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IRAQ INTERGOVERNMENTAL FINANCE REFORM –

Successful Process for Decentralization

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1. INTRODUCTION

Decentralization is not a goal in and of itself, but rather an important facet of the larger reform process that allows for growth of democracy through more transparency and accountability. It is a process generally considered to lead to positive future results, but has proven difficult to design and implement, especially during the most unstable stages of transition. Two major factors are often responsible for poor performance of decentralization efforts – weak political determination and low capacity of sub-national governments. But while these two factors remain critical, badly structured reform programs prove to be the most critical factor in inadequate decentralization. This paper highlights the importance of carefully designed decentralization efforts, and correct sequencing for decentralization reform.

Politically-Dominated Decentralization Reform

Assessments of various decentralization reform efforts in developing countries have shown that the end-result is influenced considerably by the central government's rationale for decentralization. For example, certain cases in Africa demonstrated that in the absence of external forces (such as donor-conditionality clauses or donor assistance), politically-dominated rationale, rather than the government's willingness to transfer real power and improve efficiency of local service provision, drove intergovernmental reform forces. Decentralization can become a dangerous instrument for allowing a dominant political party to extend its influence by creating a new level of local political personnel in the regions or breaking an ethnically-based opposition into multiple local jurisdictions, thus weakening the opposition forces. One can highlight political motives for decentralization reform in Nigeria "where the military regime has used local governments to undermine state-based ethnical challenges, and Uganda where the delimitation of local government areas divides the country's main ethnic power basis". Ethiopia adopted decentralization in response to a perceived need to surrender certain powers to their regions as a way of holding their ethnically fragmented nations together. "A similar political rationale and the need to legitimize and consolidate the regime that emerged from the April 2002 peace agreement may be at the root of the emerging decentralization strategy in Angola."¹

Conversely, decentralization, when properly executed, can reduce the risk of social conflict by facilitating participation of various ethnic, political, social and religious groups in the political process. However, since decentralization requires a major shift of power, both amongst different governmental levels as well as territorial areas of the state, certain parties could experience some negative consequences, at least in the short term. A conflict can occur when different ethnic groups, other than those in power at the national level, emerge with a local majority. Equally important is the reality that the governing elite, who may be dominated by particular ethnic groups, will usually resist the loss of power and influence, despite the fact that it is an intrinsic part of a meaningful decentralization reform process. Thus, by its nature, decentralization can generate conflict either by aggravating an existing conflict between ethnic or social groups, or by creating new ones.

Experience has shown that this conflict of interest resulting from decentralization reform can lead to completely opposite outcomes. For example, evaluations of decentralization

¹ Leonardo G Romeo, "The Role of External Assistance in Supporting Decentralization Reform" in *Public Administration and Development*, 23, 89-96, 2003, page 92.

programs in countries with extreme political contrasts, such as El Salvador and the Russian Federation, show that decentralization of administration can contribute to a balance of opinion and consensus. The evaluation of Indonesian program, however, shows the possible centrifugal forces associated with decentralization as repressed ethnic groups and nationalities return to self-determination. Such forces are also associated with the decentralization program in Bolivia, where the process has led to greater instability in the countryside, and contributed to the emergence of indigenous groups calling for autonomy from urban-based political elites.² Thus, it is very important to analyze the overall political situation in a country, as well as relations in society and between ministries prior to making a decision on decentralization reform. A feasibility study or gap analysis can evaluate suitability and potential extent of intergovernmental reform to determine whether there are sufficient prospects for success.

Box 1: Feasibility study for Kazakhstan

In 1995 BearingPoint prepared a report, with recommendations, that served to set the framework for improved intergovernmental fiscal relations and more efficient provisions of goods and services at all levels of government. A longer-term intergovernmental reform strategy for Kazakhstan was presented, and transitional arrangements were determined. The details associated with implementing the recommended intergovernmental arrangements were developed within a broad policy framework acceptable to the Government of Kazakhstan.

