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Fiscal Decentralization in Post-Conflict Countries

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Fiscal Decentralization in Post-Conflict Countries

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Executive Summary

Decentralization can be a mechanism for limiting conflict in ethnically diverse, post-conflict countries. The intent is to develop an overall government structure that more effectively protects minority rights, allows minority groups an appropriate voice in policy, and reduces the areas for disagreement between groups by allowing each to make its own decisions on public service delivery. Decentralization can also be an effective means of enhancing the quality of public services.

Research suggests that conflicts restart within 10 years in more than one-third of countries, and the hope is that decentralization can reduce the chance or prevent conflict from arising in the first place. Sudan and Bosnia and Herzegovina are examples of post-conflict countries that have decentralized in attempts to mitigate conflict. Decentralization likely will not reduce conflict in all countries, so care must be exercised in determining where it may be an effective strategy. Decentralization is commonly successful in places where local elections are held, local public expenditures rise, and employment increases. It is less likely to be successful if local taxes are high, oil revenues are large, and regional autonomy is strong. These are only generalizations, however, and each context must be evaluated individually.

Post-conflict countries tend to have several shared characteristics. Population redistributions during conflict are very common, likely leading to greater regional concentrations by ethnic groups and increased urbanization. A shortage of skilled workers is common, as the highest income and most skilled workers are much more likely to have opportunities to leave during the conflict. Government revenues are normally devastated and tax structures have been skewed towards sources that can be easily collected during the conflict. Government expenditures are equally skewed, with excessive expenditures on military and too little spending on infrastructure, education and health. Debt is often not serviced. Private sector employment growth is frequently weak and considerable pressure exists for the government sector to be a large employer. Employment of demobilized soldiers is often an important emphasis. The imbalance between revenues and expenditures normally means a large annual deficit, frequently financed from domestic resources.

Post-conflict governments must transition from a wartime environment to maintaining security and delivering quality services that enhance people's lives and are the basis for a strong economy. The extent of the challenge in building institutions for an effective decentralized government structure depends heavily on the degree to which a previously existing decentralized system was already in place. Substantial capacity building, development of intergovernmental assignments, and many other changes will be necessary in any event, but become particularly important in cases where most government institutions must be created anew. A significant role for donor technical assistance exists here.

Post conflict countries are confronted with the same public service delivery and financing issues as other countries, and must address a similar set of concerns. What is different is the environment in which structural and other decisions are made. The decentralized fiscal system has three basic elements: expenditure assignments, revenue assignments, and a mechanism for intergovernmental transfers. In addition, a set of institutions must be established to carry out these responsibilities. Agreement on these arrangements may be reached as part of the peace accord, but reconsideration of the structure will continue and new negotiations will be necessary as the government becomes operational.

Expenditure assignment refers to the responsibilities housed in each level of government. The key is to identify the arrangement that enhances the delivery of public services. Service delivery decisions should lean towards decentralization to the extent possible in post-conflict places to lessen the areas for conflict. Expenditure demands relative to available resources will be substantial in the early years following the conflict because of need to rebuild infrastructure, costs of repatriating the population that wish to return home, and weak revenue performance. Again, a major role for donor participation can be important, particularly in countries without natural resources such as oil.

Revenue assignment refers to the set of taxes, user fees, and other own source revenues made available to each level of government. There is wide agreement that every level of government should raise a significant share of its own revenues, but many revenue sources are best collected at the national level. Thus, it is a significant challenge to determine a set of revenue sources that can be used effectively by subnational governments. Assigned revenues plus intergovernmental transfers must finance the service responsibilities of each level of government, so intergovernmental assistance is necessary in every country. Oil revenues provide a unique case. National control over the revenues is probably best, with the possibility for some sharing back to the region – an approach similar to that adopted by Sudan.

Intergovernmental transfers are intended to serve one of three purposes: ensure that sufficient resources exist at each level of government to finance its service responsibilities, compensate for externalities, and offset undesired differences across sub-national governments in service delivery. Unfortunately, capacity to make transfers may be hampered in post-conflict countries. Transfers from the State to the Entities or even the Entities to the Cantons in Bosnia and Herzegovina were generally regarded as unacceptable both because of remaining feelings about the war and because of experiences in the former Yugoslavia. The lack of transfers resulted in dramatic differences across regions in resources for service delivery and impaired the ability to deliver quality services across the country. Transfers are now being made with the advent of the VAT, and this has reduced resource differences.

An effective institutional structure to deliver public services must be established. The policy setting must be structured so that key incentives for efficient behavior are established, and this requires:

- hard budget constraints (sub-national governments must be required to balance their budgets within their own source revenues and intergovernmental transfers without receiving gap-filling grants from the national government),
- autonomy
- accountability to the national government and local population
- elected local officials
- appropriate systems for reporting to the national government.

Generally speaking, countries do not have the luxury of waiting until new institutions are put in place before services are delivered. Schools, health care and other services must still be provided and improved even if the plan is to alter the delivery structure. The institutional environment must be enhanced even as service delivery is underway. Entire systems often must be developed including human resources, budgeting and all of the other functions that allow for efficient, accountable, and controlled governmental operations. The service delivery culture often needs to be altered as well to one that is consumer and efficiency oriented, which is a difficult task even in countries where less change is occurring.

Trying to fully introduce a decentralized structure in a short time can lead to a setting where everything seems to be a high priority, while the capacity within the government is much too limited to undertake work in all areas simultaneously. Thus, priorities must be set on which issues to address first and these must be set by the government, often in consultation with the donor community. These priorities must then be translated into action plans according to the reality of operating government.

1. Introduction

Some analysts have identified decentralized government structures as mechanisms for allowing post-conflict countries to stay together while lessening flashpoints that could create additional conflict between regions and ethnic groups within the country.[1] Experience has differed across countries regarding whether a more decentralized government structure is seen as part of the solution in post-conflict environments, though worldwide, decentralization of many service responsibilities is occurring within existing government structures.

Bosnia and Herzegovina and Sudan are two post-conflict countries where a decentralized structure has been adopted. Many causes can be found for conflict in each country but in both cases the conflicts were primarily between ethnic groups. Development of a decentralized system was a way that the warring parties could agree to end the conflict, remain a single country, and potentially prevent conflicts from reigniting. The possibility of a decentralized structure has been discussed in a number of other conflict or post-conflict countries including Iraq, Rwanda, and Sri Lanka, though a fiscally decentralized system has not been adopted. Indeed, the recent discussions in Rwanda focused on consolidating governments rather than decentralizing government further, though these discussions took place nearly 10 years after the war. The approach has even differed among the former Yugoslav republics. Bosnia and Herzegovina developed an entirely new structure. Discussions continue to take place in terms of the final outcome for Kosovo. On the other hand, Croatia did not develop a new decentralized structure, perhaps because it is much more homogeneous than Bosnia and Herzegovina. There was rapid proliferation in the number of Croatian local governments in the years immediately after the conflict, much as occurred in other eastern European countries such as Hungary, as part of the local self-government movement. Fiscal decentralization is more likely to arise in federal than in unitary countries.

The degree to which the various countries had decentralized government structures prior to the conflict differs, and the structures likely owe their heritage to many factors such as history, geography, political influences and others. Many countries have three levels of government, with national, regional and local governments. But some, such as Rwanda and Sri Lanka have five layers or more, depending on how they are counted, and may have parallel levels of political and administrative governments. Bosnia and Herzegovina has four layers. And, even after the conflict the extent of devolution varies across the countries. Some, such as Lebanon have little devolution below the national government (at least officially) while others such as Bosnia and Herzegovina have considerable devolution.

Protection of rights for minority groups is a major reason for decentralization in the post conflict countries since the conflicts often arose in part because minority group(s) did not feel that their rights would be (or were being) properly reflected in national or regional government decisions in which they would serve as a minority player. The notion is that a

[1] See Tishkov (1993) for example.

single country can be maintained with a number of functions being conducted at the national level or through coordinated regional governments, but these same regions may have independent decision-making authority for many other purposes. Should a country choose fiscal decentralization, the challenge is finding sufficient rationale for the country to remain united while allowing enough flexibility in other areas that further conflict can be avoided. Normally, a country would have a single army, and indeed the intent of agreement often is to reduce the number of militias and armies in the country. International borders, customs, passports, and international relations are clearly national functions in all countries. International and national transportation are other examples. But, many other services, such as education and local police, could in principle be delivered separately across regions of a country.

Post-Conflict Environment

Post conflict countries face similar public service and fiscal management issues that pertain to all countries. The key difference is the environment in which post-conflict countries are operating. Six specific characteristics frequently present in post-conflict countries can be identified.[2] First, large population redistributions have probably taken place. Urban areas, where food and security are often better, generally swell while the population in rural places declines. Greater concentration by ethnic group may have taken place in many countries.

Skilled workers have often left the country, and some may never return. The highest income and best skilled people have the greatest opportunity to leave and the economy's ability to recover is hampered by the loss of these workers. Further, the best planners and decision makers may have left, making it more difficult to design and implement good policy. Some workers may return, but many others may not.

Third, the private sector may be operating ineffectively, with security, poor infrastructure and other factors contributing to weak job creation even after the war. The post-conflict setting may increase the pressure on governments to provide employment as a means of stabilizing the economy. Employing discharged soldiers or finding some form of compensation can be an important near term issue. Determination of who gets to make decisions on employment can be an important factor in the attractiveness of decentralization to the government since political leaders see the opportunity to hire workers as a way to strengthen their position.

Fourth, government revenues are often devastated. Revenues are reduced both because of the conflict's effect on GDP and countries reduced capacity to collect revenue from the economy. The IMF determined that the average country will see revenues decline by two percent of GDP.[3]. The tax administration is often ineffective and must be rebuilt. Further, revenue policy is normally skewed to emphasize revenues that can be collected during the conflict, such as customs, excises and income taxes on government workers.

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[2] See Haughton (1998) and LeWarne and Snelbecker (2004).
[3] See Gupta, et al. (2005).

