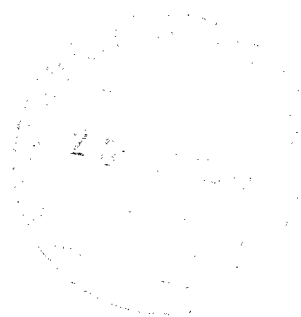


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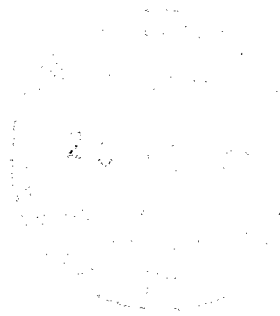
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**International Journal of
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Editor's note

The annual seminars of the *Public Budget International Association (ASIP)* have undoubtedly been a real success, even exceeding, in some cases, the participants' expectations. This is due to the considerable growth of the Association and the increasing number of countries in various continents that are interested in its activities.

As a result, a remarkable number of participants attended the last annual seminar in Guatemala City and we had the good fortune of having outstanding lecturers from the United States, France, Great Britain, Germany, Brazil, Argentina and countries in Central America, amongst others.

ASIP is currently organizing its Annual Seminar in the city of San Juan, Puerto Rico. It will take place in August of this year and a large attendance is expected. ASIP has, in this way, managed to place this unique event on the international agenda of all those interested in budgetary and public finance topics.

The *International Journal of Public Budget* helps to communicate this important activity to which may participate all members of the Budget Department (or its equivalent in various countries around the world) and also the members of various National Budget Associations that are affiliated. The official languages spoken at the seminar will be English and Spanish. This event will certainly be a success taking into account past experiences in recent years.

Included in this issue of the journal are articles of utmost importance that are today the center of attention of all specialists in financial and budgetary topics. They are current articles written by renowned researchers and functionaries from prestigious institutions throughout the world.

Susan Robinson's article, *Capital Planning and Budgeting*, explains techniques to close the gap between the communities' needs and the available resources.

Fiscal decentralization: conceptual framework, written by

Gabriel Aghón, studies the basic concepts about fiscal decentralization and offers a series of methodical guidelines to analyze such processes.

Peter Heller's article, *Fiscal Policy Management in an Open Capital Regime*, indicates how countries who decide to enter in the uncertain world of open capital regimes should handle its fiscal policy.

Finally, we include **Hennie Venter's** entire inaugural speech in order to celebrate the annual conference of the *Institute of Municipals Finance Officers of South Africa*, one of the many organizations with which ASIP has important ties of friendship and collaboration in the international field.

With its periodical publications, ASIP continues to make important contributions in conveying significant budgetary topics that are today a source of debate due to their great importance.

Capital Planning and Budgeting*

Susan G. Robinson

Congestion on the nation's roadways, growth limits resulting from inadequate wastewater-treatment capacity, and collapsing bridges are all symptoms of what many refer to as the infrastructure crisis. A number of recent studies have concluded that the nation's stock of capital goods has not kept pace with economic and social needs.¹ During the 1980s, the nation's infrastructure was wearing out faster than it was being replaced. Decreases in federal financial assistance and expanding government responsibilities in other program areas contributed to public-sector neglect of capital facilities. Increasingly stringent health and environmental standards that govern the design and operation of public works exacerbated the problem. Federal regulations imposed on wastewater-treatment plants, for example, have increased the costs of constructing and operating that essential element of community infrastructure.

*The present article is a translation of chapter 5 of the book *Local Government Finance*, edited by John Petersen and Dennis Strachota. It has been included in the present edition of the *International Journal of Public Budget* with the authorization of the Government Finance Officers Association of United States and Canada.

¹ For a review of needs studies done between the early 1970s and mid-1980s see "Infrastructure Needs Studies: A Critique," a paper prepared for the National Council on Public Works by George Petersen, Ted Miller, Nancy Humphrey, and Christopher Walker, July 1, 1986.

Even assuming popular support to increase funding for capital infrastructure, communities often find it difficult to decide among competing demands for capital investment. Many face pressures to extend infrastructure to rapidly developing areas; at the same time, they are urged to rehabilitate infrastructure in older, established neighborhoods. In addition, funding is often inadequate for the maintenance of facilities that are aging but not yet severely deteriorated. Insufficient funding allows for little more than emergency repair, not a rigorous program of routine inspection and regularly scheduled maintenance and replacement.

The need for investment in public facilities—the physical system of roads, bridges, water supply, wastewater treatment, and drainage facilities that support activity in our communities—has been well documented on a national level. For local jurisdictions, the aggregate numbers that make up the “infrastructure crisis” translate into capital investment requirements. In both mature and rapidly growing communities, this includes spending for sewer and water-treatment facilities, administrative buildings, parks and recreational facilities, schools, fire trucks, ambulances, and police cars, to name just a few. They are the investments that make our communities healthy, safe, and economically viable and physically attractive places to live.

Planning and Budgeting

Whether or not a jurisdiction has a formal capital budgeting system, each year it probably goes through the sometimes painful process of deciding which of several capital projects it will fund. Capital expenditures are a major component of local government spending. The buildings, streets, parks, facilities, and equipment required by the public sector attract widespread attention because they represent large, “lumpy” expenditures and provide tangible evidence of public spending. Without a plan, however, this process can go awry. Most jurisdictions face a continual gap between identified needs and the resources available to meet those needs. Strategies to close the gap include the assignment of priorities to capital-

investment needs and examining strategies to increase revenues available to fund capital projects.

The orderly process of capital-facilities planning is called capital budgeting. This general term differentiates the endeavor of financing long-lived physical improvements from the operating budget, which applies to those annual or routine activities financed from current resources. The capital budget usually follows an annual cycle and often is integrated directly into the operating budget process. Done properly, however, the capital budget in any given year is the current slice of a multiyear plan. To differentiate between the capital spending element of the annual budget and the longer-term capital financial planning process, a distinction is often drawn between the *capital budget* and the *capital improvement program*.

Capital Improvement Program

A *capital improvement program* (CIP) is a multiyear plan (usually covering five or six years) that forecasts spending for all anticipated capital projects. The plan addresses both repair and replacement of existing infrastructure as well as the development of new facilities to accommodate future growth. It enables one to identify needed capital projects and to coordinate facility financing and timing. An effective CIP consists of both an administrative *process* to identify the location, scale, and timing of needed capital projects and a *fiscal plan* to provide for the funding of those projects.

The CIP links a jurisdiction's planning and budgeting functions. It can help implement past policy decisions by establishing priorities among existing and competing capital needs but can also be used to measure and evaluate the merits of new proposals. The capital improvement program should be a logical extension of a jurisdiction's comprehensive land-use plan. Typically, the CIP describes each capital project proposed for development over the planning period by listing the year it is to be started, the cost to be incurred by year, and the proposed method of financing. Based on these details about each project, annual cost schedules for capital expenditures, as well as summaries of financial requirements and resources

(i.e., current revenues, general obligation bonds, intergovernmental assistance), are developed.

Capital Budget

The *capital budget* represents the first year of the capital improvement plan. The primary difference between the capital budget and the CIP is that the capital budget is a legal document that authorizes specific projects during the ensuing fiscal period. The capital plan, on the other hand, includes the first-year projects as well as future projects for which financing has not been secured or legally authorized. The "out years" of the CIP are not binding and are therefore subject to change.

The CIP process is a dynamic one. It helps a jurisdiction plan for major expenditures in the future and adjust capital projects as needs and circumstances change. The CIP's multiyear perspective allows projects to be planned ahead of actual need. The yearly repetition of the CIP process also ensures that each project undergoes several stages of review before it is finally approved and funded. Ideally, it ensures that new facilities will be evaluated within the context of a comprehensive land-use plan and weighed against demands for the repair and replacement of existing infrastructure. The best capital planning process

- Considers all proposed projects simultaneously
- Produces a planning document that considers both available financing sources and feasible timing
- Measures the impact of capital spending and financing sources on the jurisdiction's overall financial position
- Relates a community's perception of itself and its goals to a coherent program of investments

The State of the Art

The capital budget is the linchpin of financial management for local governments. Not only are capital expenditures significant in terms of their dollar volume, but they play an essential role in public service delivery and in the economic welfare

of the community. Many of the most compelling local government policy issues are articulated in the capital budget. On an organizational basis, the capital planning function is one that has potential for bringing together various departmental personnel and technical disciplines. It also provides opportunities to involve the public and particularly special-interest groups such as developers, neighborhood associations, business groups, and taxpayer associations in defining and creating the community's future.

If a community has developed a strategic plan, it will likely be implemented through the capital improvement plan. There is a symbiotic relationship between the comprehensive land-use plan and the capital budgeting process as well. Many jurisdictions, especially those that are growing rapidly, use fiscal impact models to estimate future revenues and expenditures over time and under changing conditions. An important component in determining the impact of new growth is the establishment of public costs through the capital planning process. Some governments have developed highly refined consensus-building and collaborative problem-solving techniques around the capital budgeting process. And finally, in a few instances, local governments are looking at their capital budgets in rigorous mathematical terms, using capital-budget-planning computer models.

The rationale for Capital Programming

The capital budget and capital plan are closely associated with the long-term operating program and budget, since the reason for each capital project is to facilitate the accomplishment of an operating objective. The following section discusses why it is necessary to develop a separate capital-budget process. These reasons include the special characteristics of capital investments as well as the political and administrative incentives for capital planning and budgeting.

Characteristics of Capital Expenditures

Despite their close interrelationship with the operating bud-

get, infrastructure or capital facilities have special characteristics that "justify" their inclusion and analysis in a special capital budget:

- Essential public purpose
- Long useful life
- Infrequent and expensive
- Related to other government functions
- Local government's general responsibility to provide them

Essential Public Purpose. Since the provision of infrastructure is a primary function of local government, it affects the community as a whole and the public decision-making process in particular. Without a sound physical infrastructure, government could not provide the services necessary to maintain a community's public health and welfare. Capital investments such as parks, senior centers, and transit enhance the quality of life in the community; in some jurisdictions they are viewed as absolutely essential. In all cases they must compete with other infrastructure needs for financing sources.

The relationship between a community's provision of adequate, well-managed public works and its ability to retain and attract commercial and residential development is clear. In addition to such determinants as the availability of skilled labor and the cost of energy, the condition of public facilities affects a community's ability to retain existing businesses and attract new ones. For instance, an efficient infrastructure system can reduce the costs of waste disposal, water supply, and other essential municipal services and, as a result, lower business costs and encourage private firms to invest in new facilities. The increase in economic efficiency also enables businesses to expand their markets and make better use of their resources. In addition, local government's timely provision and maintenance of infrastructure sends a clear message to both residents and businesses that government is committed to a stable community. These factors are often considered by businesses in their location, relocation, and expansion decisions and can help a jurisdiction

attract new industry without tax abatements and other costly incentives.²

As with businesses, individuals consider the availability and condition of public facilities when making investment decisions. The quality of public services (supported by a well-functioning physical infrastructure) enhances the value of residential housing along with such factors as location and other community amenities. The cost of providing adequate infrastructure can also, however, affect housing affordability at time of purchase as well as the carrying costs associated with maintaining a residence.

Long Useful Life. Capital facilities have a relatively long useful life. Unlike operating expenditures that may undergo annual or more frequent adjustments to accommodate changing circumstances, capital expenditures once made cannot easily be modified.

Infrequency and Expense. By their technical and physical nature, most capital projects involve large, infrequent expenditures that must be made before the benefits are realized. For example, it is either inefficient or technically impossible to build half a wastewater treatment plant or a bridge that stops in the middle of a river. As a result, communities make major capital expenditures only infrequently and for specific purposes, but the outlays are particularly large. Of course, the larger the jurisdiction, the more frequent and regular is the need for certain large outlays such as street repaving.

Relatedness to Other Government Functions. Each community requires certain physical structures and systems to provide residents and businesses with the urban services necessary to live and conduct business. The capital investments made by a government to support infrastructure are interrelated and are part of a system or network that provides the public with a set of goods and services. In general, all sys-

² Apogee Research, *Financing Infrastructure: Innovations at the Local Level* (Washington: National League of Cities, 1987), pp. 6-7.

tem components must be in place before the system can function properly. The relationship of capital facilities to other programs and services requires careful timing to ensure that necessary facilities are in place when development occurs.

Responsibility. Local governments shoulder the largest share of financial responsibility for providing, operating, and maintaining most public works. This is due, at least in part, to the fact that local communities and their residents are the primary users of public works. During the 1980s the national trend of shifting functions and fiscal responsibility from the federal government to the state and local levels continued. With the notable exception of highway financing, federal programs for capital projects at the state and local levels are approaching extinction. Most states lack the financial resources, administrative structure, and/ or political initiative to offset the decline in federal assistance. Unfortunately, the increase in local responsibility has not been accompanied by a parallel increase in the resources needed to do the job. Communities that cannot or will not make up the growing gap in infrastructure financing risk the loss of both population and businesses to communities that are willing to find ways to help themselves.³

Advantages of Capital Planning and Budgeting

Local governments that employ capital budgeting and programming systems are likely to derive several advantages.

The Capital Program as a Reporting Document. The capital planning process can involve citizens in shaping their community's future and help minimize complaints and after-the-fact objections to major capital projects. Input from community residents and businesses can be critical to success, and

³ Significant portions of the preceding section are from *Building Together: Investing in Community Infrastructure* (Washington: Government Finance Officers Association, National Association of Home Builders and National Association of Counties, 1990).

increased citizen participation in planning capital improvements can lead to enhanced understanding of the factors involved in building and maintaining facilities.

The complex interrelationships among overlapping and underlying jurisdictions such as towns, cities, school districts, special districts, counties, and regional governments often make capital planning especially difficult. Ideally, these jurisdictions should integrate or, at a minimum, coordinate their capital programs. Because such cooperative capital planning rarely occurs, the capital improvement document often serves as the only mechanism for coordination in the timing and location of related projects.

The CIP can be used as a means of reporting to the governing board, civic organizations, citizens, and neighboring jurisdictions. Capital projects often generate community interest because they directly affect the quality of life and daily activities of its citizens. The CIP has the potential to be an important method of communicating the financial position of the government, as well as its goals, policies, management performance, and community vision. It can illustrate the issues and concerns facing the jurisdiction, examine possible alternatives, and indicate what impact the planning and financial decisions will have on the both the community and individual futures.

The CIP as a Financial Management Tool. The CIP is a useful financial management tool. It helps policymakers determine the amount of infrastructure and equipment spending required to accommodate anticipated growth and development and provide for the orderly replacement of existing capital facilities and equipment. A well-developed capital program provides a useful frame of reference for all participants in the acquisition, construction, and financing processes.

The CIP can be employed to forecast future capital demands on current revenues, borrowing power, and levels of outside assistance. As resources or demands change, policy makers can move capital projects forward or back in time to other years, to reevaluate project priorities, or to change the revenue mix. The ability to shift capital projects and outlays is particularly important when a significant portion of the capital budget is financed

from current revenues, since it allows the jurisdiction to allocate "lumpy" capital projects over the forecast period in such a way as to stabilize or smooth out the property-tax rate.

Because of its multiyear time horizon, the CIP can provide local government agencies and departments the opportunity to carry out required plans, engineering surveys, land acquisition, architectural sketches, and site-plan reviews. The financial analysis integral to a capital improvement plan highlights the impact that capital expenditures will have on the operating budget.⁴ If the capital budget explicitly acknowledges the personnel and maintenance costs associated with capital projects, it can provide a basis for realistic operating budget assumptions and expectations.

Since the CIP schedules the timing of capital projects, it helps avoid duplication and overlap. It also encourages the principles of value engineering- the notion that a leaky roof should be repaired or replaced before a new ceiling is installed. In this sense it facilitates optimal use of public funds, reducing the possibility of overlapping or conflicting projects. Finally, because the CIP encompasses the entire jurisdiction, it can ensure that no one functional area (e.g., streets) receives more attention than others or that any one geographic area receives more public facilities than others.

The CIP's Contribution to Long-Range Policy Development. The CIP focuses attention on community goals and needs and can ensure that major capital expenditures are in line with community expectations, anticipated growth, and projected financial capability. A number of policy areas can be enhanced by the preparation of a comprehensive capital improvement program. Among the most important areas are: the formalization of capital funding objectives, that is, adopting standards that permit efficient allocation of limited financial resources; and the development of carefully structured debt policies.

The CIP process includes a system to prioritize spending for capital facilities. Establishing formal policies to guide the

⁴ *A Practical Guide for Local Governments*, Office of Local Development Programs (Virginia Department of Housing and Community Development, 1986), p. 3.

ranking of capital-project requests can provide justification for spending decisions. For example, the policies typically give greatest weight to projects or equipment required to address public-health and safety concerns. If consensus on spending priorities is reached between elected officials and staff in advance, the annual evaluation of project requests can be streamlined and made more efficient.

In recent years an increasing number of state and local governments have found that the adoption of debt policies gives them greater control over the mix of issue types, redemption schedules, and credit implications of their borrowing programs. These are easily developed in concert with the implementation of the capital improvement program. The CIP can be designed to evaluate automatically the impact of proposed borrowings on the existing debt structure. This represents an added degree of management control.

The CIP as a Positive Credit Rating Consideration. Because a capital improvement plan has intrinsic value as a financial planning tool, it gives credit-rating agency and credit market analysts some assurance that the government has carefully planned for its future capital requirements and has assessed the financial resources likely to be available to meet those requirements. It should be kept in mind that credit ratings are a judgment of the kind and degree of risk that will be acceptable to investors. Individual securities or bonds are not avoided or acquired because of the ratings, but rather because of the characteristics that are reflected in the rating.

As part of the credit-rating process, rating agencies base their analysis on four key variables: financial condition, economic factors, indebtedness, and administrative factors. The fact that a local jurisdiction has developed and implemented a comprehensive capital plan has a positive effect on each of these areas.

The Capital programming Process

The benefits described above emphasize the value to a jurisdiction of an orderly and routine method of planning and

financing required capital improvements. Like the operating budget, an effective CIP process involves several steps or activities, each of which is repeated every year. In most local governments, the CIP and the operating budget are developed separately, although some jurisdictions have successfully incorporated the overall process into the annual budget cycle.

Process Initiation

The legal basis for capital budgeting usually lies in a local charter or ordinance. In some states, the process is mandated by law. Whatever the legal foundation, each local government should establish specific policies and procedures for submitting and evaluating projects and assessing funding sources. This usually includes (1) appointing a person or group to serve in a central review and coordination function and (2) developing a system to collect, analyze, and monitor capital requests, future needs, and potential resources. A timetable for the submission of projects, procedures for initiating projects generated internally by staff and externally by the public, and a method of evaluating and ranking projects are also necessary.

The importance of two policy or procedural issues should be emphasized here. The first is the determination of exactly what kinds of items and projects will be included in the CIP. Deciding which items should be included in the capital budget or plan and which in the operating budget is essential. As a general rule, items in a local government budget are classified as capital or operating by cost and frequency. Both criteria should be applied simultaneously to determine whether a project belongs in the capital budget.⁵

Capital costs represent a significant outlay for the government—something out of the ordinary. Accordingly, smaller governments frequently require lower minimum dollar amounts for capital expenditures than do larger jurisdictions. For instance, in a small community, vehicles may qualify as cap-

⁵ Rosenberg, Philip, and Rood, Sally. "Planning for Capital Improvements," *MIS Report* 16, 8 (Washington: International City Management Association, 1984.)

ital expenditures because of their cost in relation to other government supplies, while in another jurisdiction they are routine operating expenditures. An important criterion is that any facility or item financed by long-term debt should always be considered a capital expenditure. It is not fiscally prudent to debt-finance any item that has a useful life that is less than the repayment term of the loan (or bond).

In terms of frequency, only expenditures that *do not* occur annually should be included in the CIP. For example, some governments classify items or projects as "nonrecurring" if they have a useful life of three years or more. These distinctions are useful, however, only as guidelines to help avoid confusion and increase consistency. There will always be "gray areas" that must be resolved locally. Each government must make its own decisions regarding the appropriateness of including items (usually maintenance and replacement) that recur regularly but infrequently, i.e., every five, ten, or twenty years.⁶

A second concern is the identification of prospective participants in the process. The government's infrastructure role vis-a-vis other jurisdictions and political subdivisions necessarily dictates some of the participants in the CIP process. Within the jurisdiction's own organizational structure, the main players include the operating departments (e.g., public works, parks, schools), which submit project proposals; and a central review agency such as the planning department or the budget/finance department or a CIP committee that assesses and selects projects. The chief administrative officer is generally responsible for submitting the CIP to the governing board.

The role of the legislative body varies from jurisdiction to jurisdiction. In some cases, the CIP must be approved by both the planning commission and the governing board. These bodies may take a relatively passive role, merely approving the CIP as submitted, or they may actively participate in the selection of projects and financing mechanisms used.

Likewise, the participation of residents and business interests will vary. In some communities, citizens (or citizen CIP committees) identify projects and are involved in modifying the pri-

⁶ *Ibid.*, p. 11.

ority-setting process by determining what selection criteria and weighting factors will be used. In others, the process is more ad-hoc, with citizens being given the opportunity to submit project requests and allowed to comment at public hearings.

There are advantages and disadvantages to both methods of involvement. Active citizen participation can require considerable staff time and to be successful requires in-place systems of volunteerism and activism in the community. But extensive citizen participation can also make it easier to implement controversial infrastructure improvements. It frequently provides decision makers with information about the public's perception of community needs and its willingness to incur new costs.

Resource and Demand Inventory

Local governments usually compile and periodically update an inventory of their physical plant. Because many capital project proposals will request expansion or replacement of existing facilities, it is important to be aware of the age, general condition, and original acquisition cost of all fixed (capital) assets owned or leased by the government. This information will help to track the condition of equipment and forecast replacement needs. Some indices that might be used to inventory and assess the condition of infrastructure are presented in table 5-1. It is also a good idea to determine the status of previously approved capital projects, both to monitor the CIP and to aid in the preparation of the new capital budget.⁷

The local government may also "inventory" future demands that, at a minimum, includes an annual review and forecast of changes in population, land-use patterns, and other demographic information. The "future demands" inventory identifies locations for new development, as well as any changes in the type or number of businesses or industries locating within the jurisdiction. Once this information is in hand, the data can be compared to the land-use plan and the impact on the capital plant can be estimated.

⁷ *Ibid.*, pp. 11-12.

Table 5- 1
Inventory and Condition Assessment Indices

Inventory	Condition/Performance
Unit (e.g., street, bridge, pipe)	Current Condition Rating and Date
Type of Material	Percentage of Capacity in Use
Location	Repair History
Physical Dimensions	Type of repair
Initial Value/Cost	Cost
Responsible Department	Date
Funding Source/Eligibility	Trends in Performance of Key Variables

Source: Stephen R. Godwin and George E. Petersen, *Guide to Assessing Capital Stock Condition* (Washington: The Urban Institute Press, 1984), Table 1.

Project Identification and Priorities

As with the operating budget, the capital programming process begins with the collection of proposals from departments, agencies, and sometimes private individuals or community groups. Typically, forms are issued by the central review agency. For projects that previously were included in the past year's capital program, the resubmission requires only revisions of cost estimates or other new developments. For first-time submissions, or for proposals that previously went unfunded, however, considerable information may be requested. Information typically required in the project-request form includes a narrative description of the project, its costs broken down by year of expenditure, the rationale for the project, its impact on the operating budget, and proposed funding sources. Supplemental information, such as project scheduling, construction cost estimates, and maps also may be required. Many jurisdictions require separate forms for equipment items because they do not fit readily with their capital-facilities-request forms. Thus, a CIP request packet typically involves several forms and may even require a summary form for the submitting department to complete.

Many local governments require that the submitting department assign priorities to the projects requested. This introduces one of the most common problems associated with capital budgeting—the weighting of priorities in order to allocate scarce resources. The allocation problem becomes even more significant later, but it is important to realize that the assignment of priorities can be difficult even at the level of the originating department.

Generally, the chief administrative officer will send a letter to each department head and to citizen groups calling for project submissions, outlining procedures to be used, the CIP implementation schedule, and anticipated funding levels and requirements. Often this intergovernmental transmittal letter also includes guidelines for ranking projects within each department or division. In some systems each project is rated according to specific categories, such as:

Urgent Projects:

- to meet emergency situations
- to perform work required by state or federal law

Necessary Projects:

- to eliminate safety hazards/correct code violations
- to meet contractual obligations
- to perform required renovation or repair

Desired Projects:

- to replace equipment
- to extend/enhance service
- to match state or federal funds

Ongoing Projects:

- to continue work in progress

Deferrable Projects:

- to perform nonessential renovations/improvements
- to perform projects with questionable timing or need

The departmental ranking system may also include some

more subjective evaluation. For instance, those submitting requests may be asked to answer the following questions:

- What improvement do we need most?
- Which capital projects can be postponed without jeopardizing health, safety, or other program objectives?
- How will these project decisions affect the level of service currently provided?
- Do any of the projects contain "frills" that could be cut without essentially changing the request?
- Have all alternatives and solutions been fully examined?

Once each of the projects has been given a priority rating by departmental staff, they can also be ranked (first, second, third) to indicate their overall importance when compared to items with similar priorities. These rankings typically are then sent to the central agency for review and comparison with systemwide needs.

Project Evaluation

The capital project "wish list" will probably not be fully fundable with the resources available. To compare and choose among dissimilar projects, the local government will institute procedures to evaluate each project and rank each in order of priority on a systemwide or jurisdictionwide basis.

Once departmental requests have been collected, they must be evaluated. Many jurisdictions begin by referring capital development proposals to the public works or engineering department to ascertain technical feasibility. In some cases, this is accomplished before the submission is documented on the forms. Likewise, equipment items are often reviewed by the general services director or other responsible officials. Once these technical reviews are completed, the more difficult process of comparing competing projects must be undertaken.

