that particular jurisdiction or area, perhaps with matching grant support from the center (more on this below).

On the other hand, other political as well as economic considerations dictate that certain services would be best delivered by the central government.

■ Public services whose benefits are considered national in scope, such as defence, foreign policy, etc. can only be provided by the central government.

■ The existence of substantial benefits and cost spillovers from one jurisdiction to another that can not be handled in some other way (e.g., by contracting or by grant design) suggests that central government is needed to internalize such externalities.

■ Cost effective provision of services characterized by economies of scale, such as transportation, water and sewerage, electricity, communications, etc. requires a service area larger than a local jurisdiction.

■ Centralized administration is also preferable in public services whose administration and compliance costs outweigh their advantage if carried out by lower level governments.

■ There are of course issues of stabilization and distribution where central government is the best, if not the only, alternative to carry out these policies. Stabilization measures employing monetary and exchange rate policies have little scope of being carried out at the local level. This is the domain of a central government.

In connection with stabilization measures, lower level governments have also some role to play. Gramlich (1993) contends that regional cycles can be counteracted by subnational governments. "The way lower governments can operate stabilization policy is for governments to build up their asset stocks in good years and run down these assets in bad years, or to borrow in bad years and repay in good years" (p. 234).

The principle of expenditure assignment outlined above does provide a broad guideline regarding the division of spending responsibilities among different levels of government (Table 1). This does seem to correspond with what is realized in many countries with federal structures, though some minor differences due to country-specific factors might prevail.

Table 1: Conceptual Basis of Expenditure Assignment

Expenditure Category	Service Responsibility	Provision of Service
Defence	F	F
Foreign Affairs	F	F
International Trade	F	F
Environment	F	S,L
Currency, Banking	F	F
Interstate Commerce	F	F
Immigration	F	F
Unemployment Insurance	F	F
Airlines/Railways	F	F
Industry & Agriculture	F,S,L	S,L
Education, Health & Social Welfare	F,S,L	F,S,L
Police	S,L	S,L
Highways	F,S,L	S,L
Natural Resources	F,S,L	S,L

Source: Shah (1991: 7), Table 1.1

Notes: F = Federal S = State L = Local

B. Tax Assignment

A logical extension of the principles underlying the vertical pattern of spending programs among different layers of government is the means of financing the required expenditure program. Tax assignment is one of the mechanisms to deal with this problem. The principle of tax assignment involves issues such as: What type of taxes should be levied and collected by which level of government, and on what principles? On what criteria should the proceeds accrue both vertically and horizontally? (see also Agrawala 1992 and Eshetu 1993).

In line with the broad principles suggested by Musgrave (1983) based on equity (consistency of revenue means with expenditure needs) and efficiency (minimizing resource cost) criteria,

(i) progressive redistributive taxes should be central;
(ii) taxes suitable for economic stabilization should be central: lower level taxes should be cyclically stable;
(iii) tax bases distributed highly unequally between jurisdictions should be centralized;
(iv) taxes on mobile factors of production are best administered at the center;
(v) residence based taxes such as sales of consumption goods to consumers or excises are suited for states;
(vi) taxes on completely immobile factors are best suited for local levels;

(vii) benefit taxes and user charges might be appropriately used at all levels (Shah 1991: 10 and Agrawala 1992: 24).

Following these broad principles Shah (1991) traced out specific tax categories associated with each level of government (Table 2).

Table 2: Conceptual Basis of Tax assignment

Tax Category	Determination of		Tax Collection and Administration
	Base	Rate	
Customs	F	F	F
Income Tax	F	F,S	F
Estates & Gifts	F	F,S	F
Corporate Tax	F	F,S	F
Resource Tax	F	F,S	F
Retail Sales	S	S	S
VAT	F	F,S	F,SC
Excises	S	S	S
Property Tax	S	L	L
User Charges	F,S,L	F,S,L	F,S,L

Source: Shah (1991: 14), Table 1.2

Notes: F = Federal S = State SC = Council of States L = Local

A similar view, particularly in connection with local governments, is also expressed by other authors. Bird (1993), for instance, argues that if the efficiency objective is to be attained and any meaningful local autonomy and accountability to be effected, local governments must have some degree of freedom to alter the level/rate and composition/base of their revenue. "Local governments should not only have access to those revenue sources that they are best equipped to exploit - such as residential property taxes and user charges for local services - but they should also be both encouraged and permitted to exploit these sources without undue central supervision" (Bird 1993: 211).