One general lesson that can be drawn from the assessment of politically-motivated decentralization is that although the reform establishes elected local government structures, it does not empower them with adequate administrative and fiscal resources. The incomplete nature of decentralization reform usually manifests itself in chronic weaknesses of state structures (Ministries of Local Government and the like) that should actually have expanded responsibility. In addition, the institutional framework in which decentralization reform has to be implemented is poorly coordinated. Often various sectoral ministries have input into the provision of services (those that fall under that Ministry) to local governments. Finally, coordinating ministries, (such as Ministry of Planning and Finance) also have some degree of control over decentralization. The situation becomes particularly difficult when these agencies have different views on the goals of the decentralization process.

Box 2: Case of Armenia

In Armenia the Ministry of Territorial Administration which deals with local government issues is often called “a Ministry without a portfolio.” The Ministry has only four people on the payroll, including the Minister and the Deputy Minister. It has no real power or decision-making authority. Neither has it the resources or capacity to manage decentralization process effectively.

Building Capacity for Successful Decentralization

Recent decentralization reform experience in developing countries demonstrates how inadequate managerial and technical capacity becomes an obstacle in successful reform implementation. As a rule, capacity is limited at all levels of government. Training programs are often inadequately designed and presented, and underpaid government employees leave for the private sector after being trained with public funds. Because of their lack of experience in a decentralized environment, local government staff often does not know how to manage budgets, structure programs, analyze requirements, define needs or engage in strategic planning. The lack of structured processes, including sufficient IT infrastructure,

² See discussion in “*Lessons Learned on Donor Support to Decentralization and Local Governance*”, OECD, DAC Evaluation Series, 2004

make it difficult for local officials to perform their duties in an effective and efficient manner (e.g. administer, track and enforce revenue collections).

Many developing countries struggle with a general lack of managerial and technical expertise, a limited pool of human resources and a scarcity of training and educational facilities. Often times, such challenges are used as an excuse to avoid the reform of intergovernmental relations. In addition, some central governments fear competition for qualified staff if decentralization governments were strengthened. The following two issues are significant in this regard:

Flexible arrangements could be designed for reallocating functions as local governments build capacity and resources develop. Various elements of the decentralization reform should be linked to central government efforts to build capacity and performance progressively. The local governments should know exactly what they have to do before additional responsibilities are assigned. Specific steps should be designed in a way that helps to build local political and institutional capacity. This requires prioritizing reforms, focusing on simple tasks that don't immediately overwhelm local capacity.

Extensive training effort is critical in building local political and institutional capacity. Intergovernmental fiscal reform that grants local fiscal autonomy also transfers to local governments the responsibility for the majority of the expenditures by the central government. Training of local government officials in program and project evaluation is needed to ensure they would be capable of performing these new duties effectively, especially once their activities become more independent from central budgeting.

Box 3: Development of simulation model in Kyrgyz Republic

A computerized simulation model was developed by BearingPoint in Kyrgyzstan to simulate the impact of alternate transfer designs. The model is a highly useful tool in developing intergovernmental finance policies and facilitates experimentation with alternative transfer designs. Model users can alter key parameters, observe changes in the distribution of grants among local governments, and decide whether the formula design satisfies not only theoretical but also practical requirements.

Another important consideration is development of analytical capacities. Typically, developing countries lack analytical tools in order to make rational choices between reasonable options. Such analytical tools must be developed to ensure successful decentralization reform implementation.

Donor Assistance and Coordination

The process of building a unified decentralized system is a complex task. Evaluation literature shows that successful decentralization may take more than a decade, especially in an environment of financial and political instability. In the context of delivering technical assistance for decentralization reform two issues appear to be particularly important: donor coordination and the need for long-term support.

Box 4: Donor Coordination in Macedonia

In Macedonia, BearingPoint facilitated a series of discussions among the major stakeholders - the MoF, the Ministry of Local Government, the local government finance officers association, the mayor's association, as well as over ten donor groups and projects handling various aspects of the decentralization work being done in the country. This was an important task in an environment with significant political and ethnicity issues involved in drawing boundaries; it ensured that all groups are treated in an even and coordinated manner.

Donor Coordination: It is difficult to ensure sectoral and jurisdictional coordination, especially in unstable environment. To avoid this problem donors sometimes limit their projects to particular sectors or local governments, and develop client relationships with particular ministries. Establishing forums for coordination and dissemination of information, as well as joint government-donor forums for reviewing and implementing reforms, is very important for effective coordination (see Box 4).