Some states require a formal review by the local government planning commission usually to ensure conformity with the master plan. Useful suggestions regarding other proposed activities which may have been overlooked by the original submitting agency or individual may surface at this point.

This review is not likely to produce priority changes, but rather provides an opportunity for improved scheduling of interrelated physical developments. Further, the jurisdiction's planners are alerted early to proposed future projects that could affect private development.

Upon completion of the planning review, many mid-size and large jurisdictions appoint a review committee to assign priorities and to screen or rank the various proposals. Although ultimate responsibility for recommending a capital program may be assigned to the chief administrative officer, this internal process helps to establish objective criteria and provides a comprehensive effort that cannot be accomplished single-handedly. Although certain recommendations inevitably will be overruled, and other projects may be inserted into the ultimate capital program, the product of committee review typically proves to have enduring value.

Even if the system used to evaluate and compare projects is a numerical or quantitative one, the final decision will be based on value preferences and policy choices. In order to have an effective project-selection process, the government should have clearly defined and agreed-upon criteria and a system to rank each project request. Although there are some rules of thumb for ranking projects, those making the selection decisions must ultimately rely on their own knowledge of the locality and their confidence in staff.

Most public officials find that the development of evaluation criteria and setting priorities are the most difficult part of capital programming. No matter how much care is taken, there will always be those who disagree with the ranking system. Many find that a two- or three-tier ranking system is most helpful. Frequently used general criteria for evaluating projects are

- Fiscal and budgetary impact on the jurisdiction
- Health and safety effects
- Community economic effects
- Extent of facility use
- Environmental, esthetic, and social effects
- Disruption and inconvenience caused
- Distributional effects

- Prior commitments and feasibility
- Implications of deferring the project
- Amount of uncertainty and risk
- Effects on interjurisdictional relationships
- Advantages accruing from relation to other capital projects⁸

To assist in the rating process, jurisdictions may assign numerical scores to each project based on criteria that have been developed over time. Although such quantitative approaches are attractive at first, many suffer from high degrees of subjectivity, with a bias toward one type of spending. For example, replacement equipment could receive lower scores than new development under a skewed scoring system that emphasizes growth.

If the flaws can be worked out of these systems, objective scoring programs do serve a useful purpose. They also provide guidance to project requestors, who quickly learn that certain suggestions are unlikely to be funded on the basis of objective ranking. Some governments use a two-stage evaluation procedure in which a "core" list of projects is identified first. Then a second stage of evaluation is added to allow first-time rejections to resurface and be reconsidered before a final recommendation is made. This avoids the embarrassment of submitting a mechanically pure list to the governing body for consideration, knowing very well that certain worthy projects have been excluded because they lack an adequate "point count." Ultimately, of course, subjectivity enters into the process—as it must in a public decision-making system.

Cost-benefit Analysis. For many years, economists have advocated that the public-sector capital-budgeting process could be improved through rigorous application of economic analysis techniques. In formal quantitative models, a stream of future social benefits are calculated, and the discounted present value of the benefits compared to the project cost. In a capital planning model, the formula would look something like this:

⁸ Annie Millar, "Selecting Capital Investment Projects for Local Governments *Public Budgeting and Finance* (Autumn 1988): 66-68.

$$NPV_B = -I + \frac{B_1}{(1+r)} + \dots + \frac{B_n}{(1+r)^n}$$

Where: NPV_B = net present value of benefits
 I = investment (capital cost)
 B = benefits in each future year
 r = rate of interest (social cost of capital)
 n = number of years

Unfortunately, applying this elegant model can prove elusive in practice. Although it may retain value in a few specialized instances, the problems of quantification can be immense. Primarily, this is because it is quite difficult to quantify monetarily the benefits of public spending. In the case of toll bridges and watersupply facilities, where pricing is possible, the value to consumers can be measured and captured through tolls and charges. Most public facilities, however, are built by the public sector *because* they provide some social benefits that presumably escape the pricing system. For example, public parks provide considerable value to their users, although people rarely pay each time that they enjoy the open space. Only when limited numbers of facilities are available—that is, exclusion becomes a factor—does pricing work. Generally then, the quantification of social benefit becomes a true quagmire for the analyst.

A second problem relating to net present value analysis is the issue of the social cost of capital and the rate of discount to employ. Most local governments can borrow capital funds at a low, tax-free interest rate—usually below the rate on U.S. Treasury bonds. On the other hand, the local government's investment portfolio may receive higher returns on taxable government securities. Which interest rate should apply? Or should the analysis use the cost of money to private taxpayers who must finance costs through taxes and fees and thus detract from their future accumulation of personal wealth? In general, the lowest, usually taxexempt, interest rate has been used for net present value calculations, although this introduces a bias toward completing as many public projects as possible because the denominators of the calculation are

reduced-which mathematically increases the net present value that will be derived. As a consequence, most practitioners believe that the net present value methodology, while useful in the comparison of like projects, should not be the rationale in assigning priorities.

Financial Analysis. Once projects have been identified, the planning and engineering feasibility of each evaluated, and a preliminary rank-ordering process begun, it is necessary to conduct a financial analysis. Analysis is needed at the aggregate level, as well as on a project-by-project basis. On the project level, the economics of project financing must be examined closely. The central review agency must assess the feasibility of the project, the impact of the cost of the project on the jurisdiction, and the effect of future maintenance and operational expenses on the operating budget.

At the macro level, the financial capability of the local government is estimated—How much capital spending and debt financing can be supported by the local tax base and the local economy? To determine the government's capacity to absorb additional debt and to finance capital spending from current revenues, several tax and debt-burden studies can be undertaken. First, the total overlapping tax burden on local taxpayers is determined. To calculate the total overlapping tax burden, the tax levies for county, city, township, school district, and special districts are added together. Relative tax information is collected and compared. A jurisdiction's total tax rates can then be compared with averages for their region, state, and the nation. Because of differential tax structures, national comparisons may not be relevant, but at the regional level comparative analysis can be fruitful. Jurisdictions with high total tax rates relative to their neighbors may be vulnerable to future taxpayer backlash. The exception to this rule is that affluent suburbs with high tax rates are often both able and willing to sustain above-average levels of public expenditure.

In addition to competitive position and taxpayer attitudes, local officials also should determine whether there will be any risk of overburdening local properties during periods of business downturns (recessions). Communities with highly cycli-

cal economies must be particularly careful to gauge their capacity to bear high debt burdens when local industries operate at less-than-average capacity.

The next area of analysis is an examination of overlapping debt burdens. Local governments may encounter resistance to new bond issues from taxpayers in localities that already have absorbed above-average levels of debt. Certainly, the bond rating and underwriting communities will be likely to discourage aggressive capital spending programs in such jurisdictions. This suggests that the costs of borrowing will be higher in riskier, high-debt localities. Debt statistics can be presented in per-capita terms or as a percentage of aggregate property valuations or personal income.

Financial analysts also will be inclined to study the trend of a government's borrowing and its overall leverage. Unless driven by economic growth, jurisdictions with rising per-capita debt and rising debt as a percentage of property value will be looked upon unfavorably as having overly ambitious capital programs.

Another helpful analytic technique is an examination of the existing debt service schedule. By plotting existing debt-service payments over time, policymakers can determine their future "spending opportunities." A well-planned capital program can take advantage of this "envelope" by slotting spending programs into the future so that tax rates could remain stable even though new capital spending increases. Some jurisdictions also have established policies that require that debt be redeemed at a predetermined rate, which limits the ability of local officials to burden future taxpayers with principal payments that balloon in the distant future.

Looking beyond historical information, projections of future revenue capacity also should be made. This creates several estimation risks and analytical complications. Revenue growth depends on several key variables, including demographic trends, tax policy, and the general business cycle. Communities that experience population growth may find it difficult to make accurate determinations of their future financial condition.

To forecast revenues, it is necessary first to understand the nature of the local tax and user-charge structure. Some gov-

ernments have elastic tax bases, relying heavily on income taxes, sales taxes, and fees related to growth. Others may find themselves dependent on stable, but relatively inelastic, property taxes. In states with constitutional tax limitations, the probability of revenue increases must be discounted. Future tax increases to finance specific improvements may be a direct function of the capital improvement program and the ensuing political campaign needed to "sell" it. In some cases, a status quo estimate of future revenues on the basis of existing tax rates, assuming no new voted millage or tax-revenue sources is made.

Funding Source Identification. Only a limited pool of resources is available to fund all the requested capital projects. The challenge is to identify the full range of resources available (both current and borrowed) and to determine how these funds can be used to meet the needs with the highest priorities. Among the major sources of funding that should be considered are

- *Pay-as-you-go financing*—costs are paid directly from current income, such as taxes, fees and user charges, and interest earnings
- *Grants from other governments*
- *Debt financing*—tapping external funds through the issuance of debt in the capital market
- *Public/private ventures*, including privatization

Most governments find that current revenues are inadequate to fund all the projects in their capital plan. For this reason, a well-structured capital improvement program should include a review of all financial resources that might be available to meet current and future capital needs. The mix of financing methods that will be used to fund a CIP is likely to be one of the most important decisions made in developing and executing a capital planning effort. In the case of debt financing, for example, amortization rates and repayment schedules are determined by the parameters established by the mix of financing tools used. Each method of financing has advantages and disadvantages, and each should be viewed in

the context of its applicability and its effect on the jurisdiction's spending levels and overall fiscal health.

No one method of financing is appropriate for every project or capital facility. Prudent financial management calls for a combination of sources and methods to be used to fund the capital requirements of a local government. Too much reliance on one source or method jeopardizes the entity's fiscal health and its ability to respond to changing economic and demographic conditions.

In most large jurisdictions, each department typically submits funding source recommendations with their project requests. The central reviewing agency must then determine the appropriateness of each source recommendation.

There are no hard-and-fast rules for determining a "good mix" of financing methods. Every jurisdiction must develop its own set of criteria that recognizes the legal and practical limits of each approach. These decisions are based on the characteristics (cost, location, timing) of the capital expenditure in question, as well as on the financial analysis (fiscal capacity, requirements for operating purposes and debt service, limitations on the revenue system), and finally on historical, economic, and political constraints operating within the jurisdiction.

Project Scheduling

After projects have been evaluated and rated, and potential sources of available resources identified, the next task is to determine the timing of all the projects. The projects must be placed into time slots that fit both the jurisdiction's needs and the availability of resources. The end result will be a sequential listing of projects that can be reasonably financed, designed, constructed, and implemented.

This is, however, generally a trial-and-error process. Some projects will be interrelated; the sequence of developments sometimes take precedent over finances. Bond referenda may be required. Engineering capability and staffing also may impose constraints on the volume of work that can be undertaken in any given year. Known political priorities of the governing body may also enter into the decision making, partic-

ularly for capital programming activities. Like the operating budget, the capital budget or CIP is sure to go through many iterations after review by various participants in the process. A preliminary CIP is usually submitted to the governing body, with the final adopted plan published after action by that body.

Urgency and feasibility will likely dictate the initial field of candidates for the capital budget. If funding capacity remains-which rarely occurs-projects with lower priorities can be considered. The more frequent occurrence, however, is that projects initially scheduled or desired for the early years must be deferred pending funding ability. For the remaining projects, the timing of development will likely reflect tactical factors, such as a replacement schedule, the prospects for funding from outside sources, or political factors.

Once a government has formalized its capital planning process through the adoption and implementation of a CIP, subsequent years' efforts are usually simplified. As the prior year's capital budget is implemented, completed projects can be crossed off, and the second year of last year's CIP becomes the beginning list for the subsequent capital budget. Also, new suggestions can be entertained, and projects that were considered but not included in the prior CIP can be added if funding priorities change. Sometimes, a multiyear education effort is required to develop political and community support for projects that would properly belong in the capital program if revenue constraints were removed by action of the governing body or voters. Some governments therefore add a final column to their presentation, showing projects that are desirable, but for which funding is not available.

An important but often overlooked aspect of the capital program is the orderly process of planning for the replacement of existing facilities and equipment. Although some governments do not maintain sufficiently precise records to assist them in the capital-facilities-replacement process, a growing number have developed impressive processes. In some localities, a facilities inventory is used to establish clear documentation of the condition of available capital facilities and the probable timing of needed improvements. This can include a formal decision to allocate a fixed percentage of

annual revenues for capital facilities and equipment replacement, making it possible to engage in pay-as-you-go financing on a regular basis, eliminating the tendency to defer replacements, which results in greater maintenance costs. Replacements and renovations thus take priority over new developments or program expansion.

For equipment financing, many local governments have created motor-pool funds or other internal-service funds and include depreciation in the rental charges that are levied against user departments. The advantage of this approach is that the depreciation process ensures that cash will be available when the time comes to replace equipment. For small communities, this eliminates the need for borrowing to finance major equipment such as fire trucks and public works vehicles. Many local governments initiated such replacement programs during the early phases of the now-defunct Federal Revenue Sharing program using newly found "windfall" revenue to initiate the funding program. Unfortunately, jurisdictions that now attempt to implement such programs in periods of economic constraint find it difficult to locate the "seed money" to fund accumulated depreciation. A further drawback of this funding mechanism is the problem of intergenerational equity. By charging depreciation to existing taxpayers through service charges that ultimately are funded through taxation and user fees, the replacement of future capital equipment is ensured. It will be future generations, however, not the present generation of taxpayers, that will benefit from the eventual replacement of today's equipment and facilities. So why should today's taxpayers incur the cost of future benefits? Further, some analysts argue that tax-exempt financing for general governmental equipment produces lower costs than the depreciation and pay-as-you-go approach implicit in the internal-service fund approach. From a long-term standpoint, however, equipment financing is a very minor element in the overall CIP. The costs absorbed by today's taxpayers in funding a depreciation system often work out to less than 10 cents per household. This would appear to be a minor price to pay for the assurance that the future has been provided for.

CIP Adoption

Generally, a preliminary capital improvement program and capital budget are prepared and presented to the governing body. This effort provides an opportunity for informative discussions of key financing and policy issues, as well as a detailed presentation of proposed projects. The CIP usually includes a transmittal letter from the chief administrative officer, capital budget policies, long-term financial forecasts, financial summaries, summaries of revenues and expenditures by category or function, project descriptions and project summaries, special analyses, maps and charts or graphs, and a glossary or other reader aids.

During the review of the preliminary CIP, the policy dimension of the capital programming comes into focus. In jurisdictions with elected executives, the CIP often provides an opportunity for strong executive leadership. Public hearings customarily are held before final deliberation by the governing body. These opportunities for public input may represent the final opportunity for citizen involvement. In many jurisdictions, a subsequent public hearing may be required at the time of debt authorization or appropriation of public funds. Nonetheless, the public hearings attendant to the capital program offer an important vehicle for individuals and interest groups to represent themselves in the context of a capital priorities system. Once the capital program is approved, the first year of the CIP, the capital budget, is authorized.

Implementation

The capital budget appropriates funds for the projects in the first year of the CIP and recommends the authorization of necessary bond issues. This legislative authority does not extend to the remaining years of the CIP, thereby requiring an annual update of the program. The progress of all authorized capital projects and expenditures should be monitored throughout the year. Each project may be assigned a project manager, who is responsible for ensuring timely completion. Regular reports from project managers will ensure that the projects are on schedule and can also serve as the basis for the fol-

lowing year's CIP submissions. Monthly or quarterly reports are typically provided to the chief administrative officer so that deviations, delays, change orders, and overruns are detected immediately. Similar information (in a more condensed format) can also be provided to the governing body, permitting elected officials the opportunity to review systematically the overall program instead of individual pieces.

As the year progresses, new projects and ideas will surface, and one or two projects may fall behind the original timetable. The resulting changes help the preparation of the next year's CIP planning effort, which will begin before the current year's projects are completed. Eventually, a cyclical rhythm will develop, and officials will become accustomed to the discipline and rationale inherent in the capital programming process.

Conclusion

Capital planning and budgeting is an essential element of financial management. Local governments increasingly are using the capital plan as a policy tool and as a vehicle for public communication. The CIP represents a framework for decision making. It provides a forum to discuss and resolve the political choices that a jurisdiction makes about what to build, where and when to build or buy it, and how much to spend for it.⁹ For many of the local governments that use it, the CIP provides the only forum in which decisions regarding the physical development and maintenance of the community interact with those concerning its financial and fiscal future.

⁹ Rosenberg, p. 4.

Fiscal Decentralization: Conceptual Framework*

Gabriel Aghón and Gerold Krause-Junk **

I. Introduction

During the past and the current decade up to now, substantial changes have taken place in the intergovernmental relations schemes of the Latin American and Caribbean countries. They arise out of what may be called a decentralization wave, which has been accompanied by constitutional and legal rules which redefine the State structure as well as the allocation of resources and competences to the different government levels with an apparent and, in some cases, significant resurgence of the subnational governments' role, in terms of their relative strengthening, both regarding their function as suppliers of basic services and public spending administrators and, to a lesser extent, as collectors of their own income.

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The purpose of this document is to present, as a conceptual framework, the fiscal decentralization regulatory principles and/or criteria which have been considered as basic concepts to be taken into account in the development of the project and, mainly, in the analysis of such processes which is intended to be carried out in the case studies.

The initial part describes, in general terms, the meaning of fiscal decentralization and the analytical models which are usually applied in its analysis. The second part deals with such complex aspects as the measuring of a process of this type and the limitations derived from it. A third and fourth part refer to the possible advantages or arguments in favor of a fiscal decentralization and the possible disadvantages or problems which may result from it without reaching a sound conclusion in one direction or the other.

Finally, the fifth part of the document goes over the main advantages and disadvantages of fiscal decentralization and provides some possible solutions which may be applied to determine a decentralization strategy aimed at better obtaining certain economic objectives and optimizing the net benefits that may be expected from a decentralized public management.

II. Concept and meaning of fiscal decentralization

Decentralization may be defined, in general terms, as a process of transfers of competences and resources from the national or central administration of a certain State to the subnational administrations: state and municipal in the federal countries, and regional and local in the constitutionally unitarian countries. Within this context, the decentralization of public finances requires, as a previous condition, that the country be territorially divided into inferior or smaller units, each of them having its corresponding regional and/or local governments and being closely related to the superior unit or central government.

Thus, a country may be assumed to be undergoing a decentralization process when its subnational or territorial administrations have been endowed with a series of signifi-

cant powers, which requires, in addition, the timely and adequate availability of financial resources to that end. For such reason, the intergovernmental fiscal relations issue becomes an essential aspect in view of its implications in terms of the public sector's efficiency and equality in the assignment and distribution of the powers and resources within a State.

In other words, a decentralized fiscal system presupposes the existence of at least two different levels of political competence. Fiscal decentralization occurs when the fiscal competences (public revenue and spending) shift from the superior or central level down to the inferior or subnational level, and it implies, in general, a process directed from the central level. Thus, the granting of certain administrative independence upon the local authorities is not generally considered as fiscal decentralization and it may rather be understood as an administrative deconcentration process.

When a decentralization process is analyzed in its fiscal dimension, as a general rule, political systems are studied with national governments having a key role as income collectors and public spending administrators. Due to diverse political and economic reasons, the advantage and possibilities of transferring certain powers to the subnational governments are analyzed.

In this sense, it is advisable to study what kind of functions the State must continue to perform in a centralized manner and which of them may be decentralized and to what extent. For such purpose, it is practical to use the traditional Musgrave¹ view which differentiates three types of public sector functions (allocation, distribution and stabilization) and to revise the main proposal for their handling before the decentralization process.

As regards the distribution and stabilization functions, the diverse arguments aim at the convenience of their centralized management by the national government and only in the allocating function do the discussions and analyses give importance to the subnational governments' participation in the

¹ Musgrave, Richard and Musgrave, Peggy (1989) *Public Finance: In Theory and Practice*.

achievement of an efficient allocation of resources, particularly in the offer and supply of public property, a theory that will be discussed later in chapters III and IV. The superiority (in terms of achieving a pareto-superior allocation) of the local supply of certain public property on behalf of the local governments is defined in what came to be known as Oates'² "Decentralization Theorem" which establishes the following: "For public property –whose consumption is defined for geographical subgroups out of the total population and whose supply costs for each product level of the property of each jurisdiction are the same for the central government or the respective local governments– it will always be more efficient (or at least as efficient) that the local governments provide the pareto-efficient product levels to their respective jurisdictions than the supply by the central government of any prefixed and uniform product level for all of the jurisdictions". The theorem is based on the assumption that the preferences of diverse communities –in the interior of a country – are heterogeneous and that a homogeneous supply of public property on behalf of the central level will result in allocations which may be improved in the pareto sense if each local government provides a differentiated level of public property to its respective inhabitants. The latter is possible since each subnational government has more information about the community's needs. Finally, it is worth mentioning that the result pointed out will not be that clear if considerable scale economies appear in the production of public property, since this way the central supply will be more convenient.

In practice, there are generally several alternatives for transferring functions and/or responsibilities concerning income and spending matters from the central to the subnational levels;

- The first one is associated to the central idea to promote decentralization processes in both fiscal aggregates: public spending and income. This consists of having the subnational level (regional and local) freely decide upon the

² Oates, Wallace (1972) "Fiscal Federalism"

amount and quality of the public spending to be incurred in and the income to be collected by it. Each one of the subnational levels' jurisdictions may do so in free competition with the other jurisdictions at its own level and with the central government. This may lead to a high degree of fiscal decentralization, although the result will depend to a large extent on what the central government does. If the latter is not willing to waive a certain sphere, for example, if it drains all tax bases possible and provides all kinds of public services, then, the decentralized government may not, perhaps, find enough margin for planning its own activities.

- A second way implies the maintenance of a certain restrictive and/or limited criterion over the dynamism which may result from such processes and of certain precaution for dealing with the undesired effects which may be derived from a central or national perspective. Therefore, it consists of establishing strict limits among the government levels and allowing the jurisdictions of the territorial levels to act as they wish, provided always that they remain within such levels. In so far as expenses, this restriction means that each government level is allowed to use money exclusively for purposes established within its own powers; in the expenses sphere, the decentralized units are allowed to collect public funds only in a certain manner, for example, through some taxes within the scope of their own competence.
- A third way, perhaps in addition to defending the public management centralist schemes, gives its support to a higher centralization of the public spending and the tax arrangement through a larger restriction upon the powers of the decentralized governments in fiscal spending or income matters.
- Also, there are other modalities where the lower or subnational level fiscal competence may be reduced through regulations making the rendering of certain services compulsory, or even providing the central government with powers to decide upon the amount and quality of the services entrusted to the lower level merely in so far as the administrative and technical aspects of their rendering is con-

cerned. From an extreme viewpoint, the fiscal competence of the subnational level may be reduced even more, down to zero literally speaking. That is to say, it becomes practically nonexistent. Such is the case of a system in which the decentralized government must depend exclusively on the transfers made by the central government without simultaneously being transferred additional spending liabilities. The decentralized fiscal policy is restricted, therefore, to the new ways of deciding on how to spend that money. Now, if the central government also decided how to use the transfers, there would be no fiscal decentralization whatsoever, on the contrary, it would hinder any attempt in this sense.

The decentralized government reaches a higher financial competence degree when it may somehow influence on the transfers to be made to it. But, once again, that depends fully on the system according to which the transfers are made.

If we consider, on the one hand, the decentralized government's right to determine its own expenses and financing sources and, on the other hand, the restriction of its powers through narrow limits fixed by the central government, we are undoubtedly faced with a large variety of combinations of intergovernmental fiscal systems and, therefore, with possible fiscal decentralization processes.

At present, there is ample literature and discussion available regarding the previous considerations. In the analytical framework, the contributions by the Public Choice theory and the fiscal federalism in the economic modeling of the subnational governments and decentralization stand out. In this sense, two analytical models³ gain special importance:

- 1) The "principal-agent" model where the government's central level is the "principal", having ample supervision and/or control over the decisions of the programs that are

³ Campbell, Tim (1991) "Decentralization to Local Government in Latin America: National Strategies and Local Responses in Planning Spending and Management". World Bank, Paper Work, Report No. 5, page 6.

carried out by the subnational governments or "agents". Likewise, it recognizes that the decentralized management constitutes a strategy which promotes efficiency in the allocation and supply of local public property.

As it is well pointed out by some experts in the issue, "the agency problem" is limited to the design of incentives and instruments leading local initiative to the direction determined by the governmental priorities of the central level. In other words, the responsibility is entrusted to the national level and the subnational governments must be liable before such level.

In a "principal-agent" model the use of intergovernmental transfers as an instrument to promote the orientation of the spending towards certain sectors and the efficient implementation of a public spending program become of main importance. Likewise, the tax structure as well as the access to the indebtedness must, in general, be in agreement and/or consistency with the macroeconomic policies. This model tends to appear in the Latin American countries with unitarian government systems, despite the efforts of a higher local autonomy in spending and income matters which have simultaneously evolved in the State reform processes.

- 2) The local fiscal choice model where a significant increase in the powers and/or responsibilities in spending and income matters is granted to the local or subnational governments. The localities obtain a large portion of their income from their own taxpayers.

The existence of a higher degree of autonomy in reaching decisions which affect the standard of living of a community in direct form are based on an election process where the responsibility is entrusted to the electorate. An example of the application of this model would be that of many localities in the United States and other countries where the taxpayers and the electorate itself express through consultations made to the community the diverse taxes combinations and options and public spending proposals, which are the subject-matter of decision-making and which must be solved under budgetary restrictions. The

description above reinforces, undoubtedly, the budgetary transparency and the accountability before the citizens.

