COORDINATION, COOPERATION AND CONTROL WITHIN DECENTRALIZED FISCAL SYSTEMS

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CONTENTS

PREFACE ................................................. 5
ABSTRACT ............................................. 7
INTRODUCTION ........................................ 9
I. BASIC PHILOSOPHIES OF COORDINATION AND COOPERATION IN A FEDERATION ............................................. 13
   1. General remarks .................................... 13
   2. Central versus decentralized government .......... 14
   3. Competing governments ................................ 15
   4. Vertical federalism: assigning exclusive responsibilities and revenue .................................. 16
   5. Horizontal federalism: procedural division of public functions ........................................... 19
   6. The functional tradition: earmarking and special funding .................................................. 20
II. COORDINATION MECHANISMS FOR INTERGOVERNMENTAL RELATIONS ............................................. 23
   1. Who should coordinate? ................................ 23
   2. What should be coordinated? ......................... 25
   3. How should be coordinated? .......................... 30
III. THE ALLOCATION OF FISCAL REVENUE .................. 35
    1. Tax assignment ....................................... 35
    2. The scope for decentralized taxation ................ 42
    3. The primary distribution of resources and vertical fiscal balance ....................................... 43
    4. The secondary distribution of resources > equalization .................................................... 45
IV. COORDINATION OF BUDGETS IN MULTILAYER GOVERNMENT .............. 49
    1. Budget autonomy and budget surveillance ........ 49
    2. Formal budget coordination principles ............. 50
    3. Monitoring the level and structure of public debt ............................................................ 52
    4. Monitoring the framework of public budgeting and control .............................................. 54
V. A EUROPEAN’S VIEW ON FISCAL DECENTRALIZATION IN LATIN AMERICA .............. 57
   1. Expenditure assignment ................................ 57
   2. Tax assignment ........................................ 58
   3. Discretionary tax policy ................................ 59
   4. Readjusting vertical fiscal imbalances ................ 60
   5. Regional apportionment of shared taxes ............ 61
   6. The grants system ...................................... 62
   7. Horizontal equalization ................................ 64
   8. Capital Expenditures .................................. 66
   9. Information ............................................ 67
NOTES .................................................. 67
REFERENCES .......................................... 77
PREFACE

The Fiscal Policy Series has the purpose of disseminating the results of the activities developed by the ECLAC-UNDP Regional Project on Fiscal Policy and by the ECLAC-GTZ Regional Project on Fiscal Decentralization. Both projects operate under close coordination and have objectives and activities covering many topics related to the public finances and fiscal policy of Latin American Countries.

The present paper was prepared in the course of the joint ECLAC-GTZ Regional Project on Fiscal Decentralization, in order to analyze the theoretical background of the coordination, cooperation and control with decentralized fiscal systems generating important recommendation for the latin american countries.

In its hoped that this issue of the Fiscal Policy Series will provide a better understanding of this matters -as well as towards a wide dissemination of the results here presented-among authorities responsible for the formulation, design and implementation of fiscal policy, as much as among all those, within the public and private sector, interested in the broad of public finances.
ABSTRACT

The theory of fiscal federalism makes a strong case for decentralizing government functions in order to enhance efficiency in allocating public goods where preferences differ among regions. Under political considerations, decentralized collective decision making fosters social and political cohesion at the level of the nation states by protecting minorities, by strengthening the accountability of politicians, and by mobilizing citizens through greater participation at the local level. Federalism respects different cultural and individual traditions among regions, and it emphasizes local diversity. Federalism thus reflects the regional dimension of democracy.

Many developing countries have adapted federal constitutions (Argentina, Brazil, Mexico), some are on their way (Colombia), and even unitary states have typically devolved certain government function (education, health, local services) to regional bodies and municipalities (Chile). Recently, the option of engaging resources through the devolution of state powers and greater use of local tax potentials has found increasing attention.

The present paper intents to demonstrate, based on the example of more mature federations in the industrialized world, that there is scope for decentralization without excessive risks for public decision making or the loss of macroeconomic control. There are various forms of informal, institutional and procedural coordination mechanisms designed to monitor and control public budgets, and there are implicit or explicit constraints to public borrowing and debt at subnational levels. Furthermore, there are attempts to cooperate among governments through framework legislation of the central government, through semi-autonomous institutions, and through economic incentives (for instance through the grants system). Such institutional provisions and procedures will be examined in view of their general applicability, and in relation to the political, social and institutional conditions prevailing in developing countries.
INTRODUCTION

The theory of fiscal federalism makes a strong case for decentralizing government functions in order to enhance efficiency in allocating public goods where preferences differ among regions. Under political considerations, decentralized collective decision making fosters social and political cohesion at the level of the nation states by protecting minorities, by strengthening the accountability of politicians, and by mobilizing citizens through greater participation at the local level. Federalism respects different cultural and individual traditions among regions, and it emphasizes local diversity. Federalism thus reflects the regional dimension of democracy.

Many developing countries have adapted federal constitutions (Argentina, Brazil, Mexico), some are on their way (Colombia), and even unitary states have typically devolved certain government function (education, health, local services) to regional bodies and municipalities (Chile). Recently, the option of engaging resources through the devolution of state powers and greater use of local tax potentials has found increasing attention. This is partly explained by successful development strategies based on regional rather than national initiatives (China). It is also nurtured by supranational institutions like the European Union and the forming of regional economic groupings (Mercosur, APEC) whereby the relationship between sovereign nation-states and supranational competencies can be expected to play a crucial role for political, economic and social developments.

While the benefits of decentralized government are usually unquestioned (see, however, Tanzi 1996), the multiplicity of government functions raises substantial problems of coordination and cooperation among public authorities. The interactions of various agents and institutions within government are sufficiently complex even for "unitary" governments and have been studied from various angles. On the one hand, the institutional approach - with a long philosophical tradition - emphasizes the need for self-sufficient government entities with clearly defined policy objectives whereby coordination is effected through interagency negotiations. This would ultimately lead to a comprehensive system of checks and balances within government. This idea stood at the cradle of parliamentary systems when public decisions became subject to the control of voters, and of modern constitutional democracies with their institutional division of powers. On the other hand, public-choice theorists have often stressed the importance, for public decision making, of particular interest groups, of parties and politicians, and of bureaucrats. And they are skeptical as to the checks-and-balance approach to controlling government through institutional design.

If anything, they emphasize control through voting whereby decentralization plays the role of rendering politicians more accountable to their citizens (Mueller 1989), including "voting with one's feet" (Tiebout 1956) as voters have the option to leave jurisdictions that
do not conform with their preferences for public services. Coordination of public agencies within government -- among the executive, the legislative, the judicature, and the administration -- is further complicated in a multi-government framework where different authorities interact which are more or less autonomous and accountable to their respective constituency. The focus of this study is on the latter type of coordination problems.

Coordination within decentralized forms of government means the attempt to commit policies at all layers of government to a common cause or objective. If the objective is national or global, the central government will typically guide such policies and play a leading role in the coordination process. Where the constitution attributes clear competencies for national policies to the central government, the principal-agent model may serve to describe the coordination process. The central government as the principal defines the objectives which are implemented through agents - local authorities. While the gains of lower tiers of government are immediate, the central government may reap informational advantages through its agents that are closer to pending political problems.

In this framework, local agents are accountable to the central government, not to their constituencies. While such models are useful to analyze intergovernmental relations especially in the horizontal model of federalism described below-, there are clear limitations where national and local goals are in conflict and local authorities are accountable to their taxpayer-voters at the same time. In this case, coordination must respect the autonomy of lower tiers of government, and eventually be restricted to information exchange among governments where the aim is to reach consensus and compromise.

Where authorities freely establish coordination mechanisms the outcome of which they consider binding for their actions, we shall speak of cooperation. Cooperation is often found at the horizontal level among lower-level governments where there are regional spillover of policy actions. For instance, two or more municipalities may pool their resources in order to build local infrastructure that is jointly used.

Cooperation is, however, also found among jurisdictions at different layers of government as long as participants feel the need to coordinate their actions for the sake of a longer-term maximization of welfare. Such cooperation, since more permanent, usually takes the form of joint-decision making and cost sharing within coordinating bodies or institutions. The German "joint-tasks" (e.g. for the construction of universities) may serve as an example of such cooperation. Where institutional cooperation in decentralized government plays a prominent role (Switzerland, Germany), one also speaks of "cooperative federalism".

The term "control" is rather ambiguous and may signify either formal surveillance of government agencies through a central authority or special institutions (like in the case of auditing budgets), or the rigorous pursuit of a principal's policy goals with the aid of fully accountable agents (as for "functions by order" in the terminology of Krause-Junk/Müller (1996). In this paper, the term "control" will mainly be used in the sense of surveillance, but exceptionally the more stringent interpretation will also be employed.
The rigorous version applies, for instance, to macroeconomic control at the national level. Macroeconomic control is a prerequisite for stable and sustainable economic development throughout the nation, and this function is typically attributed to the central government. But this function may be undermined in decentralized government by the very fact that local accountability calls not only for self-rule; but also involves independent financial competencies of lower tiers of government - including the right to borrow. Uncontrolled access to capital markets and possible mismanagement of budgets by local government may thus jeopardize efforts to stabilize the economy at the national level. However, it is far from clear that a central government would control fiscal policy more effectively than lower-level authorities. With regard to policy failures in this area, especially in Latin America, some authors even consider decentralization as an instrument to reduce government deficits by transferring responsibilities to subnational authorities which are closer to voters (Fuhr/Campbell/Eid 1995, p. 2).

Often, national control is also requested for the distribution function of government, because the decentralization of social policies would reinforce existing inequities among regions and cause policy-induced migration within a nation. This could be prevented by nationally uniform standards for social services. Furthermore, the implementation of such policies at lower levels of government would require strong regional or local administrations in order to enhance the effectiveness of providing social services - which may be costly in terms of coordination and cooperation. Central provision of social services would thus entail economies of scale in administering such policies. However, controlling distribution policies at the central level runs counter the factual experience that there is sufficient scope for interpersonal redistribution at regional and municipal levels.

The allocation of public resources is typically attributed to the lower tiers of government, but even this requires vertical and horizontal balance between expenditure needs and fiscal capacity (including grants) in order to achieve some degree of economic and social cohesion within a nation. Again, this would call for intergovernmental cooperation and control whenever the national government wants to interfere in order to mitigate horizontal fiscal imbalances among regions or to realize national goals in a federal context. Uncontrolled decentralization of government is thus not without risk for the stability of the economy, for the effectiveness and fairness of social protection, and for the efficient allocation of public resources.

The example of more mature federations in the industrialized world demonstrates, however, that there is scope for decentralization without excessive risks for public decision making or the loss of macroeconomic control. There are various forms of informal, institutional and procedural coordination mechanisms designed to monitor and control public budgets, and there are implicit or explicit constraints to public borrowing and debt at subnational levels. Furthermore, there are attempts to cooperate among governments through framework legislation of the central government, through semiautonomous institutions, and through economic incentives (for instance through the grants system). Such institutional provisions and procedures will be examined in this paper in view of their general applicability, and with respect to the political, social and institutional conditions prevailing in developing countries. The arrangements in the Federal Republic of Germany
and some other federal countries like the United States, Switzerland and Australia as well as the European Union will serve as a background for analysis.

The latter, more mature federations benefit from a long tradition of public administration both at the national and lower levels of government. As the analysis shows, coordination and cooperation in these countries has been subsided on formal procedures and the formation of consensus through the exchange of information. The autonomy of lower-tier decision making and budgeting has not been touched in principle, although there are clear signs of formal leadership of the central government (through framework legislation and the standardization of public services) which tend to harmonize lower level policies even with regard to their material aspects.
I. BASIC PHILOSOPHIES OF COORDINATION AND COOPERATION IN A FEDERATION

1. General remarks

Before discussing the various forms and instruments of coordination and cooperation in a federation in detail, it is worthwhile noting that there are different philosophies that guide decentralized policy making and intergovernmental fiscal relations. The traditional theory of federalism seeks to minimize policy conflicts through constitutional arrangements which assign exclusive competencies to the various levels of governments (vertical division of functions or "layer-cake" federalism). Where there is remaining need for vertical coordination and cooperation, this is preferably effected through economic incentives, for instance through the grants system. As to the horizontal coordination of public decisions among lower-level governments, the "layer-cake" model favors intergovernmental cooperation on a voluntary basis and in response to spillover effects that warrant collaboration on specific policy questions. General policy issues are typically dealt with according to the principle of reciprocity. Central government interference is seldom needed under this view. This model of "vertical federalism" is typical for the Anglo-Saxon world.

Although inspired by the former model, the German approach to federalism interlaces government functions and emphasizes explicit cooperation among different layers of government (Spahn 1978, Spahn/Föttinger/Steinmetz 1996). The guiding principles for harmonized -if not uniform- policies are defined at the national level and cast into "framework legislation". This secures social and political cohesion and the realization of the "uniformity of living conditions" within the nation. However, specific legislation as well as the implementation and administration of programs are attributed to subnational governments which are closer to demands and needs, options and costs (horizontal division of functions). As in the case of vertical federalism, public budgets of all layers of government are independent and autonomous.

However, tax rules are harmonized across the nation leaving little discretion for lower-level government on the revenue side. Self-rule finds its expression in the outlay functions of local budgets, and financing is secured mainly through tax sharing and the provision of unconditional grants. This interdependence of policy formulation, implementation and administration across levels of government renders more formal and institutionalized coordination and cooperation important, both at the vertical and the horizontal level and is typical for "cooperative federalism". 
2. Central versus decentralized government

Both models of federalism, vertical or horizontal, exhibit a number of variants. A fundamental question is whether the emphasis is placed on national standards, homogeneity and even uniformity; or whether the emphasis is on regional autonomy, diversity and variance. While the German constitution highlights the "uniformity of living conditions" in the nation, the European Union which essentially follows the German approach to federalism - underscores the "subsidiarity principle" and hence the supremacy of regional over supranational policy objectives.

The traditional theory of "vertical federalism" with its independent division of functions is rather centralist and often ignores problems of coordination and cooperation among governments. Stabilization and distribution functions are in the hands of the central government, and only the allocation of resources is attributed to lower level authorities. This view has nurtured centripetal trends as illustrated by the examples of the United States or Australia. In the latter case, concentration of revenues in the hands of the Commonwealth has even created severe vertical fiscal imbalances and eroded state autonomy to a certain degree (Bird 1986 or Spahn/Shah 1995).

The centralist "layer-cake" model is a convenient framework for a top-down approach to federalism. Starting from a homogeneous national policy framework, public functions can be devolved to regional and local governments in accordance with the "decentralization theorem" (Oates 1972) which obeys to certain political and economic criteria. Judicious decentralization of functions, mainly in the area of allocation policy, may thus preserve many of the features of a national policy like the uniformity of tax laws, national standards for the provision of public services, and a common framework for administration. Fiscal decentralization follows the devolution of outlay functions either through the assignment of own revenue, or through grants. At least initially, these grants can be conditioned in order to create incentives and/or to protect national policy objectives. The constitution may restrict lower-level government responsibilities or impose financial constraints, like a balanced-budget requirement. It is hard to see, however, how accountability and the efficient allocation of resources could be realized within such a system unless regional governments control own resources that are sufficiently large and allow some policy discretion (like in the United States), and are in a position to compete among themselves at more or less equal footing (Eichengreen von Hagen 1995). Both requirements are typically not met in developing countries where local tax bases are limited and taxable capacity exhibits large regional inequities.

Contentiously, Germany's approach can be characterized as a bottom up approach to federalism. The federation rests on the autonomy of lower tiers of government which limit its competencies and financial resources. And the central government can rely on the states' capabilities of implementing and administering their own and central policies. This renders the model attractive for the European Union, but it may have its limitations when applied to developing countries where administrative potentials at lower levels of government are typically weak.
However, German federalism has also tended toward centralization over the years. Although the constitution assigns full sovereignty to the states, current legislation has eroded such sovereignty to some degree. Moreover, the states have often been incapable of resolving pending conflicts without the help of the federal government. This has contributed to reducing their effective power. Nevertheless, the general approach of German federalism is an important reference point for European economists and politicians alike, because the European Union will have to be built upon the national sovereignty of its member states (CEPR 1993). In order to avoid the German fate of centralization, European national governments have protected, through the Maastricht Treaty, their sovereignty against usurpation by the Union through a "subsidiarity clause" which establishes the primacy of national and regional policies over centralization.

Diversity of national policies with all their facets is thus sheltered, but this calls for coordination, cooperation and harmonization of government policies in order to realize common policies and to achieve "social and economic cohesion" within the Union over time. Similar problems may arise for other supranational projects such as Mercosur and APEC. Moreover, the realization of a Monetary Union with a single currency in Europe has evoked the specter of potential "budget ball-outs", by the European Central Bank, of capricious or profligate member governments, which would require budget coordination and control in order to preserve macroeconomic stability within the Union.

3. Competing governments

More recently, attempts have been made to counteract the centrist bias of the "layer cake" model by marrying it with the "subsidiarity principle", but without succor of explicit intergovernmental cooperation. Coordination of public decisions is essentially left to the market and to competition among governments. This market analogue to the coordination and cooperation of decentralized government may be labeled "competitive federalism" (Israel 1992, Kasper 1995). A decentralized government system is seen to be "a surrogate for competition, bringing to the public sector some of the allocative benefits that a competitive market brings to the private sector (Tanzi 1996, p. 299). This follows -Tiebout (1956) who argued that, if public goods are financed by local taxes that reflect the costs of provision, mobility between localities will provide information and bring about an efficient outcome in the allocation of resources. The Tiebout model thus relies on mobility and competition to solve the preference revelation problem that both the central and local governments face in determining the local demand for public goods.