Fifth, government expenditures are normally skewed and inefficient. Increased spending on military and lesser spending on infrastructure, education and health are common. Workers are paid infrequently and poorly and pensions are partially paid or not paid at all. Debt is generally not serviced. Expenditures are often cash balanced, meaning payments are made until the money is gone and then deferred until additional revenue is collected.

Finally, a large deficit is probably occurring. The deficit is usually heavily financed from domestic resources, exacerbating the macroeconomic effects. The good news is that the resulting inflation is often not systemic and will quickly erode as money growth slows with lower deficits.

The extent to which these characteristics apply to any one country depends on several elements of the conflict. The severity and breadth of the conflict significantly determines the degree to which the country's economic capacity is affected. The conflict may affect the entire country, as in Bosnia and Herzegovina, or may be limited to specific regions, as in Sudan. A significantly broader share of Bosnia and Herzegovina's productive capacity was destroyed, which meant the tax base was severely damaged. This raises the challenge of rebuilding the country and developing an infrastructure that can support rapid growth. On the other hand, Sudan's fighting has been limited to several, albeit large, regions and the oil capacity has remained in place and continued to expand. The conflict between the government and the Tamil ethnic group in Sri Lanka has also generally been contained to relatively narrow areas except for some limited actions. Lebanon was very heavily damaged during the civil war from 1975 through 1990, but the damage was more localized during the recent conflict between Hezbollah and Israel. For example, Beirut was largely unaffected except for some large sections in the southern suburbs.

Prior existence of appropriate institutions can be important since it is costly and difficult to build an entirely new structure, which is currently happening in Southern Sudan.[4] But, transitioning old institutions to undertake entirely new functions or approaches can also be difficult. Further, participants in the conflict may see old organizations as vestiges of the previous system and not the change that is anticipated from the peace agreements. Many of the national and regional government institutions had to be entirely created in Bosnia and Herzegovina though the local government system was already in place. Sudan has a very asymmetric experience. Institutions in the Government of National Unity were already in place and substantially unaffected, but the Government of Southern Sudan is being largely created in a formal sense. Some new institutions are necessary even at the national level in Sudan because of the peace agreements and conflicts have developed as the responsibilities of some new organizations compete with some pre-existing ones.

Significant population redistributions during the conflict can leave countries with a number of challenges. Enabling refugees to return to their homes can be very expensive. It also often requires deciding how to address those who have filled the void while the refugees were gone. For example, unclear records may exist on original ownership of

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[4] Of course, some institutional structure will have developed during the conflicts, but it will often be woefully inadequate for a modern, operating government structure.

property. Squatters may have moved into the property when people fled, and the previous tenants want to return. Dealing with these issues is complicated when they must be addressed for wide groups of people.

But, many refugees may not want to return, as with the groups that fled from the south to Khartoum during the fighting and do not want to return to Southern Sudan. The refugees may have moved into camps (as have the Palestinians in Lebanon) or informal settlements in large cities. They may feel that there is little waiting for them in their former home and that basic services such as schools, clinics, and water are generally unavailable at their old home. The refugees may also feel that they are better able to earn a living at their new location, even if they are eking out a relatively meager existence. Thus, the country can be forced to both expend resources allowing refugees to return home and to spend resources to offer basic services in the crowded areas.

Why Fiscal Decentralization?

Much has been written about the potential advantages of fiscal decentralization. Many of the advantages can apply equally to post-conflict and other countries as well. Generally speaking, the advantages of fiscal decentralization are on the spending or service delivery side of government. The revenue side of government is often hampered by decentralized government structures, whether or not the country is in a post-conflict environment.

The key potential advantage of fiscal decentralization for post-conflict countries, and some others as well, is the capacity to protect the rights of groups that are minorities by virtue of their ethnicity or region. For example, the Dayton Peace Accords divided Bosnia and Herzegovina into two entities, Serbs primarily populate one and Croats and Bosnian Muslims primarily populate the other. The Croat-Bosniac Federation is further divided into 10 cantons and many municipalities. Eight of the 10 cantons are primarily populated by one of the ethnic groups or the other. The Constitution further provides for special consideration for minority groups (which of course may not be a “national” minority) within cantons or municipalities. Most service delivery is devolved to the entity or canton level and these governments are generally responsible for both generating the revenues and for choosing and delivering services.[5] The Serb Republic is divided into many municipalities but with much less devolution of service responsibility. The Government of Southern Sudan was created to allow the southern region to have responsibility for delivering many services throughout much of the southern part of Sudan, and the peace agreement further calls for a vote after six years to determine if Southern Sudan is to remain part of Sudan. Delivery of many services was also decentralized to states throughout Sudan, including to the three Darfur states. Intergovernmental revenue arrangements are complicated in both Sudan and Bosnia and Herzegovina and are discussed further below.

The regions of both countries are responsible for many publicly provided services where national control is unlikely to offer economies of scale or where large externalities in

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[5] Adoption of a Value Added Tax has led to tax sharing in Bosnia and Herzegovina that was not present in the first 10 years after the conflict.

service delivery exist. Primary and secondary education, primary and secondary health, and local police are services where delivery disagreements could arise across the country and for which the sub-national governments have taken responsibility. The opportunity for differences to escalate between groups can potentially be lessened if each is responsible for services delivered to its constituents.

Decentralization is intended to provide a political mechanism for bringing together the varied views of the different ethnic groups. The hope is that views are diffused so that the winners in various political decisions can be diffused as well.

On the other hand, value may exist in terms of nation building in forcing various groups to work together. Effectively the question becomes, is nation building achieved more effectively by requiring the various parties to work together to achieve agreement on myriad smaller issues or is nation building better achieved by requiring the parties to agree only where it is necessary. This calls for careful evaluation of the conditions in each country.

An obvious need exists to prevent conflict before it develops or to keep it from restarting. There is some evidence that conflict begins again in more than one-third of post conflict countries within 10 years (see Collier et al, 2006). Does fiscal decentralization work as a conflict mitigation strategy? Siegle and O'Mahony conclude that decentralization is an effective conflict mitigation mechanism in some countries but not others. Generally, they find it lessens ethnic conflict in places where decentralization efforts increase the role of local elections and expand local expenditures and employment and increase conflict in places where local taxes become high or where regional autonomy grows. Conflict is also greater when the central government has limited control over security and where reliance on natural resources is high.

Perhaps the best conclusion is that decentralization can work to mitigate conflict and to build a nation but it is unlikely to be successful in all places. Further, considerable time will be necessary to build a cooperative nation and a combination of willingness on the part of the ethnic groups and international pressure are likely to be necessary to achieve success. Other strategies, including the creation of multiple countries, may be the better strategy in some cases. Thus, decentralization must be used as a strategy where these elements are most likely to be in place.

Fiscal decentralization offers a number of other potential advantages. Economists argue that fiscal decentralization can be more efficient. The notion is that national governments generally seek to provide similar services across the country without consideration of local demands. This can allow service demands to be met on average, but create dissatisfaction for those wanting either more or less than the average service level. Greater efficiency in service delivery would result if the service levels were better aligned with local demands. Of course, national governments could in principle choose to differentiate services across regions and achieve the same result as a series of sub-national governments. Also, there is often a presumption that place specific information on demands for public services is better available through local governments so that the national government may not know the local demands as accurately. A related expectation is that constituents feel better able to communicate directly with local officials than with national officials. Efficiency can be enhanced with local governments if any of these points correctly reflects conditions in countries.

Further, efficiency may result as sub-national governments compete with each other for businesses, workers, and capital. Disagreement exists over the extent to which efficiency gains result from the competition. Competition can be efficiency enhancing as governments have the incentive to keep taxes low and provide services efficiently in order to attract resources. Competition can also be harmful if it causes governments to set tax rates too low, particularly on certain resources such as capital, in an effort to attract mobile resources. For example, sub-national governments often grant tax concessions as a means of attracting or retaining businesses. The concessions can be outright reductions in tax liabilities or can result from decisions to administer the tax structure less vigorously for some firms (as is reputed to occur in China, for example). Tax concessions may have little effect on the location of businesses, and when they do may cause firms to locate in areas where the economic costs of production are higher, even if the costs including taxes are reduced. The result can be lower taxes that are too low on capital relative to other factors without any economic benefit.[6]

Some have asserted that decentralized government structures allow countries to grow more rapidly, but the research on this question is mixed at best. A reasonable conclusion is that we should not presume that fiscal centralization will enhance or impede growth and any effects will depend on the specifics of the decentralization. Efficiency in the public sector is one of only many factors affecting growth and its effects may be hard to separate from other determinants of growth. Problems have also resulted when tax bases have been decentralized without the corresponding expenditure responsibility (such as in Brazil) or when the national government felt it needed to bail out sub-national government debt (such as in Argentina).[7] Certainly sub-national governments do not have the same incentives to consider macroeconomic effects when undertaking expenditures and tax policies.

2. Characteristics of a Fiscally Decentralized Government Structure

Post-conflict countries often must transition from a military based movement that led to the conflict to efficient governments from which people can have an expectation of security and service delivery. A decentralized system is likely to be good policy if it helps make this transition and is the most effective means of service delivery.

Bahl and Martinez-Vazquez (2006) provide a comprehensive analysis of how fiscal decentralization should be ordered and developed in a country. They describe a process that begins with a national debate on decentralization policy and continues through steps such as passing a decentralization law and implementing the decentralization program. We do not address the steps necessary to enact a general decentralization strategy.

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[6] See Inman and Rubinfeld (1996).
[7] See World Bank (2007).

Decisions on adopting a decentralization strategy in many post-conflict environments will be made through the peace discussions. Instead, our focus is on the substantive elements of implementing government service delivery and finance in a decentralized context. Unfortunately, it is very difficult to implement decentralization in a piece meal fashion. Getting the incentives right is a key aspect of a successful local government structure and this normally requires having all of the elements of the decentralized structure in place in a clear and well conceived fashion. But, trying to fully introduce a decentralized structure in a short time can lead to a setting where everything seems to be a high priority, while the capacity within the government is much too limited to undertake work in all areas simultaneously. Thus, priorities must be set on which issues to address first and these must be set by the government, often in consultation with the donor community. Then, these priorities must be moved into action plans and the reality of operating government.