According to this brief description, it is expected that this model be presented in the Latin American countries with federal government systems which, within the series of state modernization strategies, expressly contains that of the strengthening of the subnational governments' autonomy.

As a matter of fact, neither of these two models of the subnational governments' behavior appears in pure and separate form; on the contrary, in the Latin American countries a combination of elements of both models takes place.

In view of the advantages that one model or the other may offer in order to reach certain efficiency, equality and stability objectives, it is convenient to use those key elements which within the national development strategies may consolidate the fiscal decentralization processes in Latin America. For example, the "principal-agent" model presents higher effectiveness in the design and application of policies tending to reduce the poverty suffered by large population sectors. On the other hand, the local fiscal choice model offers, in theory, better possibilities to promote efficiency in the allocation and supply of mainly local public property and it reinforces, at the same time, the accountability over local spending.

Each country must decide upon the desired level of centralization and decentralization of its functions and competences and determine the most suitable and adequate financing mechanisms to be promoted.

III. Measurement of the degree of fiscal decentralization

The degree of fiscal decentralization in a country would seem to be, in principle, the result of the combinations of measurements of the public spending and financing, limiting itself to the participation by the subnational governments in the total public spending and financing with its own resources (fiscal autonomy).

Nevertheless, the measurement of fiscal decentralization is an even more complex issue, where the previous considerations are merely a partial indication which must be complemented from other perspectives, such as the political-administrative dimension, the legal dimension and fiscal restrictions of these processes which in the diverse countries acquire their particular characteristics.

As an example, if we hypothetically started with two identical fiscal systems and we introduced a new decentralization measure in one of them (the transfer of a central government's competence to an inferior level), this system will probably be more decentralized. But systems are not identical in the world and, therefore, it is difficult to know exactly which of the two is more decentralized. This makes measuring decentralization an important problem and, as we will see, difficult to solve.

Except for the restrictions faced by the quantification of a process of this kind, a simple way to advance in this direction is, as previously mentioned, to measure the relative dimensions of the income and expenses budgets of the central and decentralized levels (see Tables A-1 and A-2 in the Annex). Besides, it is possible to divide the budget according to the diverse expenses' functions and to present the participation of the different levels in such functions. Yet, as it has already been said, the reorientation of a certain amount of public expenses or income through a decentralized budget provides little evidence as to the degree of autonomy in budgetary jurisdiction matters.

The first objection to such a simplistic interpretation may be related to the fact that the amount spent is not at all a good sign of the importance of the public services rendered at all.

The second objection refers to the fact that certain expenses and income appear in budgets of different levels in simultaneous form. For example, a transference from the central or national level to the subnational level would inflate the general public budget. Therefore, the expenses financed with this resource must be allocated to a single level and then it becomes necessary to decide whether such expenses are to be charged to the budget of the jurisdiction making the transference or receiving it. The answer will depend on the relative

importance of each one of the jurisdictions to determine the expenses involved.

Undoubtedly, we are considering the expenses actually incurred by a sublevel as part of the central government's budget when the latter does not only finance them but also determines the amount and destination of these expenses.

The influence exercised by the jurisdictions of the diverse levels in public spending and income matters is, in fact, much more important in order to determine the degree of decentralization than the amount of the corresponding budgets. Thus, on attempting to measure the fiscal decentralization it becomes important to find out how to make these influences evident.

Thus, the expenses actually appearing in the budget of a single jurisdiction may be subdivided, at least, into the expenses incurred during the performance of functions of the voluntary and compulsory type and carried out upon assignment or delegation by another level (See Table A-3 in the annex).

The "voluntary" functions are those which a certain jurisdiction may carry out with full freedom. The expenses related to such function indicate, in fact, a decentralized fiscal autonomy. The "obligatory functions" simply lead the decentralized government to act in conformity with the general rules established by law or by the superior level, whilst the functions performed through delegation by another level must be strictly carried out in the manner established by the level giving the order. Thus, the obligatory functions leave substantial margin for the interpretation and ingeniousness of the decentralized level. If a jurisdiction assumes functions through delegation, it is merely acting as an agent of another jurisdiction. Such an activity does not imply that the policy is decentralized. On the contrary, these actions must be attributed to the activities of the fiscal branch office giving the order.

Similarly, not all such income appearing on the budget of a single jurisdiction must be considered as a sign of its fiscal autonomy, especially when the subnational government may not freely dispose of all of the resources, neither does it have authority to influence on the quality and amount of its income.

If we consider the taxes, the tariffs or the expenses charged to the users, the net transfers received, and the credits as the main income groups (see Tables A-4 to A-7 in the annex), the diverse ways in which a decentralized fiscal branch may exercise influence in an autonomous manner will be easily observed. The highest degree of autonomy will appear when a decentralized branch office has legislative, administrative and utilization powers regarding its own budgetary income.

The above case is, however, exceptional. On the contrary, the central level fiscal branch offices exercise, to a large extent, influence over most of the income or they even establish them.

If the main taxation income assigned to the diverse levels are taken into account, the influences exercised among them may be related to the determination of the tax base and rates, the proportion of the taxes (within the framework of a tax distribution system), the surcharges (within a surcharge levy system) and the tax administration.

Likewise, the subnational government's non-tax income are, to a large extent, beyond the scope of the decentralized branch office's political sovereignty. The other levels may, for example, restrict the credit financing (amount and purpose) and they will apply, mainly, their own political ideas in the management of the fiscal transfers (see Tables A-8 to A-10).

If the transfers merely fulfill the purpose of financing the expenses "by order" of another level, they should not be considered, in principle, as income for the receiver's office. If we consider, on the one hand, the transfers serving only to settle an account and, on the other hand, those being not subject to condition, in respect of which the fiscal receiver's branch offices may freely dispose of, there certainly exist many intermediate categories: for example, conditioned transfers, balancing transfers, transfers for no fixed period, etc. It is evident that each category implies a different degree of autonomy of the decentralized branch office.

With the information suggested on the tables mentioned, an attempt may be made to measure the degree of decentralization, subjecting us to present a somewhat qualitative description, a "photographic vision" of the different fiscal levels and their reciprocal relations. Certainly, if we want to

advance beyond a qualitative description, an attempt must be made to elaborate some quantitative measurement of decentralization. As a matter of fact, this has been done in some studies, for example, with the "vertical budgetary balance" as elaborated by Hunter⁴, and recently considered for Latin American countries such as Brazil⁵.

Hunter defines a vertical balance coefficient (v) as follows⁶:

$$V = 1 - \left[\frac{aT_o + bT_s + cR + dG_o + eG_c + fB}{E} \right]$$

Where:

E = Subnational government's expenses

TO = Tax income derived from taxes decreed by the subnational governments.

Ts = Subnational government's tax income obtained from tax distribution.

R = Subnational government's non-tax collections.

Go = Non-conditioned transfers with no fixed period.

Gc = Conditioned transfers received from the federal or national government.

B = Subnational governments' net loans.

Values a, b, c, d, e, f, are between 0 and 1 and they correspond to considerations expressing the percentage of each component of the income controlled or audited by the subnational governments.

The higher the subnational government's degree of influence, the lower the consideration will be (and vice-versa). For example, a = 0 means that the territorial States or entities are capable of adopting decisions in an automatic manner, with-

⁴ Hunter, J.S.H. (1977), "Federalism and Fiscal Balance". Camberra

⁵ Shah, Anwar (1991), "The New Fiscal Federalism in Brazil", World Bank Discussion Papers, No. 124, Washington D.C.

⁶ This section is totally based on the paper by Professor Gerold Krause Junk and Ms. Regine Müller "Fiscal Decentralization", prepared for the regional project on Fiscal Decentralization (CEPAL/GTZ).

out interference by the national or federal government, in order to modify their tax income (T_o) according to the voters' preferences. When d and e are close to the unit this means that there exists little negotiation power with respect to the national or federal government. In such a case, the government's state or subnational level may scarcely influence the aim and scheme of the federal or national programs in inter-governmental transfer matters.

As regards the vertical balance coefficient (v), it may vary from zero up to the unit. When its value is close to zero, it indicates a full vertical unbalance. When the coefficient (v) is close to the unit it may be interpreted as indicative of the full autonomy of the territorial States or entities.

The determination of the vertical balance coefficient may be very difficult to estimate. For this reason, it is necessary to have, in the first place, a clear concept of the fiscal autonomy and, in the second place, more or less detailed information about the constitutional and legal rules, the intergovernmental decision power, and the States' negotiation power which allow to estimate to what extent each government level controls each one of the tax income sources.

Taking into account the difficulties for the estimation of the vertical balance coefficient, Hunter suggests three simplified versions of the coefficient mentioned:

- 1) In the assumption that the state or territorial taxes (T_o , T_s) and the subnational governments' non-tax income (R) are fully subject to their auditing (that is to say: a , b , $c = 0$).

$$V_1 = 1 - \left[\frac{dG_o + eG_c + fB}{E} \right]$$

- 2) Supposing, in addition to the statements in 1) above, that the federal or national government has full control over the States' transfers and loans (that is to say: d , e , $f = 1$).

$$V_2 = 1 - \left[\frac{G_o + G_c + B}{E} \right]$$

- 3) In the assumption that the federal or national government audits only the conditioned transfers and loans.

$$V_3 = 1 - \left[\frac{G_c + B}{E} \right]$$

It is evident that these methods of quantification of the degree of financial dependence of the subnational governments regarding the federal government do not provide fully satisfactory information. The considerations are highly subjective. Besides, the aggregates used in the formulas involve elements representing totally different degrees of decentralized autonomy.

Now, if the idea is to empirically contrast the so-called vertical or horizontal fiscal unbalance or lack of equilibrium of the subnational government levels (see Table No. A-11) the starting point is undoubtedly the fiscal information or statistics and the homogeneity in the methodological treatment both of some basic concepts and classifications and the figures' uniformity itself. In this aspect, it is convenient to take into account the limitations of the fiscal statistics at international level, particularly the deficient data sources at the subnational governments' level which, as a result, make it difficult and complex to see the complete picture of sources and uses of the public income.

Generally, while following the suggestions in the international manuals⁷, the unifying of the subnational levels' fiscal statistics would be recommended under a methodology commonly known as "effective operations" which, as its name indicates, it takes, on the one hand, the income actually collected and the cash payments within the respective fiscal period. Such a viewpoint provides a clearer vision of the impact of the fiscal operations over the national income and the aggregate demand. Likewise, it facilitates the compatibility of the fiscal figures with the monetary and currency exchange fig-

⁷ Reference is made both to the Manual of Statistics on Public Finances of the IMF and to the National Accounts System of the United Nations.

ures. This treatment is relevant in the economic analysis with an aim to estimating the determinants of the deficit or current savings of the government territorial levels and, on the other hand, its way of financing. Table 1 shows a common way of arranging the variables in order to determine the fiscal deficit at the subnational or regional governments' level⁸, and its financing.

Table No. 1
Public Income and expenses as per government levels*
 (Deficit and Financing)
 -Million Pesos-

- A. CURRENT INCOME (1+2+3)
 - 1. Tax Income
 - 2. Non-Tax Income
 - 3. Transfers Income
 - a. From National or Federal level
 - b. From another level
 - B. CURRENT EXPENSES (1+2+3+4)
 - 1. Functioning
 - 2. Debt Interest
 - 3. Transfers Paid
 - a. To the Nation or Federal Government
 - b. To other levels
 - 4. Other expenses
 - C. DEFICIT OR CURRENT SAVINGS (A-B)
 - D. CAPITAL INCOME
 - E. CAPITAL OR INVESTMENT EXPENSES
 - F. NET LOAN
 - G. TOTAL DEFICIT OR SURPLUS (C+D-E-F)
 - H. FINANCING (1+2+3)
 - 1. Internal
 - 2. External
 - 3. Others
-

* This refers to the non-financial public sector of the different levels of the Government: National or Federal, Regional or Provincial and Local or Municipal. It includes, at each level, the central (Centralized Ministries and Agencies) and decentralized sectors (basic public services companies and sectorial decentralized agencies).

⁸ The regional or subnational governments are part of a group of institutions of the public sector which "develop activities of production of non-commercial services, mainly for collective consumption and income transfers". See document "Serie Política Fiscal 1" of the "Proyecto Nacional de Política Fiscal", page 14.

IV. Possible decentralization benefits

A fiscal decentralization process significantly affects the operation of the economy, mainly, as regards the allocation and supply of local public property. This is why it is useful to analyze the main arguments for and/or against (benefits and costs) to introduce them to the central discussion, which is summarized in how a process of this kind may promote better results of the public management in terms of the efficacy, equality and stability purposes.

Before examining the possible benefits, it is convenient to consider in the analysis the following assumptions or hypotheses:

- a) Some public services are limited to certain economy sub-regions in the sense that all of the benefits are received exclusively in the region where the services are rendered;
- b) The public expenses or income necessary for the rendering of these services have effects exclusively within the scope of such region, and
- c) There are no distribution problems among the local (or interregional) levels which may not be easily solved.

Under the previous assumptions, it is clearly advantageous to establish independent jurisdictions for each one of these regions and provide them with autonomy as regards the rendering of these services for the following reasons:

- 1) In general, the demand in public property or services differs from one region to another due to the citizens' preferences or income differences. Therefore, the rendering of public services on a regional level should also be different. In this way, it is considered that the independent jurisdictions or regional and local governments have considerably higher capacity than the central government to provide that differentiated offer.
- 2) Even when the public property demand is similar in all of the regions, it is estimated that the small independent jurisdictions or localities are in a much better position to satisfy these demands in view of the proximity between the politi-

cians and the citizens, which implies a higher degree of identification of the local basic needs and a better auditing or control in projects' implementation. Undoubtedly, the introduction of the elections' mechanism to know the citizens' preferences constitutes an advantage of decentralization.

- 3) The regional equivalence between the public spending and the taxes collected may also imply a high degree of personal equivalence (taxation per benefits). The result of this is that those persons demanding public services will take the total cost (or at least the marginal cost) into account. In this manner, a financing of public spending derived from the locality itself leads people to state or to be willing to disclose their preferences more clearly. Likewise, the tax evasion incentive is smaller since the benefits of tax payment are more tangible.
- 4) The decentralized administration may, perhaps, operate more efficiently (lower administrative costs) than the central administration, which requires delegated bodies in the localities, a lower size of the decentralized branch offices and their further knowledge about the local needs and regional characteristics.
- 5) The fight for political power in the small branch offices may cause less harm than in bigger ones. The illegal practices gain larger transparency. Therefore, the risk of having an agent in charge of making the decisions liable for misconduct is lower. There is a higher probability to incorporate or to become adapted to external political factors of a transient nature (for example, the postponement of an expense for future electoral periods).
- 6) The regional diversity allows for freedom of election and mobility—at least to companies and residencies of mobile characteristics—. In the best hypothesis, this is translated into the gathering of people with similar preferences. Tiebout's⁹ local public property model offers an excellent conceptual framework in this aspect of migrations and sizes of localities.

⁹ Tiebout, Charles M. (1956) "A Pure Theory of Local Expenditures", *Journal of Political Economy*.

- 7) The regional and local autonomy leads to competition for production factors and, therefore, to a better supply of public services. This may happen in a statistical sense (a more favorable interregional division of the work) and in a dynamic sense (initiation of creativity and of economic innovations, also in the public sector).
- 8) The political component constitutes one of the decentralization advantages. A decentralized policy in public finance matters contributes to the practice of democracy. This may be beneficial mainly in countries lacking a strong democratic tradition.
- 9) Even though no evident economic advantage is explicitly recognized to decentralization, the free determination by the smaller branch offices may be considered valuable in itself. This is, at least, the message of the so-called "subsidiarization principle" which prefers individual to collective.
- 10) Even though an abstract comparison reveals certain advantages of a decentralized policy in public finance matters, perhaps there exist concrete situations which may favor decentralization. Such a situation may appear when centralism and population density are very high and the decentralized public finance may strengthen some "compensatory power". To a certain extent, this argument is based on the second-best theory.

As a synthesis, the subnational governments perform an important function in the supply of basic local public services. Within this context, as it is affirmed by the World Bank Development Report¹⁰ (1998) dedicated to the public finance issue, the decentralization of powers in the expenses and income matters may improve the efficiency in the allocation of resources in the public sector on allowing a close correspondence between the public services and the multiplicity of individual preferences and equality, through a closer relation of the benefits of the services and their costs.

¹⁰ World Bank (1988), Development Report, Chapter 7.

V. Problems of fiscal decentralization

On identifying the possible advantages of the fiscal decentralization in the previous chapter, some assumptions were presented which, being examined more thoroughly, are not in fact realistic, at least if it is a strict interpretation. Due to this, the decentralization is not only an advantageous political instrument, but it also gives rise to problems or difficulties which, if not solved with special caution, could turn decentralization into a political and economic disaster instead of resulting in all of the benefits previously mentioned.

Within the scope of the State economic functions, the problems may be considered mainly in terms of the economic functions of allocation and distribution (even when in decentralization matters both these aspects seem to get mixed). As regards the stabilization function, there is undoubtedly the broad concept that the macroeconomic policy by reason of its implicit objectives (prices stability and high employment rate) should be entrusted to the government central level, a discussion in this case being irrelevant about a possible decentralized management of such function. Nevertheless, in the analysis it is necessary to take into consideration the relations existing between the fiscal federalism and the macroeconomic policy in terms of the possible undesired effects on promoting such processes.

Thus, we will make a brief description of the difficulties that may be brought about with the allocation and distribution functions and some general considerations on the macroeconomic effects.

1. Allocation

In contrast to the assumptions made in the analysis of the benefits, the fiscal policy functions performed by a decentralized branch office affect the individuals who are beyond the frontiers of that jurisdiction, either through the public services themselves or through the public spending and the acquisition of the financial resources which accompany any public property supply. But if the so-called external factors are inevitable, the allocation problems constitute rather a cer-

tain consequence of the existence of some local public property, in which its efficient production and supply is definitely at the intermediate or national level. In order to classify the different aspects, we will distinguish between two types of problems:

1.1. Problems relating to the interjurisdictional external factors

Even though the supply of public property on behalf of a decentralized branch office or local government produces direct positive effects on the welfare of the individuals who are not in that jurisdiction (or more clearly, of the persons not forming part of said jurisdiction electorate), it is highly likely that the persons in charge of elaborating the policies of that region will not take these effects into account regarding welfare matters. This is valid provided that the persons outside the jurisdiction may exercise some kind of political or economic pressure over that jurisdiction or find some compensatory plan.

A local or regional administration, in general, takes into consideration the benefits and costs which occur within its jurisdiction and not the external factors caused by it beyond its own territory, therefore, the pertinent public property will be provided in amounts lower than those socially optimum from the national perspective and, therefore, an efficient allocation of resources is not to be expected. What may happen in fact is that the decentralized branch offices present an opportunist behavior, well-known in the theory of public property as: "Free Rider". Perhaps they may even totally interrupt the supply of certain property and speculate about the fact that their own population may have free access to such property supplied by other jurisdictions.

The interjurisdictional external factors take part not only in the direct supply of public property but they also appear with the public expenses and their financing, which are necessary instruments in the process of offering public property. As regards public spending, there exists, undoubtedly, a tendency that the decentralized jurisdictions prefer to orient these expenses towards the local suppliers and to attach,

therefore, the interlocal (or interregional) division of work and the possible scale economies which may be derived from the coordination between the localities and from a certain centralized management to ensure the best available service. The well-known reason for this lies in the exclusion of any effect related to income or employment beyond the frontiers of the different jurisdictions.

In addition to the problems of a political nature relating to the partisan preferences (pertaining to the clientele), corruption may play an important role. Such phenomenon, of course, is not limited to the decentralized systems but the public financial policy organized in a decentralized manner runs the risk of acquiring other discriminatory characteristics. Perhaps, in a decentralized system, if considered as a whole, there is less discrimination than in a centralized one due to a better policy auditing on behalf of the community.

The interjurisdictional external factors also constitute an important problem as regards the raising of all kinds of public funds. One of the negative consequences of the external factors derives from credit financing, particularly if the credits assumed by the decentralized jurisdictions and finally discounted by the Central Bank increase the money offer, the inflationary rate and displace private investment. The subnational governments' indebtedness must be applied to the operation of priority investment projects which produce benefits in time, thus achieving certain intergenerational equality. But even, the users' rights or the basic public services' tariffs may have negative external effects, for example, if they are charged in discriminatory form to all of the users of other jurisdictions.

Yet, there is no doubt that the most important external factors appear with respect to tax payment. If a decentralized jurisdiction may freely choose the tax base and rates, it may be tempted to "export" taxes, that is to say, to transfer part of the tax charge unto persons residing beyond its limits. This is done, just as it is explained by the international trade theory, by using the monopolistic power of the region involved, in order to favorably modify the exchange relation. Likewise, a region or province in a decentralized system may proceed similarly in respect of the rest of the economy, if the fact of being

the sole supplier of certain products or natural resources occurs. This proceeding would be optimum at a local level but suboptimum at a national level.

A more realistic method to show advantages at the expense of other jurisdictions consists in offering taxation preferences. This may be done explicitly, through the offering of lower rates, or indirectly, for example, through a highly favorable tax administration from the taxpayers viewpoint.

The rivalry in taxation matters among decentralized fiscal branch offices may certainly lead to absolutely different results. In the best hypothesis, it forces the territorial entities to be efficient¹¹. In the worst case, it may lead the competing jurisdictions to financial bankruptcy.

1.2. Migration Problems

One of the main ideas of the fiscal decentralization consists of offering to the private sector diverse groups of policy measures, among which people may choose the most suitable to their individual interests. If a residence or a private company can not get favorable changes introduced in the community fiscal policies, they would opt, in principle, for emigrating to a place where their preferences are better represented. Often, the emigration menace alone helps to change the Municipality fiscal policy.

The capacity of migration or peoples' geographical mobilization, has been theoretically dealt with by Tiebout¹² in his local public property model which states that as opposed to the national public property (where the solutions delivered by the political process must be accepted), in the case of local public property there is a market-type mechanism which achieves a higher efficiency.

Being aware of the Tiebout model restrictions, migrations within a decentralized system framework also give rise to many other problems. In fact, it is convenient for each taxpayer to basically live (work or produce) at a place where

¹¹ Kenyon, D.A. and Kincaid J. (1991) "Competition Among States and Local Governments", The Urban Institute Press, Washington.

¹² Tiebout, Charles (1956). *op. cit.*

many solvent people live (work or produce), due to their capacity and willingness to pay for public property. In such a case, the tax or price to be paid will be relatively low (for each cent of tax paid, the taxpayer receives a considerable amount or high-quality public property and must pay relatively low sums for a specific supply) and, therefore, the well-off, as a result of agglomeration and segregation, will try to be isolated, something they obtain quite easily if the decentralized fiscal policy gives them the opportunity.

The ghettos of the poor constitute, therefore, the other side of the situation. Of course, the creation of private clubs is always an alternative to the exclusive settlements. These strategies to prevent the immigration of the poor may be applied in different ways, from restrictions in the dwelling sphere to a very exclusive and limited supply of public services.

An important issue derived from the previous statement, is the size of the localities, which has been discussed by Buchanan¹³ in the so-called "theory of clubs" which, applied to local governments presents problems, since migrations' restrictions imposed upon a part of the citizens of a certain locality would be in conflict with the expected mobility of persons which must exist in a country of democratic tradition.

If we consider that one of the main functions of the fiscal policy consists in offering protection against the individual's economic bankruptcy, then, the community that is willing to offer a higher security degree than others will be a great attraction for those persons undergoing an economic crisis. In order to prevent such phenomenon ("New York City Effect"), it should be foreseen that communities offer a lower security degree than what is considered adequate.

2. *Distribution*

According to a largely accepted opinion, the distribution function should not be subject to decentralization. This does not constitute an evident position, since the main arguments in favor of decentralization, particularly a strict orientation

¹³ Buchanan, James M. (1965) "An Economic Theory of Clubs".

towards the individual preferences and a high degree of transparency of public policy and its effects are not less valid in the distribution sphere than in respect of any other policy. On the contrary, the citizens of various communities may express a different opinion about the income redistribution programs and probably the individuals living in a small jurisdiction are much more interested in the economic situation of their fellow citizens than those living in a State where such programs are designed from the central level.

But, any substantial distribution policy would face serious problems. If the communities established these types of programs, for instance, social security payments (or real transfers) to the inhabitants with low income, the automatic attraction of "poor" people could be expected as well as the departure of persons with payment capacity, the disparity (richness and poverty) in a country's territorial space would become noticeable. This behavior taking place among different localities would cause an economically inefficient migration, with future financial problems for the governments having larger redistribution programs.

In view of the above, it is convenient that the government at a central level be entrusted with this type of redistribution programs, thus being able to reflect the interest of most of the localities and persons in a country, that is to say, the desires of a certain locality. The decentralized branch offices may only act on the basis of more or less uniform regulations and occasionally introduce some additional corrections where necessary.

But even when the policy in distribution matters is a core issue, it is probable that the decentralization of other fiscal responsibilities may give rise to distribution problems. This is due to the fact that distribution among the decentralized autonomous branches themselves becomes an important issue.

This is not all that obvious. The income of the decentralized fiscal branches may reflect, basically, local (or regional) economic situations. Thus, if the interlocal (or interregional) inequality of the private income is accepted to a certain extent, why not accept public income inequality? There are several possible answers in this respect.

- a) The equality in the supply of public property and services is perhaps considered a more significant objective than private income equality.
- b) The equality in public property offer is considered easier to achieve than private income equality (a possible reason is perhaps that the excess redistribution charge may be lower).
- c) The equality in the supply of public property offers constitutes a key instrument for subsequently achieving the equalization of the individual private income.