Need for Long-Term Support: Decentralization efforts are time consuming and difficult. Once the system has been established it will take years to function properly, and highly competent technical assistance throughout this period is very important. Also, exit strategies should be incorporated into structured and formalized programs and long-term sustainability concerns should be addressed in the very early stages of implementation.

Defining a Starting Point

Some decentralization experts argue that a faster reform is more beneficial. Their argument rests on the belief that if the process is unnecessarily extended, the more probable a rise in support for the former status quo becomes. Thus, they argue, it is crucial that the entire program be put in place and institutionalized through practice as quickly as possible to achieve visible results. This requires putting accumulated practical experience of sound intergovernmental system implementation in place wherever possible.

It is, however, important to note that when a decentralization program is adopted quickly or under pressure, there is no time to foster adequate consensus for reform among numerous players of all levels. Hastily developed programs usually result in adoption of an inappropriate and/or inefficient enabling environment, including weak support during the implementation phase. Consensus is a crucial factor for longer-term success.

It is not surprising that even the most carefully designed programs meet political and bureaucratic opposition. Because decentralization decisions require a major shift of power relations among people, they almost always encounter strong resistance. Even after such decisions have been made, there is often a strong, determined and continuing support for reversal. It is therefore important to design and build a politically negotiated process for decentralization reform (see Box 5).

Decentralization experts note that building a consensus between key players on decentralization goals and objectives is sometimes more important, at least in the early stages of the process, than the initial shape of an intergovernmental system.

Box 5: Presidential Working Group on Local Government Law in Tajikistan

A Presidential Working Group on Local Government was established by Presidential Decree No. 797 of 11 July 2002. According to the Decree, the working group is to “elaborate new draft laws on local government and local self-governance in settlements and villages and to review the current legislation relating to local government and local self-governance.” This group is composed of representatives of the Presidential Administration, the Ministry of Justice, Deputies of Parliament, and local governments. This Working Group received a substantial amount of international donor community support in its efforts. The WB IBTA-2 project has provided comments on the draft laws. The UNDP supported the Working Group with assistance in both technical and administrative ways, including comments on the draft laws and support in holding public roundtable discussions. The USAID Local Government Reform Project provided a high level of technical support and the financing of a study tours for members of the Working Group to learn about local government reform efforts in other countries.

Another lesson learned is that many decentralization reforms “have been superficially based on programs designed for dissimilar countries and textbook solutions.” While fiscal literature is always a useful starting point, by definition it has a narrow focus. The ideas of fiscal decentralization have been developed in the context of industrialized countries, and are therefore culture and institution bound. “Equally important, the conceptual models focus on normatively desirable outcomes, but they say nothing about the requirements and processes for implementation, which are often considerable, complex, and context specific.”³

When designing and implementing decentralization programs it seems to be important to make sure that they⁴:

- Have the right balance between devolved powers and adequate human and financial resources;
- Have the right balance between local autonomy and central government control;
- Have the right balance between support to local government bodies and civil society organizations;
- Have the right balance between capacity building and devolution of power; and
- Have the right balance of financial support and policy advice.

To summarize, three important factors must be in place for decentralization reform to succeed:

- First, the institutional framework for decentralization must be carefully designed, coordinated and built. Political mechanisms must be thought-through to hold the local governments accountable.
- Second, local governments must have the institutional, technical and managerial capacity to deliver assigned services.
- Third, local governments must have the financial resources required to meet their responsibilities.

A country like Iraq can not easily meet these conditions. It is, therefore, important to note that even when experienced experts design a seemingly flawless decentralization reform, a “perfect” intergovernmental system will not appear quickly or without unforeseen challenges.

³ Paul Smoke, “Beyond Normative Models and Development Trends: Strategic Design and Implementation of Decentralization in Developing Countries”, Management Development and Governance Division, United Nations Development Program, November 2000

⁴ “*Lessons Learned on Donor Support to Decentralization and Local Governance*”, OECD, DAC Evaluation Series, 2004

2. INSTITUTIONAL AND ADMINISTRATIVE STRUCTURE OF IGF SYSTEM

This section discusses the elements of fiscal decentralization reform. These elements are: an adequate enabling environment; assignment of expenditure responsibilities to sub-national governments; assignment of own-source revenues to local governments; and the establishment of an intergovernmental transfer system. Each of these elements is discussed in detail below, outlining principles, providing examples of successful implementation, highlighting most common problems and possible ways to solve them. Additionally, thoughts are provided on building an intergovernmental structure and an enabling environment for decentralization in Iraq. Other issues of discussion include determining the appropriate size and number of local jurisdictions, deciding on the number of tiers in the intergovernmental system, and establishing the depths of home rule for local governments.