In line with this view, he outlined specific characteristics of an ideal local tax. Accordingly,

(i) the tax base should be immobile to allow local authorities some leeway in varying rates without the tax base vanishing;

(ii) the tax yield should be adequate to meet local needs and sufficiently buoyant (i.e., expand at least as fast as expenditures) over time;

(iii) the tax yield should be stable and predictable over time;

(iv) the tax should be perceived to be reasonably fair by taxpayers;
(v) the tax should be easy to administer efficiently and effectively;
(vi) it should not be possible to export much, if any, of the tax burden to nonresidents;
(vii) the tax base should be visible to ensure accountability (Bird 1993: 214).

Based on such characteristics, local governments should, whenever possible, charge for the services they provide, and where charging is impracticable, they should finance such services from local taxes such as local property tax (generally levied as a supplement - piggybacked- to central income tax), etc.

What one observes from the general principles of tax assignment and from Table 2 is that certain taxes (for instance, income tax) could be levied, collected and administered by different layers of government. It suggests that concurrent taxation may exist vertically between different layers of government. It also implies the possibility of having different tax rates on the same tax base horizontally, i.e., between jurisdictions at the same government level. But this introduces some problems into the system.

1. Problems of Vertical Tax Assignment

This view of vertical tax assignment (Spahn calls it the layer-cake view) attributes own taxes to each level of government - according to the regional distribution of benefits derived from public services provided by each layer of government. Certain taxes (for instance, excise duties) are often administered at the level of production, which means that those states where the production of taxed goods is located would benefit most. Similarly, when it comes to business income tax, since the location of firms and their network of regional plants within the federation could not be dictated by tax consideration and the attribution of taxable income to the different plants is arbitrary, it becomes quite complex to attribute taxes from this source to regional governments.

There are also other problems associated with vertical tax assignment:

- The assignment of taxes may not correspond to the central government's obligations in the area of demand management.

- Taxes may react differently to the swings in the business cycle and growth, and hence the development of public funds may jeopardise a steady, continuous, need-oriented expansion of government services.

- The vertical distribution of tax yields may not follow the development in the vertical distribution of functions among the tiers of government.

- The assignment of taxes to regions may accentuate existing regional discrepancies in economic potential - by inducing imbalances in the provision

> of infrastructure - and hence jeopardise any commitment to more equilibrated growth in the federation (Sphan 1991: 9).

Spahn, in line with Germany's experience, argues that it is much preferable to use joint or shared taxes to overcome the shortcomings associated with the layer-cake approach of tax assignment. At least, major taxes need to be joint taxes and the proceeds can be vertically apportioned using a country-specific revenue sharing formula. Actually, such a formula can also accommodate any desired equalization effect if the distribution of funds works asymmetrically among regions.

2. Problems Associated with Horizontal Tax Assignment

As hinted earlier, according to the tax assignment principle discussed above, there could exist different tax bases and tax rates at the same layer of government. This non-uniformity in tax rates is said to be much inferior to that of a uniform tax system, particularly on *administrative* and *efficiency* grounds.

It is obvious that working with one tax code rather than many is less burdensome. It is likely that double taxation or inter-regional loopholes may arise, particularly if different regions work with different principles, for instance one using the origin and the other the residence principle, both using different types of taxes.

Different tax systems may also introduce inequity within a federation. Applying different rates on the same tax base across regions implies different tax burdens, particularly for a similar level of public service. This may be considered unfair by those jurisdictions with higher levels of tax burden and may endanger the social and political cohesion of the federation.

> Regional taxation in a federation may entail 'tax arbitrage' in the sense that mobility of resources (capital, labor, goods) will allow taxpayers to shift taxed activities to those regions where the tax burden is the lowest. This would lead to ruinous tax competition among the different regional governments in a federation, and it would hence entail a suboptimal provision of public goods within all regions (Spahn 1991: 10).

So it is argued that uniformity of taxation is desirable both under distributive and allocative considerations. Uniformity of tax rules stresses the argument of regional fairness or equity. It simplifies tax coordination under administrative aspects. It also avoids tax competition among regions with distorting effects on the flow of capital, on migration and cross-border shopping. This further fosters social cohesion.