Thus, even when the interlocal (or interregional) inequality of the income redistribution is a mere reflection of the private income differences, perhaps it is not regarded tolerable. Whatever the tax bases assigned to a fiscal level may be, it is highly probable that the tax collection differs from one jurisdiction to another, notwithstanding the regulation or equalization measure applied (for example, as per inhabitant), unless the tax collection is distributed as from the inception on a per capita basis. The problems are not less important if it is necessary to take different needs into account and the public utilities are deliberately used for developing private activities in backward regions. Up to the moment, decentralization has scarcely achieved desirable results.

3. Fiscal decentralization and macroeconomic effects

Starting with a general consensus about the responsibility of the national or federal government in the management of the stabilization function, it is convenient to make a brief reference to some undesired effects which may be derived from a fiscal decentralized process and which hinder the achievement of macroeconomic goals. Some of the main reasons illustrating this issue are stated below:

First, the significant increase in the intergovernmental transfers, although they may increase the local expense level—with a high degree of uncertainty from the public expense efficiency viewpoint—, may accentuate the national government fiscal deficit. This may be even more serious if the

design of the transference system does not purport explicit and transparent criteria which may promote efficiency, fiscal effort and equality in the allocation of public property resources and supply.

On the other hand, a higher saving capacity of the subnational governments and the generation of deficits in their finances promote the excessive use of the indebtedness, in some cases, difficult for the central government to control, which leads to disastrous effects from the macroeconomic stability perspective and, similarly, to serious restrictions in the local financial management itself. The recent experience shows the advantage of introducing severe restrictions to the capacity and amount of indebtedness of the subnational governments.

The substantial increase in other types of income such as share and/or transfer of national revenue, or some extraordinary and transient characteristics in time such as the so-called "royalties", which, at the same time have a quite discretionary use, undoubtedly may give rise to higher expense pressures with undesired effects on the macroeconomic policy. If an inefficient use of the resources is added to this -low profitability or a bad investment quality- the macroeconomic implications could be even worse.

The practice of transferring competences and resources is quite complex and, in general, -at least in its initial phase- implies serious fiscal effects for the national government. In practice, a simultaneous process of competences and resources transfers does not take place, which is the outcome of various reasons, amongst others of the institutional, political, economic and technical type, which make an at least neutral fiscal result impossible, and, on the contrary, give rise to additional net costs for the national finances. Nevertheless, the expectations are -facing this possible initial unbalance- that once this stage of process transition is over, the new competences are actually assumed by the subnational governments and that the national government expense level be reduced. Anyway, the results of the Latin American experience have not been very encouraging up to now.

VI. Recommendations

Like any measure of economic nature, in a decision for or against decentralization both the advantages and disadvantages must be taken into account and an adequate intermediate way is to be found, in case it is necessary. Some elements of the decentralization strategies are examined below, which could very possibly lead to the achievement of higher net benefits in the public management.

1. *Specification of decentralized functions and competences*

The keystone of any decentralization scheme is the specification of the fiscal policy competences of basically non-centralized nature. Of course, in an economy there is reciprocal dependence among all factors and, therefore, it may be difficult to find a fiscal measure within a single decentralized branch office which produces no effect beyond the territory of such jurisdiction; under this quite restrictive hypothesis there would exist no further advantages for decentralization. Now, the diverse circumstances in practice reaffirm, on the other hand, the advantage of specifying the competences of a decentralized nature for such reasons as follow:

- a) Various public functions, although they give rise to some external factors when exercised by the decentralized branch offices, are basically of decentralized nature because the external factors are of little importance.
- b) From a regulatory viewpoint, some interjurisdictional external factors have simply no influence because they are the result of the activities of a community, that is to say, issues within its own jurisdiction. For example, the inhabitants of other communities may not like a community's basic teaching system, but this is assumed to be beyond their competence.

Therefore, the fact that a function or competence is considered to be centralized or decentralized does not merely constitute a matter of technical nature, but, undoubtedly, value judgments also take place.

If the experience of different countries is examined a large variety of functions or competences of central and decentralized type (intermediate and local levels) may be revealed. Generally, among the first to be mentioned are: the defense sphere, foreign relations, international trade, currency and banking, unemployment insurance coverage and social security, air transportation, telecommunications, among others.

Among decentralized competences or responsibilities, there is, on the one hand, the intermediate level (department, provincial, state or regional level) including, in general, those relating to university teaching, highway transportation, among others. In so far as local responsibilities, mainly the elementary and secondary education levels are included, interurban transportation, dwelling, drinking water services and the sewage system, bridges, preventive health care, police services, parks, fire protection, waste disposal and zonification, among others.

Some competences are considered as the joint tasks of two or more levels. Among them we can mention university education, the environment and natural resources, health care, social welfare, natural resources, industrial promotion and agricultural development.

Summing up, there will always be some public properties that are eminently local, others whose interjurisdictional external factors require the department and/or provincial level participation and still others whose efficient production and supply are definitively on a national level.

2. Determination of Jurisdictions

In many countries, the inferior level jurisdictions are determined beforehand and probably –or practically– may not be modified. In that case, fiscal decentralization must be based on this existing structure. In other countries, perhaps the existing jurisdictions may be restructured, possibly through the separation or merger of the different jurisdictions. But the enormous cost of such a transformation is not irrelevant. On the basis of experience, any jurisdiction restructuring presupposes important compensations and secondary payments to overcome political resistance. If restructuring is

possible, it would be advisable to abide by the following basic rules:

- a) To the extent possible, a jurisdiction territory must include the scope of effectiveness of any function carried out in that jurisdiction. Therefore, the narrower the scope of effectiveness of the functions assigned in a decentralized manner the smaller the delimitation of the decentralized branch offices will be.
- b) It is also necessary to take into account the production factor. The jurisdictions must not be too small, in a manner impeding the use of scale economies in the production of public property and services. But, of course, it is not necessary that each community offers a complete variety of all local property. The communities may cooperate among themselves and perform some kind of division of work.
- c) On the other hand, the decentralized branch offices should not be very big either. The main reason for fiscal decentralization lies in the close relation existing between the politicians and the citizens so that policy auditing and the observaton of preferences may be carried out more easily and efficiently.
- d) As far as possible, the delimitation of jurisdictions must take into account the existing settlements of persons with similar preferences. The best way to achieve this is through using the historic and cultural links as the main delimitation criteria of the new political boundaries.
- e) The general structure of a level must be "balanced" in the sense that each jurisdiction is not only viable but it may also perform its own function within the group of all jurisdictions of the same level.

3. Relation between full autonomy in expenses matters and functions autonomy

If a decentralized jurisdiction has been endowed with full autonomy in respect of the implementation of certain functions, the adequate thing would be total autonomy regarding the corresponding expenses. In a more concrete manner: the decentralized jurisdiction, on performing one of its functions,

must have freedom to decide whether public spending must actually be incurred in, as well as its amount and purpose. This guarantees the flexibility of the public offer according to the potential changes in the electorate's preferences and encourages saving resources use. In principle, such "autonomy in expenses matters" is a necessary condition for the efficient implementation of the decentralized functions.

As it has been stated before, there always exists, on the other hand, the risk that the public contracts discriminate in favor of the local suppliers. As a consequence, it seems necessary to set up regulations about inviting people to present project proposals and that the authorities of the superior levels exercise a minimum auditing.

Another problem appears in the case that there are positive external factors in the supply of certain decentralized public property and services. In such a case, the cost distribution between the different jurisdictions seems to be a proper instrument. It is evident, therefore, that no jurisdiction may exercise full autonomy in respect of local spending. In addition and to a certain extent, autonomy disappears in respect of certain functions and also as far as the corresponding expenses are concerned.

The solution may be found in two different ways: in the first place, the responsibilities derived from the implementation of functions could also be divided and have some tasks turn into a "joint function" of two or more jurisdictions (for example, the superior level establishes the rules and the inferior level acts freely within the scope of such rules). Therefore, a new correspondence of liabilities in respect of functions and expenses would somehow occur. The price, of course, would be a mixture of political responsibilities, a fact which may be in danger of being inefficient.

The second solution is just the opposite: in cases where expenses are shared, one of the jurisdictions involved would assume the highest responsibility regarding the whole project and the financial contribution of the other jurisdictions would be more or less governed by certain rules to protect them from policies having electoral purposes.

4. *Decentralized Financing System*

The performance of functions and the determination of expenses within a decentralized context results undoubtedly useless if the subnational governments do not rely on the corresponding financial resources. There certainly exist different possibilities of regional and local governments' financing, none of which is exempt from problems. We will present, in the first place, some general rules on decentralized resources and, in the second place, reference is made to the convenience of the different public financing systems. Later on, the possible advantages and disadvantages of the diverse tax systems within a multiple level fiscal system will be analyzed.

a) General rules in decentralized financing matters

- 1) What appears to be a trivial condition, is perhaps the most difficult to comply with: the decentralized financing must be enough to finance the current expenses or the operation expenses of the corresponding level. If this were not so, decentralization is indifferent and it becomes rapidly inefficient. The sufficiency of resources presupposes that the decentralized branch offices may somehow have access to an important tax base.
- 2) One of the premises of federalism and/or decentralized financing lies in that if, on the one hand, the individuals with similar preferences are allowed to get associated and decide upon the expense level related to a certain demand of local public property, in like manner, by reason of the fiscal joint liability, the income structure must be allowed to be adjusted with a higher liberty margin, particularly in the sources of income derived from taxes themselves and tariffs and/or charges to users.
- 3) The decentralized financing must keep certain relation with growth and appear stable before the economic fluctuations. Such a condition guarantees the financial stability of the decentralized branch offices in the long and the short run. In other terms, it must be self-sustainable fiscally speaking, and consistent with the national policies of stabilization and growth. The latter is important because

the burden of the stabilization policies must not be imposed upon the decentralized fiscal branch offices.

- 4) The decentralized revenue must somehow reflect the contributions made by the decentralized branch offices to the local (or regional) economic development. Such condition presupposes the possibility of creating the adequate incentives for the private and public sectors. The residences and companies have an approximate idea of the public property and services cost and may bind the government to show an active interest in the local (or regional) economic development.
- 5) The collection of the decentralized revenue should not cause serious effects beyond the jurisdictions' limits. The reason to establish such condition consists in limiting the inefficiency of the external factors and to protect the communities from the adverse effects derived from rivalry in the collection matters.

The subnational levels, mainly the localities, should impose charges upon those bases having a low interjurisdictional mobility. Therefore, the taxes having a fixed base –for example, real estate– seem to be more efficient than the taxes levied against personal property –for example, assets–, which could be evaded easily and, therefore, undermine any important effort in taxation matters.

- 6) A decentralized revenue system must, apart from being tangible, predictable and transparent, must promote incentives for a higher autonomy and accountability before the subnational governments' communities.
- 7) An additional criterion in favor of a decentralized financing system is the possibility to promote a certain degree of territorial or interregional equality among the diverse branch offices of a decentralized level. The revenues from the decentralized jurisdictions, particularly those derived from the fiscal transfers must promote the efficiency and equality criteria in the mobilization and allocation of resources.

b) Adequacy and strengthening of the subnational finances

As specified by the World Bank Development Report (1988), by strengthening of the subnational governments' finances, the public sector's efficiency may be improved and the need of

intergovernmental transfers for other policy purposes may be reduced, as will be seen later on.

Taking into account the diversity of financial instruments with the diverse government levels (taxes, rates and/or surcharges, credits, share in taxes, intergovernmental transfers, etc.) it is convenient to mention that some of them specially reinforce the fiscal capacity and autonomy, whilst others try to solve the issue of vertical and horizontal unbalances. As a matter of fact, the objectives to be designed and solved are multiple under the basic principles of efficiency, equality and a higher responsibility by the subnational governments in the course of their administration.

Thus, and taking into account to the series of financial resources within reach of the subnational governments and their due balance and combination, some of the basic criteria oriented to their achievement are mentioned below.

The fiscal joint liability understood as a higher fiscal autonomy in the income field, as in its conception related to the performance of the fiscal equivalence principle, recommends the use of taxes and the tariffs and/or charges as fiscal instruments which promote the correct allocation of resources between public and private uses. The previous statement also implies the search of transparent taxes, whose fiscal burden may be clearly noticed by the taxpayers.

Theoretically, the taxes must accurately transmit the signs of costs and benefits derived from public property through the fiscal burden borne (fiscal equivalence principle). The assessments certainly constitute decentralized collections, provided their conception is subject to the conditions established in the paragraph above. Compliance with such criteria does not only depend on the type of taxes which serve as decentralized collection sources, but also on the influence exerted by the different decentralized branch offices over the tax bases and rates (fiscal autonomy). Once again, this is determined by the general tax system which governs the relations among the different fiscal levels.

The tariffs or rates charged to the users must comply, at least, with conditions 2 to 5 above. Likewise, they must establish a strict relation between the private economic activity and public utilities, because it is logical to suppose that the pri-

vate sector's activities demand public services consistent with their own economic activity. They must be used as a means of financing the local private property supply which reflects the production cost and benefit of this property. They follow, in some way, the benefit principle, in respect of which the tariff system must be fair and, therefore, it is not likely that they will give rise to important external factors. Besides, they are clearly visible. They could be translated into a revenue inequality in the interlocal (or interregional) sphere, but such circumstance would simply reflect the diverse demands in public services matters.

If the benefits of the local services are extended to other jurisdictions and even to the national level, financing may not take place exclusively with charges to users and taxes, but the use of the so-called intergovernmental transfers becomes necessary, a financing instrument of the subnational governments which has had growing importance within the fiscal systems' structure and whose design involves different criteria, among which the vertical and horizontal fiscal equality is worth mentioning, the guarantee to the subnational levels for the rendering of an equivalent basic services level, as well as the achievement of the economic policy goals in general, among others.

Even though credit is at first an adequate financing mechanism of the subnational governments' priority investment, it constitutes, as a result of the experience of several countries, the least appropriate financing resource for the inferior levels in the fiscal hierarchy, since it may give rise to adverse effects against the macroeconomic fiscal balance. Therefore, it is advisable that the intermediate level audit and restrict, to in significant extent, the credit financing of the local level; at the same time, the intermediate level must voluntarily refrain from granting important credit financing and/or submit itself to the restrictions from the central level.

5. Choosing an adequate tax regime

The allocation of taxes within a fiscal system of multiple levels may be carried out, in principle, according to three different systems: a) separation of taxes, b) distribution of taxes and c) levy of tax surcharges.

a) Separation of taxes

In a separation of taxes system, each fiscal level establishes its own taxes. But this aspect refers only to the fiscal collection distribution and gives basically no answer to the question about which level has sufficient competence to decide over tax law matters and which of them is in charge of tax administration.

However, if this system is compared with the other two tax regimes –to be analyzed later on– the tax separation offers the largest possibility that the decentralized branch offices may have powers to administer the tax base and rates and even to create new taxes. Therefore, of all tax regimes within a fiscally decentralized economy, the separation of taxes is the one intrinsically presenting the most defined vocation towards decentralization. Basically, if tax laws constituted an issue reserved for the central level, it would merely involve an easy means of delegating some legislative powers to the decentralized levels.

Even though tax separation is apparently a good option from a fiscal decentralization perspective, there are several aspects which leads us to revise this first impression. In the first place, it is known through experience that in a decentralization process directed from the central level, the latter reserves all of the most important tax bases which, at the same time, may lead to a minimum decentralization of the income where the limitations of the regional and/ or local tax payment are evident due to its reduced collection potential. Even if the subnational levels achieve a relevant tax structure they will never be confident that sooner or later they will not be deprived from substantial elements of the tax base, since the central level is always tempted to grant tax deductions at the expense of other levels.

As long as the decentralized branch offices have extensive legislative and administrative powers, this may not result beneficial neither to the economy in general nor to the decentralized branch offices themselves. The general tax structure may become misleading and difficult to understand for the individual taxpayer. The appraisal for tax purposes becomes onerous for each contributor and for the tax administration.

The most serious problem has to do with rivalry in tax mat-

ters. As it has been explained before, the tax competence is a critical issue. In the best assumption, it may turn into the driving force to reach efficiency and ingeniousness. In the worst case, it will lead the decentralized branch offices to a disastrous fight to obtain the best tax bases. If the aim is to achieve the former and to prevent the latter, the competence in taxation matters must be restricted to very few instruments, perhaps to a single taxation rate of a tax on a rather fixed base (for example, real estates).

b) Tax distribution

Tax distribution refers basically to the allocation of the general tax collection between two or more levels. But, implicitly, it also deprives the decentralized branch offices from any direct legislative power. Not only is it necessary to determine proportions in uniform manner (that is to say, centrally), but also the tax bases and rates, because, the system would not work properly in another way, even though a decentralized level as a whole (for example, through a representative body) could participate in the tax legislation process.

Therefore, as contrasted with the tax separation, a tax distribution system seems to leave no margin for the tax autonomy of the decentralized level. But this does not mean that the decentralized levels may exert no influence at all over the tax collection. If the tax collection is considered as the product of the "price" and "amount" of the taxes, the decentralized branch offices may not influence on the former, but they may certainly do so on the latter. What they can do and actually do will depend on the manner of distributing the tax collection among the diverse branch offices.

The "natural" form of distributing the proportion of taxes of a certain level among the jurisdictions that make up said level consists in leaving the respective tax collections at the place where they originate. But for most taxes, the local (or regional) collection of a tax does not have much to do with its economic origin, which could constitute a more adequate basis for its distribution. But where does a tax originate? Is it the place where the property generating profits is produced or sold or even the place where the producer lives?

In practice, this type of issue must be solved pragmatically. Therefore, instead of allocating the tax collection on the basis of a well-elaborated theory on the local origin, it is preferable to examine the consequences of the diverse tax distribution systems.

As a matter of fact, we can find many different allocation formulas. In Germany, for example, the value added tax, as long as its collection is assigned to the States, is basically distributed per inhabitant, with a density factor that favors the highly-populated areas. These factors are also applied in other countries (for example Australia and Switzerland), but in this case with the opposite effect: they favor the scarcely-populated areas. The distribution as per inhabitant, of course, makes the determination of the number of persons a profitable operation and it is specially logical to think that the small communities may become very interested in recognizing the residence if the tax allocation is made applying the rule as per inhabitant.

Other possible allocation formulas take the income into account (weighted or not), the real capital, the volume (sales), the added value and the needs (to be defined in different manners) both in the local and regional spheres.

Tax distribution really is not opposed to the establishment of incentives to the decentralized branch offices. Depending on the tax distribution rules, the communities may dedicate to all types of active tax policies. What they are not entitled to do is to change the tax laws (for example, to adapt the tax rates to the citizens' special preferences). Therefore, if a community (State or province) is highly successful to attract taxpayers, it may not distribute the resulting tax collection through a reduction of the tax rates. On the other hand, it is somehow forced to maintain a high level –possibly inefficient– of the public spending.

So that whilst the tax separation involves the risk of the excessive use of decentralized tax measures, the tax distribution –even though it is true that it does not prevent the adoption of ingenious tax strategies– lacks an essential element: the means of modifying the “taxes price”. This seems to make the search for an intermediate system the ideal solution.

c) Levy of surcharges

The levy of surcharges implies a system in which the central level fixes all taxation rules to satisfy its own needs, whilst the decentralized jurisdictions are entitled to levy surcharges. To some extent, the central level is willing to allow that certain decentralized charges "ride" over their own taxes.

In accordance with this system, the subnational governments have no right to administer the tax bases (although they may, of course, like in the other two systems, attract the pertinent private activities for generation of taxes), but they have the power to modify the general tax rate and to adjust, thus, the tax burden to their citizens' preferences. The grant of this type of tax exercise must lead, in principle, to a certain decrease in the intergovernmental transfers from the central level to the government levels which are entitled to establish surcharges levies.

Even though this type of tax system or arrangement does not allow the access to the optimum fiscal decentralization level, since the subnational governments are not discretionary over the assessment determination and administration, they have at least the authority to decide with certain liberty the expected income level and to obtain it through a relatively simple procedure. An example of such system occurs in Spain with the establishment of surcharges over the tax on the individuals' revenue (IRPF) in favor of the autonomous communities.

If the levy of surcharges is limited to a single tax or to several ones, the system preserves its transparency as long as the central tax regime is transparent itself.

d) Mixed system

In any decentralization process, the three systems mentioned may be used, naturally, in connection with the different taxes. The tax on real estate and some secondary assessments may be allocated in separate form to the decentralized levels. The value added tax would be adequate for tax distribution and the tax on the central level revenue may be an option for the levy of local surcharges.

6. Equalization of the differences in interlocal or interregional income matters through the use of transfers

Even when the equality of interlocal (or interregional) income per inhabitant is considered an important aspect in the selection of taxes of a decentralized nature as well as the determination of jurisdictions, the distribution of the tax collection may generally involve a high inequality degree. It is believed that an adequate decentralized system requires some fiscal equality scheme which may basically guarantee the financial sufficiency of the government's subnational levels (vertical equality) and make up for the disparities in the spending capacities of the subnational levels (horizontal equality).

In order to achieve a certain fiscal homogeneity, the scope of the measures to be adopted must be considered. This will clearly depend on the inequality degree in the original distribution of resources and on the inequality degree which appears to be tolerable in a society. Besides, the influence that a jurisdiction may possibly exercise to improve its own financial situation is very important. The more it can do for its own commitment or self-financing, the more it will be valid to foresee that tax equalization through the transfers mechanism unmotivates any similar effort by the different jurisdictions and, on the contrary, emphasizes the fiscal dependence of the central level. Therefore, the latter should not reward inefficiency and punish the fiscal effort. On the contrary, it must encourage efficiency in the assignment of competences, equality to the diverse territorial levels and a higher autonomy and liability of the subnational governments in their management.

A really difficult issue is how to approach the equality aspect (vertical and horizontal). At first sight, the fiscal equalization seems to be the equality of tax income per inhabitant. But it is necessary not to overlook two problems.

- Some communities perhaps have a scarce tax collection, but have a considerable amount of other income such as the public utilities of the state-run companies or the rights derived from license grants. It seems inadequate to disregard them or to consider them fully. A theoretically unsat-

isfactory but pragmatic solution consists in taking them partially into account.

- The public property demand increases generally with demographic density. This is partially derived from the non-competitive nature of the public property consumption. Thus, the larger the number of persons using a certain public property, the lower its cost per inhabitant will be. Therefore, we may come to the conclusion that in equalization it is necessary to take into account the demographic density and to allocate more financial resources per inhabitant to the highly populated communities.

On the other hand, when a community relies on certain (tax) revenue per inhabitant, the demographic density increases the absolute tax income and –in the assumption of a certain production cost– the amount of public property available. As a consequence, non-competitiveness could be translated into a higher individual benefit degree. Therefore, an even lower allocation of resources to the highly populated communities could be alluded.

It is difficult to reach a clear result in respect of both items. From a pragmatic viewpoint, this does not mean that the demographic density has no importance with respect to the payments among the fiscal levels. On the contrary, the density is generally accepted as a substitute for the “centrality” of a community, that is to say, the degree in which it renders services to the citizens belonging to such community.

There are several manners to implement equalization through the transfers, among which the horizontal and vertical type transfers are worth mentioning, both conditioned and non-conditioned, and the balancing and non-balancing transferences, a topic which has been treated in detail by such authors as W. Oates, R. Bird and Rémy Prud’homme¹⁴, among others.

¹⁴ See, among others, the studies by Prof. Richard Bird on the following subject: “Federal Finance in Comparative Perspective” (1986) and “Intergovernmental Fiscal Transfers in Developing Countries” (1991). Also, the book published by Prof. Prud’homme (1991), “Public Finance with Several Levels of Government”.

Since financial inequality constitutes a problem of distribution of resources within a tax level, the horizontal equalization in the interior of such level seems to be the adequate corrective agent. But, perhaps, we have to admit an exception: if some jurisdictions do not reach a minimum financial situation, the intervention of the subsequent superior level appears as an adequate function. In this case the transfers may be designed following the criterion of searching for an equalization of the revenue per capita among the localities. This forms part of the system's stabilizing function.

If we could be certain that the receiver's office jurisdiction uses transfers as it fits best to its interests, the non-conditioned transfers would surpass the conditioned ones. But this is not, undoubtedly, an absolutely realistic hypothesis. Therefore, the condition feature seems to be specially adequate when "minimum" transfers are required or in the case of discretionary transfers. The condition feature may be related to the selective use of transfers, the implementation of a special policy, the sharing of general expenses ("balancing transfers"), etc.

In general, equalization subsidies must abide by certain rules which guarantee compliance with their objectives. There is simply no rule providing for all contingencies. Therefore, sometimes it seems adequate to adopt different measures, for example, when a jurisdiction is affected by a serious financial crisis which could not be overcome through the mere application of the rules provided for normal situations.

7. Internalization of the inevitable external effects

There is no way to avoid the effects of a decentralized jurisdiction public policy beyond its frontiers. Therefore, it is necessary to implement some process to incorporate the external effects.

It seems useful to distinguish three different types of external effects: a) those affecting some proximate jurisdictions of the same level; b) those affecting in some way or another all of the jurisdictions of the same level; and c) those affecting other levels in a multiple level fiscal system. For each case, an adequate incorporation plan is required.

- a) The proximate jurisdictions, for example the central communities and their satellites must constitute common institutions; participation will be obligatory, if necessary.
- b) If all or some jurisdictions of a certain level are affected, it will be necessary to find some harmonization form.
- c) Other levels (for example the central level) must grant special transfers to incorporate the external benefits of certain measures or of some omissions of the decentralized policies. In case of negative external factors, as may be foreseeable with the credit financing of the decentralized branch offices, the central level may be allowed to audit and restrict this type of operation.