An adequate enabling environment

In a transitional and politically unstable environment, legislative and capacity building efforts should help develop the base for implementation of decentralization. Constitutional clauses and laws should mandate the level of autonomy, rights and responsibilities of local governments, thus forming the foundation for decentralization reform. It is important to note that the enabling environment is a necessary but not sufficient condition for success of decentralization reform. There are several examples of countries with sound constitutional and legal provisions that did not manage decentralization reform successfully. An often-cited example is Indonesia, which adopted a decentralization law in 1974, but became more fiscally centralized following adoption of the law.

There are, however, many success stories where constitutional clauses and laws built a solid enabling environment for fiscal decentralization. “The 74th Amendment (1994) to the Indian Constitution, for example, laid a constitutional base and process for proceeding with decentralization to municipalities. Bolivia passed the often-cited Law on Popular Participation (1994), defining a strong legal and institutional framework to pursue decentralization. The South African Constitution (1996) outlines an important role for local governments, which the central government is now struggling to deliver on.”⁵

Today, Iraq is facing an enormous challenge as it must fundamentally reform its laws and institutions so that they are better equipped to function efficiently under a completely new political and economic system. Institutions and laws that took decades and sometimes centuries to evolve in the Western world must be created in Iraq in a very short timeframe. Below, several issues are addressed that must be carefully thought through when designing the intergovernmental environment for Iraq.

Determining the Appropriate Size and Number of Local Jurisdictions

When selecting the appropriate size and number of sub-national governments, it is important to keep three factors in mind:

- Resident homogeneity;

⁵ See Paul Smoke, “*Fiscal Decentralization in Developing Countries: A Review of Current Concepts and Practice*,” United Nations Research Institute for Social Development, February 2001

- Geographic scope of service; and
- Economies of scale.

Resident Homogeneity. In a democracy, different political candidates will offer different packages of publicly-provided goods and services financed through different revenue-raising procedures. An individual's evaluation of these packages will be an important determinant of his or her vote. But once a decision is made, the citizen cannot change it (at least for a period of time) and is compelled to pay taxes to finance the chosen package. Thus, democracy has a cost. A majority of voters can impose an unwanted outcome on a minority. This characteristic of democracy plays a significant role in justifying the existence of local government. If collective decisions are made on a small scale, fewer voters are likely to be dissatisfied with the outcome. Voters in a small area are likely to experience similar economic, social and environmental conditions and to have similar backgrounds and experiences. These conditions help determine voter preferences. If conditions are similar for all voters, then their preferences are likely to be similar also.

Based on these considerations, it can be argued that local governments should be as numerous and small as possible. But there are countervailing factors which may raise caution flags about letting local governments get too small to be able to provide the services and functions assigned to them in an effective manner

Geographic Scope of Service. The benefits of different publicly-provided goods and services are felt over varying geographical areas. The benefits of a police station, for example, extend over an area that can be effectively patrolled out of that station. The benefits of a military strong enough to deter attack, on the other hand, can extend over the entire country, even into areas with no military installations. Given the geographic scope of the services, therefore, one would conclude that police services could be provided by sub-national units of government while military protection could not be.

It would not, however, be correct to conclude that because police services *could* be provided at the sub-national level that they therefore *must* be. The "geographic scope" criterion is much more important in determining the minimum size (in terms of area) of sub-national government than the optimal size.

Economies of Scale. There are other reasons to limit the number of jurisdictions. Running a democratic government requires a civil service, elected officials and an electoral process. Many of the costs of establishing such institutions are essentially fixed, or more accurately, they do not rise in proportion to the size of the population of a jurisdiction. A city of 200,000 is unlikely to cost twice as much to administer as a city of 100,000. Returning to the police example, the operation of a police force has a number of more or less fixed administrative costs -- preparing the payroll, assigning tasks, etc. Moreover, a certain size of police force is necessary to facilitate a division of labor that would allow various individuals to specialize in dealing with various types of police problems, ranging from controlling traffic to solving felonies.