The decentralized fiscal structure in every country has three basic characteristics: expenditure assignments, revenue assignments, and a mechanism for intergovernmental transfers. In addition, an appropriate set of institutions must be put in place to carry out these responsibilities. These must either exist or be established regardless of whether the country is in a post-conflict environment or not. The structure may also require a wealth sharing mechanism, which can be viewed as part of the intergovernmental revenue structure. Expenditure assignment determines the expenditure side of the budget for each level of government and the revenue assignment and intergovernmental transfers (and possibly the wealth sharing) determine the revenue side. These must be carefully developed with consideration of how each relates to the other. A government that is neither too big nor too small requires establishing the right incentives as a component of each aspect of the decentralized government structure. This section addresses each of these elements and discusses the types of incentives that need to be in place. The fiscal decentralization program must also consider political accountability, fiscal discipline, (which includes facing a hard budget constraint and controls over expenditures and borrowing) and the civil service, factors that receive relatively little attention here.

2.1 Expenditure Assignments

Pressure to deliver quality services may be unusually large to legitimize the new or reformed governments. On the other hand, the lack of mobility that exists in many ethnically charged places might prevent people from moving because of poor quality services so there is little pressure from people voting with their feet. In any event, delivering high quality public services is essential to allowing the country to begin investing in itself again and to provide infrastructure and other services that are necessary for a vibrant economy.

Expenditure assignment refers to the responsibilities housed in each level of government. The key is to identify the set of delivery arrangements that enhances the delivery of public services. The benefits of good governance and service delivery are broad and include the likelihood that corruption can be reduced, which is a major concern in many post-conflict countries. Expenditure assignments can be made in the Constitution, as is the case with Bosnia and Herzegovina. Alternatively, expenditure assignments can be made by statute. Or, assignments may be based on historical practice or agreement without any direct legislation that establishes the pattern. Sub-national governments have no constitutional authority to undertake service delivery and instead are subordinated to the national government in unitary states.

The assignments may be changing over time as evidenced by the worldwide trend towards decentralizing education. The decentralization process effectively means shifting decisions about service provision from national government agencies, such as the Ministry of Education, to regional or local governments. Sudan has decentralized responsibility for many services at the same time as the peace accords with the south and with Darfur (which has not been sustained) were signed. Decentralization has occurred not only in the conflict areas, but also across the country for such basic services as education and health care.

A distinction should be made between responsibility for service delivery and actually hiring the workers and producing the services. Assignment refers to the level of government that makes decisions on which services to provide, the level of service provision, quality standards and so forth. The actual production could be contracted out, done by force account, or through a myriad of possible arrangements. Decentralization need not preclude privatization.

Criteria for Expenditure Assignment

Several factors should drive the decision on which level of government should be responsible for service delivery. The emphasis is generally on decentralizing to the extent possible in post-conflict places to lessen the need to reach agreement across groups on many elements of service delivery. Each broad service should be decomposed into its component parts, each of which could be delivered at different levels of government. For example, education could be decomposed into such components as setting performance standards, which might be assigned to the national level, secondary schools, which might be a regional function, and primary schools, which might be a local responsibility. Indeed, the services might be decomposed even further with, for example, some standards set at each level of government or with curriculum set at the regional government level and schools at the local government level.

Expenditure assignment is an art, not a science and the specific application could vary across countries. Thus, the following factors should be seen as directions that assignments should follow rather than hard fast rules. First, service delivery should be pushed downward to the extent that there is a strong aversion for cross subsidies across ethnic groups. Distaste for cross subsidies was strong in the former Yugoslav regions because of the extent of cross subsidies (estimated at two percent of GDP) that took place prior to the split. Thus, each region was anxious to be separate for both expenditure delivery and revenue raising in Bosnia and Herzegovina. Similarly, consideration should be given to shifting service delivery downward if there is a strong unwillingness to work together, even when there may be benefits from doing so. Transparency may also be enhanced in the decision-making process with more localized decisions.

Second, service responsibility should generally be shifted downward further the more that tastes for services differ across regions. Little efficiency gain is possible from attuning services to local tastes if the various regions have similar demand for services. Third, service delivery should be higher up in the government structure to the extent that externalities exist in the delivery of services. Geographic externalities arise in the delivery of services when the benefits of service provision accrue to people who live outside the service delivering government. Examples include when air or water quality is improved or when people educated in one place move and work in another. Delivery by a higher-level government allows these externalities to be "internalized."

Fourth, service delivery should be pushed higher in the government structure to the extent that economies of size exist in delivering the services. The potential cost savings from delivering services higher up in the system are often much smaller than anticipated, and in many cases are exhausted once populations of 50,000 or so are being serviced within a city.[8] The geography for service delivery is an important reason since most services must be taken to the user for consumption or the consumer must go to the service for consumption. People need water, sewer services, and electricity at their home and place of business and students must be able to travel to schools. For example, treatment of water is often subject to economies of scale, meaning per unit costs fall as more water is cleaned, but per unit distribution costs often rise as the geographic area across which water is delivered goes up (though cost savings associated with water may continue beyond 50,000 people for many areas). Pipes must be laid over longer distances, power must be used to pumped the water, and so forth.

2.2 Revenue Assignment

Revenue assignment refers to the set of taxes, user fees, and other own source revenues that is made available to each level of government. There is wide agreement that every level of government should raise a significant share of its own revenues. Assigned revenues plus intergovernmental transfers must finance the service responsibilities of each level of government.

Defining a Local Revenue Source

Each revenue source has four components: administration, definition of the base, choice over the rate, and ownership of the revenue for use by the government. Any one or all of these could be devolved to the decentralized governments, so the issue is which set constitutes revenue decentralization. Revenue ownership is an essential element of devolution. Revenue ownership alone, which is the only devolved component in many countries such as for most local revenues in Lebanon and Sri Lanka, is not revenue devolution since it is effectively a grant where the amount received by the government is

[8] See Fox and Gurley (2006) for a detailed review of size economies and the gains from consolidation. The report can be found at http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2006/05/05/000016406_20060505110205/Rendered/PDF/wps3913.pdf

determined by the situs of where the revenues are collected. Assignment of a percentage of tax revenue alone occurs in many transition countries such as Croatia and Kyrgyzstan.

Sub-national governments also could be given the responsibility to administer taxes. Many national governments establish the rates and bases for sub-national government taxes and expect these same governments to collect the revenues. Ownership and administration of the revenues still represents limited devolution and sub-national governments cannot influence their revenues at the margin. This offers the advantage that the sub-national governments have a greater incentive to collect the revenues for themselves than does the national taxing authority. National tax administrations have smaller incentives to collect taxes for the sub-national governments than for the government that determines their resources and their salaries.[9]

Control over base definitions or rates can also be decentralized as a way to give local governments greater ability to differentiate service levels. Base differences can raise administration and compliance costs for taxes that are used throughout the country since multi-jurisdictional taxpayers, such as many large businesses, must accommodate the differences that exist across the country. Thus, nationally uniform bases for taxes are generally preferred and base differences should generally be modest across the country except, perhaps, for taxes that are very localized.

Allowing local control over rates is an effective way to expand the extent of devolution and give sub-national governments some control over their revenues without creating significant compliance burdens. But, tax rate differentials, and particularly tax rates on mobile activity, can lead to harmful tax competition so some constraints on local rates are common.

Criteria for Revenue Assignments

Assignment of revenues across levels of government should be based on four criteria. First, taxes should be assigned so that each level of government has the resources necessary to finance its service responsibilities. This calls for greater decentralization of tax sources in countries that have selected more expenditure devolution. However, the other criteria below suggest that developing and transition countries with significant fiscal decentralization on the expenditure side will be unable to assign sufficient revenues to sub-national governments (and this is probably true in developed countries as well). The more productive taxes are generally more difficult for sub-national governments to impose effectively. Thus, some form of intergovernmental transfers is probably necessary to provide sufficient revenues for sub-national governments, but these can be politically difficult to make in post-conflict countries, and particularly in those with an ethnically charged environment.

Second, taxation of more mobile economic activity should usually be left for the national government to lessen the extent of tax competition. Mobile economic resources, such as

[9] The tax administration often retains a percentage of revenues collected for sub-national governments, as in Sri Lanka. However, the percentage is often too small to be an effective motivator for tax collection.

capital, will tend to be undertaxed relative to other factors because of the competition.[10] A related issue is that sub-national taxation should be imposed on beneficiaries of services provided by the government. Tax exporting, which occurs when non-beneficiaries pay taxes, tends to encourage governments to deliver too much service since local constituents receive benefits for which they do not pay.

Third, taxes should be assigned to a level of government where they can be effectively administered. Again, this suggests that taxation of mobile activity, remote transactions, and other activity that can be moved, hidden in other jurisdictions, and so forth is better done at the national level. Ownership of customs duties where the imported items are to be consumed, as was sought in Bosnia and Herzegovina, is very difficult to do practically. Visible and lower mobility bases, such as property, are better local sources.

Finally, tax ownership must follow the Constitution and international treaties and agreements. The Constitution and international agreements can be changed, but assignments must not violate these until new agreements are reached.

2.3 Natural Resources and Oil

Natural resources, and oil in particular, raise important issues in some countries and pose a challenge as to who gets the revenues in decentralized countries. Siegle and O'Mahony's conclusion that heavy reliance on natural resources raises the likelihood of ethnic conflict argues for particular attention to such issues. As a general rule, natural resources are better taxed at the national level because of local incentives to overtax them as a means of exporting the tax burden to non-residents of the region. Tax exporting tends to cause governments to become excessively large. Further, regional taxation of oil leads to wide differences in access to public services across regions and encourages people to migrate to oil regions because of the available public services.

But, those in the region where the resource is located often feel ownership over the revenues. Further, extraction of oil and other natural resources normally impose significant public service, congestion, and other costs on the regions where it occurs and some of the revenue should be used to pay for these costs. The best approach is likely to be national control over the revenues with the possibility for some sharing back to the region – an approach similar to that adopted by Sudan (see case study below). Indeed, wealth sharing with other regions may be a necessity in post conflict environments in order to prevent wide fiscal disparities across regions, though the sharing need not be directly linked to oil revenues. In addition, a number of countries allow local property taxes or royalty taxes to be levied by regional or local governments that have oil resources.