It should, however, be appreciated that, depending on the degree of development of the specific economy at issue, introducing some degree of nonuniformity (for example, different tax rates among regions) without jeopardizing the benefits of tax uniformity might as well be beneficial to foster competition.

C. *Inter-governmental Transfers*

Transfers are another aspect of inter-governmental fiscal relations. In order to maintain fiscal stability (and by implication political stability), there should exist some broad correspondence between resource availability and functional responsibility. Adopting the principles of expenditure and tax assignment can not guarantee a balanced budget at all levels of government. Some degree of mismatch between resource means and expenditure needs at various levels of government - *vertical fiscal imbalance* - is likely to occur. To resolve this issue, mechanisms of revenue sharing and transfers are frequently designed and implemented.

Also regional variations in the correspondence between revenue bases and expenditure requirements exist in most, if not all, federal systems. This inconsistency between revenue raising ability and fiscal needs of governments at the same level in a federation - *horizontal fiscal imbalance* - stands as an outstanding problem, particularly in developing countries. Regions differ significantly in their development level and resource endowment. For instance, some are industrial areas that could provide buoyant tax revenue, while others may be dominantly rural areas where greater backlogs in the provision of physical and social infrastructure prevail, hence calling for higher expenditures. Such a dichotomy is a salient feature of most developing countries. To mitigate such economic disparities, inter-governmental transfers - from the center to the region or vice versa, as well as from region to region - can be employed.

Therefore, intergovernmental transfer, in principle, involves not only a vertical flow of resources from the center to lower level governments, but also a reverse vertical transfer from surplus regions to the center, and horizontally from wealthier to poorer regions. For various reasons, however, both political and economic, central governments usually have greater revenue raising capacity than lower level governments.

Transfers have not only economic effects (effects on such policy objectives as allocation efficiency, distributional equity and macroeconomic stability) but also reflect closely the nature of a country's political system. Hence, a well-designed system of inter-governmental transfers is essential to any decentralization strategy.

The basic tasks of inter-governmental transfers include closing the fiscal gap, fiscal equalization, ensuring a minimum standard of public service, pricing externalities, and achieving stabilization and political objectives. Some of these are discussed below.

(i) Closing the Fiscal Gap: Often, for a variety of reasons, lower level governments encounter a budgetary imbalance, revenue falling short of expenditure needs. This is referred to as fiscal gap or vertical fiscal imbalance. Some of the reasons for the imbalance include:

- inappropriate expenditure and tax assignment;

- limited and/or unproductive tax bases available to lower levels of government so that tax rates would be inefficiently high;

- regional tax competition, i.e., lower level governments, fearful of loosing capital and skilled labor and business activity to other jurisdictions, do not fully exploit business tax potentials and thus under-provide public services (Shah 1991: 32).

Note that, as discussed earlier, most of these issues would not arise if tax uniformity and a joint tax system prevail. In the absence of these, however, the fiscal imbalance created can be bridged using unconditional non-matching grants. Unconditional grants are much preferred by recipient governments as there is no restriction regarding what purpose they are used for. However, many argue that, as far as possible, unconditional grants should be avoided. Bird (1993), for instance, contends that "since local governments should be accountable to the central government to the extent they are financed by transfers, there is no role for completely unconditional transfers" (pp. 229-235). A similar view is held by Gramlich (1993).

√ **(ii) Fiscal Equalization:** This is perhaps one of the most important aspects of inter-governmental grants. The existence of differential net fiscal benefits across regions is of high concern for central governments as this has the potential to turn easily into a political issue.

A number of reasons are provided for the root cause of differential net benefits:

- regions differ in natural resource endowments, which gives rise to different revenue sources;

- some regions have relatively higher income, enabling them to raise greater revenues from existing bases; and

- some regions may have a population structure with a high dependency ratio, i.e., greater population of the young, old and the poor, or naturally difficult terrain, or generally higher cost disability factor (Shah 1991: 35).

Such factors make some regions relatively worse off than others. This encourages fiscally induced migration of factors of production such as capital and labor - particularly skilled labor. A substantial movement of factors of production to resource-rich areas would create social and economic problems and thereby serious inefficiencies and inequities. As factor movement takes place in response to fiscal considerations alone, inefficiency will arise; and as identical persons in various states are treated differently by the public sector as a whole, this causes inequity.