It is true that the "layer-cake" approach, which assigns independent revenue and outlay functions to the different tiers of government, in conjunction with the principle of subsidiarity would, by itself, serve as a coordination mechanism through horizontal competition among regional governments. Rivalry among public jurisdictions would, like market forces, constrain government and bring about effective policy coordination. Moreover, competition among governments would not only help to realize static efficiency
gains; it could also foster dynamic welfare improvements through its effect on experimentation and innovation.

However, the model tends to overrate voters' mobility and the capacity of the market to deal with non-rival and non-excludable public goods, externalities, and other market imperfections, although it may serve to constrain an oversized and expanding government sector which is continuously eroding the scope for private economic activities. Switzerland comes closest to such precepts, but it has neither avoided the need for coordinating policies, nor the expansion of its public sector.

"Competitive federalism" may eventually be appropriate for highly industrialized economies with an oversized public sector, especially where horizontal regional inequities in fiscal capacity are small. In developing countries, however, such policy is likely to fail. Vertical competition among a central and lower-tier governments may flounder due to the latter's incapacity to implement and administer policies. At the horizontal level, it is likely to externalize existing regional inequities and/or induce impoverishing regional migration. Horizontal tax competition among governments could eventually retrench the scope for public policy action well below efficient levels. And often, government involvement at lower levels is small and there is no need to constrain their action. On the contrary, it is presumable that efficiency and national welfare would increase through the strengthening of local governments, not by curtailing their functions through market competition.

4. Vertical federalism: assigning exclusive responsibilities and revenue

The vertical approach to federalism attempts to coordinate government actions implicitly through the constitution. According to this view, consumption of government services can be defined over ideally distinct geographical areas forming separable layers of constituencies for each public good. Larger constituencies supersede smaller regions, forming higher layers of government responsibility whenever this is warranted by a larger geographical distribution of public goods. Efficiency considerations then require that regional governments decide on the supply of public services for their respective jurisdictions rather than to provide these services at uniform levels across all regions. Public constituencies are thus ideally formed and delineated in accordance with the local distribution of "internal" benefits derived from government activities.

The efficient outcome would reflect both specific preferences as well as the ability to pay of taxpayers within each region. As a consequence there would be no conflict between governments at the vertical level - neither for the provision of public goods itself, nor for its financing (which would obey the principle of pure benefit taxation). The philosophy is to avoid conflicts a priori, and hence the need to coordinate policies among public authorities.

However, national priorities may rival with preferences couched at lower levels of government; public functions may overlap at various layers of government; and they may
collide with government decisions at the same level. In some instances (as in the United States or Switzerland), different levels of government compete for the same revenue source (tax overlapping), and conflicts have to be resolved by legal rules on reciprocity and mutual immunity. Moreover, local resources may prove to be insufficient in regard to local needs, which occasions unavoidable vertical and horizontal fiscal imbalance among governments. Conflicts of this nature are inescapable in the "layer cake" model, which calls for a continuous redefinition of the constitution by the Courts, or for effective coordination and cooperation among authorities -despite the endeavor to impute government responsibilities exclusively.

Nonetheless, the concept of dividing government competences and resources vertically is powerful in avoiding potential friction, overlap and waste within decentralized government. All federations, including the German Federal Republic and the European Union, have adapted this approach to varying degrees. Furthermore, the theory of federalism establishes positive guidelines for distributing expenditure functions vertically among layers of governments.

Modern welfare economics has established a compelling case for the government to provide public goods, to compensate for externalities, to ensure an adequate production and consumption of merit goods, to provide insurance in the case of information asymmetries, and to regulate natural monopolies (partly through public ownership). In the case of public goods, externalities, and natural monopolies, the criteria for deciding between central and local provision are fairly clear cut. Public goods with a national impact should be provided at a central level (e.g., national defense), while most others are better provided locally (e.g., policing). Similarly, the central government should deal with externalities that cut across localities (e.g., air and river pollution) while local governments can control activities that have a restricted impact (e.g., aircraft noise). And natural monopolies based on national networks (e.g., telecommunications) need to be regulated centrally, while the regulation of local monopolies (e.g., in-city transportation) can be decentralized.

In the case of merit goods like health, education, and other social programs, the issue is less clear. Just as the central government has an advantage in securing efficient income redistribution, the central government should-in support of wider social objectives—ensure access to a minimum level of health, education, etc. But this can be done without the central government being actively involved in the provision of these services. Economics provides little guidance as to whether social spending should be a central or local responsibility, although there is a presumption in favor of central coordination of local provision based on the argument of regional fairness and social cohesion.

One important argument in favor of centralized distribution policies is based on Tiebout (1956) who has stressed the importance of interjurisdictional migration as an effective constraint on regional taxation and hence on the scope for redistribution at lower levels of government. Comparably high local tax rates combined with generous social policies would ostracize the rich, as they would attract the poor.
This centralist view is, however, questioned by other authors (e.g. Tresch 1981) who emphasize the need to respect different local preferences with regard to redistribution\(^\text{11}\). The real issue should be whether the required degree of coordination does, or does not, warrant central provision. Many federal states explicitly assign responsibilities for social welfare functions to subnational governments. And public health and education as well as land use or rent controls -also functions typically attributed to local jurisdictions- have profound distributional implications (Sewell 1996).

As it turns out, there are wide differences across countries in which merit goods are provided centrally as opposed to locally (Hemming/Spahn 1996). Traditionally, local governments have often assumed an important role in alleviating social hardship of their citizens, and more recently, there is a debate in the United States whether federal welfare programs should not be handed over to the states concomitant with fiscal resources in the form of unconditional bloc grants. In developing countries, decentralization may even be a precondition for the effective targeting of social spending to specific situations and locations (Gomez 1993).

The criteria for distributing tax revenue among governments are less salient and often contradictory (Spahn 1988, 1995, and the more detailed discussion below). First, local taxes should enhance the accountability of politicians, they should thus be non-exportable, so that their burden falls on residents. Second, efficient local taxes should respect the benefit principle of taxation. Many local services fees and user charges fall in this category, but taxes e.g. a tourist tax or a local business tax - can also be defended under the benefit-tax principle where they are understood to correspond to local services rendered. Third, local taxes should be non-distortive in that they do not affect allocation decisions in the private sector. At the regional level, this criterion is particularly important since it may lead to horizontal tax competition among government. Taxpayers attempt to avoid local taxes by transferring the tax base into low-taxing jurisdictions. This imposes discipline on the variability of tax rates, and to the extent that local governments need some freedom to vary rates. Furthermore, the tax base must be regionally immobile.

Also, regional taxation is often inequitable among jurisdictions (e.g. of natural resources) and it may be unreliable as a revenue source where tax bases vary with the business cycle (e.g. income taxes). While some federations have opted to centralize such taxes in order to avoid these effects, others continue to operate such taxes, or surcharges thereon, at the regional level (e.g. Canada). Finally, local taxation is often restricted by the requirement of administrative simplicity which is difficult to accomplish for some typical local taxes (e.g., the property tax).

Since it is difficult to realize all criteria for tax assignment at the same time, revenue of local governments from their own sources is often insufficient to meet expenditure needs where government functions are commonly more decentralized. This requires tax sharing or supplementary funding by the central government. Such financing serves to correct vertical imbalances between fiscal capacity and needs, and to mitigate horizontal regional imbalances at the same time.
Tax sharing provides unconditional funds and thus respects the budget sovereignty of lower tiers of government. This is also true for unconditional general-revenue grants distributed by the central government, but often such funding is subject to certain conditions defined by the grantor, which renders the transfer system an effective instrument for coordination within the "layer cake" approach. Such form of coordination is, however, often criticized as allowing the central government to impose its preferences and to restrict the budget autonomy of lower-level governments. The coordinating function of grants will be further examined below.

5. Horizontal federalism: Procedural division of public functions

Although the German model of federalism equally attempts to separate government functions vertically (e.g. defense at the federal, education at the state, and communal services at the municipal level), it mainly follows a different philosophy which can be labeled "horizontal federalism". As sketched above, the emphasis is laid on legislative functions (in particular framework legislation) at the central level, and states and local governments (municipalities) are generally in charge of implementing and administering policies. Policies may thus be divided through stages of processing — from an initial policy concept which is typically uniform and defined by the center, through its realization and administration whereby supervision and management is thoroughly attributed to lower tiers of governments. For one thing, this distribution of responsibilities is to safeguard the independence of the states. For another, it is to realize the "uniformity-of-living-conditions" within the nation, a principle based on collective welfare arguments and equity.

This approach emphasizes the administrative role of the states not only in areas of their own responsibilities, but also in areas of federal responsibilities: The states execute most of the federal laws as matters of their own concern (for instance social welfare and environment protection), and in some special cases they execute federal laws as agents of the Federal government or, in Krause-Junk and Müllers terminology, "by order" (e.g. federal highways). In this case, the federal government can give directives, but it also assumes the costs. Similarly, local governments have safeguarded the right to regulate their own affairs within certain limits. Besides their own duty, they also accomplish tasks assigned to them by law (for example, registration offices). Municipalities are supervised by the states, and the same model of a horizontal division of functions also applies to the relationship between states and their communes.

In the horizontal model of federalism, central administration is less developed in general (except for specific functions like defense, foreign affairs etc.), and the states bear the brunt of administrative responsibilities (including for tax administration). This requires high professional competences of public servants at lower-level administrations. Moreover, municipalities have to spend a large share of capital expenditure in such fields as communal services (sewerage etc.), health, sports and recreation, schools, housing and road construction. They carry out, on their own or on behalf of higher tiers of government, a large share of public investment in Germany (about two thirds of the consolidated total).
This particular horizontal distribution of functions is explained by history. The German Reich was built, in 1871, upon a great number of sovereign states which insisted on their political independence and could rely on operative and competent own administrations. The basic idea was to preserve the benefits of lower-level administration while focusing the central government’s power on the molding of a national identity and on the achievement of economic and social cohesion. This historic experience of Germany very much resembles the process of European integration.

As in Germany, European government will continue to dwell on the nation-states of the Union. A central authority, the European Council, may want to coordinate policies at the supranational level or attempt to foster cohesion within Europe, but its competences originate from national sovereignty and the implementation and administration of policies will essentially remain in the hands of the states. It is for these reasons, that the German experience is of prime importance for the shaping of intergovernmental coordination and cooperation in the European Union.

The horizontal interrelationship between policies asks for effective and often institutionalized mechanisms for coordination and cooperation. The formulation of national guidelines through federal legislation requires participation of the lower tiers of government. While the implementation of policies within such guidelines may vary among regions, it may - in some instances - become subject to formal responsibility sharing and cofinancing arrangements among levels of government. Also the harmonization of genuine state policies, where the central government has no right to interfere (e.g., in education), requires more formalized cooperation mechanisms and even intergovernmental institutions. Such characteristics of the horizontal approach to decentralization are often associated with "cooperative federalism".

However consensus forming is not confined to the government sector atone; it often involves consultation and coordination processes among public and private sectors which may also be effected through institutions, albeit more loosely conceived. In this regard, the German approach exhibits similarities with the Swiss model of public decision making where the constitution preserves a continuous and more rigorous consultation process between the private and the public sector -even for ordinary legislation, through expert-based discussions and consulting procedures (Vemehllassungsverfahren) whereby government agencies of different levels, political parties, economic and social groups are involved in preparing laws¹³.

6. The functional tradition: Earmarking and special funding

Systems of functional government tend to occur in centralized states and they are typical for same more centralized Latin American countries (e.g. Colombia). Decisions concerning different sectors and policies are taken at the central level by the competent authorities, be they ministries or agencies. Then, these decisions are implemented in the various administrative subdivisions of the country by single purpose agencies, structured along a
rigid vertical hierarchy. For example, the Ministry of Health decides the quality and quantity of services to be delivered to the targeted population and the distribution of funds among various administrative subdivisions. Then, in the case of a two-tier hierarchy, the effective provision of these services is mandated to the regional branches of the ministry. In its pure form, a functional system does not need, or have, a general budget. Typically, distinct revenue sources are earmarked for certain purposes and attributed to the various ministries and central agencies, or to special funds.

In the functional model, the use of earmarking is often motivated by accountability problems or mistrust - the national government is not sure that public moneys will be used for the "appropriate" purpose. A vertical hierarchy, with a number of special funds and earmarking, is expected to ensure that resources are "properly" being spent in accordance with centrally made decisions. However, as the implementation is decentralized, the absence of proper information flows and budgetary procedures can severely hamper the task of monitoring the outcomes, or of judging policy priorities correctly. Arbitrariness and corruption are possible under such auspices. Differently, in a decentralized system, accountability is provided by voters' scrutiny of the use made by governments of their taxes and "untied" transfers.

The vertical funding of public functions through earmarked taxes entails severe budgetary inflexibility, and it bears the risk of inefficiencies and waste. Resources attributed to the funded programs may escape public attention and democratic control, and they may diverge from local needs in the longer run. Also, it is politically difficult to abolish strings once they are attached to the use of public resources. Moreover, the earmarking of revenue allows specific interest groups to shelter a share of public resources, often for long periods. And finally, the vertical funding of public activities reduces the scope for autonomous public policy at the territorial level, and it often implies the supremacy of national goals. This runs counter the spirit and the objectives of decentralization.

In industrialized countries, special funds detached from general budgeting are severely restrained. Typically they are used to coordinate the funding of social programs based on specific financial contributions of individual members - like public pension funds - with the aim to protect the entitlement acquired by the group or individual persons against policy makers' greed. This logic is stringent in particular for fully funded schemes where the contributions serve to nurture personalized capital accounts. It should also apply to pay-as-you-go funding or revolving funds where contributions are being used to make recurrent payments based on legal entitlement. In practice, however, the latter schemes often serve to absorb - at the expense of the group of the "insured" - general Commitments of a merit-goods character (like bonuses for education, for motherhood, etc.) that should ideally be disbursed from tax revenue, not specific contributions. This practice blurs the boundary between ordinary budgeting and specific funding. Moreover, there is always the temptation to ease temporary budget constraints at the expense of specific funds and their contributors, which entails the risk that these funds are unsustainable in the longer term.
II. COORDINATION MECHANISMS FOR INTERGOVERNMENTAL RELATIONS

Figure 1 on the following page attempts to categorize the main dimensions of coordination mechanisms for decentralized and quasi-autonomous public budgets. The various forms of control existing in industrialized countries (federal and unitary) and in some selected developing countries will be examined and reviewed with the aim of developing recommendations for reform in Latin America. Such recommendations shall bear in mind that similar problems of budget coordination may occur among independent nation states within the framework of greater supranational cooperation and economic integration (including the European Monetary Union).

1. ¿Who should coordinate?

Coordination and cooperation among governments has various facets. The fundamental question "¿who should coordinate?" connects to the basic philosophies of federalism discussed before. As-stressed already, the "layer-cake" model attempts to avoid clashes and conflicts among governments by assigning independent and autonomous revenue and expenditure functions a priori through the constitution. This may be based on certain criteria (derived from the decentralization theorem), but it may be said to be neutral as to the dominance of either level of government. In practice, however, coordination through apriori assignment of functions tends to work in favor or centralized government.

Where national priorities dominate, coordination is effected through the central government either directly -through national legislation to be implemented by subnational authorities and directives- or indirectly through framework legislation which leaves some policy discretion for subnational governments. In the horizontal model of federalism, policies may be defined by the central government, but ample discretion of lower levels of government allow them to respond to local preferences, and their role is de facto much stronger than it appears. Although responsibility is divided among layers of government, voters can hold their local politicians accountable for public services with a visible impact on their constituency.

Alternatively, sovereignty may continue to reside at lower levels of government which transfer part of their sovereignty to a central authority or delegate certain functions to a higher level within limits (e.g., the European Union). Such limits can be substantial, or formal. A unanimity rule can preserve national sovereignty for each member of the federation through an effective veto power, but it may also block decision making and
impede the shaping of supranational policies. Despite its propensity to impair decisions, the unanimity rule may still work as a coordination instruments as long as it serves to promote the exchange of information, affect policy attitudes, and foster the convergence of policies or compromise over the longer run. Other decision rules will relinquish some autonomy of subcentral governments to the benefit of more flexible decision making and the realization of a common cause at a higher level of sovereignty, but there may be extra costs of coordination and cooperation under such circumstance.

Figure 1: Main questions relating to coordination and cooperation in decentralized government

- What should be coordinated?
- Who should coordinate?
- How should be coordinated?

Revenue side
- Expenditure side
- Transfers among governments
- Budgeting
  - Borrowing, financing
  - Government debt
  - Financial deficit/Accrual deficit
  - Term-structure of debt
  - Long-term budget commitments
  - Contingent commitments
- Non-budget items
  - Cost control
  - Resource use
  - Staffing

Formal coordination
- Standardization of information and information exchange
- Indicator-related coordination (GDP, own revenue, needs, etc.)
- Balanced budget requirement
- "Golden rule"
- Formal leadership
- "Fiscal incentives"
- Conditional funding
- Closed-funding
- Institutional cooperation
  - Procedural rules
  - Coordinating bodies
  - Control and sanctions
  - Democratic legitimacy and cooperation conflicts
The polar cases where either the central government or a representative body of subcentral governments determines the pace of public decision is supplemented by various forms of joint-decision making between higher and lower levels of government where both levels play an equal part. Such coordination machinery is typical for some federations like Australia or Germany. In Australia, for instance, the Loan Council coordinates public borrowing among governments of all level through joint decisions (which, more recently, are no longer binding). In Germany, there are certain areas of joint responsibility of the federal and state governments (e.g., the construction of universities) where decisions are taken conjointly within established bodies (Planungsausschüsse). Such joint responsibility is often associated with cofinancing.