Access to oil revenue may lessen the need for donor aid contributions, as in the case of Sudan. But, the need for technical assistance may be every bit as great. Further, oil revenue seems to be associated with additional conflicts and may lessen the leverage that the international community and donors have over the governments.

[10] See Inman and Rubinfeld (1996).

3. A Case Study of Bosnia and Herzegovina[11]

Yugoslavia's breakup had many causes, including fiscal and quasi-fiscal redistributional concerns. Redistribution policies by the former Yugoslav government appear to have encouraged political separatism, as prosperous republics became more and more reluctant to share with poorer republics. The lack of transparency in the allocation system allowed every republic to argue it was disadvantaged by the redistribution system and lost as other regions gained. The cross subsidies had been expected to build national unity, but achieved the reverse as they lessened budgetary autonomy of the better off republics and enhanced the central government. A fiscal breakdown occurred when the three most prosperous republics — Slovenia, Croatia and Serbia — withheld tax revenues owed to the Yugoslav federal budget in 1991. These economic effects and nationalism led to ware between the various parties in Bosnia and Herzegovina as in other former Yugoslav republics.

Bosnia and Herzegovina provides an example where excessive decentralization occurred for expenditures, and even more so, for revenues. The case study identifies some of the outcomes and some possible solutions. The case study also illustrates some other examples where the incentives arising from the structure led to perverse outcomes.

3.1 Expenditures

Expenditure assignments for Bosnia and Herzegovina were made through the Dayton Accord and the Constitution. Actual experience shows that the various groups are unlikely to agree on the assignments, even if they are built into the Constitution. And, officials can always disagree over the meaning of specific wording, particularly if they are not negotiating in good faith. Indeed, groups may seek to renegotiate the agreements even after they have come into force. Unfortunately, solving disagreements and reaching new arrangements is very difficult in an environment where little trust exists and where at least some parties are not negotiating in good faith.

The Dayton Agreement was a political rather than an economic plan for devolving government. Table 1 illustrates broad expenditure assignments that were discussed for Bosnia and Herzegovina based on the four criteria laid out above. In many cases the proposed assignments and the actual assignments are the same, but several differences and the resulting problems are discussed here. Despite these difficulties, services continued to be provided, but less efficiently than if the assignments had been at the best level of government, and often after a significant amount of negotiating to agree on relative responsibilities.

Two specific types of problems are identified here. First, the agreements in Bosnia and Herzegovina provided for extreme protection of minority rights and significant fiscal devolution. Gains would likely result from the Entities assigning certain functions to the

[11] See Fox and Wallich (1998, 2007) and Fox (2003).

State as the country continues to grow together. Assignment of functions to the State requires that three conditions be in place: (1) significant efficiency gains would result for the country, (2) the gains would be Pareto optimal across the Entities and (3) there is strong confidence that the agreements would be honored and sustained. Administration of the value added, customs and excise taxes at the state level is evidence that agreements can be renegotiated (albeit with heavy influence from the international community).

Two specific areas can illustrate where the expenditure assignments differed from what appears to be good policy. Education is an Entity (in the Serb Republic) and cantonal (in the Federation) responsibility but higher education is probably better done at the State (national) level than the canton level. This has created a number of problems, most of which could be handled with either coordinated service delivery by the entities and cantons or the State taking over responsibility for higher education.[12] One example of the problems is that a State umbrella law is necessary to ensure that degrees earned from Bosnia and Herzegovina universities are accepted across Europe. This is difficult to achieve since the State has no role in higher education.

A propensity exists to proliferate the number of universities since each canton has some incentive to develop its own. This is exacerbated by universities being established on ethnic grounds, as evidenced by two universities in Mostar Canton – one primarily for Croat students and one for Bosniac students. In addition, essentially all public financing of universities, which covers about 60 percent of costs, is provided by the home canton though students come from other cantons as well. Fifty-one percent of students at Sarajevo University come from outside Sarajevo Canton, the largest out-of-canton share of any university. The combination of these factors likely means that there are probably too many universities, a strong tendency to underfinance each university since the home canton only values education received by its students, and potentially overspending on higher education in total. As discussed above, education could be divided into its component parts with many parts delivered at the Entity or canton level but with higher education at least coordinated by the State.

Health care is also a cantonal and Entity responsibility but tertiary health care is probably better delivered at the national level. The high level of care and expertise required for tertiary health care exceeds what can be provided in each canton or even each Entity. Sarajevo Canton houses the only tertiary hospital and provides it with some subsidies. But, the Canton has the incentive to restrict usage by people from other cantons or to seek some form of additional financing from non-residents. At a minimum, a tendency exists to underprovide the service, leaving Bosnia and Herzegovina with less tertiary health care than would be efficient for the country, and lower access to care than people demand.

Second, conflicting assignments existed. For example, customs policy was a State function and customs administration was an Entity responsibility. But, it is very difficult

[12] Interestingly, the federal government directly provides for no higher education in 6 of 12 federations reviewed in Hauptman (2007) and directly provides for the majority in only two of the federations, Nigeria and Venezuela. Federal funding is significant in 8 of the 12. Bosnia and Herzegovina's small size makes canton responsibility for higher education particularly problematic.

to define what is policy versus administration. Also, many services, such as human rights, health care, environmental policy and transportation infrastructure, were assigned to both the Federation and the cantons and it was necessary to determine how the responsibilities were to be divided. And, the Dayton Agreement and the Constitution were essentially silent on the role of municipalities, meaning each entity or canton must determine what responsibilities were to be handled at the municipal level.

Table 1: Recommended assignment of public functions

Service category	Type of service	Level of government
Healthcare	Primary Secondary (hospitals, curative) Tertiary (infectious disease, research)	Municipality Canton Entity
Education	Primary Secondary University	Municipality Canton / municipality Entity
Transportation	Roads/highways (intracity) Roads/highways (intercity) Airports Public transportation: intracity Public transportation: intercity Public transportation, taxis International	Municipality Canton / entity / state Entity Municipality Entity Canton / municipality State
Environmental	Air / water pollution Water / forestry	Canton Entity / state
Housing	All	Canton
Solid waste, water, sewer, fire	All	Municipality / canton
Land use / zoning	All	Municipality
Licensing / regulation	All	Canton
Cultural policy	All	Canton
Tourism	All	Canton
Social Welfare	All	Canton / entity
Telecommunications	All	Entity / state

Source: Fox and Wallich (1998)

3.2 Revenues

The tax structure in post conflict countries is generally drawn from the preconflict heritage. It is the system that people are familiar with and the one that the tax administration knows how to collect. The tax structure in Bosnia and Herzegovina at the end of the war followed the Yugoslav heritage but with ownership reflecting a strong sense the revenues should remain in the area where they are collected. The Dayton Accord did not assign any revenues to the State level except for some very limited sources such as passport revenues and instead assigned revenues to the Entities and cantons. Almost all expenditures were also devolved below the State so this allowed for greater correlation between where expenditures take place and where revenues are owned. A tax sharing arrangement was retained for most tax revenues with the Entities sharing a percentage of collections with their component cantons or municipalities. For example, the cantons in the Federation retained 80 percent of the revenues collected in their borders and the municipalities received the remaining 20 percent.

The resulting system led to wide differences in resources across the Entities and between the cantons and municipalities and to harmful tax competition between the Entities. Per capita canton revenues differing by four fold and per capita municipal revenues varying 200 fold in the Federation (see Levitas, 2007). Intergovernmental transfers were generally regarded as unacceptable in Bosnia and Herzegovina with an expectation that each government would raise the revenues to finance its service responsibilities but also based on the view that each Entity owned the revenues collected inside its territory. Even a willingness to collect revenues at higher levels of government and distribute them by formula was unacceptable (both within the Federation and across the country) to the governments. This certainly complicated tax assignment and led to widely different expenditure levels across cantons and entities.

Such extreme revenue decentralization created many perverse effects, a few of which are mentioned here. Entity tax administrations were responsible for tax collection but the level of trust after the war was much too low for effective mutual cooperation to occur even though such agreements were reached on paper with assistance of the international community. Customs and excise duties on imported commodities, which are collected at national border by essentially every country, were being collected at border by each of the Entities. This allowed importers to plan their tax burden by importing into the Entity that would treat their import most favorably. Sales taxes were being collected by each Entity but with differential rates and bases that offered easy opportunities for evasion or avoidance. Competition had developed in many ways prior to the agreement. For example, the Entities varied the level at which sales taxes were collected, with one collecting the tax at retail and the other at border for some commodities. This opened an easy opportunity for firms to import the commodities in the Entity collecting sales taxes at retail and sell them in the Entity collecting sales tax at border. This exempted the imported items from tax in both Entities. Income taxes were supposed to go to the residence of the worker, but no agreement existed to shift revenues across Entities. Corporate income taxes were collected at the corporate headquarters, which provides incentives to place the headquarters in a low tax jurisdiction. Many of the problems that existed across Entities could have been corrected through cooperation between the Entities or through national collection of the revenues.

Political incentives were also perverse. The Federation Parliament set the base and rates for canton taxes. On several occasions the Parliament lowered tax rates or exempted base, thereby reducing cantonal revenues, without even informing the cantons. One canton complained of concessions to electric production and another about concessions to automobile assembly, and the payroll tax rate was reduced from 15 to 10 percent. The base and rate changes may or may not have been good policy but they were enacted without knowledge of the government owning the revenue and without the Parliament having to directly confront the revenue consequences of the actions.[13]

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[13] Papua New Guinea, on the other hand, forms a committee of central government, local government and independent people to consider tax policy changes before they are enacted. Canada requires the three

The international community worked with the two Entities to reach agreements on indirect tax harmonization,[14] in order to lessen tax competition and allow the country to operate as a single economic space. The Entities could in principle violate the harmonization agreements, but it was generally felt that the agreements would stay in place with strong encouragement from the international community. The harmonization agreements were tediously negotiated across the span of more than one year. Each Entity had a strong desire to ensure that it collected the customs and excise tax revenues for commodities consumed within its borders, but collection efficiency is greatly enhanced by imposing the taxes and duties at border or manufacture to reduce evasion. Thus, a system was required that ensured revenues were collected at border but were transferred (as necessary) to the Entity where consumption would take place. And, the arrangement needed to operate in an environment where the trust level between the two Entity tax administrations was so low that direct cooperation was not happening. A system was developed, but it was costly and difficult to operate because of the specific conditions that existed at the time. Further, it did not address difficulties in financing the State nor fiscal inequalities across jurisdictions.