8. Transparency of the normative interactions and maintenance of the political responsibility

Since the decentralization process is, in the first instance, a political decision, it must rely on a clear constitutional and legal framework which may later be translated into a scheme of competences and resources of the diverse government levels. An adequate decentralization process must establish, in principle, the liabilities and/or competences of each government level and in parallel form –and subsequently as far as possible– the type and amount of resources with which such competences will be financed.

Once the autonomous fiscal branches have been created, they may also be used as central level agents and functions of a higher level may be assigned to them. But, in doing so, there is some risk that both types of policies (inferior and superior levels) become indiscernible (normative confusion) and that the voters may not distinguish the corresponding liabilities. Therefore, it is very important to be clear as to what type of activities a certain decentralized jurisdiction is fully liable for or not.

As regards the activities that a decentralized branch must carry out through delegation by a superior level branch, the latter will be liable for costs. Only and as long as the decentralized branch exercises some influence over the special characteristics of the service involved, then, it may also be required to share costs.

In the case of a system having more than two levels, the problem of communication among the different levels appears. For example, within a three-level system, the supervision of the central and intermediate level in local level matters may be inefficient. Therefore, it seems adequate that the central level polices mainly, the investment programs addressed or related to the local policies, be channeled through the intermediate level (province, department and/or region), which, at the same time and within the local competences framework may collaborate both financially and technically with the local initiatives. In other words, the intermediate level must represent, as far as possible, the local level interests and become one of the coordination instances in the fiscal tax relations. If not, the interference by the central and the intermediate levels may be translated into an entangled and misleading normative.

9. Improvement of the subnational governments' assimilation and management capacity

Along with the strengthening of a decentralized financial system, not only is it essential to increase the expense of the regional and local levels, but also to improve its quality. Thus, a rationalization in the use of the resources must be promoted if their use were at the national or federal level, and at the same time, acceptable utility rates must be shown.

Decentralization should not go beyond what is allowed by the local level assimilation capacity in order to efficiently assume the responsibilities transferred upon it. As a result of this, part of the success of the decentralization strategy is related to the strengthening of the subnational governments' administrative and technical capacity in the management of their competences and resources.

In this sense, the perspective of an "efficient" subnational government must be willing to implement State rationalization and/or modernization policies through programs for the local governments' institutional, administrative and management strengthening, which, guided by minimum efficiency criteria may offer an improvement of the human resource productivity and local management capacity.

Likewise, and for the correct evaluation of such processes, it is necessary to rely on duly available statistical information on the situation of the intergovernmental fiscal relations and the sphere of the subnational governments¹⁵ themselves. The deficiencies and lack of information systems do not allow for the follow-up and the strict evaluation desired for purposes of adjustments and recommendations of fiscal decentralization policies in harmony and coherence with the macroeconomic policies. Undoubtedly, the improvement of the fiscal information systems at subnational level constitutes a basic instrument for the elaboration of policies and evaluation of the fiscal decentralization processes in Latin America and the Caribbean.

Summing up, and as it is affirmed by several international authors and agents involved with these topics, the success of the fiscal decentralization processes depends, to a large extent, on the subnational governments' own management of their administrative and technical capacity within a context of higher autonomy and accountability.

¹⁵ In Wiesner (1992) "Colombia: Descentralización y Federalismo Fiscal. Informe Final de la Misión para la Descentralización", recurrent reference is made to the importance of the subnational fiscal information systems.

TABLES ANNEX

MODELS TO BE USED IN THE PROJECT

Table A-1
Cash income as per government level
(in national currency and in proportion of GNP)

	1984	1985	1986	1987	1988	1989	1990	1991
INCOME	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %
<hr/>								
Federal or National Level								
- Central Sector								
- Decentralized Sector*								
Intermediate Level								
- Central Sector								
- Decentralized Sector								
Local Level								
- Central Sector								
- Decentralized Sector								
<hr/>								
Total								
<hr/>								
Consolidated Central Sector **								
Consolidated Decentralized Sector								
<hr/>								

* The decentralized sector includes both the decentralized bodies and the state-run companies.

** This category includes the central sectors of the three government levels.

Table A-2
Cash expenses as per government level
(in national currency and in proportion of GNP)

	1984	1985	1986	1987	1988	1989	1990	1991
INCOME	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %
Federal or National Level								
- Central Sector								
- Decentralized Sector*								
Intermediate Level								
- Central Sector								
- Decentralized Sector								
Local Level								
- Central Sector								
- Decentralized Sector								
Total								
Consolidated								
Central Sector **								
Consolidated								
Decentralized Sector								

* The decentralized sector includes both the decentralized bodies and the state-run companies.

** This category includes the central sectors of the three government levels.

Table A-3
Assignment of competences and/or functions to the different government levels

2 Delegation Level		A General public services (drinking water, health care)			B Highway Infrastructure			C Education and Health			D Others (dwelling, agricultural development, tourism, environment, etc.)		
		n	i	l	n	i	l	n	i	l	n	i	l
Delegated Level	Voluntary Functions	n											
		i											
		l											
Obligatory functions established by some statutory regulation		n											
		i											
		l											
Functions through delegation by another government level		n											
		i											
		l											

n= national or federal level; i= intermediate level (state, provincial or department); l= local level (municipal, community)

Note 1: These tables are qualitative (they must be filled in with X)

Note 2: The consultant may enlarge or redefine the functions' categories (e.g.: include citizens' safety, etc.)

Table A-4
Income as per categories in the diverse government levels
(in national currency and in proportion of GNP)

	Years	1985	1986	1987	1988	1989	1990	1991
	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %
NATIONAL OR FEDERAL GOVERNMENT								
a.- Tax Income								
b.- Non-Tax Income								
c.- Transfers								
d.- Credits								
e.- Other Income								
	Sub-Total							
INTERMEDIATE GOVERNMENT								
a.- Tax Income								
b.- Non-Tax Income								
c.- Transfers								
d.- Credits								
e.- Other income								
	Sub-Total							
LOCAL GOVERNMENT								
a.- Tax Income								
b.- Non-Tax Income								
c.- Transfers								
d.- Credits								
e.- Other income								
	Sub-Total							
TOTAL								

Note: The sub-totals include the decentralized bodies for said government level. If otherwise, please specify.

Table A-5
Tax income as per tax class and government level
(in national currency and in proportion of GNP)

Years	1985	1986	1987	1988	1989	1990	1991
	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %
PRIVATE INCOME TAX							
a.- National Level							
b.- Intermediate Level							
c.- Local Level							
CORPORATE INCOME TAX							
a.- National Level							
b.- Intermediate Level							
c.- Local Level							
VALUE ADDED TAX							
a.- National Level							
b.- Intermediate Level							
c.- Local Level							
FOREIGN TRADE TAXES							
a.- National Level							
b.- Intermediate Level							
c.- Local Level							

(see next page)

Years	1985	1986	1987	1988	1989	1990	1991
	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %
REAL-ESTATE TAX							
a.- National Level							
b.- Intermediate Level							
c.- Local Level							
PATENTS TAX (Industrial, Commercial, Vehicles Registration, etc.)							
a.- National Level							
b.- Intermediate Level							
c.- Local Level							
CONSUMPTION TAX							
a.- National Level							
b.- Intermediate Level							
c.- Local Level							
OTHER INCOME (SPECIFY)							
a.- National Level							
b.- Intermediate Level							
c.- Local Level							
TOTAL							

Note 1: The consultant may modify this table according to the country's main taxes

Note 2: In case of taxes shared by different government levels, specify which tax follows each modality (with a foot note) and as income of each government level its portion derived from the distribution process must be included.

Table A-6
Non-tax income as per government type and level
 (in national currency and in proportion of GNP)

	Years	1985	1986	1987	1988	1989	1990	1991
	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %	Amount %
PENALTIES AND TOLLS								
a.- National Level								
b.- Intermediate Level								
c.- Local Level								
LICENSES OR PERMITS								
a.- National Level								
b.- Intermediate Level								
c.- Local Level								
TARIFFS OR CHARGES TO USERS								
a.- National Level								
b.- Intermediate Level								
c.- Local Level								
ROYALTIES								
a.- National Level								
b.- Intermediate Level								
c.- Local Level								
OTHERS								
a.- National Level								
b.- Intermediate Level								
c.- Local Level								
TOTAL								

Note 1: The consultant may alter the table according to the main non-tax income of the country's different government levels.

Note 2: Intergovernmental transfers are not included, they are indicated on another table.

Table A-7 (a and b)
Subnational governments credit and financing

Powers according to matters involved	Programming (determination and uses)			Indebtedness authorization (real and legal indebtedness capacity)			Negotiation of financial conditions			Supervision and control		
	n	i	l	n	i	l	n	i	l	n	i	l
Type of credit institution												
Bank not for profit												
Commercial Bank												
External credit agency												

n= national or federal level; i = intermediate level; l = local level

Note 1: This table is of qualitative nature (it must be filled in with X)

Note 2: Each government level (n, i, l) includes the central government and the respective decentralized sector.

Note 3: Table (A-7a) corresponds to the intermediate governments and (A-7b) to the local governments.

Table A-8 (a and b)
Transfers¹ — From the national government to the intermediate and local⁴ Criterion²
Year 19—

Jurisdictional unit ³	Intermediate governments			Local governments			Total		
	Total	Per Capita	% Total	Total	Per Capita	%Total	Total	Per Capita	%Total
1.-									
2.-									
3.-									
8.-									
9.-									
10.-									
TOTAL									

¹ Transfers may be conditional, unconditional, etc. (see document)

² The criteria used to allocate the transfers may be the population level, the poverty level, the fiscal effort, etc. or a combination of them. The consultant must be explicit as regards the criterion used for the respective arrangement.

³ The jurisdictional units will be the relevant ones in each country. They may be states, provinces, regions, departments, etc. They refer to the intermediate levels.

⁴ In the case of transfers to the local governments, they must be classified under the jurisdictional unit of the corresponding intermediate level.

Note 1: It is understood that a table (A-8a) for the intermediate levels and another table (A-8b) for the local levels must be presented.

Note 2: This table is also suggested in the case of the shared taxes which are not classified as transfers.

Table A-9
Intergovernmental fiscal transfers in 19—
 (in national currency and in proportion of GNP)

Receiver Distributed by	Federal and/or central government level	Intermediate Government Level	Local Government Level
Federal and/or Central Government Level			
Intermediate Government Level			
Local Government Level			

Note: It is recommended to present this Table for the last year of available information. Likewise, it is advisable to present an additional table with information on other year/s with certain anticipation (3 or 5 years) for comparison purposes.

Table A-10
Federal or National government transfers to the State and local governments in 19—
 (in national currency and in proportion of GNP)

Government Level Function	Intermediate Governments Total % as per total inhabitants	Local Governments Total % as per total inhabitants	Intermediate and Local Govern. Total % as per total inhabitant
Public Services in General			
Public Order and Safety			
Health and Education			
Social Security and Welfare			
Dwelling and Community Services			
Entertainment, Culture and Religion			
Agriculture, Hunting and Fishing			
Mining, Manufacturing and Construction			
Others			
TOTAL	100%	100%	100%

Note 1: This classification corresponds to the one carried out by the International Monetary Fund, nevertheless, the consultant may enlarge or redefine the classification suggested according to the characteristics of the country under consideration.
 Note 2: It is advisable to present this table for the last year of available information. Likewise, it is advisable to present an additional table with information referred to other year/s (three to five years) with certain anticipation for comparison purposes.

Table A-11 (a and b)
Intermediate Governments (States, Provinces, Departments, Regions, etc.)
and/or Local Governments

VERTICAL BALANCE

(in national currency and as GNP average)

	Independent Income ¹		Shared Taxes	Transfers	Total Income	Autonomous Expenses ²	Non-Autonomous Expenses ³	Total Expenses	Vertical Balance	Other Indicators									
	Tax	Non-Tax								(1)	(2)	(3)	(4)	(5)	(6)	(7)	(1)/(5)	(5)/(7)	(4)/(7)
Years																			
1985																			
1986																			
1987																			
1988																			
1989																			
1990																			
1991																			

¹ Independent income refers to income for which the government level has autonomy with respect to the national level. (e.g. without including transfers).

² Autonomous expenses refer to those expenses established by the intermediate or local governments independently from the decisions by other government levels. The consultant must be specific in the calculation methodology of this scope.

³ The non-autonomous taxes could be defined as those related to functions delegated by the national or federal level and, generally, they are financed through conditioned transfers. In case of suggestions for the calculation of this scope and the criteria used, accuracy in the methodology applied is requested.

Note: Table (A-11a) corresponds to the intermediate governments and another Table (A-11b) to the local governments.

Table A-12
Year 19— Intermediate governments
VERTICAL BALANCE
 (in national currency and in proportion of GNP)

	Independent Income ¹		Shared Taxes	Transfers	Total Income	Autonomous Expenses ²	Non-Autonomous Expenses ³	Total Expenses	Vertical Balance	Other Indicators									
	Tax	Non-Tax								(1)	(2)	(3)	(4)	(5)	(6)	(7)	(1)/(5)	(5)/(7)	(4)/(7)
Years																			
1985																			
1986																			
1987																			
1988																			
1989																			
1990																			
1991																			

¹ Independent income refers to income for which the government level has autonomy with respect to the national level. (e.g. without including transfers)

² Autonomous expenses refer to those expenses established by the intermediate or local governments independently from the decisions by other government levels. The consultant must be specific in the calculation methodology of this scope.

³ The non-autonomous taxes could be defined as those related to functions delegated by the national or federal level and, generally, they are financed through conditioned transfers. In case of suggestions for the calculation of this scope and the criteria used, accuracy in the methodology applied is requested.

Note: Presentation of this Table is suggested for the last year of available information. Likewise, it is advisable that an additional Table with information referred to other year/s with certain anticipation (3 to 5 years) be presented for comparison purposes.

Fiscal Policy Management in an Open Capital Regime*

Peter S. Heller**

I. Introduction

Much has been written since the Mexican crisis of late 1994 caused policy makers to reexamine their approach to conducting macroeconomic policy in an increasingly globalized world. The potential swiftness of capital flow movements, their heightened sensitivity to changed expectations, and the relative transactional ease with which movements can occur suggest the growing complexity of the institutional environment facing policy makers. In times of crisis, monetary policy measures normally represent the first line of defense in responding to a significant change in capital flows. However, authorities are often unwilling to allow significant exchange rate adjustments. Hence, there are obvious limits to the role that

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monetary policy can play beyond the short term. Even where a country's fiscal policy is not an obvious factor causing a shift in capital flows, it may be asked to play an important part in the overall macroeconomic policy response, despite the unavoidable delays inherent in adopting and implementing fiscal measures.

Particularly interesting is the seeming *asymmetry* in the perception of the appropriate role of fiscal policy under capital mobility. Specifically, fiscal tightening is usually seen as a necessary policy response to a *capital outflow*, reflecting the need to reduce absorption in the context of an unfinanceable current account balance, while limiting the adverse effects of a squeeze in credit on private sector investment. If associated with monetary tightening, and assuming that expectations are otherwise unaffected, it should have the effect of raising interest rates (increasing the attractiveness of the local currency). Further, such fiscal tightening may also be seen as necessary to strengthen the market assessment of the medium-term viability of a country's fiscal stance. Yet, in the context of significant *capital inflows* and in a world where capital flows are highly elastic, a tightened fiscal policy stance is also often advocated, given the ineffectiveness of monetary policy to sterilize inflows, absent a significant exchange rate appreciation.

Here it should be observed that the macroeconomic policy context and the problems created by inflows are typically seen as different from those associated with outflows. In the former, the authorities are often primarily concerned with preventing an exchange rate appreciation and limiting overheating. In this context, it tends to be taken for granted that capital mobility is high. There are few capital restrictions and usually direct investment inflows are heavily sought. In contrast, when there are capital outflows, the concern is usually to pre-empt or limit a balance-of-payments crisis; often the flows occur despite the presence of formal capital account restrictions. Also, more often than not, an unbalanced fiscal sector is perceived as a key factor underlying the capital flight.

Moreover, whereas much has been written on the specifics of the fiscal strategy needed to offset an adverse turn in the

balance of payments,¹ the nature of the fiscal adjustment appropriate for responding to sudden or large capital inflows (and to the capital outflows that reverse such inflows) has received significantly less attention (perhaps because it is assumed to be analogous). And, for both inflows and outflows, but particularly as regards volatile capital inflows, there has been limited consideration of the opportunity cost of changing the components and structure of revenue and expenditure when fiscal instruments are used to re-equilibrate demands for domestic and foreign assets.²

This paper explores the issue of whether there should be a change in the stance of fiscal policy and in the underlying structure of revenues and expenditure when the capital account becomes open and there is a prospect of increased capital volatility. A number of specific questions are raised. First, what is the appropriate underlying fiscal stance in a new, more open, capital regime-compared with the stance in the previous regime? Second, having adopted an appropriate stance, how should fiscal policy makers further respond to significant shifts in capital flows, inward or outward? Is the "asymmetrical" response discussed above always warranted? Third, should the nature of the fiscal response differ depending on the source of the capital flow problem-whether it is exogenous or caused by factors in the domestic policy environment?

Fourth, if the fiscal position is itself significantly affected by capital flows, how does this affect an analytical assessment of the appropriateness of the fiscal policy stance? Fifth, looking beyond the macro stance, should the underlying composition of fiscal policies (viz., the constituent tax and expenditure policies) be modified in a more open capital environment, in order to reflect in part the constraints such an environment would impose on such policies? Finally, which fiscal instruments are best adapted for responding to significant capital flow movements, and is there a core of fiscal policies that are

¹ See Nashashibi et. al. (1992); Fiscal Affairs Department (1995); and Schadler et. al. (1995).

² For a recent discussion on some of these issues, see T. Ter-Minassian (1996).

less suited—and therefore should not be adjusted—for such purposes?

There are no easy answers to these questions. The analysis in this paper reflects a review of the literature of the last 18 months and an attempt to synthesize the implications for fiscal policy at a broad brush level. Most important, it seeks to provoke further discussion and analysis. In what follows, Section II briefly surveys the types of macroeconomic challenges posed by an open capital environment; it also raises the issue of whether certain elements of the fiscal structure should be excluded for the purpose of macro policy adjustments. Section III discusses the issues that arise in determining the appropriate fiscal stance and response as one moves to a more open capital account environment. Section IV examines how the structure or composition of fiscal policies may need to be adapted to operate in a more open capital environment. Finally, Section V provides some concluding remarks.

II. The policy context

A. Factors influencing shifts in capital flows

A more open capital environment is particularly complex for policy makers because of the inherent uncertainty about the likely magnitude, speed, and possibly even direction of capital flows during any period. Such flows may occur “smoothly” —within a relatively limited band of uncertainty about the factors that may affect such flows in the near term— or may be subject to occasional bouts of “disorderly” movements, with unexpected shocks forcing an emergency policy response. The size of the flows may also be large, particularly relative to the size of the domestic economy. The existence of greater uncertainty implies that fiscal policies need to be formulated bearing in mind that one could observe *significant* inflows or outflows at any point in time. Under such circumstances, three questions can be raised: whether fiscal policy is an efficient and sufficiently flexible instrument for a macroeconomic policy response to such shocks in the capital account? Second,

if it is to be used, what are the implications for the underlying composition of expenditure and revenues? And, third, what are the most appropriate fiscal instruments for such a response?

Exogenous factors

To some extent, the uncertainties facing policy makers may reflect exogenous factors over which most countries have little control. Shifts in the economic environment of the industrial economies (e.g., interest rates, real growth) are obviously important to smaller countries because they affect industrial country interest rates and thus the differential between the rates available in a given country and that of plausible alternative investment opportunities elsewhere.

More generally, shifts in the economic environment of other emerging market or industrial economies may arise from a contagion effect caused by adverse developments in another country, or from the perception of stronger, more positive investment options in other countries. By its underlying macroeconomic policy stance, a country may seek to reduce the degree to which it is vulnerable to such exogenous factors, or at least those factors giving rise to large and disorderly capital flows. Adding to the uncertainty, of course, is the difficulty of fully gauging the reaction functions of different market players to exogenous developments, i.e., of local investors and more importantly, key international institutional investors; this further complicates the task of policy makers in emerging markets in predicting changes in the domestic demand for money.³

Endogenous factors

Some of the factors potentially affecting capital movements must be considered as relatively endogenous, viz., affected by a country's own policies. Most obviously, an excessively

³ For a discussion on factors influencing capital inflows and measures of volatility, see Claessens et. al. (1995) and Calvo et. al. (1993).

expansionary fiscal policy may itself be the source of the capital flow problem. Coupled with a tight monetary policy, this could lead to high real interest rates that initially provide an environment that attracts (or indeed encourages) capital inflows, but which is susceptible to rapid reversals. Similarly, countries that have accumulated a large public debt burden may be subject to significant interest rate premia, thus increasing their vulnerability to a turn in investor sentiment. In such cases, fiscal policy would need to play a role in responding to capital flows, less because it is an effective policy instrument, and more because it is the principal source of the problem. But even in the absence of obvious fiscal imbalances, market perceptions about the firmness of fiscal discipline are an important factor influencing investor expectations and a source of potential instability in capital flows.

Capital flows (both portfolio adjustments and direct foreign investment) may also be influenced by the domestic institutional environment, particularly the extent to which it supports productive and profitable investments. The range of fiscal policies which may be considered supportive is wide, from the provision of a disciplined fiscal regime with relatively low and stable tax rates to more debatable approaches, such as the provision of corporate tax incentives for foreign investments or the establishment of free-trade zones.

Another aspect of endogeneity relates to the extent to which the fiscal position is itself affected by capital flow movements or by the general macro policy stance adopted in the context of an open capital regime. For example, Hausmann et al (1996) have noted that in Latin America, capital flows tend to be highly correlated with cyclical movements in the economy (viz., inflows associated with strong economic performance, and the converse for outflows). Moreover, such flows may also have an independent influence which exacerbates a fiscal imbalance (with capital inflows associated with booming imports and high customs duty receipts, and outflows associated with a corresponding weakening in the fiscal accounts).⁴ The weak fiscal position that has arisen in periods of capital

⁴ Hausmann et. al. (1996).

outflows and recession have made it difficult for policy makers to tighten fiscal policies in response to the adverse turn in the balance of payments. The existence of such endogenous relationships must be taken into account in assessing and formulating the appropriate macroeconomic policy stance in relation to capital flows (see Section III.B).⁵

B. Underlying structure of fiscal policies

To summarize the discussion so far, as the capital environment becomes more open, there may be additional pressures for fiscal adjustment. A central issue for this paper is the extent to which fiscal policy should play such a role and if so, whether this can occur without adversely affecting the other redistributive and allocative roles that governments should play in society. Specifically, the paper argues that, in identifying possible macroeconomic policy responses, and in understanding their limits, one must examine whether certain elements of the fiscal structure should be relatively insulated from adjustment. It also raises the subsidiary question of whether the fact of a country operating in a more open capital environment should itself motivate a change in the composition of the fiscal structure.

The possible need to insulate fiscal functions may be explained by the concept of the basic or "core" allocational and distributional roles of a government. Economic theory suggests a justification for government roles that are of a public good nature, or for which there may be significant externalities. Other core roles may derive from the constellation of political forces and the social values in a society: redistributive outlays and fiscal federal transfers may be important reflections of the social conscience and the balance of political power. The need for protecting certain activities might also arise from the high opportunity cost of

⁵ For example, such endogeneity might be perceived as desirable, allowing fiscal policy to exert a strong automatic stabilizer in response to significant shifts in capital flows. The issue then would be what preconditions would make it useful for the fiscal stance to be so responsive.

changing some policies, the large efficiency costs of allowing for variability, or high contractual costs of delaying or curtailing certain programs.

Recognizing the blurriness of the borders which delimit the fundamentally necessary roles government must play, one can nevertheless assert a general principle. There is a core set of expenditures associated with such roles and functions which need to remain *outside* (or nearly outside) the realm of frequent adjustments in pursuit of macroeconomic policy objectives if a government is to retain its legitimacy and maintain minimal efficiency. Section IV expands further on the issues involved in clarifying what such core expenditures might be and the issues involved in determining what scope there would be for expenditures to be adjusted.

Similar considerations would suggest that there are limits on the extent to which the revenue structure should be changed for macroeconomic purposes. Certain tax regimes play well-recognized roles in influencing rates of investment and savings, production and pricing decisions, and the supply of labor. The effective rates of the income tax are particularly relevant in this regard, but tariff adjustments also have important effects. Frequent changes in the tax and tariff policy environment within which economic agents make resource allocations would be disruptive and thus undesirable. This would argue that tax rate or base adjustments on macroeconomic grounds should be associated with those elements of the revenue structure which would have the least distortionary impact on allocative decisions. Unsurprisingly, this would suggest a focus on such tax bases as the general sales tax or excise taxes on goods subject to relatively inelastic demand.

As will be elaborated further in Section IV, a more open capital environment may also impose constraints on a government's ability to use revenue measures for fiscal adjustment. Competitive pressures may limit the effective tax rates that can be imposed on mobile factors of production—most obviously, on capital incomes. Even those taxes that are less directly targeted at mobile factors, such as a general sales tax, may nevertheless be constrained by the need to avoid a comparatively high tax environment.

Even if one could agree on a normatively desirable expenditure or revenue structure, the actual fiscal structure is likely to depart from it. Fiscal structures are the product of the institutional inertia of past policies and may offer considerable scope for rationalization in the composition of both revenues and expenditures. Similarly, there is also always room for a rethinking of the definition of "core," in terms of the nature of a government's expenditure policies, the way in which they are produced, or the distribution of the burden in their financing. Also, if the level of outstanding public debt is high (relative to GDP), there is the possibility of a virtuous circle as fiscal deficit reduction strengthens market perceptions, reduces interest rate premia and, given a lower deficit, facilitates lower interest rates and thus further allows for cuts in the burden on the budget of debt service.⁶ Thus, our argument does not imply that fiscal structures should not be adjusted over time, but rather that the scope for fiscal policy as a macroeconomic policy variable, given debt service or personnel or contractual commitments should, over time, become fairly, limited.