Incidentally, there are also coordinating bodies with an independent or semi independent status. The legitimacy of such bodies is, of course, based on democratic mandate, yet governments transfer, in these cases, specific competences onto such bodies with the aim of defusing potential intergovernmental conflicts. This is the case of independent central banks, for instance, where governments "bind their hands" against their own largesse in financing budget deficits. The aim is to strengthen the credibility of fiscal policy. Another example is formed by the Australian Grants Commission which established a mechanism for determining grants entitlement of the states, and which independently monitors variations in the need for such grants. In both instances, a high level of professional competence is required an which these institutions base their reputation. Although coordination through independent bodies is usually expressed in the form of recommendations, their importance for effective policy adjustments can not be overemphasized.

Apart from the need to coordinate action between higher and lower level authorities, there is also the need to cooperate horizontally at any one level of government. Horizontal coordination is often effected ad hoc on a contractual basis and confined to specific issues of common interest (e.g., pollution control of rivers by bordering regions or nations). However, federations and supranational institutions like the European Union need to coordinate policies on a more permanent basis. This is often effected through regular meetings of heads of regional governments (like the European Council or the Premiers' Conferences in Australia), or confined to specific policies (like the German Kultusministerkonferenz - a standing conference of the states' Ministers of Education). Where there are conflicting interests among the participants of a horizontal coordination process, like in the German Finanzausgleich among regions, the central government may interfere as a broker (e.g. through national legislation) in order to establish common rules that are perceived to be fair from a national point of view.

2. What should be coordinated?

As to the policy domains which require coordination, these very much depend on the basic philosophy adopted. The independent vertical assignment of taxes does not seem to require much revenue coordination among layers of government, especially if lower levels of
government use typical benefit taxes. But this may cause tax overlapping and inconsistencies rendering the tax system complex and costly in terms of compliance (like, originally, the income tax system in Switzerland\textsuperscript{15}). It may also entail vertical fiscal imbalances with the need to agree on the redistribution of finance (like in Australia). In developing countries, the prospects for vertical Fiscal imbalance are particularly acute since taxing powers of lower-level governments are severely restricted in practice through various political, legal, and administrative constraints\textsuperscript{16}. Moreover, direct taxation seems to be increasingly subject to international tax evasion and competition among regional governments demanding policy coordination even at the supranational level (Tanzi 1995)\textsuperscript{17}.

Indirect taxation at lower levels of government requires coordination as to the principles of taxation (origin or destination principles), on the treatment of interregional trading of goods and services, and, eventually, on tax rates\textsuperscript{18}.

Equally, the vertical division of outlay functions does not avoid the need for expenditure coordination whenever there are economies of scale in producing public services, but risks of failure in providing standard or adequate levels of services through local governments. Smaller jurisdictions face potentially higher administrative costs than larger ones, and in some instances the political and institutional infrastructure for local policy may be lacking altogether. At the municipal level, institutional fragility is often acute, especially in developing countries.

For this reason the devolution process must be supported - in these countries - by institutional reform, the strengthening of administrative infrastructure and procedures, the training of local officials, and the dissemination of information. Apart from the setting of national standards, the central government must therefore assist lower-level jurisdictions where administrative capacities are crucial. There is also the need to encourage horizontal cooperation among states and among municipalities where the incidence of local public goods extends beyond administrative borders and where there are economies of scale through joint administration.

This implies that a differentiated approach is often appropriate in developing countries because some better-off states may be wholly capable of administering their own policies and will resist central government interference, while others, the poorer regions, will require effective assistance - not only financially, but also in kind. Such differentiated policies by a central government could easily be misinterpreted as violating the principle of regional nondiscrimination within a nation and have to be implemented judiciously and with political sensibility.

As mentioned already, the intergovernmental transfer system is of key importance to coordination and cooperation within a federation and supranational policy making. It is used to correct fiscal imbalances and to supplement funds to lower-tiers of government for financing their own expenditure functions. This renders the transfer system suitable for achieving, through fiscal incentives, certain policy objectives as defined by the grantor government. A well designed grants system will have to respond to the needs and costs of providing public services of lower-tier governments, while taking local taxable capacity and
revenue policies into account. Both needs and own taxes of lower level governments must be standardized in some way in order to render the transfer system immune to strategic behavior of receiving jurisdictions.

Australia avoids strategic behavior of the states by determining the distribution of the total amount of Commonwealth general revenue grants with reference to the relative per-capita revenue-raising capacities for all recurrent own-source revenues, the relative per capita expenditure needs (costs of providing standard services) for all recurrent expenditures and the differential per capita amounts of most recurrent specific purpose grants. In effect, each state’s or territory’s share of the total Commonwealth general revenue grants depends on its standardized deficit, which is the product of its population and its per capita grant relativity. The latter is assessed as its per capita standardized expenditure minus its per capita standardized own-source revenues, plus (or minus) its differential per capita specific purpose grants.

This approach—which has been developed by the Commonwealth Grants Commission—requires a mass of information in order to come to the value of standardized needs and own-source revenue. Typical state services have to be monitored by statistical indexes that relate actual state expenditure to national standards by categories and underlying contingencies (like the elderly population, the number of school children, of pregnancies, etc.). This has effectively lead to informal coordination and cooperation in controlling non-budgetary items such as the use of resources and, more generally of the costs of public services. It enables all participating governments to identify their own relative position vis-à-vis the national standard, and to strive for cost reduction in specific areas of competence. Equally, this method serves to highlight areas of fiscal competence where local tax potentials are under exploited relative to a national per-capita average. Since the unconditional grants are distributed on a standardized basis, and not on effective budget performance (or "gap filling"), the incentive to control costs and the use of resources is fully preserved. Coordination and cooperation in this area is thus implicit in the grants arrangements.

More explicit forms of coordination and cooperation often exist in the area of staffing. It is essential for public services to be non-discriminating among regions, i.e. that they be provided at standard levels of quality. This requires homogeneous training and, consequently, some homogeneity as to the pay scale of public servants. An example is provided by the situation in Germany where even tax administration is highly decentralized. Understanding that only uniform standards in training programs could secure and maintain a high standard of performance in tax administration throughout the nation, a "Federal Law on the Training of Revenue Officers" defines common qualifications that have to be met by applicants to tax administrations of the states. As regards the training of tax officers, one can find, once again, a reflection of the German model of cooperative fiscal federalism: Operating within the framework of the aforementioned law, the States have to set up, each on its own, the institutions and all the necessary provisions to train qualified staff.

While many countries, in particular developing countries, do not attempt to standardize quality and pay of public officials among different public authorities, it is
important for staff to develop a common perspective on the overall policy goals, the role of administration, and how their specific tasks will serve to attain the goals. Dissemination of information can be an initial step in a process to modernize state and municipal administrations and to render them responsive to local demands. It could also be useful to develop an intergovernmental network to share innovative ideas in public administration. In order to realize an organized dissemination of information a coordinating body is needed. This could be established by the central government or through interstate cooperation. A coordinating body is one way to provide technical assistance to a large number of local administrations, and to qualify their staff.

Coordinating public budgeting is an important, perhaps the most ambitious, form of intergovernmental cooperation. In a decentralized government system, the annual budget is the expression of state sovereignty and, therefore, comprehensive material coordination and cooperation is ruled out because it would obliterate the self-rule at lower tiers of government. Budget coordination is thus mainly understood in a formal sense whereby information is traded to provide interjurisdictional reference and orientation points, and to allow self-induced policy adjustments at all levels of government. Formal budget coordination thus requires, for instance, the standardized classification of budget items, transparency in the budget process, and common principles for establishing, executing and controlling the budget.

Moreover, governments are required to be clear about their short- and long-term fiscal intentions by reporting to the legislature in regular intervals. Coordination may indeed go beyond any single budget to include future budgeting as well, for instance by providing orientation through comprehensive medium-term financial planning for the public sector as a whole. Germany has instituted such a framework for budget coordination in the federation while avoiding to inflict upon the sovereignty of its member states. The principles are laid down in a federal law (Haushaltsgrundsätzegesetz) and they either define a common setting to be filled by state legislation, or they are applicable directly to the states. The more important aspects of such formal budget coordination are further discussed below.

More explicit material budget coordination is also found in some instance, but it requires acceptance of constrained sovereignty and, eventually, a sanction mechanism. In Germany, for instance, responsibility is explicitly shared among the federal and the state governments in certain areas, and cofinancing acts as a constraint on these "joint tasks". Since the budgets of both the federal government and state governments mirror the financial impact of these joint responsibilities, one could also speak of partial material budget coordination among layers of government. The withdrawal of cofinancing acts as a sanctions mechanism in this case.

A different approach is taken by the European Union which attempts, through the Maastricht Treaty, to coordinate sovereign budgets of its member states through statistical indicators relating the public deficit and the level of debt to GDP. These are to lie within certain quantitative limits for member states to qualify for entry into the European Monetary Union, and these criteria are supposed to guide budget policies even post-entry. As it appears at the time of writing, this formal budget orientation has contributed to focus the
discussion on the causes of precarious budget performance, whether they are structural or cyclical, whether they are mitigating or accentuating. This is likely to have a material impact on public policy over the longer term. Again, information exchange and standardized guiding rules are powerful instruments to bring about policy coordination in a decentralized government system.

Another example of coordinating deficits and debt within a federation is through cooperation in financing the budget, i.e. when accessing capital markets. The Australian Loan Council, for instance, was set in place to optimize the timing of bond flotations by the states and the Commonwealth, and it later developed the competence to limit competition among governments for deficit funding. After the ascent of Keynesian ideas for fiscal stabilization, the Loan Council even acquired, under the supremacy of the Commonwealth, competence in the area of macroeconomic management of state budgets. However, more recently the power to borrow has been returned to the states (Financial Agreement Act of 1994).

Formal budget coordination and deficit constraints of the public sector have not only focused the attention on formal criteria to standardize information for intergovernmental comparison. It has also raised the awareness on what is being measured and compared. This relates to the definition of the public sector (e.g., inclusion of social security funds where the systems of social protection differ; or the exclusion of state companies where governments are liable to cover eventual operating losses). It also questions the cogency of monitoring financial deficits where these can be easily manipulated through lucrative accounting”. Management of the US federal budget after the Gramm-Rudman Act of 1985 provides an illustrative example here (Stockman 1986, Muris 1994).

New Zealand has recently introduced reforms (Fiscal Responsibility Act of 1994) that require the government to follow principles of responsible fiscal management, and to assess their fiscal policies publicly against these principles. It is also required to publish fiscal intentions and objectives, to publish a range of reports resulting in a comprehensive set of fiscal information prepared under generally accepted accounting practice (GAAP). Furthermore, it has to refer all fiscal policy reports required under to the Act to a parliamentary select committee24. New Zealand (and, recently, the Australian Capital Territory) are possibly the only jurisdictions in the world that apply sector-neutral accounting standard which apply to both public and private sectors. The reporting system is accruals based25 but it also reports on cash flows. Moreover, it attempts to monitor net public debt as well as the impact of the budget’s operating balance and revaluation changes on net worth. The purpose of such reporting is to add to the integrity and credibility of the government’s statements. Such comprehensive and standardized reporting and financial planning could also be used to foster intergovernmental coordination and cooperation in a multilayer government setting.

Long-term commitments in the form of hidden liabilities as well as contingent commitments of the government may be particularly troubling the transparency of the budget. Although off-budget, such claims must be continuously watched and evaluated as to their impact on future budget developments. This is in order to take appropriate and
timely legislative measures that prevent budgets from deviating from a sustainable path. This applies in particular to the implications of the welfare system on public budgets where long-term demographic and employment trends can be identified and evaluated as to their budgetary risks.

3. How should be coordinated?

The various examples of intergovernmental coordination and cooperation constitute a host of instrumental options - loose arrangements based on the standardization of information and information exchange, economic incentive mechanisms, institutional forms of cooperation, "collegial" or "hierarchical", and more or less rigid mandates which are enforced through legal or political sanctions.

It is useful to distinguish output-oriented and process-oriented coordination. And coordination can be discretionary or effected through rules. Budget coordination according to the Maastricht criteria in the European Union, for instance, is based on rules and oriented toward a targeted output or outcome. Coordination of education policies through the German Conference of Ministers is process-oriented rather than directed toward specific outcomes. This implies that decisions taken are highly discretionary.

Informal - provisions to coordinate public decision making may be very powerful. The necessity to standardize information requirements will force policy makers to identify and recognize unresolved coordination problems. Information standards may become behavioral norms and induce effective policy adjustments. At the very least, they allow to make intergovernmental comparisons, emphasize deficiencies of public policy, and focus the public discussion and the attention of voters on pending policy problems and coordination failures.

Most informal forms of coordination and cooperation are indicator-related. A typical example is, again, the attempt of the Maastricht Treaty to coordinate European economic policies through a set of criteria26. Although these criteria are by no means binding, they have exhibited a significant impact on policy adjustments and focused the discussion on pending budgetary problems of potential entrants into the Monetary Union.

Equally, the Australian arrangements for attributing unconditional grants are based on a definition of standardized needs and fiscal capacity relative to their national averages, which - apart from its financial purpose- has contributed to identify deviations of local policy outcomes from national reference points. Such byproducts have served to highlight the need for effective policy adjustments among states.

Formal rules may, however, be more severely binding like, for instance, a balanced-budget requirement for the lower tiers of government. Constitutional restrictions of this kind exist for most of the states in the US, and were (are) even discussed for the federal government in countries like the United States and, recently, Germany. More
frequently such formal limitations are found at the municipal level, for instance in Argentina, China, Italy or Japan. They emanate from a constitutional or political obligation of higher-level governments to finance the deficits of local governments - explicitly or implicitly.

Although strictly binding in formal terms, such rules are often bypassed in reality, however. For instance, Chinese municipal governments often use the borrowing power of state firms (of which they are the owners) to access capital markets. Thus, budgetary guarantees can be used to substitute budget deficits, and even prohibitions of all independent borrowing by subcentral governments may prove to be counterproductive. Similarly, there may be rules that restrict access of lower tiers of government to certain forms of finance, for instance to central bank financing, or to foreign capital markets. Again such rules can easily be circumvented as demonstrated, for instance, by the Brazilian states which have often used the borrowing power of their state banks to tap central bank finance.

Another indicator-related borrowing restriction typically found in practice is the so-called "golden rule" which limits the budget deficit to capital outlays of government. This does not really restrict the level of borrowing, because capital formation may be discretionary high, but it may force governments to establish a capital budget separated from the current budget, and force them to balance the latter. This may have a certain impact on budget discipline provided the definition of capital investment is narrow, unlike, for instance, from Colombia where human capital formation (e.g., outlays for education and health) may also warrant additional borrowing under a "golden rule."

Germany practices a "weak golden rule" for a unified budget, which has been further debilitated through constitutional provisions allowing governments to incur additional debt in the case of "disturbances of the general equilibrium."

This provision, introduced in the heydays of Keynesianism toward the end of the sixties, has played a major role in the context of financing German unification when the "disturbance" argument was irrefutable. But even before unification, this general provision proved to be extremely difficult to enforce because of a lack of firm criteria on which a sanction mechanism could be based.

Another informal coordination machinery relates to the informal leadership of a central government, a mechanism that should not be underrated. Germany and Switzerland are typical examples of the federal government providing guidance through the setting of standards and own policies. In Switzerland such guidance was often tacit, while Germany has even adopted a formalized legislative approach through framework legislation. Formal leadership exists also at the horizontal level where some governments tended to be more innovative, eventually setting the pace for coordinated policies among regions in general. Informal leadership does not necessarily require institutionalized forms of cooperation, but often regional spillovers call for more formalized coordination mechanisms. Transportation and telecommunication is a typical case for vertical and horizontal coordination whereby the federal government takes a lead in defining supraregional transport requirements and a network of national roads and rails, while the states and municipal governments are
involved in defining their regional needs for feeder access to the national road and rail network. Education policies form an example of horizontal coordination among the states in Germany where the aim is to achieve equal opportunities for students within the nation as well as the mutual recognition among regions of qualifications of students and teachers in order to foster educational and economic mobility.

As will be discussed, intergovernmental coordination and cooperation also uses fiscal incentives to bring about desired results. These are typically associated with intergovernmental transfers and the grants mechanism. Unconditional grants or tax sharing, typical for german grants mechanism. Unconditional grants or tax sharing, typical for Germany for instance, are usually inappropriate to induce such behavior, but the Australian model of distributing such unconditional funds illustrates that the use of certain criteria may convey useful information and thus encourage policy adjustments. We consider this a formal approach to coordination, however, not coordination through fiscal incentives.

Fiscal incentives embody a financial penalty for not complying with the policy objectives which are defined by the grantor government. This is typically achieved through conditions attached to the funding. Such conditions may take the form of simple matching requirements which is a form of passive cofinancing. Cofinancing may also be combined with responsibility sharing and joint decision making as in the case of the German "joint tasks". This requires active involvement of all participating governments as well as an institutionalized setting for decision making.

Conditions may also stipulate that grants be spent on certain activities only. However, this is binding only to the extent that the recipient authorities would not have entered upon such activities without the grant. Often, however, such activities would have been undertaken anyway -with or without grant- in which case the financial transfer frees budget resources which would have been otherwise spent in that particular policy area. This problem renders this type of conditions less restrictive for the behavior of subcentral governments. There may however be an impact of such conditions on qualitative aspects of public services to be rendered by lower-level governments. However, unconditional grants may also inflate local budgets, because of a flypaper effect whereby fiscal illusion and bureaucratic tendencies lead to expenditure being higher if grants are paid to local governments than if local residents received the grants instead (Gramlich 1977).