Adoption of a VAT in 2006 was the first step towards national tax collection and towards acceptance of a formula based distribution of revenue. Imposition of the VAT with a national administration recognized the greater ability of the national government to collect tax revenues. Beginning in 2001, the international community worked with the government to develop a tax system that moved towards a VAT (see Levitas, 2007). Considerable pressure from the international community combined with recognition that admittance into the European Community would require use of a VAT was necessary to enact the VAT. The goals were to improve financing of the State, improve nation building, and move away from the tax sharing arrangements that operate between the Entities and their component jurisdictions. A single account system was developed that began receiving revenues from the customs and excise taxes in 2004 and then from the VAT in 2006. A State level tax administration that could collect the national VAT had to be developed initially. The Entities continue to want revenues distributed according to activity within the respective borders so a proxy for the location of final consumption is used. The measurement of final consumption is very difficult so distribution of the revenue between the two Entities remains a vexing problem.

The distribution agreement also specifies the percentage of revenues that must go to cantons and municipalities from the Federation share and to municipalities in the Serb Republic from the Serb share. The formula to distribute revenues to individual cantons and municipalities in the Federation is being phased in over six years.

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provinces levying an identical structure with the nation to agree before changes in the VAT base are enacted.

[14] Tax harmonization was complicated by the existence of the independent district of Brcko, which was being operated through authority of the international community. Brcko was generally permitted to impose lower tax rates.

3.3 Intergovernmental Transfers

Federalism makes many transfers that are implicit within national governments explicit. For example, in a centralized system the national government may raise revenues in one part of the country and use the resources to deliver services in another part (at least this is true to a degree), but this transaction is effectively hidden within the government (and may not even be thought of in these terms). In a federal system, this transaction becomes explicit because resource transfers must be made to the sub-national government. Such transfers are more difficult to make in a post-conflict environment. The result is that making grants and other transfers, which are subject to considerable political discussion in all countries, is more difficult in post-conflict countries. The need for well considered, transparent and politically acceptable grant systems grows even more in post-conflict countries.

Intergovernmental transfers are generally intended to serve one of three purposes: ensure that sufficient resources exist at each level of government to finance its service responsibilities, compensate for externalities, and offset undesired differences across sub-national governments in service delivery. First, as described above, most revenues are better collected at the national level and transfers are necessary to move the revenue from the government where they are most efficiently collected to the government where expenditures are assigned. Thus, transfers are generally made from higher to lower levels of government, though there have been exceptions. The Entities made upward transfers to the State of Bosnia and Herzegovina in the early years since little revenue raising authority existed at the national level. The initial transfers were made begrudgingly and heavy intervention from the international community was necessary to ensure that the transfers took place. Upward transfers are historically common in transition countries such as China and Vietnam where sub-national governments traditionally collected taxes for the national government.

Second, transfers are intended to lessen the extent of service delivery inequality that exists across sub-national governments. The equity argument was not accepted in Bosnia and Herzegovina since each Entity appeared to place no value on access to services in the other Entity. Inequalities arise both because of differences in *capacity* to pay and differences in *needs* for services. Inequalities also appear to exist if there are differences across regions in their *willingness* to pay for services. In general, transfers should be based on differences in the capacity to pay or differences in service needs not because of a lack of willingness to pay. Countries create perverse incentives if they provide larger grants in places that are less willing to rely on their own sources. These grants encourage sub-national governments to reduce their own revenues to increase their transfers.

Third, transfers are intended to offset economic inefficiencies that occur when the benefits of public services extend beyond the geographic area of the sub-national government. Obvious examples are transportation systems and roads that need to be consistently provided across the country and that are used by people from many regions. Education and health care are other services with important externalities because the entire country benefits from an educated and productive national labor force.

Unfortunately, the capacity to make transfers may be hampered in post-conflict countries. Transfers from the State to the Entities or even the Entities to the Cantons in Bosnia and Herzegovina were generally regarded as unacceptable both because of remaining feelings about the war and because of experiences in the former Yugoslavia. Small transfers were initially made from the Entities to the State since the State had almost no revenue authority. The lack of transfers resulted in dramatic differences across regions in resources for service delivery and impaired the ability to deliver quality services across the country. The allocations that are now being made from the VAT are best seen as transfers, so a more conventional intergovernmental transfer system is now in place. These allocations have allowed the resource differences to be narrowed across cantons. Sri Lanka budgets for larger per capita transfers to the North East Province, where many of the Tamil are concentrated, than to other regions. But, many of these transfers may not actually occur. On the other hand, wealth sharing is generally accepted in Sudan, as will be discussed below.

Vertical Distribution

Every intergovernmental transfer system has two major components: a means to determine the total amount of transfers between the national and sub-national governments (termed the vertical distribution) and a mechanism for determining how the transfers will be divided between the recipient governments (termed the horizontal distribution). In practice, the vertical and horizontal structures are likely to be conceptualized together rather than being developed in separate steps as discussed here.

Vertical sharing is intended to ensure that each level of government has access to the resources necessary to carry out its expenditure responsibilities and to ensure that the other objectives of transfer programs are met. Conceptually, the total vertical transfer can be estimated by subtracting the *capacity* to raise revenues from own sources from the cost of meeting the expenditure assignments for each level of government to yield the need for intergovernmental transfers. In late 2006 an experts group followed this approach in determining the general size of the vertical transfers in Sudan. Unfortunately, the data to make these estimates are often inadequate and based on historical experience rather than the actual cost of providing an appropriate level of services. Similarly, the capacity to raise revenues is determined by the amount of revenue that has been raised rather than the capacity to generate resources from the sub-national levels. Thus, considerable care must be exercised in going through the analysis. Further, such an analysis should not be purely mechanical, since the generation of revenues locally and the desire to provide services locally are affected by each other and by the structure of the transfer system.

A specific structure must be adopted to make the vertical transfers. Around the world, vertical transfers are made using some combination of three mechanisms: revenue sharing of certain tax revenues, reimbursement of specific costs, and discretionary ad hoc grants. Ad hoc grants are ones where the amount is determined annually, often based on a perception of available resources at the national level. Reimbursement grants are ones where the transfers are structured to cover specific costs, such as wages for teachers.

Transfers in Sri Lanka are based on a combination of cost reimbursements and ad hoc criteria. A block grant is made primarily as reimbursement for annual wage costs (though reduced by provincial own source revenues), but over time the grant becomes more ad hoc since the central government determines how much is to be distributed by setting salary and employment levels. The grant does not cover all wage costs since actual employment in sub-national governments can differ from the employment level used to determine the grants. Other Sri Lankan grants are ad hoc, with both the amount allocated and the amount actually distributed (which differs in non-predictable ways across the years) being based on annual decisions by the central government.

Revenue sharing involves assigning a percentage of a specific tax or set of taxes for transfer to sub-national governments. For example, Sudan has a grant intended to transfer 44 percent of VAT revenues to the states. Sudan also sets its current transfers as a percentage of non-VAT national revenues. Revenue sharing is common among transition countries such as Hungary and Croatia. Revenue sharing most effectively meets the goals for intergovernmental transfers if the sharing percentage is fixed for a number of years. As with many countries, Sudan has varied the percentage from year to year, particularly for the current transfer. The transfer effectively becomes ad hoc if the sharing percentage is changed annually, which makes the revenues much less predictable. Of course, a fixed sharing percentage means that sub-national governments share both in the revenue growth and the revenue shortfalls experienced by national governments. Sub-national governments are generally happy with revenue sharing on the upside of revenue growth since their transfer is buoyant. But, revenue sharing can create significant fiscal stress for sub-national governments when revenue growth slows or revenues decline because they often have little capacity to borrow and few other revenue sources to exploit. Nigerian states have experienced wide revenue fluctuations in recent years because of their tie to volatile national revenues.

Horizontal Distribution

A mechanism must be adopted for distributing grants across sub-national governments once national governments have decided on the size of the vertical transfer. The horizontal transfer must be carefully structured because its design creates incentives for sub-national governments that can have very important influences on their behavior. Transfer systems that are predictable and transparent and that hold governments accountable will encourage the greatest efficiencies from sub-national governments. The design can also influence the willingness to raise revenues locally and to provide high quality services, or the reverse. The effects can be harmful to good governance if the incentives are perverse.

Around the world, horizontal distribution is achieved through four mechanisms: derivation of the revenues, formula, cost reimbursement, and discretionary ad hoc decisions. Derivation-based grants distribute revenues to the specific sub-national government where the taxes were collected, which means they are always tied to a vertical transfer based on some form of revenue sharing. Nonetheless, any of the other approaches to horizontal distribution could also be used to allocate a revenue sharing pool. Derivation-based grants are used in a number of countries including Bosnia and Herzegovina (from the Entities to the municipalities), Germany, Hungary and Kyrgyzstan. Derivation grants are best used as unconditional transfers since a strong relationship is unlikely to exist between the tax revenues raised from a particular source and the expenditure needs for a specific service. Countries often think of the derivation-based revenues as the own source revenues of the sub-national governments but analysts normally conclude that derivation-based revenues are better seen as transfers because the states cannot set the base or rate and do not collect the tax. Thus, all decisions on the revenues, and probably the accountability to the taxpayers, are at the national level.

The horizontal transfer using formula-based transfers is determined using a set of arithmetic calculations. The key to a formula-based grant is structuring the formula with the appropriate criteria and weights. Normally, the criteria should represent considerations such as the ability to raise revenues locally or the expenditure needs of the sub-national governments. The weights should reflect the relative importance of the factors in the formula. Formulas can be complicated, as in Hungary where more than 30 “norms” are used to measure expenditure needs, or they can have only one or two factors. A number of countries, including Australia, Germany, India, Rwanda and South Africa, use formulas for making the horizontal transfer of revenue sharing grants.