III. The response of fiscal policy to a more open capital environment

A. The appropriate underlying fiscal stance

In a closed capital regime

The starting point for an exploration of the impact of a shift to a more open capital environment on fiscal policy is the appropriate underlying fiscal stance in a relatively more closed capital regime. If the structural fiscal balance, S , is defined as the fiscal balance⁷ that would, for a given constellation of revenue and expenditure policies prevail at the economy's potential

⁶ As with the case of Denmark and Ireland in the 1980's, an appreciation of the real exchange rate may reduce external debt service costs significantly.

⁷ In what follows, the fiscal balance is defined as equaling revenue minus expenditure and is stated as a share of GDP.

output (or NAIRU) level (hereafter, Q_p), the *appropriate* structural fiscal balance, S^* , is defined to be that S which is financially sustainable over the longer term, given the context of a relatively closed capital regime.⁸

Fiscal sustainability must take into account the size of the outstanding explicit public debt, the expected long-term growth, the implicit public debt associated with clearly recognized intergenerational trends (e.g., the effects of an aging population on the government's likely long-term fiscal obligations), and any government guarantees or contingent liabilities (e.g., to the banking system, public enterprise sector, etc.). The government's role in promoting infrastructural investment may also be a factor. Where such investments are socially profitable, and where sufficient externalities warrant their being undertaken by the public rather than the private sector, the overall fiscal balance may incorporate such capital outlays, thus yielding a lower value of S^* .

In Figure 1, the appropriate structural balance, S^* , is shown as realized at the potential output level, Q_p (note: this S^* could be a surplus or deficit, depending on individual country circumstances);⁹ given the tax and expenditure structure, the actual balance will fall below S^* at output levels below Q_p , reflecting the lower tax revenues and higher social transfer payments associated with reduced output and employment. The relationship between the actual fiscal balance and output, for any given set of tax and expenditure policies, is shown generally as an $F(q)$ function. Clearly, the actual fiscal balance may also vary if the tax-expenditure policy mix changes.

In an open capital regime

The conventional fiscal policy response. If a government is pursuing appropriate sustainable policies, as reflected in a structural balance S^* , should an opening of the capital

⁸ See Heller et. al. (1986); Fiscal Affairs Department (1995); Khan and Reinhart (1995); and Cheasty and Blejer (1993).

⁹ The F functions ignore the fact that changes in the composition of expenditure and revenue may have an impact on Q_p .

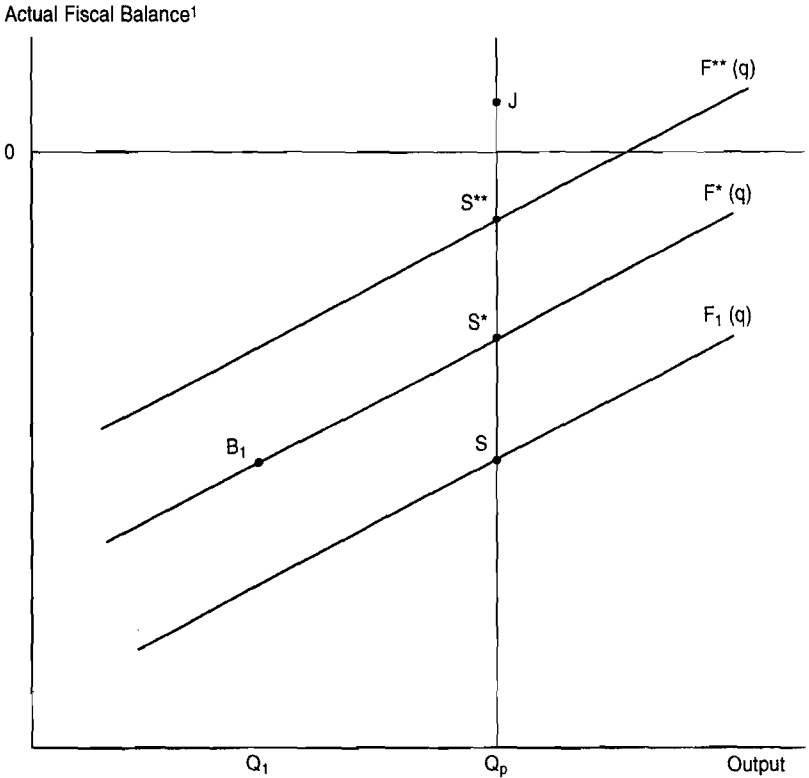
account lead to a change in these policies and thus in the appropriate structural balance? Obviously, this depends on the roles given to the different macroeconomic policy instruments in response to capital flow movements. For example, if changes in the exchange rate are allowed to bear the brunt of the effect of capital flows, there is obviously less need to adjust fiscal or monetary policies. In contrast, in situations where the authorities are unwilling to allow the exchange rate to adjust, a monetary policy response to inflows will be inherently limited, and fiscal policy may need to bear the brunt of the pressure to adjust demand.

It is also likely to depend on the *nature* and *size* of the flow. For *capital inflows*, particularly where exchange rate stability is sought, some types of flows may facilitate increased productive investment (public and private) and increased imports in the economy.

Higher externally financed public investments may be reflected in a lower S^* without excessive strain on the money supply and inflation. However, other inflows or an overall flow which is large in aggregate terms may prove to have more of a monetary effect; efforts to build up a larger stock of international reserves and the associated need for sterilization will ultimately prove costly to the Central Bank, force higher real interest rates (which are in turn likely to provoke further inflows), and, most important, may be difficult to sustain beyond a limited period.¹⁰ Since the interest costs of sterilization are quasi-fiscal (viz., borne by the Central Bank and reflected in the size of its transfers to the government), the choice of a fiscal adjustment-cum-sterilization response over a simple exchange rate adjustment requires that this quasi-fiscal operation be taken account of in determining the size of the fiscal adjustment.

¹⁰ For example, in the Czech Republic, efforts at sterilization of inflows to tighten liquidity conditions became increasingly more difficult in late 1994, where almost 80 percent of primary securities sold to sterilize external inflows had been acquired by nonresidents and foreign banks' branches. Although most studies suggest that sterilization is a feasible option for central banks to pursue, there is also a recognition that in quasi-fiscal terms, this can become expensive. See Schadler et. al. (1993).

Figure 1



(n.b. Structural balance = actual balance only at Q_p)

¹ The zero balance line here is purely illustrative. Its actual position would depend on individual country circumstances.

Even recognizing that fiscal policy is a more cumbersome instrument that achieves its effects with greater delay, fiscal consolidation (say a further tightening of the actual fiscal position to J relative to S^{*} in Figure 1) may be required to ease pressure on domestic financial markets, limit crowding out,

and reduce expansionary pressures from the capital inflows. Such a tightening may have the initial effect of reducing output below Q_p , unless offsetting monetary policy measures are taken.

In a situation of *capital outflows*, when outflows are large enough to put pressure on the external account and reserves, fiscal consolidation is likely to be unavoidable if domestic absorption is to be reduced.¹¹ Consolidation may also serve to strengthen the confidence of international investors. However, here, fiscal consolidation is likely to be procyclical, aggravating the usual adverse effects on the economy that are associated with capital outflows.

It is clear from the above discussion that the desirable *direction* of the fiscal policy response to a change in capital flows is relatively well-understood. What makes an opening of the capital regime more complicated for fiscal policy managers is that there becomes far less predictability as to the nature of the flows that would need to be responded to. As noted earlier, one may be dealing with flows which are *large* relative to the size of the domestic economy; subject to significant *volatility*, often as a consequence of exogenous factors; and subject to a higher degree of *unpredictability*. Should the possibility of significant unpredictable volatility in the size and direction of capital flows call for frequent fiscal policy tightening beyond the appropriate underlying fiscal stance of S^* ?

Certainly, one approach to fiscal policy management would be that the appropriate underlying balance would not need to be changed, but that the particular conjunctural circumstances would nevertheless periodically force fiscal policy to be tightened temporarily beyond S^* , with the stance returned to S^* when the capital flow incident had abated. This suggestion reflects the view that the macroeconomic arguments for fiscal tightening pertain, *regardless* of the underlying structural balance target. Thus, there is no reason to change the underlying structural fiscal stance that was appropriate when

¹¹ As Milesi-Ferreti and Razin (1995) have pointed out, the effectiveness of such policies may be compromised if there is a significant Ricardian offset, as would arise in situations where the burden of public debt is large relative to GDP.

capital markets were closed, and which had reflected underlying savings-investment balances; all that is required would be a change in the conjunctural fiscal stance as shocks occur.

The argument against this approach is as follows. If the implication of a change to a more open capital environment is that there will be greater unpredictability in terms of the frequency and size of the response that is needed, then it may be very costly and undesirable to have the *content* and *composition* of expenditure and revenue policies subject to such frequent adjustment. If expenditure policies are formulated with consideration of their optimality in terms of allocative and equity criteria, one must seriously doubt the appropriateness of adjusting them in response to conjunctural volatility, particularly given the high political and transaction costs of such changes.

Similarly, if the revenue structure is appropriately balanced in terms of realizing equity objectives and minimizing allocative distortions, one must question whether the fiscal authorities should continue adjusting the level of rates or structure of the different tax bases in response to macroeconomic pressures arising from capital flow movements. In effect, there is a very high opportunity cost associated with changes in the core tax and expenditure structures (and underlying policies) and in the key tax rates in the economy.¹²

Tightening the underlying fiscal stance. An alternative approach would argue for minimizing such opportunity costs by insulating, as much as possible, core revenues and expenditures from the need for frequent macroeconomic policy-induced changes. Yet to achieve such insulation and avoid frequent changes in fiscal variables, the underlying fiscal position would have to be both strong and consistent with the core policies. Such reasoning argues for a *preemptive tightening* in the underlying fiscal position as one moves from a closed to a more open capital environment.¹³

¹² And this does not even speak to the political economy of reform issues associated with changes in many such core (or noncore) policies.

¹³ Governor Frenkel has orally argued this perspective in recent seminars on the macroeconomic impact of capital flows. The point has also been made by Gavin and Leiderman (1995), and Corbo and Hernandez (1994).

Specifically, the fact that the appropriate policy response is qualitatively the same in both cases of inflows and outflows suggests that there is a higher, appropriate structural balance, S^{**} , and an associated fiscal balance function, $F^{**}(q)$, applicable to economies with unrestricted capital movements (see Figure 1).¹⁴ As with S^* , the new target S^{**} is set with a view toward medium to longer term sustainability. If fiscal policies are called upon beyond this for further macroeconomic adjustment, the required ad hoc policy measures should then be significantly more limited (see Section III.B). Other macroeconomic policy instruments, particularly the exchange rate, would have to carry more of the load. Recourse to further fiscal policy adjustment would require a convincing argument that the social cost of using other macroeconomic policy instruments, *including* allowing the exchange rate to change, would outweigh the cost of "tampering" with the optimal fiscal structure. More generally, policy makers would have to accept that the quid pro quo for a tighter underlying fiscal balance, S^{**} , would be a commitment to avoid further ad hoc tinkering whenever possible.

The role of external expectations. So far, the proposal to tighten the fiscal stance as the capital regime is opened has been justified with reference to the "asymmetry" of response recommended to capital inflows and outflows, and the observation that governments in an open capital environment are likely to be called upon to offer such responses relatively often. Another argument for moving to a structural balance $S^{**} > S^*$ (which may simply imply a lower deficit rather than a larger surplus) is that a tighter underlying structural fiscal position constitutes a statement to domestic and international markets on the soundness of a country's underlying macro economy and on the enhanced capacity of a government to adopt (or accept) an *appropriate* fiscal policy stance in the

¹⁴ Calvo (1995) has argued this in a different way, noting the asymmetry of market perceptions in periods of short run financial turbulence. He argues that fiscal authorities should err on the side of "underestimating the permanence of capital flows" and thus seek "larger than symmetric fiscal surpluses in capital inflow periods" (p. 18).

context of any shock—from capital flows or domestic economic exigencies.

In effect, by starting off with a tighter stance, a government will be in a stronger position to allow countercyclical automatic stabilizers to function, rather than being forced by external considerations to tighten the budget further in a procyclical way that would weaken the domestic economy even more.

In other words, preparedness for openness to capital flows provides an in-built discipline to the conduct of fiscal policies. Fiscal policy can thus play the role of an "anchor," stabilizing market expectations with respect to both the underlying tightness of the fiscal position *and* to the potential swings in a country's fiscal position that are seen as acceptable and consistent with the rules of prudent fiscal policy management.¹⁵ This may also facilitate limiting the sensitivity of the economy to contagion effects.¹⁶ It should be noted however, that the success of such a strategy requires the market to be in a position to understand how the authorities perceive the role of fiscal policy, greater transparency of the actual fiscal position, and adequate clarity as to the rules by which fiscal adjustments will occur in response to capital flows.

Containing interest rate costs. A third argument can be made for a tightened underlying fiscal position. In an open capital market with a relatively fixed exchange rate, interest rates will be more sensitive to international pressures and will be more likely to reflect interest rate premia associated with the perceived risk of an individual country's securities. Since countries running loose fiscal positions are usually seen as higher risks, it can be argued that larger levels of government indebtedness lead to higher interest rate premia in the financial market, and that this relationship is most likely nonlinear (as shown in Figure 2).¹⁷

¹⁵ Calvo (1995) has argued this point in terms of the fiscal position being sufficiently strong such that a government is not perceived as being "forced into medium-run costly fiscal adjustment which [would validate a market perception of a] bad equilibrium." (p. 15).

¹⁶ A virtuous circle may arise from the market's perception of a stronger fiscal stance. By facilitating a fall in interest rate premia, it may reduce debt service costs.

¹⁷ See Tanzi and Fanizza (1996) for empirical evidence on this issue in the

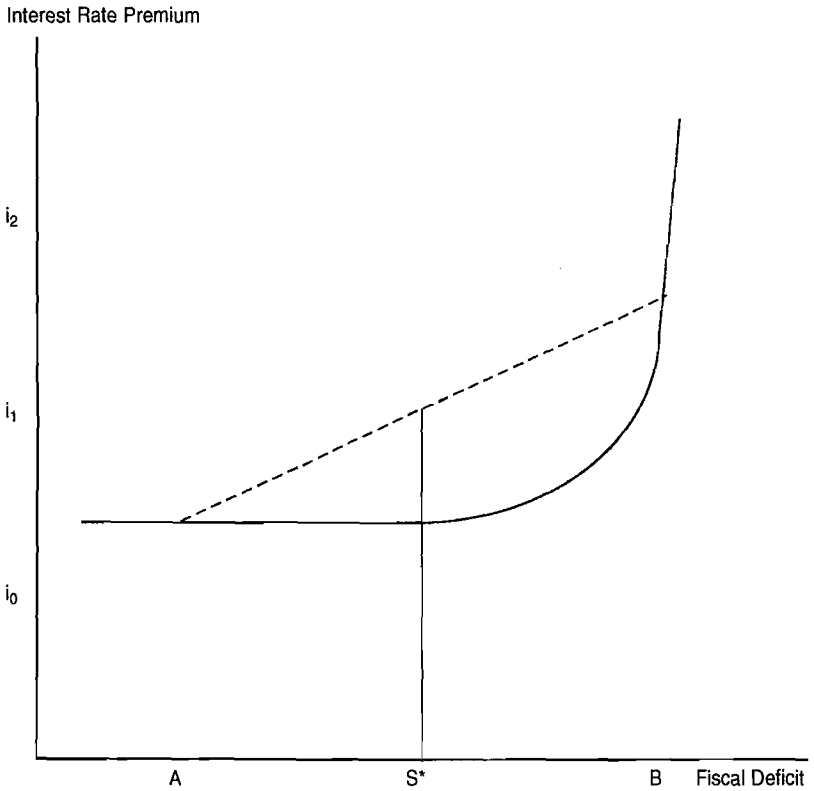
While maintaining the closed economy structural balance target of S^* may be consistent with a long-term sustainable position, it also implies that with any variability in the fiscal deficit, as between A and B, the actual mean interest rate premium that one would be likely to observe would not be i_0 (associated with S^*), but rather the average of the interest premia observed, viz., i_1 (reflecting the average between i_0 and i_2 for deficits A and B, respectively). Tightening the fiscal deficit to a lower position, say A in Figure 2, would allow the average interest rate premium to remain closer to i_0 ' even with some variability in the deficit.

This point emphasizes another important factor arguing for a tighter underlying fiscal stance. The interest rate burden of servicing government debt may prove larger in an open capital market. In principle, accessing a wider world capital market may allow a government to tap new sources of funds from a far deeper capital market than is available domestically, thus potentially reducing the average effective cost of borrowing. However, to the extent that a government has, in the past, been able to force the domestic market to accept government debt obligations at a below market interest rate, the opening of the market is likely to limit the availability of such captive sources of financing. In effect, liberalization eliminates the possibility of such quasi-fiscal taxes. In such circumstances, the interest cost of any new debt to be issued, either for rescheduling of old debts or for the financing of new deficits, will be more market-related.

Thus, the burden of risk premia becomes far more apparent in an open capital market environment, potentially raising the average effective cost of borrowing and thereby increasing the pressure on a government to take steps to limit the extent of the risk premium. These issues are particularly relevant for governments whose debt to GDP ratios has led to the cost of borrowing to be near the rising portion of the risk premium curve (e.g., point B in Figure 2).

G-7 countries. Also, Bayoumi et. al. (1995) and OECD (1995) for empirical evidence of such a relationship in the states of the United States and for the Canadian provinces.

Figure 2



Finally, one obvious exception to the argument for a tightened underlying stance would arise in countries where the authorities want to use the opening of the capital account to increase the rate of capital accumulation in the economy. Although this strategy may be concentrated on attracting direct foreign investment or greater equity financing of domestic enterprises, it could also include tapping foreign capital markets for the government's own investment program. The danger in adopting a more relaxed structural balance (a lower S^{**}) is that investor sentiment may prove fickle, leaving a

shortfall in financing that must ultimately be met from domestic monetary sources. This would suggest the need either to ensure that augmented public investment budgets are financed from long-term capital flows that are not easily reversed by foreign investors, or that the public projects are sufficiently small or adaptable that they can be put on "hold" if necessary (the latter being the safer option, given the inertia associated with most investment projects).

Magnitude of adjustment

This paper stops short of discussing the magnitude of tightening needed in moving to a more open capital regime. Obviously, the likely effect of the capital regime opening on the size of capital flows would be important to monitor carefully. As with the proverbial party where many are invited and no one comes, when the opening does not yield significant change in the size of capital flows, one would not need to adjust fiscal policy preemptively beyond S^* . The problem arises when one begins to observe a significant pickup in flows, greater interest by a broad range of outside investors, and a greater sensitivity by local residents to external interest rate developments. In such circumstances, the argument for preemptive tightening from S^* to S^{**} becomes more relevant, and would be motivated primarily by three principal factors: the desire to contain adverse effects due to the possibility of having to adjust the structure of expenditure and revenue in response to unpredictable capital flows; limiting the prospect of being faced with excessive risk premia; and the need to engender greater international confidence in the durability of the fiscal position.

The magnitude of change would thus need to be large enough to be noticeable to external markets and to lead to a significantly lower trajectory in the ratio of public debt to GDP over time. Equally, it would have to be large enough to allow for the possibility of higher deficits in periods when some fiscal expansionary impulse might be needed on various grounds.¹⁸ Consideration would also need to be given to the

¹⁸ It is interesting to note a recent study by McDermott and Waistcoat (1996) which argues that the size of fiscal consolidation is an important factor influ-

short-run macroeconomic impact of such a fiscal consolidation, which could prove contractionary in the absence of crowding-in from the private sector.¹⁹

B. The role for fiscal policy with an adequately tightened underlying stance

If the underlying fiscal position has been adequately tightened as capital markets opened, what then would be the role of fiscal instruments in the overall macro policy response if capital flows occurred? To some extent, the appropriate response of fiscal policy would depend on the source of the flows. We have noted that capital flows could arise from exogenous factors (e.g., a change in industrial country real interest rates, a contagion effect, or a change in the relative attractiveness of countries' investment possibilities); or endogenous ones (e.g., a perception that a country is maintaining unbalanced macroeconomic policies, or the "pursuit" of capital inflows for investment purposes); or an interplay of both (e.g., exogenous disturbances leading to capital outflows that weaken the fiscal balance and thereby inspire further speculative attacks).

Exogenous factors

The argument for a prior tightening of the underlying fiscal stance is particularly compelling as an *ex ante* response to the problems induced by capital flows caused by exogenous factors; such a tightening may create an "announcement" effect that can reduce the risk of being subject to such exogenous fluctuations. Further *discretionary* fiscal policy may nevertheless be necessary if exogenous shocks occur. Gavin and Lei-

encing the success of fiscal consolidation (where success is determined by whether it leads the ratio of public debt to GDP to start to decline and stay on a declining trend). In particular, they note that the "average magnitude of [a] two-year fiscal contraction was 4.0 percent of potential GDP for the successful cases, but only 3.2 percent for unsuccessful cases" (p. 13).

¹⁹ See a recent World Economic Outlook annex on the "Exchange Rate Effects of Fiscal Consolidation," International Monetary Fund (1995).

derman (1995) have noted that if speculative flows are a particularly important problem, then one may need to maintain a stronger reserve objective in order to address the possibility of reverse flows; the prospect then of a more active sterilization policy may then imply the need for an even tighter underlying fiscal position than S^{**} .

Alternatively, the fiscal position might be moved temporarily from S^{**} to a temporarily tighter position J (figure 1). In the latter case, the operative question is how to minimize the opportunity costs of having to make such temporary adjustments to what was a preferred—and perhaps optimal—fiscal structure. In effect, there should be a very high opportunity cost associated with changes in the core structures (and underlying policies) and in the key tax rates in the economy for which there are important allocative effects. Section IV.C will discuss the components of a preferred approach to further fiscal adjustment in more detail.

A dilemma will arise if the stronger underlying fiscal stance and the improved discipline in macro management itself becomes a factor influencing capital flows. In some countries (notably in Southeast Asia and Eastern Europe), increasing inward flows as countries respond prudently to an inflow “problem” have created pressures for further fiscal consolidation which may exceed that warranted on structural considerations alone. A fiscal strategy which seeks to insulate the core fiscal sector must be clear as to the limits on the pressures that can be accommodated by a purely fiscal response. As previously mentioned, the issue becomes that of the opportunity cost of using fiscal rather than other macro economic instruments.

Beyond a certain point, by not allowing the exchange rate to adjust (particularly in the context of higher productivity growth), too heavy a burden is placed on monetary instruments (with high opportunity cost) to adjust, including the cost of maintaining expensive real interest rate premia. Given the limited time frame over which monetary intervention can be sustained, the burden inevitably is shifted toward the need for fiscal adjustment. Such interest rate premia may also engender excessive fiscal costs, both in immediate debt service but also in terms of the possibility of higher bailout costs

in the financial sector if such higher rates weaken the profitability of banks and other financial institutions. For countries concerned with maintaining a relatively stable exchange rate, this may at least imply the setting of a significantly wider band within which the nominal exchange rate can fluctuate.

Endogenous factors

It was noted above that fiscal policies may be as much the source of the problem as the solution. Clearly, when a country's macroeconomic policies are unbalanced at the outset (e.g., an excessive structural fiscal deficit combined with a very tight monetary policy stance), there is a clear argument for strong fiscal adjustment that moves the fiscal balance to a sustainable long-term position.

More interesting is the case where the fiscal balance has been adjusted to S^{**} , but where the economy and fiscal position are strongly affected by capital flow movements. We have already noted the observation by Hausmann et. al. (1996) that in a number of Latin American economies, capital inflows have a strong positive impact on the domestic economy, with an improvement in the fiscal balance through increased VAT and tariff revenues associated with the higher imports facilitated by capital inflows, and more generally, buoyant income taxes. Similarly, the converse relationship pertains during periods of capital outflows, with a weakening both of the economy and in the fiscal balance.

This correlation is particularly likely where capital flows are associated with direct investment (which would have a direct stimulative effect on employment and output levels), but may also be true for portfolio or short term capital flows. To the extent that capital inflows are correlated positively with a strengthening of the economy, there may also be an inverse relationship with outlays for unemployment insurance. Interest outlays may also be positively correlated with inflows (thus offsetting some of the positive fiscal effects), to the extent that efforts at sterilization lead to higher interest rates and a higher quasi-fiscal deficit.

Abstracting from any expenditure responsiveness to the emergence of inflows, this implies that one may, in effect, see

a shift in the F function according to whether capital is flowing in or out. Figure 3 illustrates the sensitivity of the fiscal balance to capital flows. The function $F^{**}(n)$ illustrates the relationship between the fiscal balance and output in an open capital regime (see Figure 1), during a period with a normal (n) level of capital flows. *Ceteris paribus*, a higher level of capital inflows may be associated with a stronger fiscal position, reflecting a higher level of tax and tariff receipts. This suggests that with larger inflows, one would expect an uniform upward shift from $F^{**}(n)$ to $F^{**}(i)$ (where i connotes inflows); conversely, lower fiscal receipts associated with significant capital outflows (o) would lead to a shift from $F^{**}(n)$ to $F^{**}(o)$.²⁰ In other words, the fiscal balance is influenced both by the output level and by the magnitude and direction of capital flows into the economy.