Therefore, a fiscal equalization grant is required to enhance both efficiency and equity. An effective central government equalization grant aims at augmenting (or equalizing) the fiscal capacity of regions to a certain chosen standard, commonly the national average capacity. Some countries also account for the expenditure needs. The measurement of fiscal capacity differs from country to country. In most cases it takes account of population size, tax rate, degree of urbanization, etc.

A common system, though not widely used in developing economies, is the Representative Tax System (RTS). The RTS, by measuring the fiscal capacity of a region (state or local), provides the basis for estimating the equalization entitlements. Given information on both the tax bases and tax rates for each region as well as the standard of equalization (i.e., the median, the mean, etc. of fiscal capacity of all regions), regional equalization entitlements can be calculated (Shah 1991: pp 41-42).

$$ENT^i = POP_x * \left[\{PCTB_v^{\,i} * TXR_v^{\,i}\} - \{PCTB_x^{\,i} * TXR_v^{\,i}\}\right]$$

where,

ENT = equalization entitlement
POP = population
PCTB = per capita tax base
TXR = tax rate
i = particular revenue source
v = national average
x = region or state.

The sum over i, that is the overall revenue sources considered for equalization, indicates whether a given region/state would receive a positive or negative entitlement from the inter-regional revenue sharing fund. For fiscal equalization the common form of grant is an unconditional non-matching grant.

In principle, an equalization grant could also take place horizontally, as mentioned above. A mechanism whereby better-off regions transfer funds to the relatively poor ones can be organized or developed. For instance, one particular feature of German federalism is a horizontal grant system among the states in which the central government has little role (see Spahn 1991).

(iii) Ensuring a Common Minimum Standard of Public Service: Another economic rationale for inter-governmental transfer is to ensure the provision of a common minimum standard of public service across jurisdictions. As discussed earlier, expenditure assignment to lower level governments is based largely on efficiency, accountability and local autonomy criteria. This may conflict with the national equity objective. Consider, for instance, public services such as education, health, social welfare, etc. The status of health is directly related to economic well-being. The poorer one is, the higher the incidence of disease. Also, education enhances further equality of opportunity for jobs/income among members of society.

Because of this, most governments, particularly in developing countries, view such services as a fundamental public responsibility, and strive to provide them uniformly across jurisdictions - as redistribution in-kind. Hence, provision of these services primarily rests on the equity objective.

Local governments, in order to achieve their efficiency objective, may under-provide such crucial services, which inevitably affects particularly poor regions adversely. To maintain an acceptable minimum standard of service without affecting other objectives of lower level governments, conditional non-matching grants could be used. Such grants would not affect local government incentives for cost efficiency while ensuring compliance with centrally specified standards of service.

Also, the existence of a common minimum standard of public service fosters mobility of factors, thereby contributing to efficiency gains. For instance, establishment of some minimum standard of social services will encourage labor mobility. Similarly, maintenance of a certain minimum standard of infrastructure will enhance the mobility of factors and goods. In this case too, conditional non-matching or conditional closed-ended matching programs would encourage provision of a common standard of public services across different regions. Such a program, is non-obtrusive, i.e., regions would be free to spend the grant on any other program they choose, provided they meet the condition of providing the required minimum standard of service. Such grants in pursuit of a common minimum standard, hence, serve both efficiency and equity objectives.

(iv) Pricing Externalities: The transfer rationale with the strongest basis in the economic literature concerns inter-jurisdictional spillovers. Transfer is required to correct for inefficiencies arising from spillovers.

The benefits of services (or goods) provided in one jurisdiction may spill beyond the jurisdiction to benefit neighboring jurisdictions not contributing to the costs. In such a situation, governments providing the service or good, considering own benefits only, tend to under-provide or produce below the optimal level. Basically, a matching grant program whose rate is set by the size of the spillover could be designed to encourage the optimal provision of public services. An open-ended conditional matching grant that modifies relative prices would be appropriate.

In principle, compensation can be made by the beneficiary jurisdiction directly without central government concern, though such an arrangement is perhaps a rare case in practice. The problem regarding spillover compensation is, however, the difficulty in measuring the magnitude or degree of the spillover, at least for certain services.