Cost reimbursement grants are intended to finance specific costs of sub-national governments. These are often, though not always, linked to vertical transfers that are also based on cost reimbursement. The transfers for health care or education in some countries can be perceived of as cost reimbursement grants. Sudan has recently made cost reimbursement transfers to finance police, higher education, and the judiciary. Sudan has also made transfers to replace revenues from a previous tax on agricultural production, and these can be thought of as cost reimbursement grants. Finally, ad hoc grants are made though annual discretionary decisions at the national level.

4. A Case Study of Sri Lanka

The Sri Lankan conflict has been waged for three decades and owes its heritage to an effort by the Tamil minority, housed primarily in the north and east of the county, to seek a country that was separate from the Sinhalese majority. In 2001 the Tamil agreed to seek a separate region rather than an independent country and agreement was reached for a ceasefire. Norway was invited by the Sri Lankan government to monitor the ceasefire and to broker an agreement on regional autonomy but accord was not reached despite numerous rounds of peace talks. A new government promising to take a harder line with the Tamil was elected in 2005 and attacks against the government were resumed.

Greater regional authority, at least in the Tamil areas, may offer the opportunity for a peaceful settlement, but agreement on a regional structure has not been reached as yet. The Sri Lanka government is an example where a decentralized government appears to exist but where most control is maintained at the center. Sri Lanka has eight provinces and 315 local governments, but relatively little fiscal decentralization. The provinces were created in 1987 by the 13^{th} amendment to the Constitution with the intent to create a strong regional level of government that could alleviate the Tamil concerns. Nonetheless, the provinces are more accountable to the national authorities than to local people and have served to emasculate the previously existing decentralization to municipalities. Thus, the 13th amendment has been a failure in devolving the unitary government. Combined provincial and local governments spend less than 15 percent of total government expenditures, compared with countries such as India and South Africa where sub-national governments make about one-half of total expenditures.

Governors are appointed, though provincial and municipal councils and mayors are elected. The elected councils operate parallel to the administrative apparatus and have little power. The budgeting and planning process appears to be a bottom up exercise as local and provincial authorities prepare budgets. However, the employees primarily work for the All Island Service and may be transferred from province to province. As a result, their incentives suggest they often will respond to national authorities and not local needs. The local councils are often directly involved in the planning process but Provincial Councils only see budgets after they have been prepared and submitted to the national government. Local budgets are tightly constrained because the central government must approve all permanent staff and the local governments have little own source recurrent revenues. Local authorities raise about one half of their revenues from own sources primarily using the property tax, rental income, and sales of services but the amounts are generally small. Less than one-fifth of Provincial expenditures are financed with own source revenues, with the balance coming from national grants. Provincial revenue sources are assigned in the 13th Amendment to the Constitution and include the turnover tax, stamp duties, court fines, excise duties, motor vehicle licenses and fines. The turnover tax, a levy on business revenues, generates nearly one-half of provincial own source revenues.

Most sub-national revenues come from grants, as evidenced in Table 2.[15] On average, more than 81 percent of revenues is from grants, but the relative role differs dramatically by province. Western Province, which includes Colombo, raises more than 60 percent of revenues from own sources and Uva Province generates less than 7 percent.[16] Interestingly, per capita total revenues are not higher in places that raise more revenues from own sources (such as Western and Central Provinces), which suggests a potential disincentive to raise own revenues. The major grant is of the "gap filling" variety, which means the revenue fills the gap between recurrent expenditures and the ability to raise revenues from own sources. Gap filling grants give sub-national governments the incentive to expand expenditures wherever possible since they are not accountable to raise the revenues. Similarly, the governments have incentives to lower own source revenues since the grant will tend to fall as more revenue is raised. The grant system appears to offset many of the differences that exist in the ability to generate own source revenues with grants more than offsetting own source revenue differentials.

[15] Municipal revenues are generally very small with the exception of Colombo.
[16] Own source revenue data are not available for the predominantly Tamil area of North East Province.

Table 2: Sri Lanka Provincial Revenues, 2003

Province	Own Revenues	Total Grants	Total Revenue	Per Capita Revenue
Western	5457.3	3481.6	8938.9	1667.3
Central	739.3	5028.8	5768.1	2388.5
Southern	569.9	5093.7	5663.6	2487.1
North East	N/A	5976.9	5976.9	4662.2
North Western	506.2	4944	5450.2	2525.9
North Central	250.6	3185.9	3436.5	3108.1
Uva	216.4	3087.4	3303.8	2822.0
Sabaragamuwa	320.6	3808.1	4128.7	2309.2
Total	8060.3	34606.4	42666.7	2430.1

Source: Sri Lanka Finance Commission and author's calculations

Provincial service responsibilities are specifically laid out in the Constitution but the national government has infringed upon some of these responsibilities. Education is an example, with national schools having been inserted next to provincial schools, but with much better resources. Further, most employees at all schools are part of the All Island Service and may be more responsive to central than to provincial authorities.

5. A Case Study of Sudan[17]

A conflict existed between Sudan's national government, primarily responsive to the Islamic community, and the south that was primarily composed of Christians and animistic religions from 1982 through 2005. An attempt by the north to gain greater control over the south was the primary cause. The Comprehensive Peace Agreement was signed between the Government of Southern Sudan (GOSS) and the national government in 2005. A separate conflict between the government and rebels in Darfur (in western Sudan) reignited in 2003. The Darfur Peace Agreement was signed in 2006, but the agreement has failed to maintain peace in the region.

Sudan has a significant subnational government structure, though decision-making has traditionally been relatively centralized. Sudan has 26 states, 16 of which are in the north and 10 of which are in the south. The number of local governments in the north has been in transition over the past 15 years through various expansion and consolidation policies. The GOSS with a broad government structure that includes 23 ministries and 19 independent commissions was established by the CPA. In addition, the 10 southern states each have eight ministries. Legislatures are operating at the GOSS and state levels. The GOSS has very wide latitude in running affairs in Southern Sudan.

The Constitution lays out responsibilities for states and the national government, but not for the localities. In 2006 a substantial decentralization of service responsibilities to the states and localities took place, with responsibilities for education, health and other

[17] See Bahl, Fox and Vaillancourt (2004) for a description and evaluation of the Sudanese intergovernmental system prior to the Comprehensive Peace Agreement.

services devolved. Prior to the decentralization, the sub-national governments undertook about 20 percent of total national spending. Most sub-national tax revenue comes from a series of federally imposed taxes that are collected by the Ministry of Finance and National Economy, including the business profits tax, the rental income tax, the capital gains tax and the stamp duties, with the revenue distributed based on the location of collection. States levy and control a series of small levies such as auto license fees and user fees for water and solid waste collection. Sub-national own source revenues comprise less than 7 percent of total government revenues.

Sudan provides an interesting example of designing transfer systems for post conflict countries, particularly regarding the relationship with the south. The Comprehensive Peace Agreement (CPA) and the Interim National Constitution (INC) in Sudan require two basic types of transfers: sharing of the oil wealth and transfers from the national revenues. The presence of oil revenue probably makes it easier to have a resource to transfer and may make it more necessary to make transfers because every region believes it should share in the wealth.

Oil revenue is owned by the national government unless it is pumped in the south (where much of the oil is located). Oil is shared when it is pumped in the south, with the GOSS receiving 50 percent of revenues from oil that is pumped in its territory and the locality where the oil is pumped receiving 2 percent of oil receipts. The remainder accrues to the national government. However, oil revenues received by the national government, as with all revenue, is to be shared with the states as described below.

But, Sudan shares more than oil revenues. The CPA and the INC also call for grants to be made to states from the National Revenue Fund (NRF), which is to be composed of all national revenues. The documents specifically require that the transfers be equalizing and transparent. The transfer system must be developed and a mechanism must be established to ensure that the transfers are transparent and properly made.

Transfers from the NRF require a definition of which revenues are to be included. The National Revenue Fund is defined by the INC and is to be administered by the National Treasury, which is part of the Ministry of Finance and National Economy. The intent is for the total available resources of the national government to be transparent to all potential recipients. National revenues have grown rapidly in Sudan in recent years, as oil revenues have begun to expand. According to the INC, the NRF is required to include all "revenues collected nationally for or by the National government…" (art.197) including all taxes and oil revenues and is to consist of all accounts and sub-funds. These provisions mean that the NRF is to contain all tax revenues; all non-tax revenues including oil receipts, user fees, ministry or departmental revenues; and public sector company profits. This sets a very high standard for transparency in the government budget since it requires all revenues to be reflected in the NRF. The NRF is a broader definition of the pool of revenue from which distributions will be made than is adopted in essentially any other countries around the world. For example, Australia only shares VAT revenues, Germany shares various taxes at different percentages, and Jordan allocates transfers from fuel tax revenues (see Table 3). On the other hand, India, Nigeria and

Rwanda provide transfers from broad based tax revenue pools, but these countries do not share from all non-tax revenues.

The NRF is defined very inclusively because of concerns that various revenues can be misreported and the transfers will be smaller than expected. As an example of the concern, in the past the Ministry of Finance is believed to have reported some revenues that were collected at border as customs duties rather than VAT because VAT revenues were to be shared and customs duties went entirely to the national government. Many difficult definitional decisions remain despite the attempts to define the NRF rigidly. For example, profits of public sector companies are presumably included in the NRF, but this requires acceptance of a particular set of accounting standards. Decisions also need to be made regarding whether cash or accrual accounting is used to measure revenues in the NRF and how privatization revenues are to enter the NRF. A related issue is whether all oil revenues or just net revenues after exclusion of various expenses are to be reported to the NRF. The NRF also appears to include all departmental revenues, such as those that are collected by the Ministry of Defense and the Ministry of Justice. Again, the issue again arises regarding whether these Ministries are able to subtract various Ministry expenses before the revenues are included in the NRF.