Another type of fiscal incentive is through closed funding of a given government program. A limited amount of finance is offered to lower level governments which are encouraged to compete among themselves for the funding. The idea is to initiate and stimulate competitive public services or investment programs at the local level. It is essential, however, that the assignment of such funding be based on firm and controllable criteria in order to achieve this goal. Policy discretion, opaque criteria, arbitrariness and political partisanship for the distribution of such funds may breed corruption and abuse. This would exterminate the fiscal stimulus, and it would even become counterproductive as a coordination instrument.
Institutional cooperation requires procedural rules and, eventually, coordinating bodies that allow representatives of the various political jurisdictions to inject their voice into a joint decision process for reaching policy consensus. Such consensus is essential for coordinating the behavior of lower-tiers of government which would otherwise feel uncommitted to follow the policy directions defined and/or to implement such policy in their jurisdiction. This could imply coordination costs, but such costs may be more than outweighed by the benefits of "orderly" behavior, which is not to say that such consensus forming would be conflict-free.

Institutional coordination should not only be targeted toward reaching accordance among various jurisdictions as to policy objectives and instruments. It should also exert some control on the implementation of such policies. This is the reason why a coordinating body is needed in order to monitor such policies effectively. It requires a competent and permanent bureaucracy which is capable of collecting and analyzing conforming information on a recurrent basis. Such body must not necessarily be the same which is responsible for coordinating the decisions. In the European Union, for instance, the Council is responsible for joint-decision making, but the Commission is typically in charge of implementing and controlling policies. The Commission itself is subject to parliamentary control and, as to the execution of its budget, to a review process by the Board of Auditors.

Review and control is pointless without a sanction mechanism. The fact that decentralized democratic governments are themselves subject to political constraints exerted at the regional level renders this a most delicate question however. Effective juridical or political sanctions are only possible where sovereignty of subcentral governments has been explicitly abandoned and transferred to the higher level. In the vertical model of federalism, the policy would be executed by the central government and there would be not case of policy coordination or sanctions. In the horizontal model, however, "hard" juridical or political sanction provisions exist, and could (and should) eventually be used by the central government.

Where lower-tier governments retain their sovereignty or autonomy, intergovernmental sanctions are typically "softer". The higher level may supervise subcentral policies in a formal sense in order to secure their constitutional, legal and administrative correctness. A central-government may also convey information to coordinating institutions, competing jurisdictions or to the public in order to reinforce the political accountability of non-conforming local constituencies. Or it may penalize non-cooperating authorities through the system of intergovernmental transfers.

However, all such sanctions against non-cooperating lower tiers of government find their limits in the democratic legitimacy of their mandate. No government can be forced, in the interest of a higher-level "consensus", to agree on policies that run counter the interests of a majority of their electorate. This is why some democracies have installed, in addition to intergovernmental cooperation, consultation and coordination procedures among government and private interest groups in order to avoid such conflicts (e.g. the Vemehmias-sungsverfahren in Switzerland). At the very least, governments should take care to inform their citizenry and to explain their policies to the electorate.
III. THE ALLOCATION OF FISCAL REVENUE

Intergovernmental fiscal coordination will typically have to deal with two types of problems: The first concerns the vertical distribution of financial means in accordance with the assignment of functions at a minimum level (revenue function), and it comprises the assignment of taxes to each layer of government (including tax sharing) and vertical financial transfers in the form of grants. The second problem relates to the necessity to correct the resulting primary distribution of resources among states in order to achieve horizontal "fairness" among regions and to enable the states to provide standard levels of services across the nation (equalization function). In practice, both functions are intertwined yet it might be helpful to distinguish them when looking at a given system of intergovernmental grants.

1. Tax assignment

It has been mentioned before that exclusive rights to tax of each layer of government are crucial not only under fiscal aspects. They also impinge on the efficiency of the public sector because they imply financial incentives. The financing of local services is particularly important because theory attributes the allocation function predominantly to this layer of government.

The theory of federalism provides certain guidelines to local taxation, but their impact on actual arrangements is remarkably weak. The way local services are financed in different countries varies widely—Scandinavian countries (with unitary constitutions) typically raise significant local revenue from own taxes (on average as high as 15 percent of GDP), and local budgets in Austria, Germany, France, Japan and the United States also rely heavily on local taxation (albeit at a lower level). However, many countries finance local budgets mainly through grants, in particular Italy, the Netherlands and the United Kingdom. Most scholars agree, however, that local taxation is a constituent part of local autonomy and should be preferred to other forms of finance like grants or tax sharing.

The following principles for decentralizing finance and taxation in multilayer government can be distinguished: local accountability, tax-benefit link, non-distortion, regional equity and long-term efficiency, reliability and stability of tax bases, tax-sharing as implicit insurance, and administrative simplicity.
1.1. Local accountability

Local politicians should be responsive to the expressed preferences of their local citizens, or encounter defeat in local elections. This is the basic principle of accountability of local policy makers, and it is essential both for economic efficiency and democratic representation. The principle calls for own tax bases of local governments, and it is the essential argument against the financing through grants or tax sharing with higher levels of government. General revenue raised by and transferred from other levels of government tends to blur the issue of local responsibility and accountability. The principle also supports the quest for policy discretion of local politicians and parliaments, and it entails the right to determine their own tax rates.\(^\text{30}\)

Discretion in local tax policy is a necessary, but not sufficient conditions for accountability. Accountability also implies that local taxes be borne by local citizens. There must be an equivalence between the provision of local public goods and the tax carried by local voter-citizens. If taxes can be exported onto citizens of other jurisdictions, accountability is reduced as local voters can shift the burden of financing the local budget onto others. Local incidence or non-exportability of the tax must be valid at least at the margin, for incremental or higher-quality services, while standard local services might be financed through transfers from other jurisdictions. However, standard local services must be defined in a way so as to avoid strategic behavior, i.e. they must be outside the control of regional government.

The accountability criterion favors a local personal income or a property tax. A tourist tax or local business taxes rank poorly under this principle because these taxes can usually be "exported" to other jurisdictions.

1.2. Benefit-tax link

The benefit-tax-link principle emphasizes efficiency aspects of local taxation as to the provision of public goods. If a link can be established between a tax and the willingness to pay for a public service, the tax plays a role similar to a price in a quid-pro-quo market transaction. This would enhance individual (and/or collective) welfare in the provision of public goods. While market prices will automatically emerge in functioning markets for private goods, a tax price for public goods is more difficult to establish. Yet for many local services, fees and user charges as well as contributions of beneficiaries to the financing of local investment projects can be defined and employed successfully (Edling 1996). A tourist tax - although in conflict with the accountability criterion - can also be defended under the benefit-tax principle as long as it is sensed to be equivalent to local services received.

Furthermore, the principle works in favor of local business taxes whenever local services are perceived as factor inputs by local firms and hence "purchased" through the tax. Although one may object to the business tax on grounds that it can be "exported" to other jurisdictions and that it falls to strengthen accountability at the local level, the argument is weak when taking an integral view of the tax. Moreover, the objection rests on very narrow assumption on the shifting of the tax.
It is not certain, for instance, that a local business tax is shifted onto producer prices and thus "exportable" as held by its opponents. The tax may represent payment for local inputs that would otherwise appear as private costs of the firm. This is true whenever the benefit-tax link dominates- Local business taxes may thus be used to finance local infrastructure for business, to lower the firm's operating costs through communal services, and so forth. Cost-reducing effects might also show up indirectly, for instance in labor productivity, when the quality of the local labor force improves through education, recreational facilities or health care.

The benefit-link principle may also call for an intermediate level of government whenever local benefits exhibit spillovers that accrue to a region rather than to a locality. In this case, benefits can be "internalized" for the beneficiaries of a region, and the tax be seen as a market equivalent for the service consumed. Alternatively, this could eventually be achieved through negotiated payments among groups of municipalities that share the costs of a supraregional local service; it may also be achieved by the establishment of functional regional bodies or districts (like utilities for water and energy supply, or waste disposal).31

1.3. Non-distortion

Taxes should be non-distortive in that they do not affect allocation decisions within the private sector. Taxation should ideally be "neutral" in that sense. At the municipal stratum this criterion has a particular significance since taxpayers can always avoid a high level of local tax by shifting the tax base to low-tax jurisdictions. This leads to horizontal tax competition among local government with potentially ruinous consequences for the municipalities' ability to raise tax revenue at all.

Horizontal tax competition among jurisdictions has two dimensions: (i) it imposes discipline on the variability of tax rates, and (ii) it restricts taxation to tax bases that cannot easily be transferred to other municipalities.

The first issue vanishes if all municipalities impose the same tax rate. This could either be achieved through national coordination (legislation) or through horizontal cooperation. Yet uniform rates are in conflict with the accountability principle and should be avoided under this aspect. Furthermore, some regional variation in tax rates is likely to be tolerated by taxpayers. This is in view of the benefit-tax principle as long as these variations reflect the regional pattern of demand for public services. Thus tax-rate variability is desirable and -within the limits imposed by the benefit-tax principle- also feasible. Ruinous competition - by which local governments underbid each other through lowering tax rates mutually until they reach a zero-level -can be avoided by national legislation that imposes a "floor" on local tax rates.32

The second issue is usually addressed by selecting an immovable local tax base. As long as the tax base cannot be shifted to other jurisdictions, taxation is neutral and efficient (in the sense that it does not exhibit "excess burden"). The argument is in strong support of a local property tax and a local income tax based on the residence principle. It also
favors a local business tax. In particular a local and tax seems to be an ideal candidate under this guideline.

While land is indeed physically immobile, the tax base of a land tax may not be, however. This is the case whenever municipalities have the right to define their own valuation rules or to concede tax preferences and exemptions at their discretion. Under these circumstances, the tax base might be eroded although the physical base remains untouched and is, of course, immobile.

This calls for coordination or national legislation as to the definition of the local tax bases. Valuation rules, tax preferences and exemptions relating to local tax bases should all be uniform throughout the nation in order to avoid the de facto erosion of a base that is physically immobile. With standard rules for the tax base, no tax benefits can be reaped by the inefficient cross-hauling of tax bases from one municipality to another. The only incentive to reallocate resources from one jurisdiction to another should subsist in the differential of tax rates. Horizontal tax competition among municipalities must, however, be allowed to operate -as is required under the principles of accountability and public-service efficiency (benefit-tax link). However, it should be restricted to the setting of tax rates only.\textsuperscript{34}

1.4. Regional equity and long-term efficiency

Local taxation should ideally reflect a regionally equitable revenue pattern for reasons of distributional justice among jurisdictions. This is, of course, a pure value judgment, yet it may also be warranted on political grounds if social fairness and cohesion of the nation are felt to enhance political stability. On these grounds, taxes on bases that are unevenly distributed across jurisdictions (like natural resources) are not suited for local use because they usually entail large regional inequities. The regional-fairness principle is difficult to realize in practice since the distribution of most tax bases can be expected to be regionally inequitable to some degree. A local turnover tax is, however, closely linked to local economic activity, and it would rank higher, on this scale, than most other taxes.

The principle of regional equity contradicts the aforementioned neutrality argument which views the local immobility of the tax base as efficiency improving. Indeed, natural resources -like and- are locationally immobile and should rank high as local tax bases on neutrality grounds. But this is often perceived as unfair by those regions that are devoid of such resources. Moreover, the neutrality argument takes a narrow view on efficiency as it dwells on the non-interference of taxation with the allocation of private goods; it disregards the benefit-tax-link criterion which stresses the more efficient use of public goods.

Under the benefit-tax link argument, natural resource taxation at the local level should be avoided. This is because it is most unlikely that local public services and infrastructure financed through local resource taxation would enhance collective welfare and/or be sustainable in the longer run.\textsuperscript{35} Economic history is full of examples where a temporary resource boom has financed local investments that failed to produce the expected returns over a longer term. More generally, the longer-term rates of return of natural
resources seem to be higher when invested nation- (or even world-)wide rather than confined to the region of origin. It is thus preferable to tax natural resources at the national level not only for reasons of regional fairness, but also for reasons of longer-term efficiency.

In practice, a balance has to be struck between the regional government’s interest to have its citizens benefit from the wealth of local resources, and the nation’s interest to avoid large regional inequities and/or to make more efficient use of resources in the longer-term. This usually calls for some revenue-sharing arrangement between the local and national governments which can take various forms and rests ultimately on political negotiation. It must be stressed, however, that this type of tax sharing may not only be more equitable than exclusive tax assignment rules, it may also be efficiency enhancing, a fact that is not always realized by scholars of fiscal federalism.

1.5. Reliability and stability of tax bases

Local governments have to provide services on a continuous and reliable basis, local infrastructure should also expand continuously, with the larger, bulky investments being financed either through borrowing or with the assistance of higher level governments.

While borrowing must, in principle, be available for local governments to bridge emerging revenue gaps, this should neither be used on a recurrent basis, nor for macroeconomic stabilization purposes at that level. However, steady outlay performance calls for a reliable and sustainable revenue base, a base that remains largely sheltered from the cyclical variations of economic activity. It is therefore questionable whether municipalities should be given the progressive personal income taxes because these tend to exhibit greater fluctuations over the business cycle than other taxes, although local income taxation might be commendable for other reasons. This explains why local income taxes are typically proportional\(^8\). Where local governments are allowed to piggy-back on a national personal income tax, a proportional surcharge on the tax base is often preferred to a surcharge on national taxes due or paid (which would be progressive).

A local business tax also ranks low on account of revenue-stability, because local business activities might be subject to large fluctuations over the cycle; it may also be an unreliable revenue source if local businesses face a long-lasting structural crisis. However, the conclusion is not as straightforward as that. It hinges on the type of business tax employed which varies significantly among countries.

The various forms of business taxation employ very different tax bases. Business activities are assessed for tax purposes on the basis of local (gross or net) turnover, of local value-added, the local wage bill, local business capital, or local profits. Sometimes, effective cash or accrual accounting figures are used, sometimes the tax base is defined in legal terms that are independent from business decisions (for instance standard valuation rules). In some cases the business tax is similar to a minimum tax on notional capital or notional returns\(^9\). And often, the business tax appears in the form of a scheduler tax with different combinations of tax bases.
The local incidence of these tax bases is not always clear where firms operate at a supraregional level (for instance, what is local profit?). In these cases, the distribution of a compound national tax base (for instance, national profits) onto municipalities is effected by a standard procedure based on obvious local variables (like local turnover or the wage bill), or a combination of such criteria. In Germany and the United States, for instance, a formula-based apportionment rule is used for attributing corporate tax revenue to the states.

Obviously, no general conclusion can be drawn on the reliability and stability of a local business tax under these circumstances. A minimum tax on local capital is certainly less volatile than a local profits tax. A local tax on gross turnover or on the wage bill would rank somewhere in between. Furthermore, it has been argued that a local minimum tax on capital must lead to a perilous erosion of the local capital stock when firms do not make profits and still have to pay tax. This could undermine the longer-term reliability of the tax base itself. These problems encountered within the realm of local business taxation lead us to a next point -- the role of local tax sharing as an insurance device.

1.6. Tax-sharing as implicit insurance

It is well known that individuals may prefer a reliable and stable certainty equivalent to volatile and unstable revenue. For this certainty-equivalent they are willing to sacrifice resources and pay an insurance premium. Where risks can be pooled and be defined empirically, corresponding insurance contracts will be supplied by private companies - provided the government establishes rules for orderly market operations.

Similarly, regional governments have an interest to stabilize their revenue basis and may be willing to trade-in volatile sources of revenue for more reliable and steady elements. Take, for instance, the case where local budgets depend largely on a local business profits tax. This tax can be expected to be highly volatile in response to the business cycle and produce little or no tax revenue during recession. In cases, for instance, where a municipality depends on a large local employer, the situation could even become critical if the company is forced to go out of business or incurs bankruptcy. This will put strain on the local budget just at a time when revenues are most needed to cope with a local unemployment problem.

Revenue risks and structural uncertainty form yet another rationale for tax sharing between the lower tier and higher-level governments. Again, tax sharing could be welfare-enhancing and improve efficiency. This swap of revenue bases through mutual tax sharing represents an implicit insurance device for the local sector since resources of the business tax are pooled and handed back in the form of a more refillable revenue source which hinges on overall macroeconomic performance.

Local tax sharing poses, again, the problem of devising a horizontal regional apportionment formula for the shared taxes. Various criteria can be employed, although the most prominent feature is the derivation principle. Other criteria are also used where this leads to regional inequities. Local turnover, local value-added, the local wage bill, or local capital installed have already been mentioned when discussing the business tax before.
Moreover, local tax sharing arrangements may include equalization provisions: an equal per-capita component or standardized needs criteria based on statistical information outside the control of local governments. It is questionable, however, whether the central government should engage in local horizontal equalization. Ideally, the central level should concentrate on equalizing revenue among states or provinces, and leave local redistribution to a middle tier. Provincial equalization of local government finance should, however, be coordinated and subject to some general principles for the whole nation which is achieved through a framework legislation at the central level.

1.7. Administrative simplicity

Local taxes have to be administered by all municipalities alike, large or small. Since smaller jurisdictions face potentially higher administrative costs per unit of revenue raised than larger ones, the local tax system as a whole is constrained by the formers’ ability to administer the taxes. Otherwise, regional inequities would result from the effective variance in taxes collected. This calls for a simple local tax system.

Administrative simplicity works against many of the taxes that rank high according to other criteria of local taxation. A local income tax, a local VAT, a local business tax may all be commendable under most criteria, yet they are cumbersome to administer at the regional or local level. Even a property tax, the ideal local tax candidate for most scholars of federalism, rates poorly under administrative aspects since it requires sophisticated valuation rules in order to be efficient.

Industrialized countries like Germany or the United States with a long-standing tradition of public administration at lower levels of government may be able to administer local taxes effectively, in particular if the rules for assessing the tax base are the same through framework legislation or the tax base can be derived from a national standard base (like the US states’ income taxes). However, the situation is more complicated for developing countries where smaller jurisdictions may have limited administrative capacity. In many instances there are solutions to administrative problems, however.