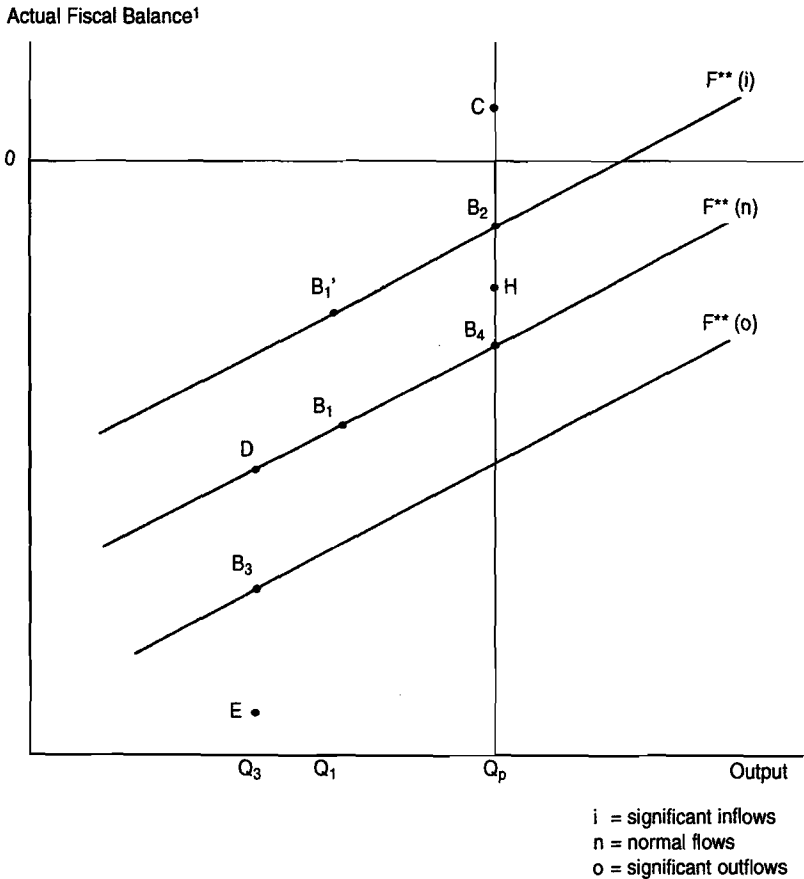
However, one would also expect some degree of covariance between capital flows and output, such that from a fiscal position and output level corresponding to a given normal level of capital flows (B_1 on Figure 3), additional inflows may shift the economy to a higher level of output (Q_p for illustrative purposes) and the fiscal balance, correspondingly, to the stronger position observed at B_2 ; outflows may correspondingly cause a contraction in the economy to Q_3 and reduce the fiscal balance to the level reflected at B_3 . Such endogenous changes in the fiscal position are analogous to those more conventionally observed in the response of the fiscal balance to cyclical movements in the economy.²¹

The issue then arises whether the asymmetrical fiscal policy response to such capital flow movements discussed at the beginning of the paper is in fact still desirable, even with a tighter underlying fiscal stance. Specifically, in periods of inflow, should fiscal policy be tightened further, beyond the

²⁰ The nature of the shift in the F function as capital flows change may be more complex than taking account simply of the relationship of government revenues to capital flows. For example, if monetary sterilization efforts lead to higher interest rates, this may increase overall government debt servicing costs and thus cut into the positive impact of inflows on revenues.

²¹ This also implies that the structural balance at Q_p may vary according to the level of capital flows.

Figure 3



¹ The zero balance line here is purely illustrative. Its actual position would depend on individual country circumstances.

level observed at B_2 (e.g., at C), and in periods of outflow, to a fiscal balance exceeding that observed at B_3 (say at D)? Note that some shift in the fiscal position would already occur on account of the capital flows; during outflows, as Hausmann et. al have noted, there would be an endogenous weakening in

the fiscal stance as one moves from B_1 to B_3 ; with inflows, a further fiscal tightening in the fiscal balance would be observed in the move from B_1 to B_2 .

In the latter case, one might observe that a government chooses to respond to its healthier fiscal position by relaxing expenditure discipline or cutting revenues. In other words, it could choose to maintain the pre-inflow balance observed at B_1 , rather than the stronger possible position seen at B_2 . Indeed, the government might adopt an even weaker fiscal stance as at D, as the availability of inflows could inspire additional external borrowing for public capital projects. The danger of a larger deficit would be the difficulty of reversing the expansionary policies if capital flows dried up—particularly if the increased expenditures were on core outlays (for example, increased entitlements). For prudence, a government should maintain, as a minimum, the endogenous fiscal strengthening implied by the move to B_2 . Besides being in line with the macroeconomic policy stance discussed earlier, it would also provide a cushion against an endogenous weakening of the fiscal stance in subsequent periods of capital outflow. Talvi (1996) notes that such a stance would also allow an improvement in the debt maturity profile during an upswing, and an accumulation of liquid reserves, thereby further strengthening the overall policy response.

In other words, the existence of this type of endogeneity effect does not invalidate the previous policy recommendation about the appropriate reaction to capital inflows, (viz., some observed tightening though the magnitudes involved might be different). An important aspect of fiscal policy analysis in such an environment would be to *recognize* the endogenous impact on the fiscal position of the inflow of capital and the strengthened position of the economy and, in analyzing the macroeconomic situation, to take this into account in assessing the fiscal policy stance (i.e., not accepting a weaker fiscal balance than obtained at B_2).

More problematic is the question of whether discretionary fiscal tightening should be called for during capital outflows, despite the already weakened fiscal position and domestic economy. Where existing fiscal policies imply a high deficit (say, at E) and an unsustainable current account balance, a

cutback in absorption would be necessary, despite the aggravated effect on the domestic economy. However, if one had started with the tighter, more defensible underlying fiscal stance obtained at B_1 , *it would be desirable to accept the movement from B_1 to B_3* as allowing fiscal policy to play an appropriately countercyclical role. In other words, the appropriate fiscal response to a weakened economy would involve allowing for a higher, endogenously generated, fiscal deficit. In effect, by starting from a strong fiscal position, it will be possible to accommodate an endogenous deterioration in the fiscal balance with less danger of it being perceived as jeopardizing stabilization. Thus, a government can avoid having to react to external pressures for tax increases or further expenditure cutbacks in order to achieve a tighter fiscal position at a time when the economy is weak.²²

C. Problems posed for fiscal analysis

One issue highlighted by the above discussion is the greater difficulty faced by authorities and the market in assessing the actual degree of tightness or looseness entailed by a given fiscal policy position when the capital regime is open. For example, in Figure 3, with significant capital inflows, one might observe an improved fiscal position as one moves from B, to H. While this would appear to imply a strengthening of fiscal policy, in fact, it represents a more relaxed fiscal position than is consistent with the structural balance appropriate for this level of inflows and output. Similarly, a deterioration in the fiscal balance associated with a move from B_1 to D as a result of outflows would represent a *tightening* relative to the structural balance consistent with this level of outflow

²² In some respects, this mirrors the argument being advocated by many with respect to fiscal policy rules in a post-Maastricht world, where by a norm fiscal deficit of no more than 1 percent is seen as desirable (viz., the so-called Stability Pact that has been agreed by candidates for membership in the European Monetary Union). This would then allow, in a period of recession, that automatic stabilizers play a role (and which could then imply a higher fiscal deficit, but still less than 3 percent of GDP, during such weaker periods).

(viz., at B_3). Such further tightening would then be inadvisably contractionary.

In other words, the impact of capital movements adds considerable complexity to efforts to get a true reading of the actual stance of fiscal policy at any time. This underscores the need for greater transparency about the "fiscal rules" that govern the fiscal stance, the nature of the fiscal policy response to capital flows, and the actual fiscal position, in order to ensure that the market *correctly* perceives the actual conduct of fiscal policy.²³

IV. The impact of a more open capital regime on the fiscal structure

The thrust of the paper so far is that a move to a more open capital environment should prompt the authorities to tighten the underlying fiscal stance. This should significantly reduce the extent to which fiscal policy should then be used to respond to capital flow shocks. However, it should also be clear that the move to a tighter fiscal stance S^{**} in a more open capital regime does *not* rule out the use of some fiscal instruments in responding to capital flows. Nor does it imply that fiscal restructuring, particularly with respect to revenues, may not be needed. Neither does it imply that there may not be a change in the actual fiscal position as capital flows occur—indeed, this is likely. Rather, what should be clearer is the explicit tradeoff that would be required between policy changes for macroeconomic objectives relative to the opportunity cost of changes in the fiscal structure.

The force of this argument is particularly strong if there is a perception, at the time of capital account liberalization, that the composition and level of government expenditures is reasonably optimal and close to the "core" necessary outlays, and that the structure of the revenue system (including tax rates and base) is appropriate. However, as noted earlier, it is more than likely that, when consideration is being given to an open-

²³ This point has also been noted by Talvi (1996).

ing of the capital account, the fiscal structure is not optimal. On the one hand, this may delay the opening of the capital regime. However, from another angle, the necessity to tighten the fiscal stance with an opening of the capital account provides an opportunity, over time, to achieve a more appropriate fiscal structure, while at the same time insulating that structure more convincingly.

This section examines some of the key conceptual issues that should be considered in adjusting the underlying *structure* of fiscal policies in the context of an opening of the capital regime. In particular, a more globalized economy, with capital and conceivably labor more mobile, will impose constraints as to the type of fiscal structure that can be sustainably maintained. Significant differences in tax rates will provoke capital (and possibly labor) mobility; moreover, substantial differences in expenditure policies may have comparable effects. Second, adopting the tighter fiscal stance proposed in Section III will require governments to obtain greater clarity, both as to the core expenditure functions and tax policies which should be relatively insulated from macro pressures and in terms of the fiscal instruments that can best be used for macroeconomic adjustment purposes. Third, it may be necessary for fiscal authorities to consider whether one should seek a reduction in the sensitivity of the fiscal position to shifts in capital flows through a change in the composition of revenue and expenditure.

A. Constraints on the fiscal structure arising from greater globalization

In the last two years, the constraints that globalization may impose on specific fiscal policies has begun to receive attention. For example, Tanzi (1995) has pointed out that a more open capital environment will constrain country "policy makers in their choice of tax structures and tax levels,²⁴ with

²⁴ See Tanzi (1995) for an extensive discussion on the impact of globalization on tax policies.

countries having much less ability to maintain significant differentials in tax rates on relatively mobile factors of production. Corporate profit tax rates are the most obviously constrained, but tax rates applicable to other forms of capital income (e.g., scheduler tax rates on interest, dividend income or capital gains) also cannot diverge significantly from those prevailing in other competitor capital markets. While Tanzi has noted that this has initially led to alternative forms of tax competition, notably in the less obvious ways (such as the definition of the taxable base), the shift in competition merely creates new loci of pressures for a narrowing in such other differences.

It is also possible that increased immigration, particularly of skilled labor, may be facilitated by the process of globalization. Andersson (1995) has noted that if tax rates on capital income (particularly on financial capital) are lowered in order to continue to attract financial capital flows, it may be difficult to sustain high tax rates on human capital, given arbitrage possibilities and perceived inequities in the distribution of tax burdens. Both Andersson and Tanzi have noted that the possibilities for emigration of high productivity individuals is a factor influencing (if not constraining) tax rates on labor incomes. This results in downward pressure on tax rates "as something that is more or less inevitable."²⁵ Although the above considerations are less relevant for general sales taxes and excises, some analysts have noted that there are also limits on the extent to which the rates of these taxes can diverge. Pressures for harmonization of the VAT in the European Community have steadily intensified in recent years (Tanzi, 1995); the growing possibilities of cross-border shopping because of enhanced communication technologies is also a constraining element.

Thus, on the revenue side, open economies may be more constrained in terms of their capacity to raise the share of revenues that can be derived from some of the more important tax bases. As other authors have noted, this will force greater reliance on those tax bases for which greater degrees of free-

²⁵ Andersson (1995), P. 4

dom exist in the application of differential tax rates (notably sales and excise taxation, taxes on labor income, and property taxes).

Less attention has been paid to the implications of globalization for the expenditure side of the fiscal accounts, but one can easily envisage that significant differentials in the generosity of public benefit programs –unemployment insurance, health care benefits, pension systems (particularly in terms of the qualifications required for eligibility in drawing benefits) will be a factor inducing migration.²⁶ Understandably, such differentials may induce greater restrictions on eligibility rather than efforts to narrow differentials in benefit rates, if immigration proves costly for fiscal outlays (witness recent efforts in California and even at the federal level in the U.S.). In aggregate terms however, such competitive pressures may also limit the ability of governments to curtail certain types of expenditure programs.

B. Identifying the “Core” functions in the fiscal structure

In terms of **expenditures**, it is easy to assert one’s professional instinct that there is a core of government functions which should be “outside” the scope of fiscal policies used for responding to macroeconomic pressures, but it is more difficult to define this core. The extensive literature on the responsibilities which appropriately inhere in government is well known. Those goods and services involving significant externalities, “public goods,” and redistributive functions would dominate any list. Most public finance analysts would include among public goods the provision of law and order, external security, the executive, legislative and judicial branches of government, the administration of market regulatory functions, and certain types of public infrastructure. Significant externalities accrue in the provision of primary education, public health immunization, and environmental regulations. Beyond the role that governments play in substituting for

²⁶ Andersson (1995), p. 103.

absent insurance markets, equity considerations obviously play a role in justifying many kinds of transfer programs. Interest outlays are by definition core contractual obligations of the Government at any time, although an obvious target for containment through a sustained reduction in government debt.

Countries obviously have different views on which of these functions are perceived as critical "core" activities (for instance, the extent to which redistributive actions are seen as socially necessary) and on the qualitative and quantitative levels at which the government should provide different services. Attempts at definition are rendered more complex when one considers less the functional attribute of an expenditure and more the process by which a public service is produced, the terms on which transfers are provided (eligibility requirements, benefit levels), and the way in which the government, as a producer, purchases goods and services in product and factor markets. Recent public sector reform efforts in such countries as New Zealand, Australia, and the United Kingdom have even sought to redefine the basis of the public sector's role and the way in which the private sector can be brought into supplying efficiently public sector functions. Thus, there may be agreement on what constitutes "core outlays" and yet significant differences as to how such core outlays are to be produced or the level at which core redistributive transfers should be provided.

Such differences may allow for a significant margin in defining core expenditures, thus giving some flexibility to a government in determining how it protects the core expenditure areas while using fiscal instruments to respond to macroeconomic imbalances. Examples would include the government's policy toward civil service compensation (including adjustments for productivity and inflation, generosity of civil service pension system benefits, and nonwage compensation); the degree of indexation provided to public and private pensioners; and the role played by privatization, deregulation, and contracting-out.

To summarize, the concept of "core" expenditure responsibilities is not immutable. Ultimately, governments must assess the opportunity costs of accepting adjustments to the

core, either in terms of the included goods, services, and transfers or in the nature of the processes by which such services or goods are produced or delivered.²⁷ What becomes important, in an open capital environment, is that governments actively consider and identify those elements in the expenditure structure (including its internal production function and transfer policy regime) which should not be subjected to significant macroeconomically induced swings. Moreover, it is best that the defining of what is the core should not be determined by short-term macroeconomic considerations.

On the *revenue* side, the issues involved in defining the core are somewhat different. The taxation of some forms of income and of goods and services are more likely to give rise to greater allocative distortions or excess burdens than others. Notably, these would include taxes on factor services (labor and capital), excise taxes on goods with relatively elastic demand, tariffs on imports, and export taxes. We have argued that those types of taxes, which have significant efficiency effects (both intratemporally and intertemporally), should be least exposed to adjustments dictated by external macroeconomic pressures; they should be relatively stable and time consistent.

As discussed, a subset of such taxes, notably taxation of capital incomes, is particularly constrained by competitive pressures in an open capital environment. The tax rates feasible for others (income taxes, import tariffs, and excises on goods in elastic demand) are constrained by the need to limit

²⁷ It is also useful to note the conflicting pressures that may emerge as authorities seek to define core expenditures in a situation where the revenue structure become more and more constrained. To the extent that it is perceived that labor incomes bear an increasing burden of taxation, the importance of a perceived link between expenditures and revenue becomes more critical. Justifying high tax rates on labor income requires a perception by the taxpayer that such taxes are matched by adequate publicly provided services and benefits; tax evasion emerges as a problem when this link is viewed as tenuous. Yet it is precisely those "core" functions which are labeled as "public goods" for which the link between taxation and direct benefit to the taxpayer is least obvious. Thus, an effort to concentrate on what might be traditionally defined as the hard core of public output may in fact prove most difficult to finance in terms of taxpayer compliance.

excess burdens, and to a lesser extent, by competitive considerations. Such constraints may be politically unfortunate, in that they may limit the extent to which those taxes most relevant for achieving redistributive objectives can be dedicated to these goals. Nevertheless, these constraints suggest that the aggregate yield from so-called "core" revenues will essentially be dictated by the opportunities for broadening the tax base of these taxes and by the rate levels consistent with these constraints. Thus, in effect, one is left with a few, albeit important, tax bases which can be considered as relatively "adjustable" (e.g., sales taxes and certain excises) outside the core and potentially adjustable in response to macroeconomic pressures (see below).

A final consideration regarding the modification of the structure is the question of whether the authorities can reduce the degree of endogeneity in the response of fiscal revenues to capital flows. The most important revenue which is directly endogenous would be tariff receipts. This would suggest the importance of reducing the relative importance of tariff revenues in total revenue, in order to reduce overall revenue sensitivity to significant shifts in import flows. This will be particularly relevant if volatility in flows is matched by significant shifts in imports of consumer goods.²⁸ Any other taxes closely related to capital flows, such as stamp duties or bank transfer taxes, should also be minimized.

C. Fiscal policy responses with limited impact on fiscal structure

Since fiscal policy instruments will need to be used at times in response to a significant shift in capital flows, the issue then is to identify those instruments which will distort the fiscal structure the least.

²⁸ While this issue has proven particularly important in some Latin American countries, this issue may become increasingly less relevant as countries move to open up their trade regimes (at least in the context of regional trading blocs).

Fiscal policy instruments that least impinge on the fiscal structure

A number of fiscal instruments are available which, while not changing the level or structure of revenues and expenditures, may affect their timing during the budgetary year, the way in which the fiscal accounts are financed, and the form and location of government asset holdings. Specifically, since governments can exert discretion on the timing of some expenditures, they may be deferred until later in the fiscal year if a capital shock arises, but is expected to be reversible. Accelerating revenue collections is typically more difficult for most types of revenue, since it would require changes in collection procedures. Only in extraordinary circumstances would one be able or wish to make such changes in response to a capital shock. However, one should note that several industrial countries have devolved the capacity for such a policy, having introduced systems for more closely aligning the accrual of tax liabilities with tax payments.²⁹ Movements in the opposite direction are easier, particularly on the expenditure side, by accelerating expenditures. Less desirable, though obviously an option, would be a delay in the collection of taxes.

Shifting the locus of government bank deposits between the commercial banking system and the Central Bank may also prove a mechanism for adding or withdrawing liquidity from a financial system in situations of significant capital flows. Also, the way in which the government manages its debt maturity structure (including the currency in which the debt is denominated), as well as the way in which current budget deficits are financed, may influence the yield curve and thus affect the likelihood of capital flows into or out of the country.³⁰ Longer term financing (particularly if externally

²⁹ For example, in the U. S., advanced payments systems have been introduced to provide for weekly or fortnightly payments by enterprises of payroll taxes and withheld income taxes. The frequency of required payments of VAT can be increased, though this may give rise to administrative complications.

³⁰ See Calvo (1995) for an examination of the pros and cons of different debt mixes in this context. In particular, he notes the dangers associated with excessive reliance on short-maturity debt, since it can trigger a "self-fulfilling

rating acts as a disciplinary force) is likely to be less susceptible to sharp capital flow movements.

A strengthening of budgetary institutions and processes and enhanced transparency in budgetary operations may, at the margin, also contribute to a perception of tightened fiscal management. The effect would be to give greater confidence to the capital market that the government can meet its budget targets and will not be buffeted by significant hidden, implicit debt of unknown proportions.

Expenditure policy instruments for fiscal policy management

The types of expenditure policy instruments that are most suitable for adjustment in response to capital flows are those which can most readily be reversed. By applying stricter criteria as to which expenditures should be "insulated" as part of the core functions, the scope for such expenditure variability would become significantly reduced. This suggests that augmented revenues derived from capital inflows (either indirectly via higher tax returns or directly from financing for investment projects) should be used to finance noncore expenditures which can be quickly curtailed as needed and with significantly lower opportunity cost, in the event of a sharp reversal of capital flows and associated diminished receipts to the budget. Keynesian "off-the-shelf" projects of limited duration and size are of this type (though it is questionable whether this was ever, in fact, a realistic perception of how productive investment projects are developed and implemented).

As noted above, the scope for flexibility may arise largely in the way in which core activities are produced, in how the government behaves at the margin as a purchaser of goods and services in the market, and in the way it adjusts the terms at

speculative attack." While recognizing that extending the debt maturity can be costly, the higher premia that may be associated with longer term debt should be "a warning signal to policy makers that credibility is slim." (p. 16). He also notes that foreign holdings of short-term public debt are particularly volatile, and it may be advisable to endow such debt with characteristics that make it somewhat unappealing to foreign holders.

which transfers are delivered in the context of inflationary developments. For example, this includes the pace at which certain fiscal outlays are adjusted for productivity (e.g., civil service wage rates) or inflation (in addition to wages, other public sector benefit payments, such as pensions), recognizing that ultimately some catching up may be necessary when a more relaxed fiscal position can be accommodated.

There are alternative ways in which the choice of candidates for expenditure adjustment have been analyzed. Reflecting the strand in the literature that focuses on the macroeconomic effects of particular expenditure cuts, Schadler et. al. (1993) have argued that in periods of capital inflow, an important consideration in cutting expenditure is the extent to which spending items are concentrated on traded or nontraded goods. During capital inflows, cuts in outlays on traded goods would further add to pressures for a real exchange rate appreciation; thus, cutbacks in nontraded goods would be preferable to achieve fiscal consolidation.

In contrast, cutbacks in traded goods would be more appropriate during periods of capital outflow, where a strengthening of the trade balance would be necessary. While such a distinction can reasonably be made with respect to certain types of public outlays (notably import-intensive capital projects), the categorization of many types of government expenditures in terms of their likely impact on traded vs nontraded goods may be less transparent, depending more on the nature of the consumption function of recipients of government payments. It may also conflict with the more fundamental allocation or distributional criteria which are the basis for such expenditures in the first place.

The possibility of a Ricardian offset might also affect the choice between expenditure and tax instruments. Tax increases could be offset by reduced private savings, thus partially reducing the net aggregate demand impact and the possible effect in minimizing crowding out effects.³¹ However, consolidation achieved through expenditure policies could have a similar effect, particularly if achieved by transfers or

³¹ Most empirical estimates suggest a Ricardian offset of about half.

income payments to groups with some capacity to reduce their savings rates.

Revenue policy instruments for fiscal policy management

In contrast to the revenue instruments that form part of the core, we have noted that other types of taxes are more amenable to adjustment. road based sales taxes on goods and services, such as retail sales taxes or a value added tax, are particularly powerful tax instruments that can be used for adjustment purposes, since small rate changes can generate significant revenue effects. Optimal tax theory would also suggest taxes on goods which are inelastic in demand (e.g., some excises). This also argues for the possibility of higher taxes on immobile factors. However, in a more globalized environment, the definition of "mobility" may be less obvious than in the past, limiting the possibility for increased taxation on real estate and inheritances.³² Finally, although we have noted the difficulties of capital taxation that is not harmonized with other emerging market and industrial economies, one can also recognize that such taxes can be a vehicle, albeit risky, to influence capital flows as an explicit policy instrument (a policy adopted in some Southeast Asian countries).

V. Concluding remarks

The aim of this paper is to provoke discussion on how countries should manage fiscal policy as they move to more open capital regimes. It asks to what extent fiscal tightening should be a significant element in the policy response to capital flow shocks. It looks at the circumstances in which it is appropriate to allow automatic stabilizers to weaken the fiscal balance, rather than responding to such a weakening with further fiscal cutbacks. And it assesses the extent to which fiscal policy—or at least certain elements of the fiscal structure—should be insulated from the need for adjustment in response to con-

³² Andersson (1995), p. 119.

junctural circumstances. It is worth stressing that the paper does not dispute the necessary role for fiscal policy in situations where the fiscal deficit and public debt burden are unsustainable over the medium to longer-term. Rather, what is at issue is the appropriate fiscal response to an increase in short run capital volatility.

The shift from a closed to an open capital regime heightens the degree of uncertainty in macroeconomic management. The additional uncertainty associated with volatile capital flows implies that fiscal policies need to be formulated bearing in mind that one could observe significant inflows or outflows at any time. Both inflows and outflows may lead to calls for additional fiscal adjustment, compared with what was considered appropriate for a closed capital regime. This is particularly likely when governments put constraints on exchange rate adjustment. The "asymmetry" in the usually-recommended policy response (a cut in the fiscal deficit to reduce pressure on interest rates during inflows; and a cut in the deficit to reduce absorption to stem outflows) leads to the argument that the expected value of the appropriate fiscal stance in an open capital regime is more conservative than when capital is immobile.

This conclusion, in turn, leads to the prescription of a need for preemptive tightening as the capital regime is opened. This somewhat contentious recommendation may be supported by several broader arguments. The tighter underlying stance permits greater insulation of core revenues and expenditures from calls for frequent adjustment following macroeconomic shocks. It provides an in-built discipline to the conduct of fiscal policies; stabilizes market expectations with respect to the underlying tightness of the fiscal position and the potential swings in a country's fiscal position that are seen as consistent with prudent fiscal policy; and responds preemptively to the possibility of higher risk premia on government borrowing.