Table 3: Vertical Distribution of Revenue Sharing Grants in Selected Countries*

Country	*Recipient Gov't*	*Vertical Share*	*Horizontal Share*
Australia	States, Localities	Total VAT less collection costs and discretionary additions	Expenditure needs and ability to raise revenue
Bosnia & Herzegovina	Localities	Tax sharing of sales, PIT, CIT	Derivation
Brazil	States, Localities	VAT, PIT shared with states; VAT, property tax shared with localities	
Canada	States	No revenue sharing, but equalization transfers to low capacity states plus other grants	Ability to raise revenue
Ethiopia		PIT, Business, Excise, Sales	
Germany	States	PIT, CIT (50%); VAT (49.5%)	PIT, CIT derivation; VAT (75% population, 25% tax capacity)
Ghana	States	Total revenues	
India	States	All centrally levied taxes (28% through 2005)	Population, income, area, index of infrastructure, tax effort and fiscal discipline
Hungary	Localities	PIT, Motor vehicle tax (50%)	Derivation
Jordan	Localities	Fuel tax revenues	
Kyrgyzstan	Localities	PIT, CIT, business tax	Derivation
Nigeria	States, Localities	Major taxes (VAT), Mineral revenues	Population, area, equality, social development
Pakistan	Localities (from Provinces)	Differs, Total revenues or revenues minus debt service, pensions, subsidy	
Rwanda – Local Authority Support	Localities	5.3 % of all own source revenues (budgeted amount not all provided)	Population, area, poverty, equal
Rwanda Community Development Fund	Localities	10.0% of all own source (budgeted amount not all promised)	Equal shares
Sierra Leone	Localities	No revenue sharing, cost reimbursement grants	
South Africa	States	Total tax revenues	Population, prior spending
Sri Lanka	States, Localities	No revenue sharing, only cost reimbursement and ad hoc	
United States	States, Localities	No revenue sharing	

*Bolded countries have some form of revenue sharing. Information was taken on grant systems operating in recent years, but all may not be currently in effect.

The Fiscal and Financial Allocation and Monitoring Commission (FFAMC) was established by the CPA and INC to propose the vertical and horizontal transfer structure for Sudan's states, to monitor the transfers, to ensure transfers are properly made to war affected areas, and to ensure that transfers are transparent and fair. The FFAMC is composed of the Minister of Finance from each of Sudan's 26 states, three members appointed by the national government, three members appointed by the GOSS, and a Chairman.

Despite the apparently clear articulation in the peace agreements, uncertainty exists regarding the specific functions of the FFAMC, just as with the expenditure and revenue assignments in Bosnia and Herzegovina. One area of disagreement is whether the horizontal distribution proposed by the FFAMC would transfer funds to all states including the states in the GOSS. The FFAMC at least initially believed that the formula should apply to all states but the GOSS wants to design its own formula. At this point, a Southern FFAMC is being created to take over the horizontal distribution for the 10 southern states, and the Southern FFAMC will presumably design an independent formula. The Southern FFAMC also plans to perform a monitoring function to determine whether transfers are properly being made to the GOSS. Nonetheless, ministers of finance from the southern states remain as members of the FFAMC Board.

The FFAMC was established with a Chairman, a small staff and a building. Controversy existed because the National State Support Fund, an organization inside the Ministry of Finance and which has been determining the horizontal distribution across states for some years, was not disbanded with startup of the FFAMC. Within about one year the startup FFAMC was disbanded and the National State Support Fund renamed the FFAMC. Thus, an organization internal to the Ministry of Finance was given responsibility for monitoring the transfer system from the Ministry and for proposing transfer mechanisms.

The fledgling FFAMC took some significant steps before its elimination. The FFAMC, working together with a local Panel of Experts, developed and recommended vertical and horizontal distributions to the Parliament for use in the 2007 budget. The proposed plan was enacted for the 2007 budget, but the required amounts were not being distributed after three months of the fiscal year. The vertical distribution was to equal 44.8 percent of the NRF, of which 28.6 percent goes to the northern states (including the three Darfur States). A clear determination has not been made of what happens if revenues differ from the budgeted NRF amounts. Will the states share in any revenue shortfalls or overcollections, or will they receive fixed amounts once the annual budget has been agreed upon?

The horizontal distribution is based on a formula with four factors. Forty percent of the revenue goes to states on an equal amount per state, 30 percent is distributed based on population (though no census has been conducted since 1993), 15 percent is based on fiscal effort and 15 percent is based on indicators of health and education needs. Relatively little objective data exist on Sudan's states so the Panel of Experts had few choices on the components to include in the formula's structure. Still, there are a few questions that could arise. The large fixed amount per state is based on the presumption that there are large costs to operating all states, regardless of the population size. The health and education indicators appear subjective, which could create some controversy. The fiscal effort factor rewards states for raising large amounts of revenue, which encourages larger governments. But, the incentive to collect more revenue is relatively modest. As previously noted, the formula will apparently be applied only to northern states, though the Southern FFAMC could adopt the same formula.

The movement of population during the conflict complicates the selection of criteria for formulas. A decision must be made on where to count population, income and other people-related criteria that have relocated. Post-conflict countries also appear reticent to undertake a census to learn where people and economic activity is located which further complicates the use of formulas. International organizations may have prepared population estimates that can serve the purpose, but the estimates will not be updated frequently and may be subject to significant error. Thus, formulas are necessary to ensure a transparent transfer system, but data used in the formulas are often very weak.

Once the vertical and horizontal distributions have been determined, the FFAMC's roles can be divided into a tracking and an auditing function. The tracking role involves watching ongoing deposits in the NRF and ensuring that proper distributions from the NRF and from the oil revenues are being made each month. The FFAMC is to report to the President quarterly on the performance. The audit function involves a more careful analysis of the NRF and distribution after the year has ended. This will be done in conjunction with the General Audit Chamber. The independence of the renamed National State Support Fund, its ability to undertake its functions, and the transparency and acceptability of a preexisting organization must be questioned.

6. Conclusions

This chapter provides some general conclusions about implementing fiscal decentralization in post-conflict countries. The conclusions are in three sections: institutional reform, expenditure assignment, and revenues and revenue sharing.

6.1 Institutional change and development

An effective institutional structure to deliver public services must be established to deliver service, collect revenues, regulate as necessary and so forth. Some form of an institutional structure for delivering public or government services exists in all post-conflict countries, often based on the institutions that were present prior to or during the war, and this will be the starting point for the structure that must be built. Municipalities continue to operate in West Bank/Gaza decades after the occupation began. Municipalities also continued to provide minimal services in Bosnia and Herzegovina even during the war. Schools operated in homes in Kosovo during recent conflicts. But, decentralization combined with the requisite new institutions that arise from the agreements and are necessary for an effectively operating government likely mean that substantial development and technical assistance are required to achieve in an effective government system. Development of the Entity tax administrations and later the State tax administration in Bosnia and Herzegovina are examples. The EU and USAID were heavily involved in providing such technical assistance. The World Bank and Canadian Forum of Federations provided technical assistance in development of the initial FFAMC in Sudan. USAID and other donors are currently working to build the institutions in Southern Sudan.

The policy setting must be structured so that key incentives for efficient behavior are established, and this requires:

- hard budget constraints (sub-national governments must be required to balance their budgets within their available own source revenues and intergovernmental transfers without receiving gap-filling grants from the national government),
- autonomy
- accountability to the national government and local population
- elected local officials
- appropriate systems for reporting to the national government.

These must be quickly instilled if they are not already in place. Then, the specific institutions can be established and allowed to mature.

Generally speaking, countries do not have the luxury of waiting until new institutions are put in place before services are delivered. Schools, health care and other services must still be provided and improved even if the plan is to alter the delivery structure. Water, electricity and other infrastructure must continue to operate. While not necessarily true with every decentralization, much of the change is often movement of staff from national to regional budgets. The same teachers, nurses and doctors will normally deliver their services both before and after the devolution. The political/management structures are where the changes occur, with key policy and operational decisions often devolved to the sub-national governments. The lack of skilled planners and managers creates a particular challenge in post-conflict countries, but the shortages of skilled workers are as real at the national as at the sub-national level so this is not an excuse to keep government centralized.

New institutions must be established if they do not exist and improved ones developed if something is already in place. Entire systems must be developed including human resources, budgeting and all of the other functions that allow for efficient, accountable, and controlled governmental operations. A new operational culture often needs to be created, which is a difficult task in businesses and government that are changing much less than is occurring in post-conflict environments. Thus, building new, effective institutions normally entails substantial transitional issues, problems and costs. Technical assistance can often go a long way towards facilitating such large changes and helping to build the required skills. For example, USAID offered many training programs in Bosnia and Herzegovina for such basic skills as budgeting. US Treasury placed long term advisors in the Entity Ministries of Finance to work with tax policy and budgeting, for the Entities, cantons and municipalities in Bosnia and Herzegovina.

The broader relationship between the national and decentralized governments must also be established. Decisions must be reached on the oversight that the national government will provide for subnational functions. Minimally, reporting mechanisms must be in place so that the national government receives regular reports on sub-national expenditures and revenues. Local governments must also be required to submit accounts to the auditor general for audit. But, the national government generally should not have approval authority over local budgets and decisions if the intent is to have a devolved government system. Sri Lanka requires such approval and represents an example where little devolution exists. National influence on sub-national decisions can operate through means such as the intergovernmental transfer system, while subnational governments have the flexibility to make decisions within their available resources. Otherwise little decentralization exists and the factors causing conflict may not be lessened.

The donor community has major roles to play in post-conflict countries and within the institutional environment. Emergency financial assistance is often needed in the form of food and housing. Longer-term financial assistance is generally necessary to help rebuild infrastructure and housing and to get the economy operating again. Technical assistance will be important on both policy and operational aspects of government, particularly since the countries often have low skill levels because of the outflow of workers. The need to build capacity is a trite statement, and is a difficult achievement, but it is essential to decentralization. Development of the best policy structure is imperative to ensure that the incentives encourage the desired behavior by government. But, good policy is useless without effective administration, and sustained institution building using both domestic and expatriate staffing is essential. USAID’s work in Bosnia and Herzegovina and Southern Sudan are excellent examples of the role that donors can play.