First, the design of local taxes can be tailored to administrative conditions. For instance, a local business tax can operate under a nationally standardized tax base which is broad, based on simple cash flow accounting and focused on easily identifiable criteria such as turnover or wages paid. Since the tax is payable only by a small number of business firms, all local governments should be in a position to levy such a tax.

Second, local tax policy can make use of existing administrative procedures of government or non-government institutions. For example, a local income tax could be tagged on the centrally levied income tax in the form of a surcharge on the base or a piggyback tax on the central tax. More complicated valuation procedures, like those required under a local property tax, could be administered at the state rather than the local level, eventually by delegation. And some taxes can take the form of surcharges on services rendered by private or semi-public companies and utilities, like surcharges on electricity or telephone bills, or on the cost of water supplied. All such levies can easily be administered
at low costs by the companies that provide the service, and the rates of the surcharges can be tailored to the local preferences of citizens.\textsuperscript{41}

2. The scope for decentralized taxation

It is obvious that not all criteria for local taxation discussed are consistent with each other and could be realized at the same time. And it is clear that they jointly limit the scope for local taxation severely. Only the Scandinavian countries are able to raise a significant proportion of GDP in terms of local taxes, mainly through a local income tax or an income tax surcharge. Most other OECD countries raise, on average, less than 5 percent of GDP in terms of local taxes with a high of 8 percent for Austria, and a low of 2 percent for Australia. All countries make substantial use of complementary grants to the local sector, albeit at varying degrees. It is thus an illusion to believe that local services could exclusively be financed through own local taxes. This is true even for the high-tax Scandinavian countries.

Furthermore, the choice of taxes for local government is also limited. Disregarding smaller taxes -like gambling taxes- more substantial local revenue can be expected from local turnover or sales taxes, a local VAT, a local personal income tax, a local business tax, and a local property tax. A local turnover tax and, a priori, a local VAT has a number of drawbacks as it must interfere with similar taxes levied at the national level. Even as a piggy-back tax, a local VAT poses problems through the tax credit mechanism. It is not clear whether a local tax credit should be accorded to inventories or the purchase of investment goods, for instance, or which jurisdiction should ultimately bear the cost of the tax credit. A similar question arises as to the tax credit for exports (respectively the zero-rating of exports). This is why all countries (but one\textsuperscript{42}) that employ a VAT have refrained from allowing the local sector to penetrate that area.

A local turnover tax -unless levied as a single-stage retail sales tax- may face the problem of "cascading" which is the cumulating of tax as goods are transacted among taxable units in the process of production and distribution. For high local tax rates, cascading exhibits significant allocative distortions, and even exports may bear the tax unless provisions are made to redeem traders\textsuperscript{43}. A cascading sales tax will have a limited scope as tax rates must remain low in order to check emerging distortions\textsuperscript{44}.

A local retail sales tax may become operational, however, be consistent with accountability, and even work as a benefit-tax. It is, however, more difficult to administer - because of the greater number of taxpayers and the difficulty to impose standard accounting. Such tax is thus susceptible to large de facto inequities through the negative distributional impact of effective tax collection.

More promising are the local personal income and local business taxes. The former should take the form of a surcharge or piggy-back tax on the national income tax for reasons of administrative simplicity. In developing countries, however, a local income tax
will raise little revenue whatever form may be chosen as long as personal income levels remain low. A local business tax is, however, feasible if care is taken to keep the tax base simple.

The revenue raising potential of a local property tax is also severely limited, While it is the ideal local tax in theory, the tax seems to raise little revenue in practice (even in developed continental European nations). Only the Anglo-Saxon world appears to raise a more substantial portion of public revenue from this tax. The reasons for the poor performance of the property tax in most countries are found in political impediments that work at the local level, more than in administrative complexities. After all, people prefer to avoid the local tax burden and local politicians often have no other choice, especially in developing countries, than to collude with local voters if they want to stay in power. Nevertheless, a local property tax - albeit fraught with administrative and political problems - is an important component of any system of local finance both for reasons of efficiency and equity.

Whatever local tax system may be established in a country, there will be need for grants and there should be local discretion as to borrowing. However, the tax-grants system must be designed in a way as to allow the criteria discussed to operate. Keys to a successful system of regional finance are the free working of accountability. This requires a local tax system that responds to demand for local public services -at least at the margin. In this spirit, user charges are expected to play an ever increasing role at lower levels of government.

3. The primary distribution of resources and vertical fiscal balance

As a consequence of the foregoing analysis, intergovernmental transfers are needed to correct for vertical fiscal imbalance that results from the assignment of taxing powers. Such transfers are "general revenue means", and they can be upward- or downward-oriented. Australia, for instance, collects all the main taxes at the central levels with downward-oriented financial flows\(^45\), while the European Union budget is financed mainly through upward-oriented grants from its member governments\(^46\). No conditions should be attached to general revenue transfers, and, ideally, the rules on such transfers should have the same rank as the rules for tax assignment -- since they are designed to guarantee the functioning of minimum government operations\(^47\).

In practice, two ways to correct vertical fiscal imbalance have emerged:

- vertical general revenue grants, and
- tax sharing.

While the economic function of both instruments is identical, tax sharing rules are politically stronger, since no party can claim the exclusive right to exploit the tax base, and sharing rules are usually established at the constitutional level. Germany, for instance, uses tax sharing as a vehicle to balance the primary distribution of resources among layers of
government. We shall call it primary distribution" of resources the one which emerges after taking general revenue means into account. The primary distribution of revenue is thus consistent with the revenue function of intergovernmental finance, i.e. it allows governments to function at a minimum level.

The practical arrangements for a primary distribution of resources are usually ad hoc since no explicit level of minimum services can be clearly defined. Under pragmatic circumstances, all governments are expected to supply minimum services at a given level of finance which is either determined at the central level or, ideally, results from a coordination process which allows lower level governments to inject their voice (like in Germany). The level of finance of the poorest constituency thus defines minimum services implicitly.

If an explicit minimum level of minimum services is aimed at, the methodology for designing intergovernmental grants has to cope at least with four sets of questions:

**Needs.** It is argued that government services should reflect certain basic needs (whatever these needs are). Regional governments should be given sufficient resources to satisfy such needs. But which services are basic, and at which level should they be supplied? Is it appropriate to assume a standard basket of basic services, or wouldn’t it be appropriate to work with different baskets for different regions (mountainous, seaside; urban, nonurban, slowly or rapidly developing etc.)? Should one take a different structure of the population into account (old, young, level of education, of health)? And how could regional differences in demand patterns for public services be accounted for? Who should decide on the level of needs, and by which procedures? What - in particular - should be done if a constituency does not provide a service considered to be essential, despite sufficient financial means?

**Costs.** Government services are provided at different cost. While some of the cost differential tends to diminish under market conditions (for instance wage differentials), others will remain, in particular those associated with local services (transportation). Such cost differentials are technically easier to deal with in principle than regionally varying preferences. Costs are measurable and cost compensation schemes can be based on statistical information. However, basic normative judgments remain as to the definition of the service to be subsidized.

**Tax potential.** Regional governments can be left with an inequitable distribution of tax bases. For instance, taxes on natural resources may be assigned to the regions which leads to an uneven distribution of tax potentials (e.g. the United States, Canada or Colombia). Such problems can be resolved through assigning those taxes to higher levels (e.g. Mexico), or, eventually, by incorporating them into a vertical sharing arrangement whereby regions are left with a portion of these taxes for political reasons or regional fairness (e.g. China, Russia).

**Unexplored potential.** Despite having the exclusive right to impose regional tax bases, a particular government may chose not to exploit them in full. This is particularly
annoying if the intergovernmental fiscal machinery would honor such behavior through compensating general revenue grants to be provided by other constituencies. This would give rise to "moral hazard" and, eventually, to mutually ruinous tax competition among governments.

It is reasonable to avoid such normative questions at the level of the primary distribution of public resources. The problems of defining needs, costs, and unexploited tax potentials should be tackled at the second stage of the grants system, with the equalization function. As said before, the assignment of taxes, revenue sharing and general revenue grants committed on a regular basis should allow each level of government to function at a minimum level, and it should be clear that any horizontal redistribution of funds finds its rationale in regional solidarity, and is financed at the expense of other jurisdictions.

This implies that minimum needs must be defined implicitly without further consideration of specific criteria. The performance of the poorest region under the scheme sets the pace for minimum provisions of services. It also implies the neglect, at this stage, of existent cost differentials for the supply of services among regions. As to the avoidance of "moral hazard" and tax competition among regions, this could be achieved either through nationally uniform tax rules even for regional taxes (as in the case of Germany), or through base harmonization rules with minimum rates (as in the case of VAT and excises in the European Union).

If regional differentials are too serious, and it is not possible to define a common set of rules for the primary distribution of resources among governments without inflicting hardship, a first set of corrective measures could be used to reduce some of the discrepancies. However, this measure should not be called "equalization", because it simply attempts to correct elementary flaws of the first-round assignment of resources. This is why this type of compensation should mainly come from the federal government and not affect the distribution of funds to other regions. Such spirit has governed the earlier "special grants" in Australia whereby the poorer states could apply for compensation, by the Commonwealth, of basic deficiencies stemming from the constitutional arrangements.

4. The secondary distribution of resources: equalization

Equalization grants or corresponding formulas for tax sharing arrangements are targeted toward interregional equity. Thus, they involve political choice and value judgments. The questions raised in the previous subchapter with regard to fiscal needs, costs of producing public services, and revenue potentials are typically posed at that level of intergovernmental finance.

The coordination of equalization in a decentralized government system is not independent from the question of vertical fiscal imbalance. Where there is such an imbalance, whether to the benefit of the central government (as in Australia), or to the benefit of lower tiers of government (like in the European Union), there is scope for
asymmetrical vertical flows of fund to correct horizontal imbalances. In Australia, poorer states (like Tasmania) will receive higher standardized per-capita grants than wealthier states (like Victoria). In the European Union, the standardized per-capita contribution to the EU’s budget of a poorer state (like Spain) would be lower than that same contribution of a wealthier country (like Franco).

Where there is no vertical fiscal imbalance (as in Germany), the problem of horizontal equalization has to be effected among the lower tiers themselves, and without significant interference of the central government. This is the basic approach of the Finanzausgleich. Thus, the poorer regions (like Sachsen) receive support from a common pool of finance which is brought up by contributions of the richer states (like Hessen). Federal legislation is, however, required to coordinate such horizontal transfers among states through a common set of rules. Such legislation is, of course, subject to Bundesrat (the states’ House) approval. The following figure 2 may illustrate the workings of different equalization philosophies under different regimes of vertical fiscal imbalance.

![Figure 2: Equalization under different regimes of vertical fiscal imbalance](image)

Legend: The length of the arrows indicate the size of the per-capita transfer (except for Germany).

As to the philosophies regarding interregional equalization, it is obvious that they differ very much among federations. Moreover, there is a host of methods to achieve the objectives of redistribution. Germany, for instance, follows the uniformity-of-living-conditions principle for distributing resources among its regions, the Länder, whereby the standard provision is related to the average fiscal performance of all states. Only marginal deviations are tolerated\(^5\). Tax competition and “moral hazard” is virtually excluded by
uniform tax legislation -even for state taxes- with only limited discretion accorded to municipalities for their local taxes. Cost differentials are not accounted for at all. This would contradict the philosophy of uniformity of living conditions which aims at similar income levels in each state.44

Other federations exhibit a lower degree of solidarity among regions, and standard provisions are defined only with regard to specific programs (like primary schooling or certain infrastructural investments), they are conditional (as regards the spending area), and they are often limited to cofinancing. Moreover, they tend to minimize resource flows on purpose. This approach is applied, for instance, in the European Union, but also in the United States and in Brazil. The European Union has adopted the much looser concept of "cohesion" for its intergovernmental cooperation, and much of this cohesion is expected to be effected through markets. Grants within the Structural Funds are designed to support regions with structural problems in providing the necessary infrastructure, which aims at establishing a "level playing field" for market operations. Whether the market will indeed create cohesion remains to be seen. There are examples where this may have happened -in the United States with regard to regional income differentials, for instance (Sewell 1996). In other cases, however, the redistribution of resources among regions was insufficient to bring about a more homogenous and regionally balanced development of incomes, for instance in Brazil or China.

Australia is an interesting hybrid which disburses general revenue grants on the basis of criteria derived from specific programming with a rather general and comprehensive character.45 This may be related to the large vertical fiscal imbalance in the Australian federation. It is doubtful, however, whether one should be that specific at the level of distributing primary resources among government, and whether such sophisticated equalization criteria should be used for disbursing general revenue grants.

Equally diverse as the philosophies are the methods of interregional equalization. Grants schemes can be comprehensive, or selective and program specific. They may be closed-ended or open-ended.46 Equalizing grants can be totally unconditional, or conditional on being spent for specific programs.47 They may require cofinancing, joint decision making within some intergovernmental body, and observance of implementation procedures or legal constraints. They may support and encourage local decision making, but may also go far in eroding any discretion or regional sovereignty by imposing a set of undesired conditions while using the grant as a bait. Often, regional governments act "on behalf of the central government in which case grants may seen as restitution of costs or "gap filling."48 Grants schemes may be organized totally at the horizontal level among states -without central government interference-, or they may imply asymmetrical vertical flows in favor of poorer regions.

Any choice to be made on the grants system - particularly the equalization part of it -- will hinge on political decisions and value judgments. This choice will, however, be decisive for the longer term through its impact on the political and cultural stability of the nation and its economic development. The uniformity-of-living-conditions philosophy of Germany may have generated comprehensive welfare improvements across regions and thus
fostered economic development in general. Also, the economic fate of regions can change over time\textsuperscript{59}. It is thus important to establish a financial constitution that is flexible enough to cope with regional diversity, and which can adjust appropriately to changing conditions, if it is to encourage regional initiatives and economic growth while generating the conditions for welfare improvements of the whole nation.
IV. COORDINATION OF BUDGETS IN MULTILAYER GOVERNMENT

1. Budget autonomy and budget surveillance

Budget coordination in multilayer government has found increasing attention in recent years as a consequence of the Maastricht project of a Monetary Union in Europe. Stability-oriented European governments are concerned that a Central European Bank would have to finance large public deficits of non-cooperating member states - directly or indirectly - which would jeopardize its ability to control the money supply, and hence inflation. For this reason, the European Central Bank will be independent from European institutions and from national governments. For the same reasons, formal budget criteria for public deficits and debt relative to GDP were defined for prospective entrants to the Monetary Union in order to coordinate their fiscal policies and to install budgetary discipline. Countries not fulfilling these criteria do not qualify for entry -an effective sanction-, and, even after entry, the Maastricht criteria will be surveyed with certain, albeit weaker, sanctions in the case of non-compliance.

The Commission has to monitor the budgets of member states and to report regularly to the Council in the context of its medium-term economic and budgetary outlook. The Council continually forms judgments on "excessive" deficits and debt, which will provide valuable information to capital markets. Markets are then assured to respond by adjusting corresponding risk premia which would create incentives to restoring budgetary discipline. Eventually, even sanctions in the form of "fines" could be imposed.

However, observance of fiscal convergence criteria and surveillance works mainly ex ante, as it is a condition for entry into a privileged club. After accession to the Monetary Union it is doubtful whether the Commission or the market could use the arsenal of financial sanctions in the case of noncompliance. After all, national governments remain sovereign in formulating their budget policies, and effective sanctions of a supranational body will be hard to implement without political tensions. Also, the market's ability to impose risk premia on certain government bonds is doubtful where it will speculate on the likelihood of an effective ball-out, by the Union, of defaulting member countries. Some countries may lose interest in complying with the criteria, and "moral hazard" could become a problem.

This view has one important defect however- it is essentially static and does not count on institutional evolution. Institutional arrangements tend to be modified in the light of economic and political transaction costs. This is also true for budgetary policies- The very objective of entering into the Monetary Union may change political conditions and
constitutional arrangements, rendering a more responsible fiscal policy possible in the longer run. Also, new arrangements and institutions will be formed that allow to effectively coordinate fiscal policies at the European level while preserving subsidiarity. Ultimately, new instruments to sanction irresponsible behavior by national governments might be developed. In the meantime, the most effective instruments of policy coordination is information.

Since coordination of budgets is a particularly sensitive issue in view of national sovereignty (which excludes direct interference into parliaments’ rights to determine the level of taxation and spending in any one state of the European Union), it should mainly be based on information and guidance by formal principles or criteria. Formal budget coordination seems to be the only possibility to reconcile political sovereignty with the need to achieve some degree of harmonization of budgets in federal states and unitary states with an autonomous local sector. As stressed before, such formal coordination may be extremely successful in material terms, because it affects political behavior - as can be observed in Europe. Germany exercises formal budget coordination of federal and subnational governments through its Law on budgetary Principles, for instance. Such principles may have a common significance for budget coordination for other decentralized government systems which warrants to discuss them briefly.

2. Formal budget coordination principles

The Law on Budgetary Principles of 1969 attempts to coordinate the budget process and its performance by guidance through uniform principles to be observed by all authorities. Such principles extend from very general provisions (like the budget principles of gross estimates, comprehensiveness, unity, clarity, periodicity and antecedence, efficiency and cost effectiveness, authorization to spend and to commit resources) to more specific rules regarding the preparation of the budget, to accounting and the rendering of accounts (including the classification of the budget), to auditing and discharge, and to rules applying for special funds set up under federal or state legislation. Also, the budget process was made more transparent in order to assess the budget’s effects on the general course of the economy. The second part of this legislation contains regulations that are generally and directly applicable to the Federation and the states, like multi-year finances planning and the exchange of budget-related information.