In summary, there's a balance to be achieved in selecting an appropriate size and number of local governments. But further complications arise because the economically optimal size of a jurisdiction for the provision of one public good or service may be quite different than the

optimal size for providing some other good or service. This can be rectified by introducing hybrid schemes of one type or another. One could, for example,

- create multiple levels of sub-national government and assign to each level the services whose optimal scale corresponds most closely with the size of units at that level;
- create relatively small local units and assign any services whose optimal scale exceeds that of the local unit to the central government;
- create relatively small local units, but allow them to cooperate with one another in the production of services whose optimal scale exceeds that of the individual units; or
- create relatively small local units and allow them to contract with private enterprises for services that involve economies of scale that cannot be realized by small units. These enterprises could provide services to multiple units.

Treating all local governments as “more-or-less-the-same.”

Treatment of local governments as “more-or-less-the-same” is another serious concern of decentralization programs. Experience shows that most intergovernmental reform programs tend to treat all local governments (large urban, small urban, rural, etc.), as if they are similar in capacity and staffing. (Box 6 presents the case of Armenia as an example.) In fact, there are great differences in capacity between local governments in most countries, even among those of a particular type. When all local governments are assumed to have the same capacity to perform, those with weak capacity will under-perform, draw criticism from above and below, and might eventually become an excuse for those willing to reverse the course of decentralization reform.

The “all-local-governments-are-more-or-less-the-same” problem usually manifests itself in highly standardized decentralization reform programs that have similar expectations of all or most local governments and tend to define performance very rigidly in terms of following specific technocratic steps. The particular circumstances under which local governments are functioning, however, may differ widely among jurisdictions, and rigid standardization may undermine their ability to achieve reform objectives.⁶

Box 6: Case of Armenia

Armenia is a small country, with a population officially estimated at 3.8 million. Despite this modest population, there are a large number of local governments in Armenia, 930 in all. Both, urban and rural communities vary considerably in size. The urban communities outside of the capital have a combined population of about 1.3 million, ranging from 211,700 to 600. The smallest rural community in Armenia has only 27 residents. Despite this considerable variation in size, the existing Law on Local Self Government gives all communities in Armenia **the same** responsibilities, regardless of their size. Apparently, many local governments, especially in the rural areas, perform poorly, as they do not have the capacity to handle many of their responsibilities.

Integrated vs. Non-integrated Local Government Units

Depending on size, two types of systems of local government units exist: integrated and non-integrated. Integrated systems are those in which the size of the local government unit is adjusted to an “optimal” size for the provision of public services. This model is followed in

⁶ Draws on Paul Smoke, “Beyond Normative Models and Development Trends: Strategic Design and Implementation of Decentralization in Developing Countries”, Management Development and Governance Division, United Nations Development Program, November 2000

Anglo-Saxon and Scandinavian countries. The non-integrated model simply takes existing settlements, of whatever size they may be, and permits them to function as local government units. To the extent that these units are too small to provide public services, other institutions can be formed to provide those services. France and many Mediterranean countries follow the non-integrative model. Among the transition countries that have also permitted local governments to follow the historical settlement structure are the Czech Republic, Slovakia and Hungary. Lithuania, Slovenia and Poland follow the integrated model.

Determining the Number of Tiers of Administrative Structure

With respect to the levels of administrative structure, several models exist. There may be one, or more than one, intermediate levels of government in a country. The intermediate levels of government may be either elected or appointed. We have provided a summary of sub-national government structure in selected countries in Table 1 below.

It is important to keep in mind that a higher number of layers of government can lead to duplication of administrative services leading to higher administration cost. Furthermore, multiple layers of government can weaken policy directions and goals of central (or higher levels of) governments. On the other hand, in a country where remoteness of some areas of the country exists, it may not be possible to administratively function with just two levels of government. One possible solution is to allow for asymmetries and flexibility at the sub-national level. Some geographically compact provinces, equipped with capable officials and experience in self-governance, might not need an intermediate level of sub-national government.