(v) Achieving Political Goals: If fiscal decentralization is made to fit or serve political decentralization, then to live with the reality, there may be a case of transfer of some resources "simply to keep some economically non-viable local governments alive for political reasons -

to salvage national pride, to provide jobs for local supporters, or for some other reason" (Bird 1993: 220-221).

Perhaps what is important from an economic point of view is to minimize any collateral damage, as for instance, transfers that simply finance deficits, or that are entirely discretionary, in the course of achieving political ends.

The design of inter-governmental fiscal arrangements, as discussed above, may be required to account for many specific objectives such as autonomy, revenue adequacy, equity, efficiency, transparency, etc. It is not, however, unusual to observe conflict between these objectives, making the issue of *priority ranking* a case to consider.

III. Borrowing Powers and Mechanisms

Notwithstanding the transfer mechanisms indicated above to fill the revenue-expenditure gap, additional financial requirements may also arise (and do often arise in practice) to implement all plan projects in each jurisdiction. To this end, the last resort is borrowing either in the open market or from governmental funds if such a pool is available.

However, as available resources need to be utilized efficiently as well as equitably, there may be a need to coordinate borrowing requirements of all subnational units of government. If so, should there be a common formula for a loan mechanism to all subnational units? Should borrowing from domestic or foreign sources be channelled through the central government? This section deals with such issues.

As there is no clear-cut theoretical guide with respect to borrowing, it is perhaps useful to outline some key issues based on country experiences. As a rule, direct foreign borrowing by lower government units should be resisted, particularly in developing economies, as this could run counter to the political as well as the overall stabilization objectives of a central/federal government.

Regarding domestic borrowing by lower level governments, perhaps this needs to be assessed in light of both the macro and micro aspects of borrowing. The overall central credit to regional governments should be consistent with the central government's stabilization objective. This implies setting a ceiling on total credit. It is also preferable to use a uniform rate and mechanism of credits across regions (maybe not across sectors). Credit to any jurisdiction should be part and parcel of its overall revenue-expenditure balance/account. That is, determination of the amount of credit should take account of tax revenue and grants. As credit involves not only repayment but also imposes strict financial conditionalities, it has the merit of enhancing greater efficiency relative to grants. Hence, in this respect, it might be advantageous to encourage or incline more towards credit rather than grants to a certain degree.

The underlying point of these issues is that the central government should impose certain conditions, with respect to both magnitude and purpose, on borrowing by lower level government units. The mechanism of control may take into account the following considerations:

- As such credit is largely for capital expenditure, projects should satisfy a standard evaluation/appraisal by an appropriate centrally commissioned body. Also, the implementation capacity of the concerned local government should be assessed.

- Consistency with overall total central credit should be maintained.

- Total debt outstanding as well as the amount of credit in any given year should be taken into account, perhaps in relation to its average revenue.

- Also, debt servicing (interest plus amortization) should be weighed against its average revenue.[4]

The overarching objective of such a mechanism should be to encourage jurisdictions to be involved in self-motivated development projects while simultaneously moving increasingly towards efficient economic management. This should be the case because lower level governments' financial discipline, particularly in connection with borrowing, will have a strong influence on the overall financial condition of the country.

IV. Conclusion

It is argued that economic development creates an environment more favorable to the gains from fiscal decentralization. But it is also not contentious, as discussed above, that fiscal decentralization has the potential to contribute to economic development. This provides a general setting regarding the extent of fiscal decentralization in a developing economy.

Decentralization may be sought primarily either for its political value or for its economic value. In this context, a policy trade-off between politics and economic development is likely to occur. A case in point is Ethiopia. Given the general backwardness of the economy (fragmented markets, partially monetized economy, and conspicuous regional disparity in resource endowment), socio-economic development - both regional as well as national - is better served with greater market and regional integration. But integration primarily requires the free movement of goods and production factors, particularly capital and labor.

However, in light of the prevailing cloud of political bewilderment associated with ethnic-based regionalism, one cannot entirely discount the likely adverse impact this may have on maintaining and further consolidating regional economic integration. Moreover, to benefit

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For details, see Mohar and Dillinger, 1991.

optimally from certain production and service establishments characterized by economies of scale, the existence of a certain minimum geographical size, which the current slices of regions/*Killil* could not satisfy, is required. Therefore, the current version of political decentralization can hardly be regarded as the best or even preferable model for regionally integrated economic development, not only for Ethiopia but for any developing economy in general.