The Law start from the premise that uniform national policy goals can only be realized if public budgets of central and subcentral governments can be monitored effectively and in a standardized fashion. Otherwise the coordination of budgets is bound to fail. This has led to a uniform framework of budget classification and outline whereby the need to form economic categories and to relate budget items to categories of the National Accounts has played a prominent role. Nevertheless, the accounting principles of the budget remain cash-oriented while the National Accounts attempt to realize an accrual concept. A cash-based budget concepts is, however, closely related to financial statements which record sources of financing the deficit and the net financial position of governments.
vis-à-vis private sectors. Obviously, given a harmonized framework of budget classification, this must facilitate the consolidation of budgets across different authorities at various layers of government.

Although the annual budget is cash-oriented, i.e. only income and expenditure items are accounted for that are expected to lead to financial operations during the budget year, all authorities are obliged to assess, on separate accounts, the expected need for spending authorizations for future budget years (Verpflichtungsermächtigungen).

The Law has reemphasized the classical principles of comprehensiveness of budgets and of accounting in gross (rather than net) terms. All public expenditure and revenue should appear on public budgets and be subject to national consolidation, and, ideally, no special funds should be tolerated that, once established, easily escape democratic control\(^\text{49}\). "Off-budget" funding is indeed a prominent instrument for circumventing budget constraints and to protect special interests. Moreover, expenditure items should appear in full cost terms, and consolidation of such expenditure with specific revenue items is ruled out. There are exceptions to this precept, however. Financing of public budgets through capital markets and the redemption of public debt are shown in net (rather than gross) terms. This was seen to be more relevant for evaluating the impact of budgetary policy on capital markets and, eventually, on monetary policy.

Other rules for budget coordination are of a procedural nature, for instance chose relating to the preparation, the establishment and execution of the budget as well as formal budget control and auditing\(^\text{50}\). Also, the annual budgets (calendar year) have to be embedded in a medium-term Financial plan which is established jointly by a Financial Planning Council representing all three tiers of government. Its objective is to reach agreement on the coordination of general budgetary policy and to support the federal government in its statutory task to achieve a harmonized stability-oriented budgetary and fiscal policy. The Financial Planning Council is, however, bound by the Constitution to respect the autonomous and independent fiscal administration of states and the right of self-governance of municipalities. It therefore acts through recommendations which are non-binding, yet have a strong impact on budget estimates and budget execution (including the level of borrowing). This requires, however, a cooperative environment in which independent budgetary authorities are willing to implement such recommendations within the realm of their responsibilities.

Medium-term financial planning is of prime importance in a situation where budgets are more and more determined by financially open-ended welfare programs. Such programs tend to establish eligibility criteria for certain transfers and services which is often passed without regard to its long-term impact on budgets, because eligibility is difficult to anticipate (e.g. the need for old-age care). Even where the financial impact of legislation is easier to evaluate (e.g. for public pensions through demographic projections), politicians - who tend to be myopic and reluctant to glance beyond the term of their mandate - often do not consider such consequences. Moreover, a cash-oriented budgeting system tends to underrate such consequences even though a medium-term financial plan may put short-run legislation into a longer perspective. This is true, at least, for the immediate consequences
of investment projects, for instance. Whether this is sufficient, is doubtful, and suggestions to reform the budgetary process and its accounting framework emphasize the need to supplement the cash concept with an accruals concept for the public budget.

Another important topic is macroeconomic management in a decentralized system. Toward the end of the 60s, Germany pioneered legislation in this area. A Stability and Growth Law was enacted which commits the federal government to accomplish certain macroeconomic targets and provides specific instruments enabling authorities to pursue demand management policies effectively. An intergovernmental Business Cycle Council (Konjunkturrat) was established to guide governments in coordinating their budgets (apart from medium-term planning), and an attempt was made to influence trading partners through concerted action (Konzertierte Aktion). Yet formal coordination essentially failed (except for the very beginning) as the crises of the early 1970s were found to be structural in nature and the arsenal of policy instruments provided by legislation to be inappropriate for such purposes.

More recently, the need for coordinating budgets in a federation in order to absorb shocks through macroeconomic stabilization policies has been questioned. Especially supply-induced shocks tend to have important regional impact which -- contrary to conventional wisdom -- makes a case for decentralizing even the stabilization function (Gramlich 1987). As Gandenberger (1996, p. 20) points out: "Keynesian appraisal ... tends to exaggerate the coordination problems with respect to the task of shock protection."

3. Monitoring the level and structure of public debt

Limitations on government deficits and controlling the level and structure of public debt is of key importance for the stability of an economy. Decentralization of government entails the risk that autonomous territorial governments, states and municipalities, will incur debt without regard to an overall constraint on public sector borrowing. Especially where own revenue is weak, and there is a feeble correspondence between revenues and expenditure this may pose a major problem for the overall equilibrium of the public sector, especially where territorial governments are encouraged to use their transfers as a leverage to enlarge their reliance on debt financing. Often the grants system (especially the cofinancing arrangements) encourage municipalities to incur additional debt without accountability (reducing the incentives to raise own revenues or restrict own expenditures). This calls for some fiscal restraints on public sector borrowing and the level of debt.

One approach to controlling public debt at lower levels of government is through the disposition of important own resources at that level. "When a subnational government retains significant autonomy over taxation, it can be asked to use tax policy to deal with the fiscal problems it creates for itself" (Eichengreen von Hagen 1995, p. 314). This argument is stressed against the need to install additional fiscal restraints in the European Union where member states are effectively controlling all fiscal resources but a few. It could also be used against fiscal restraints at lower levels of government in countries such as the United States.
or Germany where authorities either exploit important own taxes (the retail sales tax), or benefit from comprehensive tax sharing. Nevertheless, 49 out of 50 states in the United states operate under fiscal restrictions of some sort, in particular constitutional debt limitations or balanced-budget requirements.

In Germany, public debt is permitted both for central and subcentral levels of government. However, certain institutional limitations apply (Spahn 1993, pp. 61-63):

- Borrowing from the central bank is not available for all tiers of government.
- The constitution restricts federal government borrowing to the "amount of projected outlays for investment purposes in the budget" ("golden rule").
- Similar rules apply to Länder budgeting in accordance with state constitutions or legislation.
- Local government borrowing is tied to their cash flow and subject to state control. The modes of this regulation may vary from state to state.

The other major federation with borrowing restrictions is Australia where access to capital markets is coordinated by the Loan Council under the guidance of the Commonwealth. This Council was established in the late 1920s when there were concerns that uncoordinated borrowing by states could lead to ruinous competition by which interest rates would be driven up on capital markets to the detriment of Australia as a whole. Later, the Loan Council became an instrument for macroeconomic management, and more recently authority to borrow has been returned to state governments as it had become clear that Commonwealth dominance in the Council was not sustainable. Nowadays, the institution works as a clearing house for information on the flotation of public debt, and intergovernmental coordination of borrowing has become informational and more subtle.

Obviously, information is the key instrument for coordinating public sector borrowing and controlling the level of indebtedness. The level of consolidated public debt and net financial public deficits constitutes important information for capital markets, but this is certainly not sufficient. Some countries report the total of public borrowing requirements, including the rescheduling of existing debt. The latter would forego control if only the current budget and its deficit would be subject to monitoring. Moreover, the Mexican crisis has shown that neither deficits nor the level of public debt are sufficient to indicate pending budget crises because the term structure may be highly relevant for the process of rescheduling existing debt. A trend toward short-term financing and refinancing of public budgets and debt indicates increasing budgetary risks, as it may restrict the central bank’s ability to control the money supply. It is therefore of prime importance to supplement budgetary information with complementary indicators such as the level of public borrowing requirements and the term structure of public debt.
4. Reforming the framework of public budgeting and control

In recent years, public budgeting has been criticized in view of the need to control fiscal policy and to coordinate budgets on the basis of a harmonized system of accounting and performance measurement (Buschor/Schedier 1994). It is acknowledged that traditional budgeting has its strengths in allowing a systematic presentation and control of policy implementation as to its financial resources imputed and used. It also facilitates to bridge the gap between policy implementation and financing the public purse. However, there are a number of drawbacks that need to be tackled in order to monitor public sector performance and to allow effective formal budget coordination in a multi-government setting.

- Public sector accounting should reflect the use of resources as costs like any private sector business institution.

- Public sector accounting should indicate the level of present commitments for future budgets and future generations.

- Public sector accounting should ideally allow some monitoring of performance based on service-cost indicators.

- Public sector accounting should reflect the net asset position of governments at all levels.

As mentioned before, New Zealand and the ACT have pioneered public sector accounting on the basis of GAAP. There are also attempts to measure governments' net wealth position, and interjurisdictional comparisons may serve to establish service/cost indicators in order to monitor public sector performance. If the aim is to practice a "golden rule" of public sector borrowing, i.e. access to capital markets is restrained to financing real public assets the benefits of which extend over several periods, it would be useful to split the budget into a current and a capital budget (as in some European countries, e.g. Luxembourg). New Zealand has extended this approach to monitor the development of net government value with the aim of controlling intertemporal budget restrictions.

Generational accounting is another tool that has come to some prominence in recent years (Auerbach/Gokhale/Kotlikoff 1994, Sturrock 1995). It attempts to evaluate the net redistribution of public resources across generations and the sustainability of fiscal policies in the longer run. A key concept is the net fiscal residuum. The present value of expected lifetime transfer receipts for each age cohort is subtracted from the percent value of expected life-time taxes for each group. This serves to measure the degree of fiscal redistribution among generations, and it allows to assess the explicit and implicit liabilities of welfare systems that will impinge on future budget positions, in particular those related with aging populations (Auné 1993 and Chand 1996, quoted from International Monetary Fund 1996). The implementation of such concepts requires highly controversial assumptions (e.g., on a single discount rate, the incidence of taxes, etc.) and imposes a heavy demand.
on data. In addition, projections based on Generational accounting methods are subject to uncertainties such as the rate of growth, demographic change (e.g., migration), and life expectancy. It is obvious that such concepts provide useful insights on the long-term sustainability of budgets, but they cannot substitute budgeting itself. Fiscal consolidation must always be carried out on the basis of "hard" financial data and customary budgeting. Accrual accounts, generational accounts and additional information can only be subsidiary.
V. A EUROPEAN'S VIEW ON FISCAL DECENTRALIZATION IN
LATIN AMERICA

This final chapter must begin with a word of caution: Any foreign scholar of federalism
must fall in doing justice to the cultural heritage and traditions of Latin America when
commenting on its political systems and its options for reform. Latin America has both a
centralist tradition and an almost permanent conflict with local powers and the quest for
decentralization. This implies the need to analyze any decentralization strategy within the
specific politico-institutional dimensions of this subcontinent (Fuhr/Campbell/Eid 1995, p.
4). Some countries are highly decentralized (Argentina, Brazil), others have a federal
structure but the center remains dominant (Mexico, Colombia), and others are unitary with
decentralized administration (Chile) or remain in the centralist tradition (Peru).

Intergovernmental relations are indeed largely shaped by historical processes in all
federations and unitary states of the world. There is a great variety of models adopted, and
all of the solutions found seem to work reasonably well within their general political and
constitutional framework. This does not preclude adapting to new circumstances through
institutional change and innovation.

There are a great number of studies relating to intergovernmental relations in the context
of other federations. There are also conforming policy recommendations for Latin
America\textsuperscript{60}. These will not be commented here. The author rather wants to address some of
the key problems relating to decentralization in Latin American countries as seen from his
own standpoint, and to ease the question how a European would tackle these problems
against his own experience.

1. Expenditure assignment

It is crucial for Latin America's intergovernmental fiscal relations that expenditure functions
be assigned clearly and unequivocally in order to avoid duplication, political conflict, and
a waste of economic resources. The theory of federalism provides guidance in establishing
such a division of functions. Also, international comparison may help in many respects.

Outlay functions should be assigned to the provincial level whenever demand for
public services differs among regions. The region can then better tailor its public services
to local demand which is more efficient than a uniform provision of the service. This is the
essence of the "decentralization theorem" of the theory of federalism. The European Union
has even reversed the burden of proof by adopting the "subsidiarity principle" according to
which public functions should always be exercised at the lowest possible tier unless they are positively proven to be serviced more effectively at a higher level of government.

Education and support of cultural activities are such important functions of regional and local government. Education and culture also serve as a powerful tool to protecting and preserving regional minority groups. Other important regional functions are public order, public welfare, health care, regional and local and planning, roads, the use of water and other resources, the protection of the environment, the fostering of research, science and arts, universities and vocational training.

Decentralization of functions may also be warranted on administrative grounds. Provinces are typically closer to citizens and problems, and they may administer certain functions more competently than the central government. This does not exclude the possibility that provinces operate within national framework legislation or perform delegated state functions on behalf of the central government.

The allocation of expenditure functions among the tiers of government will have a bearing on intergovernmental relations as well. For instance, autonomous provincial functions require the availability of unconditional revenue which must be either own funds or closed-ended general grants which can be used at the discretion of the region. Provincial services provided within the realm of national policies may be consistent with special-purpose payments conditioned on observing national standards or framework legislation. Delegated functions, finally, would seem to require open-ended cost coverage grants (gap filling). In the latter case, it is essential that the central government has full control over the expenditure side and that inefficient cost maximization by provinces or local governments can be avoided.

2. Tax assignment

Once a clear division of functions has been established, the next step is to solve the tax assignment problem. This problem hinges very much on the assignment of outlay functions (Ball/Linn 1983) and it is crucial both for the vertical fiscal balance as well as the scope for first-round horizontal equalization. A robust local tax system may also contribute to mobilizing additional resources for public services as well as to enhance the efficiency and equity of the tax system as a whole.

Europeans tend to assign customs duties and indirect taxes to the central government, and direct taxes to regions. This is true in particular for the European Union as a whole, but it also applies - in principle - to federal countries like Germany and Switzerland. But the scope for direct taxation - at whatever level - is typically very narrow in developing countries, which restrains the value of European experience. Perhaps for that reason, Brazil has adopted, contrary to most other federations, a decentralized system of value-added taxation which entails, however, severe coordination problems (Spahn 1992). It is therefore questionable whether this approach should be adopted by other Latin
American countries. Argentina also assigns an indirect tax to provincial jurisdictions, the tax on gross receipts (at each point of sale), but only two components have a clearly defined territorial base (motor vehicles and real property). Furthermore, the potential of these taxes is restricted which entails a strong vertical fiscal imbalance.

Given the importance of the allocation function for decentralization, local taxes should be chosen on efficiency grounds, i.e. the benefit principle should dominate. Furthermore, such taxes should be simple to administer. This calls for innovation and, perhaps, new attitudes toward some user charges where people have come to expect government services for free. For instance, local taxes can take the form of surcharges on services rendered by private or semi-public companies and utilities, like surcharges on electricity or telephone bills, or on the cost of water supplied. Such levies can easily be administered at low cost by the companies that provide the service, and the rates of the surcharges can be tailored to the local preferences of the municipality. Such taxes have a distinct regional incidence pattern, and they reflect local economic activity much more clearly than some excises like the taxation of tobacco, alcohol, and petrol. In addition, their revenue elasticity with regard to income is much greater than for conventional excisable goods, and they are difficult to avoid through cross-border shopping.

On equity grounds, one may argue against such local surcharges because the charge is also falls on the poor. However, it can be demonstrated that the benefits of such subsidies are more substantial for the rich because of their much higher consumption of energy and water. A benefit-oriented approach to local taxation should therefore be combined with targeted social assistance to the poor, which is preferable to the direct subsidizing of production and distribution of water and energy. Finally, environmental charges on electricity consumption would often require prior adjustments of general and sectorial macroeconomic policies at the national level since administered pricing is still prevalent in many Latin American countries.

3. Discretionary tax policy

Discretionary tax policy of lower-level governments is very high in Europe even in unitary states. Germany accords some limited tax discretion to its local governments, albeit not for income taxes. Where it exists, discretion is highest in the realm of income taxation and user charges. Moreover, local governments must raise a significant portion of own revenue. "If they do not, the whole rationale for improved economic efficiency and enhanced governance is in jeopardy" (inter-American Development Bank 1994, p. 180).

There is no uniform approach to local tax sovereignty in Europe, yet there is wide agreement that some tax discretion should be given to lower levels of government - especially to municipalities. This includes the right to borrow provided that a national bail-out can be avoided. In order to limit such risks, own revenue of local governments should be sufficient to render them autonomous in dealing with their finances (Eichengreenv Hagen 1995). Where local tax potentials are to small, this can eventually be achieved
through tax sharing or grants to be distributed on a firm and consistent basis. However, too heavy reliance on grants should be avoided as there is always the risk of a "flypaper effect" which contributes to budgetary growth at all levels of government.

4. Readjusting vertical fiscal imbalances

The first-round distribution of shared taxes or general revenue grants should ideally avoid vertical financial imbalances to leave some scope for vertical equalizing grants. The purpose of the first round is to provide all governments with sufficiently high levels of general finance in order to allow them to function at a minimum level. If a robust horizontal distribution criterion (like weighted population) is embedded in these arrangements for a major joint tax, like VAT, the achievement of this goal does not require complicated comparisons of standardized budgets. Also, adjustments to vertical fiscal imbalances can easily be effected within the realm of tax sharing -- as illustrated by Argentina or Germany.

Yet it is not easy to determine vertical financial imbalances (except in extreme cases like Australia). Moreover, the problem of vertical fiscal balance might be severely blurred if all layers of government are allowed to incur debt. One rule should be to look predominantly on current expenditures (including the servicing of outstanding debt) and regular revenue (including general revenue grants and tax sharing means that are available on a recurrent legal basis). These budgets should then approximately be balanced at vertical levels on average, and also allow some saving for the capital budget. Capital budgets should ideally be financed by borrowing where the "golden rule" should reign7, but public borrowing of all levels should be subject to institutional constraints at the macroeconomic level which requires some intergovernmental policy coordination. This could take an institutional form like the Australian Loan Council, and it should involve the central bank.