The donor community needs to clearly understand the political environment in the country, a prerequisite to good international assistance in every country. But, the political environment in post-conflict countries is likely to be extremely complicated. Multiple, strongly held views are likely to exist across the ethnic groups, often with a high level of antagonism between the groups. Wide differences frequently exist within the various regions or ethnic groups, as is the case in Sudan, so there is not a single perspective even within the groups. It should be observed that differences within ethnic groups were not as apparent in Bosnia and Herzegovina, though those across ethnic groups were readily observable.

Further, policy formulation and operation are best achieved when developed inside the government or at least jointly between donors and the government. Imposing policy, even if very well conceived, is likely to be difficult to move through the political process. The perception that another country or international organization is imposing policy is likely to limit the acceptability in the country. As a result, donors must be fully involved with the government and must be assisting the government to achieve effective results.

Cooperation by the various donors is especially necessary in a post-conflict country because the needs are great and the number of donors seeking to offer assistance quickly will be large. The potential for wasted resources is especially high and the likelihood is that competing interests will be developed in the country in the absence of a coordinated plan.

In short, post-conflict countries are confronted with the same public service delivery and financing issues as other countries, and must address a similar set of concerns. What is different is the environment in which structural and other decisions are made and the reconstruction, repatriation and other outgrowths of the conflict. Negotiating change in institutional arrangements is a difficult challenge in all countries, but is particularly troublesome in post-conflict countries.

Fiscal decentralization potentially offers a number of advantages to many countries such as allowing competition between regions of the country, allowing service delivery to be "right-sized" to the economic costs of producing services, and allowing better place specific information on local demands for public services.

Particularly for post-conflict countries, fiscal decentralization offers a means for maintaining a single country while limiting the points of conflict between formerly warring parties. The decentralized structure was essential to achieving peace in Bosnia and Herzegovina and Sudan, and allowed them to move forward as single countries. The hope is that nation building will result from the experiences that result from working together in places of national responsibility.

It is too early to tell the effectiveness of this strategy, even after more than 10 years in Bosnia and Herzegovina. The relative strength of both Entities and the cantonal governments in the Federation can be viewed as a political obstacle to nation building. On the other hand, accommodating diversity is fundamental to federalism. The longer-term existence of Bosnia and Herzegovina as a viable, efficient country depends to a significant degree on whether inter-Entity harmonization and cooperation and Federation-cantonal coordinating mechanisms successfully develop. Positive signals can be seen in areas such as development of a VAT at the State level in Bosnia and Herzegovina. But, a decentralized structure will probably not be an effective conflict mitigation strategy in all countries.

Decentralization is only one of many factors that will work to lessen conflict. Decentralization must be combined with effective cooperation at the national level, good policy decisions, open, transparent decision, and many other factors if conflicts are to be mitigated and countries allowed to grow and prosper.

Despite the best intentions, the fiscal arrangements built into peace agreements and other documents will leave considerable room for disagreement and interpretation during the implementation phase. Substantial work and negotiation will be necessary during the implementation phase to establish working relationships, acceptable institutions expenditure assignments and revenue assignments. The lack of skilled workers remaining in the country could make it more difficult to build the institutions.

Fiscal decentralization after a conflict is likely to require substantial development of new institutions to operate the country and the various regions. The structure can be asymmetric within the regions, as in both Bosnia and Herzegovina and Sudan, but enough similarity must exist at the regional level that national service delivery programs, transfer systems, and so forth can operate. Federal systems are designed to accommodate a certain degree of policy asymmetry, but there are thresholds beyond which the lack of harmonization significantly raises costs and becomes a serious impediment to the free movement of economic activity.

6.2 Expenditure assignment

Expenditure demands relative to available resources will be substantial in the early years following the conflict because of need to rebuild infrastructure, costs of repatriating the population that wishes to return home, and weak revenue performance. Decisions must be made on which level of government will address the various needs and the importance of intergovernmental transfers likely grows if sub-national governments are to deliver many of the services. International aid is also very important in post-conflict countries during this phase.

Expenditure functions in a post conflict country are likely to be decentralized in keeping with the subsidiarity principle since a major objective is to reduce areas of conflict between the various groups. This means substantial decentralization of service delivery, as in Bosnia and Herzegovina and Sudan

Expenditure assignment allows for the appropriate aspects of each service to be decentralized and does not require that every dimension be decentralized. This may mean that a role for the national government will remain for many services, even if substantial decentralization has occurred. For example, procurement for some services was centralized in Bosnia and Herzegovina to allow the sub-national governments to benefit from cost savings.

6.3 Revenues and revenue sharing

Revenues cannot be decentralized to the same degree as expenditures without creating opportunities for substantial tax planning and evasion and for inefficiencies in tax collection. Nonetheless, it is important to identify a set of revenues for sub-national governments so that a significant share of expenditure responsibilities can be financed with own sources. Every level of government in a fiscally decentralized country needs some significant own source revenues where the local government can have some control over the total amount of revenue generated. This increases fiscal accountability and gives the sub-national governments some degree of fiscal independence.

A transfer mechanism may be necessary to ensure that sufficient revenue exists at each level of government. Intergovernmental transfers are not required, but their absence will surely lead to wide differences across regions in access to services. Large cities and areas less affected by the conflict are likely to be much better funded in the early years than are other places. The absence of transfers also weakens the national government and reduces the connections between the regions. Around the world, intergovernmental transfers have often been an unreliable revenue source for sub-national governments because they are politically easy to lower during tight fiscal environments.

Transparency is an essential characteristic of government in post conflict countries because of the lack of trust. Transparency becomes even more important for revenue flows and intergovernmental transfers as there will be a propensity to be suspicious of every aspect of the system.

7.0 Some Guidelines for the Future

This chapter provides some general guidelines based on the analysis and discussion that has been provided throughout this report.

7.1 Some Pointers

1. **Diversity.** The causes and effects of conflicts vary widely as does the pre-conflict heritage. Thus, the potential gains from using fiscal federalism will differ around the world and must be evaluated on a country specific basis.

2. **Focus on the key aspects of running decentralized governments.** Key aspects of good service delivery, including design of revenue structures, service delivery, intergovernmental transfers, fiscal discipline, and an effective civil service, are the same in post conflict and other countries. The difference is the environment in which these are carried out. The focus must be on designing a system that effectively integrates these factors in the post conflict setting.

3. **Assign service delivery functions at the level of government that can provide services most effectively.** Assigning services to the wrong level of government, such as with higher education and tertiary health in Bosnia and Herzegovina, will lead to inefficient use of resources and either too much or too little service depending on the assignments. Difficult negotiations may be necessary if inefficient assignments are built into peace agreements, but the resulting savings for the country are ultimately worthwhile.

4. **Decentralize government without doubling expenditures.** Decentralization can occur by raising new expenditures at the local level without reducing them at the national level. This is bad policy in any country, but particularly harmful in the resource starved environment of post conflict countries. Decentralization must be designed to cut costs at the national level as service responsibility is shifted to the local level.

5. **Develop a grant system.** Sub-national governments will not have sufficient resources to finance their service responsibilities and a grant system must be developed. The system must be transparent because of the lack of trust and must encourage efficient behavior by the governments. Sudan demonstrates the difficulty of designing such a system, but the inequities in Bosnia and Herzegovina demonstrate the problem of not having grants.

6. **Build formula grants with objective data.** Transparency and predictability are essential to acceptable grant systems and formula-based grants enhance both. The data also need to be based on data that are generally regarded as reliable and objective rather than on subjective measures developed by the national government.

7. **Choose local revenues carefully.** Local governments should rely on user fees to the extent possible, but this must be tempered with equity concerns and the inability to charge for essential services such as education. Local taxes should focus on activities that are less mobile, including such choices as property, local sales, and wage taxes.

8. **Insist that local governments face hard budget constraints.** Local governments cannot be allowed to spend more than their available resources with the expectation that the national government will bail them out. Governments will operate inefficiently and engage in excessive spending without a hard constraint. Formula based grants are one way to lessen the potential problem and prevent the national government from providing grants that simply fill the gap between local expenditures and revenues. In many cases this suggests that local governments should not be able to borrow, particularly if they borrow from public institutions.

9. **Audit local governments.** Local governments must be subject to external audit immediately to build taxpayer confidence, limit fraud, and ensure accountability.

10. **Counterparts are often lacking.** Many skilled workers will have left the country and there is substantial demand for those that remain. The best counterparts will be spread across many governments in a federal system making it even more difficult to find good counterparts for many projects.

11. **Pilot projects are often best.** Many projects are best done as pilots since the capacity may not exist to work with all governments simultaneously. Further, fiscal federalism offers the chance to experiment with alternative means for delivering government services so that the best approach can be rolled out to the entire country.

12. **Work immediately on enhancing service delivery.** Quality education, health care, infrastructure, and other service delivery must begin immediately after the conflict and cannot wait until the institutions are fully functional. Thus, sector service delivery improvements and institutional reform must operate in parallel, but joined efforts.

13. **Post conflict countries are resource starved, particularly right after the conflict.** Tax revenues have fallen during the conflict and expenditures are

much too low for essential services. Rebuilding infrastructure and helping populations move back to post-conflict areas are very expensive. Countries should be expected to provide some resources from the peace dividend but there will still be a significant need for aid immediately after the conflict.

14. **Politics will be particularly difficult in countries that use fiscal federalism to lessen conflict.** Fiscal federalism is most likely to be a useful approach in countries where ethnic, linguistic or geographic conflict is particularly sharp. But, these are also places that will experience difficulty reaching agreements.

15. **Build trust.** Trust is lacking between participants in the conflict and likely between the various groups and the donor community. One result is discussions and negotiations that are not in good faith.

16. **Build confidence in government.** Low quality services during the conflict, corruption, and other factors leave confidence in government very low and enhance the likelihood that people will evade taxes, engage in black market activities, and other informal activities. The creation of new government institutions, which has been necessary in places such as Sudan and Bosnia and Herzegovina, will leave confidence waning even more. It is essential to limit the degree of corruption and enhance the quality of service delivery to build confidence in the systems.

17. **Build government capacity.** The lack of skilled workers, creation of new institutions and other factors will mean very low capacity in government. Institution building and skill development projects are essential.

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