Related to this issue of policy trade-off is the potential problem involved in moving simultaneously from a command to a market economy, and from a highly centralized to a decentralized fiscal system. In principle, there seems to exist no inherent inconsistency between these two phenomena. In fact, from a historical point of view, the correlation seems to hold as such: a command economy with centralization and a market economy with a decentralized fiscal system. The former prevailed in the former socialist countries of Eastern Europe and the latter exists in many developed market economies.

The problem arises in the specific case of today's Ethiopia, where ethnic based political decentralization happens to be the underlying premise for fiscal decentralization. As hinted in the preceding paragraphs of this section, while the operation of a free market system requires deregulating all barriers that stand against the free movement of goods and production factors, the political-economy model of promoting economic development on ethnic lines seems to introduce new barriers that hamper the free movement of factors of production. A clear evidence, though partial, is the massive concentration of investment licenses in and around Addis Ababa, marginalizing all other regions (see Eshetu 1994).

There are, perhaps, two approaches to deal with the inconsistency that arises between politics and economic development: either to redraw the political map to merge it with economic regions as dictated by development theory or to tailor an economic development policy that fits the political skeleton as it stands now.

As the concern of this paper is related to the latter, a would-be fiscal tailor, from the perspective of a developing economy, aspires to come up with a model of inter-governmental fiscal relationship that possibly promotes economic development as well as fosters political and social cohesion between members of the federation. It is to this end that the following summary is drawn.

There are certainly clear-cut gains in sharing spending responsibilities between different layers of government as suggested by the literature. The literature on expenditure assignment is less controversial and straight forward. However, when coming to the real condition of developing countries in general, and Ethiopia in particular, there is one thing that should be noted. We are still aspiring to develop a democratic culture. The overwhelming majority of the population, the rural society, lacks the experience of self-administration. As such, decentralization should develop gradually, using a sort of trial and error approach, where lower level governments take a burden that they could shoulder and a responsibility that they could realize effectively and efficiently. The more the experience and skill acquired in regional/local self-administration, the higher the responsibility that could be vested on lower level governments and the less the burden of responsibility on the central government. Time as well as the level of development are factors to be conscious of for fully realizing both the political as well as economic objectives of expenditure assignment.

Perhaps the most important and contentious aspect of inter-governmental fiscal relations is tax assignment. In this regard, the underlying issue from the point of view of regional governments is one of having adequate revenue to finance activities within their purview, and not one of (political) authority on this or that aspect of tax revenue. At this initial stage of fiscal decentralization, as discussed earlier, it would be more advantageous if major taxes are shared or are joint taxes attributed to all levels of government, rather than assigned to independent levels of government, and the proceeds distributed according to a common revenue sharing formula acceptable to all jurisdictions/regions. The nature of the formula, by design, could as well involve region-specific factors towards achieving a certain degree of horizontal equalization. A greater proportion of the proceeds can be apportioned using this revenue sharing mechanism. This, apart from other advantages discussed above, makes the system more transparent and simple.

Another important issue is tax uniformity. To equalize individual burden sharing across regions as well as develop regional economic integration, it is desirable to have a uniform tax rate across regions.

Considering some particular issues of tax assignment in Ethiopia (TGE 1992b) in this context, it might be preferable if the two revenue categories, i.e., central and joint (bilateral) revenues are made or regarded as shared/joint taxes and tax yields apportioned vertically based on a formula agreed upon by all levels of government. This avoids the concern of having a highly centralized tax system as well as the problem of inequity involved in the joint tax category (see Eshetu 1993).

Regarding taxes allocated to regions, tax rates need to be uniform across regions, particularly taxes related to agricultural activities.

In general, uniformity of taxation across regions and a joint/shared tax system with an acceptable revenue sharing formula has the potential power of further deepening the political and social cohesion of a federation.

However, all this depends on one crucial factor - the political factor. As long as subnational levels of government do not have a direct say in all matters concerning inter-governmental fiscal relations, there is no guarantee for the smooth functioning of the system.

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