In a longer-term perspective, tax assignment cannot avoid emerging vertical fiscal imbalances however. Any assignment of taxes is arbitrary as regard the development of outlay functions over the longer run. Tax sharing allows to respond flexibly to such structural changes by adjusting the proportion each tier of government acquires from the common revenue pool. This is the solution adopted in Germany where the share of VAT is continuously adjusted to expenditure developments; it is also the method used to adjust VAT sharing at the level of the European Union.

In Latin America, a certain degree of fiscal imbalance in favor of the central government is, however, desirable since it creates the potential for equalization through asymmetrical vertical grants. If no vertical fiscal imbalance would exist, on average, the central authority would have no room for equalization payments to provinces and local governments. An exclusively horizontal equalization scheme like in Germany seems to be out of question for Latin America, but equalizing vertical transfer payments requires financial scope at the central level.
Some vertical imbalance in favor of particular regions may however be tolerated for the sake of political stability. For instance, if a resource tax is fully pooled, some portion of the tax might be returned to the region where the resource is located. This portion may even be excluded from accounting for further equalization provisions. The resource-rich region may retain a bonus not only for reasons of political appeasement, but also for reasons of extraordinary public services and infrastructure related to exploiting the taxed resource. However, a compromise should be found between national and regional interest which lies somewhere between to solutions adopted for, say, Mexico on the one hand, and Colombia on the other.

5. Regional apportionment of shared taxes

If there is tax sharing, the way shared taxes are apportioned to regions is of utmost importance. This is because they can incorporate a built-in first-round equalization mechanism.

If taxes are distributed according to the derivation principle, regional tax revenue reflects regional taxable potentials (assuming a uniform tax law and identical administrative efforts). This renders strong provinces strong, and leaves economically weaker provinces weak. Some would regard this an appropriate strategy for economic development as tax money is redistributed to those provinces where the rates of return are highest. The argument is doubtful, however, mainly for three reasons:

- First, a national economy forms an integral market, and prosperity of one region hinges on economic developments of other regions. Moreover, the strengthening of purchasing power in the nation as a whole may become a crucial factor for realizing economies of scale through mass-production.

- Second, prosperous regions today may face structural difficulties tomorrow, and some regional diversification of infrastructure may thus be welfare-enhancing over a longer period. As mentioned before, Germany has experienced a relative decline of the formerly prosperous North, while the previously "backward" South is now the engine of growth through its modern industries and services. The equalization scheme should flexibly respond to such structural change.

Whenever such conditions prevail, tax policy operates in a "second-best world" where equalization provisions can even be welfare-enhancing. Of course, the main rationale for equalization is regional fairness and equity, but this argument hardly convinces the presently prospering provinces. The efficiency argument may be more persuasive here.

Nevertheless, the derivation rule for shared taxes is strong and universal. In Europe, it is mainly used for personal income taxes where the residence principle applies. The rule is more difficult to affix to the corporate income tax if firms operate at the supraregional
level. In these cases, an attempt must be made to apportion the yield among regions according to indicators of regional economic activity.

The derivation principle applied to VAT, as in Brazil, seems to exhibit undesirable and potentially disruptive consequences however. VAT is essentially a tax on consumption. It zero-rates exports as it exonerates the formation of capital. One consequence could be that exporting regions lose under such a scheme (through the tax credit to exporters) while importing regions would benefit (through the collection of import tax). Brazil attempts to mitigate such consequences through intergovernmental cooperation of state finance ministers (CONFAZ), but this has lead to complexities of the system that encourage tax avoidance and evasion through false declarations. A sharing scheme with exogenous distribution criteria seems to be more advantageous here.

Germany avoids such consequences by distributing its VAT mainly according to population - which entails a significant redistribution effect in favor of poorer regions. Another portion of VAT is used for explicit asymmetrical vertical general revenue grants to be given to the poorest regions by the central government. Over the medium term, it might well be appropriate for Latin America to consider some implicit equalization mechanism for the first-round tax distribution of VAT. At least one part of VAT could be allotted according to population (or some other indicator of fiscal need) while the remainder may continue to be disbursed on the basis of local yield. Population figures could also be weighted in order to account for agglomeration effects when relating the big cities to rural areas. This might imply a two-stage distribution formula where one part of VAT goes to the region as such, and another part - with or without pass-down obligations - to municipalities.

6. The grants system

The grants system should in principle be neutral as to the decisions of lower level government. The accountability and responsiveness of provinces to regional demand patterns should ideally be unaffected by the financial system. This is, of course, not fully realistic especially for unitary countries of Latin America where the national government pursues policy goals that affect provincial budgets and decision making. Nevertheless, the general neutrality rule has a significant bearing even for unitary government. It implies, notably, the following recommendations:

- Gap-filling grants should be avoided under almost all circumstances. The unconstrained or negotiated coverage of budget costs encourages inefficient spending at lower levels of government. It is thus wasteful in economic terms. Moreover, it is intransparent and it is likely to exhibit regional inequities. Grant money typically flows to the politically strong provinces and municipalities, not where it is most efficient or most needed. The only rationale for gap-filling or cost-coverage grants exists for financing functions that are mandated to lower tiers of government. In these cases the province provides the national service on behalf of
the central government (which may be warranted on administrative grounds). It is essential however that the central government be able to control the level of spending in these cases (e.g., welfare payments through national legislation).

- Grants to regional governments should in principle be unconditional. They should be utilized at the discretion of lower level authorities, which would strengthen their expenditure responsibility and accountability. It also renders them flexible to respond to local demand for public services. Specific purpose payments (SPPS) as an alternative to unconditional grants often fail to achieve their respective goals. If SPPs are given for a specific service that would have been supplied by the province anyway, the SPP is tantamount to an unconditional grant since it frees general resources of the budget. If the SPP is given for a service that would not be supplied otherwise, it may fall to meet the pattern of regional demand, and spending would then be wasteful. Moreover, spending is different from output. Provincial governments may find ways to spend the SPP and still fail to meet a given output goal. This is why general revenue is preferable to SPPs as provincial budgets remain responsive to local demand.

- For a reduced number of issues, SPPs seem to be in order however. This is true whenever strategic behavior of lower level authorities can be excluded - like for disaster relief where the grant is given in response to events outside the control of government. It is also useful to employ SPPs whenever the central government aims at realizing qualitative policy goals that are not directly related to spending as such. For instance, SPPs could be conditioned on the adoption of national quality standards in the provision of health care or education. In these cases, SPPs become the vehicle for realizing qualitative policy objectives. SPPs then become a "bribe" where the spending decision (whether it uses the grant or unconditional revenue) of the lower-level jurisdiction is secondary.

- As mentioned before, it is doubtful whether SPPs can impose central priorities onto lower level governments - unless spending is confused with output. However, SPPs may still be in the interest of the central government if it wants to demonstrate the political will to support a specific service even if the province would supply it anyway. This is the political "signal function" of SPPS, an entirely respectable policy goal. Such type of SPPs is employed in the case of politically sensitive issues (like minorities) where the central government must have an interest to "signal" policy objectives to its voters. However, there is an inherent tendency to proliferate that type of grant. The number of signalizing SPPs should thus be restricted, and periodically be consolidated into unconditional "bloc grants" in order to clear the "jungle" of intergovernmental subsidies.

- If SPPs are provided, care must be taken in analyzing their potential disincentive effects. Not all politically sensitive issues do warrant SPPS. Unemployment, for instance, is undoubtedly a sensitive issue, yet it should not lead to corresponding SPPS. This is because such grants could be interpreted as implicit insurance which would encourage strategic behavior of provinces. This is because insurance
contracts suffer from a series of defects which may bear on intergovernmental fiscal relations as well. One such deficiency is related to "moral hazard" whereby a change in behavior is induced by the very nature of the insurance contract. At the level of intergovernmental finance this might lead to self-inflicted shocks (for instance, the surrender to unrealistic wage claims), or excessive consumption by provinces. Another problem is "adverse selection" which may tend to divide countries into groups of provinces with different "risks". Automatic compensation could also encourage political inactivity in the area of structural adjustment policies. Criteria like regional employment should thus be excluded from determining the level of grants -- because of their potential negative incentive effects. If a national unemployment insurance scheme operates at the personal level - for the unemployed - the implicit regional redistribution effects should be wholly sufficient.

Wherever there are regional spillovers, conditional grants and cofinancing models can be useful to improve public sector management (Boadway/Shah 1992), and there may be a case for horizontal cooperation and specialized development programs. However, the functional division of government with its vertically segmented funds and the earmarking of taxes - as found in some Latin American countries - is highly inflexible and inefficient and should be avoided. All such funds should be transferred into a general budgeting framework of the central government whereby some programs may be suitable for administration at lower levels of government. In these cases, SPP grants may be appropriate for a limited time of transition, but such SPP should be subject to the general policy lines discussed above.

7. Horizontal equalization

Second-round adjustments to the primary distribution of government revenue are typically concerned with equalization. Equalization arrangements can take very different forms and they can be conducted out of a situation of vertical fiscal balance (as in Switzerland and Germany) or of imbalance (as in Australia). In the first case, a horizontal distribution formula may be used (Germany); in the latter case, the states have to agree on a vertically asymmetrical grants scheme with the central government. Obviously, the states are politically much stronger in the first case while they might be somewhat at the mercy of the central government in the latter.

It was mentioned before that Latin American countries are unlikely to adopt a horizontal equalization scheme. Thus the following relates to a scheme of asymmetrical vertical equalization grants from the central government to regional authorities for which actual tax assignment and tax sharing seem to exhibit a sufficiently large scope.

Equalization should be based on a formula that is general and transparent. The formula should provide general revenue as in Australia, and it must be independent of strategic behavior at the provincial level. This requires some form of revenue and/or outlay
standardization, and it excludes, of course, negotiated elements of the grant system. The formula should also be based on hard statistical data that cannot be controlled by regional governments, and which are available at the same quality level for all provinces or municipalities.

More generally, equalization schemes of all nations have to deal with horizontal redistribution in order to equalize standard own taxable capacity, standard expenditure needs; and effects of population density and agglomeration on local expenditure needs." Some countries have formally adopted this approach by equalizing the difference between standard own fiscal capacity and expenditure needs, correcting it by factors that account for density and agglomeration effects (Germany). Others, like Australia, attempt to incorporate population density and agglomeration into the definition of needs.

The European federations emphasize revenue equalization. Revenue has to be standardized in order to define the fiscal capacity of each region. This standard must be independent from regional policy in order to avoid strategic behavior. If provinces are allowed to vary tax rates of their taxes, a standard (average) rate should be used. If they prefer not to exploit a tax source which is assigned to them, potential revenue from that source should be added into the capacity yardstick whether collected or not. Once standard revenue capacity is defined for all regional governments, the variations from average standard capacity can be equalized to a predetermined degree. Revenue capacity equalization by itself is a very powerful tool although it can be argued that it falls to account for differences in needs and agglomeration.

There may be reasons for same standard corrections to the fiscal capacity yardstick by including needs and agglomeration criteria in a condensed fashion. European federations consider needs and cost differentials by simple weighting procedures (for population density, for farmland of a certain geographical altitude, etc.) rather than by effective statistical sampling methods. Some lump-sum adjustments for different levels and composition of outlays are also effected for city states (agglomerations). However no attempt is made to standardize regional budgets explicitly -item by item- as in Australia. The simpler European approach can be regarded as a proxy to achieving the more ambitious goal of full budget equalization. It is viable as long as it is politically accepted by all participating governments.

To the question whether equalization requires the standardization of budgets (as in Australia), the answer of a European scholars of federalism would be negative. Although the Australian approach seems to offer a "scientific formula" which must appeal to chose in search of an objective basis for equalization, the approach is not without risks. These are mainly related to the immense information requirements for budget standardization. It is doubtful whether Latin American countries will be in a position at least in the short run-to supply all the data needed for all provinces or municipalities at the same level of quality. Even a simpler set of parameters bears risks as statistical criteria tend to proliferate over time when selfish political pressure is exerted to "look into more detail."

Whatever the equalization arrangements are, they must be based on firm statistical criteria. Too complicated formulas are likely to blur the political issues, they may meet
statistical difficulties, and involve complicated conceptual measurement problems to which there is no conclusive answer.

In the end, equalization is a matter of value judgments and political compromise. Europeans would prefer simple formulas that serve as proxies to the equalization problem. In practice, these simple methods have reached a high degree of equalization and are deemed to be largely successful in achieving their policy goals. The simpler the formula the higher will be its transparency and political message. The formula should, however, stress the fact that what is gained by one province, has to be borne by other region(s), in other words, the shared pool or the equalization means should be closed-ended and distribution is a fixed-sum game. This by itself assures that the mechanism is deemed to be equitable by all participants.

8. Capital expenditures

Capital expenditures might remain somewhat outside the normal arrangements for various reasons. In particular, their financing may be tied to borrowing, and only indirectly to taxation. If regional governments are allowed to borrow (as in Switzerland and Germany), there must be policy coordination of borrowing at the national level in order to avoid capital markets disturbances. If lower levels of government are not allowed to borrow, their capital expenditures must be borne mainly by the central government through capital grants.

European arrangements prefer tied (or conditional) grants for dealing with public investments at lower levels of government. Typically, grants by the central government have to be matched with own resources at the lower level. This is in order to unveil local preferences more clearly, and to enhance accountability. This idea is firmly entrenched in the Swiss and the German arrangements, and it is also found at the level of the European Union.

Germany (and to some extent Switzerland) go, however, beyond the idea of matching grants. Decisions of regional public investment projects are taken jointly by the regions and the central government. This is in view of the bulky nature of some investment projects. It also avoids patronage of same regions and a fair sequencing of projects through time given the limitation of resources at all levels of government. Germany has created various task-oriented institutions for coordinating intergovernmental decision making relating to infrastructural investments. A more formal joint-decision making machinery for provincial infrastructural investment and regional economic development may also be an option to be considered in Latin America.
9. Information

Information policies are of key importance for decentralized government. Information is needed to render coordination effective, to inform lower-level governments and their electorates on national priorities, to foster interregional cooperation, to establish transparent rules for the distribution of financial resources among jurisdictions, to measure tax bases and potentials and to monitor the efficiency and cost-effectiveness of providing public services at the regional level. It is also important to spur competition among jurisdictions and to foster innovation.

The availability of data is therefore crucial for the success of decentralizing government. It is not sufficient to based policies on existing data and prevailing perceptions since these tend to support the status quo rather than decentralization as a means to improve social welfare. "New information would probably force a debate and induce a change in policies" (inter-American Bank 1994, p. 192), which may alter the balance of interests. This largely explains the resistance against comprehensive information policies and new reporting schemes of certain influential groups which benefit under the present arrangements.

Information is also likely to affect existing institutions whose functioning (and even existence) may be questioned under the auspices of decentralization. This applies in particular to the vertical functional funds which thrive on ear-marked taxes or grants. This may explain the resistance against information policies of bureaucrats and their "clients" who benefit from the scheme. Despite such political friction, decentralization must proceed through wider and better information in order to allow effective control and to build reliable new institutions for intergovernmental cooperation.

Notes

1. The various forms of decentralized government and the different approaches to decentralizing government are described, for instance, in Inter-American Development Bank (1994), p. 183ff.
2. Krause-Junk and Müller distinguish voluntary functions, obligatory functions, and functions by order of another level (1996, p. 7). All three functions coexist, for instance, in the German model of intergovernmental cooperation. The latter (function by order) uses subnational governments simply as agencies of a central executive. The terms "coordination" or "cooperation" would be wholly inappropriate in this case. The principal-agent model seems to be pertinent to "obligatory functions". And voluntary functions are the subject of cooperation among autonomous authorities.
3. The experience of Brazil does not seem to support such optimism, however.
4. See, of instance, Krause-Junk/Müller 1994, p. 25f. and the discussion in this paper further below.
5. More recent trends reveal however that this form of coordination and cooperation seems to function reasonably well only under "good weather" conditions. More severe structural and cyclical adjustment problems -like those after German unification or the challenges of a globalizing world economy- appear to be more difficult to manage on a formal basis. This may call for a revision of coordination and cooperation within multilevel government even for the more industrialized countries.

6. The constitutional mandate to secure the uniformity of living conditions is very strong in Germany, and no other federation has gone so far in equalizing public resources across regions. The term "cohesion" used in the European Union is much weaker indeed.

7. Some authors emphasize the need to maintain a proper sequence in the process of decentralization where revenue transfers should not outface the transfer of outlay functions (Wiesner 1994, p. 192), and it is criticized that this sequencing has often been despised in Latin America (Fuhr/Campbeli/Eid 1995, p. 2).

8. Competition for fiscal resources could, however, become overly fierce and even ruinous which would limit the scope for financing lower government through own taxes. This can be avoided through intergovernmental coordination like agreements on minimum rates (see 4.1.3 below).

9. This is the essence of Oates'"decentralization theorem" cited above.

10. For a theoretical discussion of the division of functions among levels of government see, for instance, Oates (1972), Chapter 2, and on tax assignment within the "layer-cake" approach Spahn (1988). See also Van Rompuy/Abraham/Heremans (1 990).

11. For Tresch, respect of local preferences is the only original reason for decentralized government, since all other aspects result from asymmetrical information.


14. This transfer of resources among state government provides unconditional finance, and it is purely equalizing. It constitutes, for all states conjointly, a zero-sum game, i.e. the central government has no own financial interest in the outcome.