A tighter underlying stance would not preclude the need for further fiscal adjustment in the face of large and volatile capital flows. However, the required changes might be expected to be smaller. The paper argues that reducing the size of the average needed fiscal response has, in itself, important

virtues. Most importantly, fiscal policy is not well-adapted to be a useful instrument of short run macroeconomic adjustment, particularly in contrast to other instruments like the exchange rate. The components of fiscal policy—taxes and spending programs—have important economic and social objectives which could well be compromised if large quantity adjustments are demanded at short notice. In the same vein, many fiscal variables are difficult to manipulate flexibly in the short-run, with the result that fiscal interventions can involve high transaction costs and create distortions in resource allocation. The consequence of both these problems is that a response to capital flows using fiscal instruments may generate a cumbersome, slow, and uncertain economic reaction, with unintended side effects and substantial domestic costs.

If a fiscal response is judged unavoidable, the paper suggests that some components of fiscal policy are easier to manipulate and are more effective, and create fewer distortions than others. In particular, revenue-raising through sales taxes and excises is likely to be relatively successful, while expenditure cuts could best be focused in areas directly linked to the capital flows (such as investment projects). To limit disruptions to core revenues and expenditures, it may also be possible to manage adjustment through judicious timing of leads and lags—delayed wage adjustments to productivity or inflation, within-year rephrasing of expenditures, and changes in the government's financial portfolio (or even in the way the portfolio is managed).

The paper also emphasizes that the shift to an open capital regime adds considerable complexity to efforts to get a true reading of the actual stance of fiscal policy. This underscores the need, in the globalized economy, for greater transparency and clarity about the "fiscal rules" that govern the fiscal stance, the nature of the fiscal policy response to capital flows, and the actual fiscal position, in order to ensure that international capital markets correctly perceive the conduct of fiscal policy.

Finally, as many analysts have already noted, a more open capital environment imposes constraints on the type of fiscal structure that is sustainable. To account for these constraints appropriately, governments should use the opportunity of a

move to an open capital regime to reevaluate their expenditure and revenue policies, and identify those "core" elements in the fiscal structure which should not be subjected to significant, macroeconomically-induced swings. Such an exercise will also facilitate identification of the types of fiscal variables which *can* be used to respond, as needed to capital flow shocks.

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Opening speech to the annual Conference of the Institute of Municipals Finance Officers of South Africa

Hennie Venter*

Honoured guests, ladies and gentlemen.

1. Introduction

Welcome to the 1997 IMFO Conference. We live in a beautiful country with even more beautiful people where our strength lies in our diversity. We must nurse the new born baby, feed it with love and dedication so that it will become and remain an international role-player to be reckoned with at all times. In my paper, the following subjects will be addressed in brief:

- an evaluation of municipal financial administration,
- present policies and new legislation,
- economics,
- models of local government,
- the role of IMFO, and
- the 1997 Conference.

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During the past five years I have read widely and spent many hours doing research, discussing issues and philosophies in order to seek solutions and answers to the challenges of local government in a new South Africa with specific reference to the financing thereof. This paper will include some of my own ideas as well as the ideas of other people with the basic aim of setting the scene for our conference.

2. Evaluation of municipal Financial Administration

Local government administration and service delivery are based on the 1948 apartheid inequalities and malfunctions. Democratic and functional transformation of this sphere of government therefore requires more than merely setting in place a new vision and order. A total transformation is needed and that is the main aim of the interim phase until 1999. (DBSA, 1997).

We have not reached that point yet and as our President, Mr Nelson Mandela has put it: "We must roll up our sleeves higher and work harder."

Our local government financial administration is not keeping up with the challenges of the day. The needs in our community are high and the financial resources are very limited. The fact that local government generates 90% of its own income sounds healthy, but with outstanding debtors of some R7,9 billion, payment levels 70% on average, leaves us with a cash shortfall of \pm R8 billion per annum. Up to now, these shortfalls are financed by available reserves and short term loans, which are almost non-existent. In actual fact, some local authorities are using capital funds to finance operating expenditure. This is a totally unacceptable situation and in any administration or business, it is a recipe for financial disaster. (Project Viability - June 1997).

However, needs and expectations are higher than ever and let me immediately say, in some cases, unrealistic needs and expectations in too short a period of time. We therefore need realistic long term plans and strategies in order to meet the needs and to finance those services in a sound and affordable manner where our politicians and the community, supported

by an effective administration, are equal partners. Only then, the high expectations in the short term will become workable service delivery in the long term.

The role of the private sector in municipal service delivery is now more important than ever. This will not be without a price. Higher investment with a lower rate of return on capital, is the price shareholders must be prepared to pay for at least the next decade. Long term strategies should however ensure acceptable profits will still be made.

Mr Chairman, I do not want to elaborate too much on this subject as some of our speakers will address it in much more detail.

In conclusion on this section, I wish to say that we must come to terms with the real meaning of working smarter with our limited financial resources.

The following questions could assist in future discussions:

- Are we as Financial Managers and Councillors in local government responsible for policy, geared for these challenges?
- Are our accounting systems capable of providing the required information to assist in planning?
- Have all income resources been maximally exploited?
- How can we work smarter in order to deliver affordable municipal services?

The name of the game in municipal finance at present is cash-flow management and there is a lack of real cashflow management tools. If we cannot change income Rands into service Rands, manage the available Rands and most importantly, collect our dues, service delivery in South Africa will be unacceptably slowed down and National Government's policies will not be executed.

Minister Trevor Manuel, put it as follows on the 11 August 1997: "Whatever policies we adopt, we must ensure that all spheres of government are committed to implementing these policies. More importantly, we must ensure that all spheres fully understand the reasons why such policies have been adopted. The danger with a three-sphere system like ours is that each sphere begins to adopt a rather narrow and one-

sided perspective; worse still is a situation, where each sphere implements policy in a half-hearted manner because it does not feel fully committed to that policy.

This brings us to the hard bit. Since no sphere can exist or implement policy without the necessary finances, the financial policies of the government play a central role in ensuring that we deliver on our RDP objectives. Given the 300 years of deprivation, there is a huge demand for limited funds, forcing us to prioritise and phase in our policies in a considered way so as to ensure that we maximise delivery to as many of our people as possible. In this sense, it becomes a crime to waste funds, or to overestimate our capacity to spend and therefore hold on to funds which one department cannot spend when another department could do so.”

3. Present policy and new legislation

Whatever the politicians decide that the staff have to implement, must always be directed in terms of government policy. Therefore, I wish to highlight the core policies:

- The Constitution.
- Reconstruction and Development's six principles
 - an integrated and sustainable programme
 - a people driven process
 - peace and security for all
 - nation-building
 - ink reconstruction and development
 - democratisation of South Africa
- Masakhane's "Lets build together" through partnership service delivery, development, payment for service and monitoring.
- Growth, Employment and Redistribution policy.
- The Development Facilitation Act with its basic aim to integrate development.

Mr. Chairman, I will now touch on some aspects of the above-mentioned policies:

3.1 The Constitution in an Act of National Government and indicates the objectives of what the country wants to achieve. The restructuring that can take place and the instruments that can be used in this restructuring are prescribed in this Act. Applicable to our conference, the following are provisions related to local government fiscal autonomy and intergovernmental fiscal relations.

The Constitution recognises local government as an independent "sphere" of government, equal and not subordinate – in status to the provincial and national spheres. Municipalities have extensive responsibilities in respect of the development and operation of the services for which they are ultimately accountable. In respect of fiscal and financial arrangements, municipalities are responsible for their own financial affairs and have considerable powers of taxation and borrowing. The Constitution limits the taxing powers of municipalities in two ways: municipal taxation cannot "unreasonably prejudice" national economic policies and activities, and municipal governments may not levy income taxes or general sales taxes. Borrowing powers are limited only by the requirement that borrowings may not fund budget deficits, thereby imposing an effective constitutional prohibition on deficit budgeting at the local level.

Intergovernmental fiscal relations are addressed in the Constitution in two broad respects:

- intergovernmental transfers and,
- oversight and regulation of the financial affairs of municipalities.

With respect to intergovernmental transfers, the key clause of the constitution is Section 227 (1)(a) which entitles the local government sphere to an "equitable share" of nationally raised revenue in order that it may "provide basic services and perform the functions allocated to it". The central point here is that the "equitable share" is determined by considering the gap between local fiscal capacity and local fiscal needs, and agreed rules will have to be arrived at for measuring this gap and the extent to which revenue raised nationally will be made available for this purpose.

The Financial and Fiscal commission was appointed to investigate and make recommendations related to intergovernmental fiscal relations to Government. A comprehensive report was published at the end of July 1997 where the principle of vertical and horizontal equity is discussed and recommendations are made on three types of grants to local authorities namely:

- a capital grant addressing infrastructure backlogs,
- a revenue sharing grant to subsidise those households who cannot afford to pay for services and,
- an equalisation or tax capacity component that includes the two basic grants.

The document is a discussion document and local authorities should make every effort to study its contents and give comments thereon.

3.2 Masakhane is not only about payment for services, it is more focused on the quality of life for all people. There is a general awareness of the campaign but political groupings misuse this campaign for political gain. A weakness of the project is the failure to address the payment for services used by the poor.

3.3 GEAR underpins the RDP and is essentially the alignment of policies at a macro level in order to create a set of goals which are linked closely to the following four objectives:

- a competitive fast growing economy which creates sufficient jobs for all work-seekers;
- a redistribution of income and opportunities in favour of the poor;
- a society in which sound health, education and other services are available to all and,
- an environment in which homes are secure and can be places of productive work.

Much criticism has been levelled against this policy and the projected growth figure of 2,9% for this year, has now been revised as being not more than 2%.

3.4 The Development Facilitation Act is a new law which puts in place a system to speed up the development process in South Africa, and hence delivery of the RDP. The DFA also provides a new policy framework for integrated development. After the 1994 elections, it was realised that existing planning and development laws in South Africa did not allow for the effective implementation of the RDP. There were about 17 different procedures for approving developments in the country - different processes were followed in each of the old provinces, and in each of the so-called bantustans. This led to delays and confusion. Applications to develop projects could take as long as three years to be approved. This was an unfriendly development environment. The DFA therefore provides a single and clear national process for approving development with:

- a faster mechanism for obtaining approval;
- a new policy framework for integrated development.

For the first time in the history of this country, government has made an earnest and sincere attempt to entrench sensible integrated development planning in legislation. A key component of this integrated development planning approach is to link annual planning cycles with annual budgetary cycles. Although this makes perfect sense, the absence of such an approach in the past can only be attributed to the fact that real development was not a priority for past regimes. In an ironic sense, "enriched" with the experience of the past, the present government has entrenched sensible planning practice in legislation.

If one studies the regulations of the DFA and its application for example in Gauteng, it is evident that the intention is to enforce integrated development planning and to reconcile annual planning cycles with annual budgetary cycles. The whole focus is not only on developing operational strategy by involving all concerned stakeholders, it is also on ensuring that the dreams and visions of our (previous disenfranchised and deprived) people can be translated into deliverable services by ensuring that such services are supported by appropriate and affordable financial plans.

The DFA compels us to move out of the "silo mentality" of thinking in boxes. This need to think across departments at a

local authority level, instead of within the stifling "boxes" or "silos" of traditional departments, forces us, for the first time to address the needs of our communities in a holistic and integrated manner, thereby striving to create a balance in service delivery.

In addition to helping achieve a balance with regard to the provision of effective and efficient service delivery, the DFA also serves to materially support our government's RDP, Urban Development Strategy and other national policies and legislation that are aimed at rapid service delivery. A significant and enabling part of the DFA are the LDO's.

The Chapter 1 principles in the DFA cover broad issues for integrated development such as linking housing to jobs, sustaining the environment, integrating social, economic, institutional and physical aspects of development, etc.

LDOs are an important new issue. LDOs are local 5 year development plans prepared by each local area. The local authority is responsible for preparing LDOs in conjunction with other local stakeholders. LDOs must cover:

- Standards of services (transport, water, health, education, etc.) that will be provided in that area.
- Development objectives in the area: how low-income communities will be integrated, what transport is planned for, what infrastructure is to be provided, how natural resources will be used, etc.
- Development strategies for achieving the objectives including involvement of all economic sectors in development, access to finance, administrative structures, etc.
- Development targets: concrete development targets against which performance can be measured.

When completed, the LDOs are submitted to the Provincial Government for approval. In cases where a local government cannot or will not prepare LDOs, the Provincial Government can do it for that area.

One of the biggest challenges for local government financial administration, is to develop a integrated financial plan in terms of appropriate legislation that is affordable for both the local authority and the community it serves. Such a plan

should cover a five year period and should spell out the macro financial strategies that will support the LDOs.

3.5 Drafting new legislation to replace the existing four sets of ordinances and outdated Acts, seems to be well underway. The so-called White Paper process intends to address the appropriate issues. If one studies the draft Finance Chapter, it has however, still a long way to go.

Provincial Government also started to introduce their own legislation on local government and everyone is looking forward to the day when volumes and volumes of legislation will be replaced by a new streamlined document.

4. Economics

Although the inflation rate for the previous year was the lowest in 24 years, i.e. 7,4% it has slowly risen in the middle of the year to a new height of 9,8%. Economists foresee an average of 8,7% for this year with a national growth figure of 3% for 1998. In order to achieve these figures, I wish to say something about local economic development (LED).

The aim of LED is to establish and implement a strategic plan that is aimed at building or restructuring our local economy. Some elements of LED will be to:

- promote employment creation by building quality jobs on a sustainable basis;
- enhancing the local tax base;
- mobilising resources for these purposes: the resources will be from the private sector, public sector and from the community;
- training and capacity building;
- improve the local government's ability to provide services;
- create an investor-friendly environment;
- build economic stability, and
- provide a data base of what is available in this regard in the area.

In terms of the Constitution of South Africa, one of the objectives of local government is to promote social and economic development. This object is further translated into a developmental duty of local government: local government must structure and manage its administration and budgeting and planning process to give priority to the basic needs of the community, and to promote the social and economic development of the community.

The Local Government Transition Act (Second Amendment, 1996), gives content to the economic development objective and developmental duty of local government. The Act (in Schedules 2 and 2A) identifies the promotion of integrated economic development as a power and duty of metropolitan councils. This must be done within the context of the Integrated Development Planning Framework.

In general, local government collects over R40 billion annually in rates, user charges and fees. They employ thousands of people. They purchase goods and services, invest in capital projects and pay salaries amounting to billions of Rands. In many cases they determine the price and quality of our water, electricity and roads and they control the use and development of land. In parts of the country they own substantial tracts of land. They set the agenda for local politics, and the way they operate sends a strong signal to their own constituents, prospective immigrants and potential investors.

These traditional powers and responsibilities alone give local government a very great influence over our social and economic well-being. What's more, the new Constitution mandates local government to promote the social and economic development of their communities. This new mandate is spawning a new generation of local policies and programs, aimed specifically at job creation and poverty alleviation. These range from local marketing and business promotion to community development and partnerships. The basis for all local government initiatives around local economic development must therefore be national policies and legislation. (D.C.D. - 1997)

Some of the key national policies and legislation that empower local government to become involved in local economic development are:

- Reconstruction and Development Programme;
- service delivery (in terms of the Constitution);
- promotion of social and economic development and,
- co-operative governance.

Allied to the above, there has to be a consideration of the tools that are required to build an LED strategy. Some of these tools are:

- compacting cities;
- education and training;
- industrial networking and modernisation;
- building local government capacity, and
- redevelopment.

A challenge in this regard will be to increase the per capita incomes of the poor so as to reduce the income differential amongst our communities. One way of addressing this challenge is to broaden the economic base of local authorities.

In order to obtain additional cash, local authorities will have to seriously re-think their investments in some of their assets and identify those that could be sold. Some of these assets are:

- open land such as parks and industrial land;
- expensive high specialised equipment;
- loans to staff;
- staff-housing, and
- municipal workshops.

In order to do this, assets with a market value should be re-valued and brought into their books at market value.

The restructuring of the electricity supply industry in South Africa is now a given fact. The total nett saving for the consumer has not been calculated yet and I would like to see such a calculation. The possible transfer of this service should be well managed to ensure that service delivery will not be affected. The possible transfer of staff and the support administration needs to be well defined. Treasurers should therefore, before 30 June 1998, ring-fence the electricity

account, identify all assets and liabilities and ensure that the prescribed NER - tariff structure is introduced.

5. The different models of local government

The present models of local government in south Africa still need investigation and debate. After almost three years in the interim phase, it may be a bit early to readily evaluate, but it is a fact that local government has not performed as to our expectations. I wish to quote from a document prepared by Dr. Mathole Motshekga (Gauteng Legislature):

"Local government in both urban and rural areas faces certain common problems. Under apartheid there were about 800 local authorities. The interim local government system did not rationalise these structures; instead it even created additional local authorities that were not viable from their inception. Thus, even before the expiry of the term of office of the first democratically elected councillors, the need has arisen to rationalise the number of municipalities and councillors.

According to the White Paper Discussion Document, there are too many municipalities, and there are also problems with the size of councils, their demarcation and the cost of maintaining the present system. Already some councils are reported to be on the brink of collapse. There is, therefore, an urgent need to address the following issues:

- the number of municipalities;
- the number of councillors or size of municipal councils;
- the effectiveness of local democracy under the interim local government system;
- the financial viability of interim local government structures."

The new local authorities are still struggling to establish amalgamated administrations, including uniform policy, process and procedures. Bookkeeping systems still do not provide for amalgamated administrations and the Schedule 2 and 2A functions in metropolitan areas are still not appropriately finalised.

Ladies and gentleman, I am worried that the present models and boundaries of local authorities will be changed whilst the (financial) administration has not yet executed the current policy. Once again, service delivery will be seriously influenced and our communities will be the suffering party. Staff and politicians are over burdened with the workload of all the new plans and too often, plans are still in a file and not implemented.

Another important aspect under this heading is the devolution of functions to local government with specific reference to health, policing, and housing services. From time to time one gets the feeling that if the other spheres of government cannot make a success of delivering a service, it will be given to local authorities as an agent or possibly, full operation without the necessary funding. Local government neither has the capacity nor the funding to do this and Councillors and Officials should always ensure that the devolved function is fully funded.

6. The role of IMFO in local government

IMFO is a professional body that was established in 1929. The Institute is registered in terms of Section 21 of the companies Act and is an Association Not for Gain.

The Institute aims to protect and promote the interests of the profession of municipal accountants and the finances of local government in general. The Institute:

- renders expert advice to statutory and non-statutory bodies;
- establishes control over academic education and practical training of people in the profession;
- preserves and maintains the ethic and status of the profession and combats unethical behaviour and actions;
- extends accountability and transparency of local government finance to the public;
- compiles, publishes and distributes guidelines regarding local government finance and accounting;
- presents workshops, seminars and conferences on matters relating to local government finance and accounting where members can exchange views and experiences.

The Institute is managed by a Council with a Management Committee that obeys the conditions set out in the Companies Act and the Institute's Constitution. The Council is elected annually and consists of a President, Vice-President and the Honorary Treasurer as well as a number of additional members who represent all nine provinces of South Africa.

The Institute Council is supported by six specialist standing committees, nine provincial branches and a wide spectrum of working groups, interest groups and individual members countrywide. The six standing committees are responsible for:

- communication and members matters;
- administration and commercialisation;
- provincial branches;
- education and training;
- accounting practices and,
- research.

These committee members include municipal officials, officials from provincial and central governments, other professional bodies and neighboring countries.

To become a member one must have an academic qualification and complete the Institute's education and training programme. In order to qualify for registration for the education and training programme the prospective member must:

- be employed full-time in a financial capacity at a local or related authority;
- study in the field of local government finance and,
- register as a student at the Institute.

There are two levels of membership i.e. Associates and Licentiates: associate is the senior level as it requires a higher academic qualification. Each level can be achieved by acquiring a:

- university degree;
- technicon diploma;
- other approved qualification.

Different compulsory subjects are required for the two levels. Accounting is the most important of these. Prospective members also need to complete a structured practical training programme of three years at a local authority to qualify for membership.

Why join the Institute?

- membership is acknowledged as an appropriate academic qualification in local government finance;
- membership is a prerequisite for reaching the highest level in the profession. For example, membership is a statutory requirement for appointment to certain positions, particularly city treasurer in most local authorities;
- membership offers stimulation, professional (and personal) enrichment and the opportunity to meet members of the profession on a provincial, national and international level.

The Institute has a code of conduct to which all members must comply. Municipal Treasurers also have to comply with the Municipal Accountants Act (Act No. 21 of 1988). Literally thousands of municipal accountants were educated and trained to be municipal accountants by IMFO since its establishment in 1929. Currently IMFO has 887 members –all qualified as professional municipal accountants. It consists of:

- 576 Associates (the higher level)
- 311 Licentiates (introduced in 1986)
- a third level (is to be introduced during 1998)

This level, most probably called Technician, was already agreed to in principle by the Institute Council. It will enable treasury staff to become members of the Institute by completing a practical training programme. Not only will it broaden the base of Institute membership, but it will give a home to competent personnel who did not have the opportunity to study at a tertiary institution.

The Institute Council also resolved to have a re-look at the Requirements of Associate and Licentiate membership. The intention is to align ourselves to current South African cir-

cumstances and to come in line with the intended Accountancy Profession Act. Should this act be promulgated, it would be the result of an investigation by the Public Auditors' and Accountants' Board (PAAB), namely the FAESA (Future Accounting Education in South Africa). Our Institute was involved in it from the start and it still renders input. I wish to congratulate and thank the PAAB for its initiative to bring the regulation of the accounting profession under one umbrella.

One can imagine the vast experience IMFO has in its midst. At the moment 504 employees in local government finance are registered as students, i.e. persons working full-time in the treasury department of a local authority with the intention to become members. They are either busy with studies or completing the Institute's practical training programme or both.

Since 1 January 1995 a logbook system for the control and recording of the practical training of students was introduced. It is compulsory that all students undergo their practical training under the mentorship of a member of IMFO.

A full time staff of five, led by the Chief Executive, Mr Japie Bosch, supports all operations. The Institute also has ties with other professional bodies at local and international level.

The Institute is still involved with Project Viability in collecting the basic financial information from local authorities on a two monthly basis. The World Bank was requested to evaluate the questionnaire and concluded that "...in the absence of a cash-flow statement the questionnaire does a good job of providing an indirect measure of liquidity..." The questionnaire is not a credit rating, it only identifies possible problem areas to be investigated.

During the year the Institute's name was changed from "Institute of Municipal Treasurers and Accountants" to "Institute of Municipal Finance Officers". The main reason for this was:

- many local authorities do not use the term "Treasurer" anymore;
- "Financial Officer" is a better description and collective term;

- not all members are accountants and includes auditors, financial administrators, clerks, etc.

After various efforts the Institute succeeded to ensure regular publications of the SA Treasurer as from October 1997. This was brought about with the signing of a "Memorandum of Understanding" between the Institute and a British based company, Emap. This company publishes various magazines, inter alia The Local Government Chronicle (LGC) in the United Kingdom.

The LGC will be published weekly and distributed free of charge to approximately 10.000 readers. The SA Treasurer will be a monthly insert in the LGC. A full time editorial staff will attend to it. This, however, does not mean that Institute members can now sit back and wait for the publication. Contributions by members must still form an integral part of its contents. The Institute is also involved in the President's (Pres. Mandela) Special Project in the previous Transkei area where a core group of eleven people have been identified to be trained to write-up the books of local authorities and train others as well. Almost all the books of the local authorities in that area are written-up to 30 June 1996.

The Handbook for Municipal Accountants has been compiled and is available as from June 1997. All local authorities must have this and it will assist in tasks such as:

- preparing annual financial statements;
- investments;
- cost accounting;
- etc.

An investigation on municipal accounting and financial reporting is currently under way, the outcome of which could be as early as this year.

The Institute is further assisting in revising current and drafting new legislation and will play a role as stakeholder in the electricity restructuring process. The Institute has an important place as a professional umbrella body of local government finance. Many bodies rely on the expertise in our midst and it is the task of Institute members to give their

assistance. State Departments and related committees as well as Provincial Governments are increasingly requesting the Institute's views and comments on local government finance. It is in the national interest that the Institute plays a constructive role in this regard.

On behalf of the Institute, I am thankful for what has been achieved in my term of office. I want to express my thanks to the Institute Council, Standing Committees and Institute members for making possible –to summarise– the following:

- The change of the Institute's name: for practical reasons;
- The rebirth of the SA Public Treasurer: to communicate and share ideas;
- The issuing of the Handbook for Municipal Finance Officers: to become more professional;
- The establishment of a new basis for membership requirements: to bring all competent financial personnel under our umbrella;
- The increasing recognition of the Institute's professionalism and expertise: thus, enhancing the profession and
- The establishment of a sound and independent secretariat: to serve our objectives.

I am convinced that South Africa would be poorer without the IMFO. It's national importance may not be underestimated. We serve and we will continue to serve, because its our mission.

7. Conclusion

The 1997 Conference is structured in such a way that at the end of the conference, delegates will:

- understand Government's policy on service delivery;
- have a better understanding of financial options;
- have a better understanding of partnerships in service delivery;
- be equipped with tools to assist in the decision making process and hopefully, use the time to interact with col-

leagues and friends, discuss the issues of the day and also, have an enjoyable time.

I wish to thank Durban Council for their hospitality, as well as delegates for attending, all the speakers for their presentations, my Khayalami Council for giving me the opportunity to spend time on the Institute activities, the Institute Council for their support and specially, the Conference Secretary and his staff and the institute CEO and his staff. Thank you for a job well done.

My Creator for talents given: being human we are not perfect, being committed, we will do our best!

I thank you.



**IMPRESO POR
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