15. Administrative procedures and tax legislation for one and the same tax might differ significantly among regions in Switzerland. The assessment of multi-cantonal companies is burdensome both for the private sector as for tax administrators, since the rules to avoid double taxation among regions have become rather complex. Significant cooperation and exchange of information among fiscal is required, which renders the process of tax assessment and verification cumbersome. The notion of "tax jungle" is often used in connection with Swiss taxation and its administrative intricacies. Attempts made in Switzerland in the mid-1970s to introduce a uniform federal income tax with cantonal participation or to impose uniform cantonal direct taxes throughout the nation were both defeated, but recently harmonization of direct cantonal and communal taxation was successful to some extent (Spahn 1996).
16. The Mexican states, for instance, face few constitutional limitations as to their taxing powers, which they could, in principle, exert concurrently with the Federation. In practice, however, the Mexican states have only residual tax powers and they exploit mainly fees for some public services (derechos, productos y aprovechamientos) and a small number of less important taxes.

17. Groups of countries may be inclined to coordinate tax policies at the international level and to take collective action in order to reduce international arbitrage possibilities and prevent the erosion of income tax bases. Tanzi advocates for the establishment of a new international institution, similar to the WTO for liberalizing trade, in order to achieve this purpose (Tanzi 1995, p. 140).

18. See, for instance, coordination on the value-added tax in Brazil (Spahn 1992) or in the European Union (Spahn 1993).


20. After the War, responsibility for education and training of tax officers and customs officers was initially assigned to each state. As a consequence, standards and methods of training developed differently and tended to diverge more and more. As ready as 1950, the federal government took control of the training in the three branches of federal finance administration (customs administration, administration of federal property, and administration of federal taxes). Shortly thereafter the Federal Ministry of Finance was attributed educational functions in the realm of the States' tax administrations. A Federal Finance Academy performs, as one of its tasks, in-service training seminars attended by senior officials from federal as well as from state tax administrations to keep in touch with the latest developments in legislation, administration and jurisdiction. A great advantage of cooperative federalism can be seen in securing the flexibility of institutions, while "metainstitutions" at general levels must necessarily be more rigid and inflexible. Cooperative federalism is thus better apt to adjust to a changing environment.

21. For example, large municipalities could meet with medium sized municipalities to explain how to implement modern procedures that have proven to be successful. The medium sized municipalities could then, in turn, meet with smaller municipalities to discuss administration advances they have made.

22. This forms of intergovernmental coordination and cooperation is further discussed below.

23. The coterie are 3 per cent of GDP for the current budget deficit, and 60 per cent of GDP for the level of public debt. The deficit and the level of debt are defined comprehensively including not only lower tiers of government, but also non-private social insurance institutions in order to prevent budget items from being shifted strategically between the various public budgets or funds.

24. This paragraph is based on Fiscal Responsibility Act (1 995).

25. An example of the implications of shifting from a cash to an accrual basis is that if the Crown planned to dispose of an asset below fair market (necessitating a tradeoff of part of the value) this would be recognized explicitly in the budget projections.
26. Apart from the budget criteria already discussed, these are relative performance
indicators for inflation and for monetary policy (as indicated through relative
interest rate levels and exchange rate stability).

27. Some authors would also consider own revenue raising to constitute a fiscal
incentive for government because it subordinates public decisions to constraints
exerted through markets. Although sympathetic to this interpretation we shall not
dwell on it because our subject is intergovernmental coordination and cooperation.

28. In this context, attempts to constraint the financial impact of welfare policies in the
United States is of some interest. Instead of defining nationally uniform eligibility
criteria for social benefits, which entails open-ended transfers and a lack of budget
control, a prominent group of Congress advocates for closed-funding in the form
of bloc grants to the states which would allow to regain control of the federal
budget. Similar trends can be observed in Europe. In Germany, for instance, the
funding of public health schemes has been closed, with doctors rivaling for the
funds on the basis of "service points". Such institutional control may, however,
prove resistance and political unrest eventually.

29. When comparing local intentionally, it has to be recognized that the federal
countries (Austria, Germany, the United States, Canada and Australia) also have an
important middle tier which performs many of the functions that are assigned to
local government in unitary states.

30. It should be noted in passing that the accountability principle also calls for
autonomy in local public borrowing if municipalities are responsible for local
infrastructure. This implies that local investments must either increase the revenue
potential of municipalities and thus allow to service the new debt; or the debt
relating to infrastructural investment (like a school building) must be serviced
through own revenue and -- where externalities accrue to the nation -- from grants
receivable for that purpose. A central government bail-out of indebted local
governments should be ruled out. This is, however, often difficult to realize in
practice and barred either legally - where municipalities derive their competence
from higher level sovereignty or politically.

31. In the United States, even education is organized in this fashion - through school
districts. While education is, of course, a service, it involves substantial 11
externalities" (benefits) for society as a whole, which renders it intrinsically
different from a quasi-private service like water and electricity supply. This must
also affect the financing of the service. In particular, it calls for equalizing grants
in order to establish regional equity of educational opportunities, and/or to
compensate for regional spillover effects. Financing basic education according to
a pure benefit-tax principle is thus inappropriate. This may be different for higher
education.

32. This approach was also adopted by the European Union with regard to its member
countries in the case of VAT and excise taxation.

33. Standard rules for local tax bases are also commendable in view of regional
fairness.

34. Restricting tax competition among local governments to the setting of the tax rate
has the further advantage of reducing information costs of tax payers. If tax base
competition is allowed, the information requirements for locational decisions -in
particular of businesses -- might become formidable. Undesirable transaction costs pertaining to the non-transparency of the tax system must result.

35. Moreover, natural resources evaluated at world market prices might prove to be a very volatile and unreliable revenue source which must rank low on the next criterion for local taxation to be discussed.

36. Sometimes, the local income tax base is also subject to a maximum for that reason, as implicitly in the German local income-tax-sharing arrangements.

37. The German "Gewerbesteuer" has elements of a minimum tax in that business capital defined by standard valuation rules (that incorporate parts of long-term debt) is taxed; also the business profit tax base includes part of interests paid on long-term debt which is more reliable and stable than a profit tax base on its own.

38. In Germany, for instance, local governments have, at one point, handed over a share of their genuine business tax to the state and central governments in exchange for a share of personal income tax. In a strict sense, pooling the risks was not the only motive of the shading arrangements which could have been effected entirely without budging in the personal income tax. The fact that personal income tax has a stronger buoyancy than the local business tax led to a strengthening of local revenue over the longer term.

39. Some authors, e.g. Fuhr/Campbeli/Eid (1995), point out that international organizations and development banks have tended to overemphasize the role of the property tax to finance municipal budgets in Latin American countries. The potential of this tax is rather limited despite some encouraging expediencies in countries like Colombia (Bogota, Manizalez) and Ecuador (Quito).

40. A surcharge on the water bill would also be closely related to the cost of sewerage. It can thus be considered a user charge in accordance with the benefit-tax principle, enhance local service efficiency, and also finance the protection of the environment. Sewerage charges tagged on the cost of water supplied are often used for financing municipal government. in Germany, for instance, such charged may amount to twice the value of water consumed.

41. Local governments should, however, pay for administrative services rendered by other government or non-government institutions in order to avoid inefficiencies. A zero-cost tax administration would undoubtedly lead to excessively bureaucratic procedures over the longer run, and it repudiates the principle of accountability.

42. Brazil operates a sales taxes at all three levels of government with formidable administrative and conceptual problems (Spahn 1992).

43. A redemption scheme for local tax an exports raises the question of how and who should finance the scheme. it could also raise suspicion abroad and face countervailing action of foreign trading partners under the GATT.

44. Hungary apparatus a local net turnover tax as a business tax with relatively low rates (maximum 0.8 percent).

45. The vertical imbalance between tax assignment and expenditure functions is very acute in Australia. The Commonwealth’s own revenues greatly exceed its outlay responsibilities. On the other hand, the States - retaining control over almost all major government functions (except defense, foreign affairs, interstate matters and social service benefits) - are denied access to the two major sources of revenue: income taxation and sales taxes on goods. Australian States thus largely depend on
revenue transferred to them by the Commonwealth. This is effected predominantly through general revenue sharing - unconditional bloc grants - and specific purpose payments - categorical grants. This has led some authors to speak of the States as depending "on federal largesse" (Bird 1986, p. 125). or of the Commonwealth's "financial domination over the States" (Matthew/Jay 1972, p. 291).

Similarly, the German Reich (1871) had few of its own resources, only customs duties and excise taxes. Additional funds had to be transferred to the center from below (the so-called Mattikularbeiträge which are general state grants given to finance the expanding functions of the Reich).

The issue of revenue assignment, tax shading and grants may also bear on potential policy conflicts and hence the need for corrective action, or cooperation. As Shome (1994) points out, heavy use of tax sharing - rather than assignment of particular taxes to individual tiers of government -- may foster procyclical behavior of subnational authorities and jeopardize the central government's ability to reduce its deficit. López-Murphy (1995) identifies such effects for Argentina and Brazil where an automatic revenue participation of the states has limited the central government's faculty to balance its own budget and to effectuate macroeconomic stabilization policies.

Most taxes are shared among layers of government in Germany. The shares of the income tax are even fixed in the Constitution. The regulating instrument to adjust the vertical balance to changing expenditure requirements is the share of VAT which can be altered through federal legislation with the consent of the Bundesrat, the states' House.

However, some global criteria -like the number of population -have a strongly equalizing impact even within arrangements on the primary distribution of resources. If we speak of "specific" equalization criteria we mean those that go beyond such more general rules.

It may also be argued that some costs (like for transportation) are offset through savings (for instance, lower wages in remote areas), and that -on average- adjustments for cost differentials are not necessary. A further argument is that cost differentials would somehow be reflected in the tax base. A higher regional tax base -- and hence revenues -is thus a compensation for possibly higher costs- especially if the income tax is a regional tax.

The special grants operated from 1933 through 1980 and were accorded on the recommendation of the Grants Commission. The volume was relatively small because the financially weaker states were also de states with the smallest population. The special grants were financed from the Commonwealth budget and did not affect the total amount of the financial assistance (general revenue) grants. However, reference to the two wealthier "standard states" (New South Wales and Victoria) -necessary to calculate such grants- has introduced elements of an equalization provision and led to compensations that went beyond the healing of deficiencies in the primary distribution of resources.

The European Union has only limited taxing rights, and it is virtually prohibited from access to loan finance that could ease its budget constraint. The main elements of the revenue side of the EC budget, VAT and the GNP-based resource, may be characterized as general revenue grants -or tax sharing- similar to State financial
assistance in Australia, yet in the opposite direction. Although this provides stable funding to the center, it does not comprise the EU’s right to vary the scope of these means through own tax discretion.

53. This approach has even been maintained under the strain of German unification where taxable capacity of the new states in the East is roughly one third of the Western level.

54. In fact, one result of the arrangements on intergovernmental finance might have been a de facto balanced development of the various regions in the Western part of the federation.

55. The distribution model used in Australia embraces all states and territories and determines the distribution of the total amount of Commonwealth general revenue grants. It involves the calculation of grant relativities by reference to the relative per capita revenue-raising capacities for all recurrent own-source revenues, the relative per capita expenditure needs (costs of providing standard services) for all recurrent expenditures where most specific purpose grants are deducted from standardized expenditures. In effect, each state’s or territory’s share of the total Commonwealth general revenue grants depends on its standardized deficit, which is the product of its population and its per capita grant relativity. The latter is assessed as its per capita standardized expenditure minus its per capita standardized own source revenues, plus (or minus) its differential per capita specific purpose grants. Separate assessments are made for 19 revenue categories and 41 expenditure categories. For further details on the Australian grants system see Rye-Sead (1996), or Spahn/Shah (1996).

56. In the first case, the amount of resources to be redistributed is determined in advance, while the level of redistribution is unconstrained and only determined by the applied criteria in the second case.

57. As mentioned before, there are doubts whether such conditions make sense because they are often non-binding. Grants on specific programs - for instance, schooling - may free resources at the local level for other use whenever the government’s intentions were to provide such services anyway.

58. Of course, the lower-level governments may also ask the higher level to act on their behalf, as in looser confederations and international organizations.

59. After World War II, the driving economic force was in the Northern regions of West Germany while the South was lesser developed. This situation has been reversed during the last decades whereby the South, with its reliance on modern services, has achieved higher per capita incomes than the North, with its structural problems related to declining industries.

60. The Mexican crisis of 1994 illustrates that a neighboring country, the United States, and even the World Community and its international financial institutions would ball-out a country in financial difficulties even without formal commitments as may exist in a Monetary Union.

61. This Law was published in English, together with other relevant material under the title "Federal German Budget Legislation", by the Federal Ministry of Finance, Bonn, November 1988.

62. The only typical exception to this rule are social security funds. Moreover, temporary funds (like the Treuhandgesellschaft, an institution which was to privatize
Eastern Germany's state firms and property, or the Germany Unity Fund which managed East German public debt) were established in the context of German unification, but later integrated in government budgets. In Latin America, there is often an excessive refinance on special funds, and the earmarking of taxes and transfers for specific purposes, based on purely sectorial considerations (e.g. Colombia). This implies inefficiencies as discussed earlier oh in section 2.6.

Before the budgetary reform of 1969, not a single federal budget law was established before the beginning of the relevant fiscal year, yet, even after the reform, the implementation procedure did not function satisfactorily since the legislature tended to delay adopting the budget. A decision of the Constitutional Court of 1977 obliging parliament to approve the budget within the prescribed time limits was successful, however, and the federal budget was regularly established before the beginning of the fiscal year. Detailed instructions on financial and budgetary administration are entrenched in administrative regulations pertaining to the Budget Law.

Furthermore, Keynesian demand management had rapidly become unfashionable in Germany, and the instruments provided by the Stability and Growth Law were in the doldrums. The Law regained some prominence in the context of financing German unification when The term "disturbance of macroeconomic equilibrium" was re-interpreted in a structural sense.


However, Gandenberger (1996) suggests that "fiscally decentralized countries, while still showing an unsatisfactory fiscal performance, are doing somewhat better than more centralized ones" as regards the problem of high and unsustainable deficits.

The trend toward short-term financing of public budgets can also be observed in countries like Germany where government bonds with maturities below 3 months are increasingly being floated. Since the Bundesbank concentrates its openmarket policies on money markets and on the low-maturity end of the bond spectrum, such trend could entail pressures on the central bank to undertake financial rescue operations" in the case of problems in rescheduling short-term public debt.

Interestingly, the scheme for distributing unconditional grants to the states as developed by the Australian Grants Commission has generated a valuable set of information allowing such interjurisdictional comparisons of performance. It does not only provide useful information; it also combines with an incentive mechanism that tends to improve on sector performance since grants are accorded only at a :"standard level" of services. The opposite would result from "gap filling" which would work as a disincentive to controlling costs.

See, in particular, the 1994 edition of Economic and Social Progress in Latin America of the Inter-American Development Sank (108), and the references given there.

A surcharge on the water bill would also be closely related to the cost of sewerage. It can thus be considered a user charge in accordance with the benefit tax principle, enhance local service efficiency, and also finance the protection of the environment.
in Germany, such surcharges have become very important and may amount to twice
the price of water itself.

71. Telephone is often inaccessible to the poor anyway, so a surcharge on the telephone
bill does not seem to have a negative distributional impact.

72. The discretion is given for the and tax and the business tax (local tax on gross
capital and gross profits of enterprises).

73. This means that only capital formation is financed through borrowing which exhibits
returns allowing to service the debt. Where there are "social returns" that cannot
be realized through the market, the government budget must service the debt
through current outlays.

74. This idea runs counter to the solution adopted in Germany where special regional
conditions leading to a higher tax potential through royalties are evened out at the
level of second-round equalization.

75. In Colombia, a tax reform of 1986 had introduced a sharing system of royalties
according to which 47.5 percent of the royalties were accorded to the producing
departments, 12.5 percent to the producing municipalities, and the remaining 40
percent to the national government. This settlement was considered as totally
inadequate by non-benefiting territorial governments. Royalties became a
controversial problem in the national political arena and guidelines for a more
equitable distribution of the royalties have been settled by Articles 360 and 361 of
the Constitution. The former article includes among the direct beneficiaries of the
royalties the coastal and fluvial ports used for the transport of natural resources.
The second article establishes the right of all non-producing areas of the country to
have a share of these revenues through a newly created Royalties’ Fund (Fondo de
Regalías). Discussion of Law 141 of 1994, which specifies the criteria for the
distribution of the royalties, has been the stage for deep disputes and intense
bargaining among territorial interests.

In Mexico, royalties on petroleum extraction is a national revenue source, but there
is a small equalization fund which is to compensate municipalities for damage
relating to the extraction and commercialization of petrol. The amount of this fund
is equal to only 3.17 percent of an additional duty on the extraction of petrol.

76. In the United States, for instance, the Massachusetts formula has won some
prominence whereby revenue is apportioned to regions according to a mix of
indicators of local economic activity like the wage bill, turnover, and capital
installed.

77. Cost differentials for supplying specific public services could also give rise to
equalization provisions (as in Australia). Such differentials are however of minor
importance in a fully integrated market economy. This is true even for Australia
(except for the Northern Territory with its sparse population). Where they are
important they could be dealt with specifically -as it would have been necessary in
the case of German unification- and not within the generalized formula since the
information requirements would be high. It is also not easy to standardize costs. If
a formula fails to standardize costs, however, this must encourage inefficient
spending and should be considered with great care.

78. It is also questionable whether Australia has indeed found the objective magic
formula for equalization, even for herself. The approach remains essentially political
as to key elements (like the share to be distributed and the degree of equalization) and many parameters must be based on "informed insights" which are judgmental. It must be stressed that equalization is essentially a political undertaking and that distributional questions cannot escape value judgments. Moreover, the Australian grants formula is used for distributing unconditional general revenue. It is doubtful whether such formula should indeed be so explicit as to specify different needs of providing crocodile or shark protection for instance. This means overstressing the exactitude of distributional justice which is likely obtained at much lower costs with a similar degree of "accuracy" (see Spahn/Shah 1995).
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