Table 1: Subnational Government Structure in Selected Countries⁷

Country	Population (in millions)	No. of Subnational Tiers	No. of Top Tier (Region / Province)	No. of Lower Tier 1 (District / County)	No. of Lower Tier 2 (Town / Municipality / Community)
Armenia	3.8	2	11		930
Bulgaria	8.3	2	9		255
Croatia	4.5	2		21	595
Georgia	5.4	2	12	61	~1,000
Hungary	10.1	2		19	3,170
Macedonia	2.0	2		34	123
Moldova	4.3	2	11		911
Poland	38.7	3	16	373	2483
Slovenia	2.0	1			192
Tajikistan	6.1	2	3		70

A study on the evolution of local government in the Balkan countries reveals a common tendency for middle-tier governments. The middle-tier governments are “increasingly

⁷ The World Bank, Poverty Reduction and Economic Management Unit, Decentralization in the Transition Economies: Challenges and the Road Ahead; June 14, 2001.

becoming territorial units for bridging state and local policies, for guaranteeing the execution of central government policy on local territories and for providing top-down coordination of the activities of local self-government.”⁸ In unitary government structure, such as the one existing in Iraq and typical for the countries of the Former Soviet Union, the tendency toward state control over local government actions and vertical subordination of local governments puts the local governments at the bottom of a “hierarchical pyramid of competencies.”⁹

In considering how to organize the various tiers or levels of government, Iraq has several options from which to choose. The goal is to strike an intricate balance between local autonomy and central oversight. This balance can change over time. It is unlikely that local administrations will initially have the capacity to take on complete responsibility for a full slate of powers. But over time, as experience and capacity grow, more authority may be shifted and greater autonomy in exercising that power may be transferred.

Issues for Iraq

There are a number of universal factors which affect the pace and depth of local government reform. Among them are the history of local governments in the respective countries, the experience the countries have had with local self-government, and the length of local government reform activities. In addition to a lack of experience with local self-government and a history of highly centralized administration, Iraq is facing a daunting task of creating an efficient intergovernmental system in a way that reduces existing ethnic tensions and concerns – an approach which calls for numerous and small local government units, consistent with the Resident Homogeneity principle discussed above. However, this approach might not be feasible in Iraq taking into account the lack of self-governance and the long tradition of unitary government structure. Some of the sub-national units might be too small to efficiently handle substantial devolution of fiscal authority. Hence, a balance should be struck in selecting an appropriate size and number of sub-national governments. The economically optimal size of a jurisdiction for the provision of public goods or services may be quite different than the one that can mitigate ethnic tensions.

⁸ Emilia Kandeveva, “Introduction to Comparative Local Government in Central and Eastern Europe: A Balkan Perspective”, in Christine Zapotocky, ed., *Decentralization: Experiments and Reforms* (Budapest: Open Society Institute, 2000).

⁹ Igor Muntianu and Victor Popa, eds., *Developing New Rules in the Old Environment: Local Governments in Eastern Europe, The Caucasus and Central Asia*, Budapest: Open Society Institute, 2001.

3. EXPENDITURE ASSIGNMENT AND SERVICE DELIVERY ¹⁰

This section deals with expenditure assignment process. It is important to stress correct sequencing of intergovernmental reform – assignment of expenditures to sub-national governments has to precede the assignment of revenue and design of intergovernmental transfer system. Further, the significance of clarity in expenditure assignments is detailed. Finally, the expenditure assignment issues relevant in the context of Iraq are outlined.

Expenditure Assignments Should Come First!

The design of intergovernmental fiscal policy should always begin on the expenditure side. A clear assignment of functional responsibilities among different levels of government is the most fundamental step in the design of a system of intergovernmental fiscal relations. Designing the other facets of a decentralized system – revenue assignments and intergovernmental transfers – in the absence of clear expenditure assignments can be equated to putting the cart before the horse. When expenditure responsibilities are not clearly stipulated in the law, it is not possible to either assess the adequacy of the revenue assignment or effectiveness of intergovernmental transfer system in closing the gap between the assigned expenditures responsibilities and assigned revenue sources.

Box 7: Case of Russia

Russia's federal, oblast, and rayon governments did not have legally assigned expenditure responsibilities. Rather, tradition and inertia led to "accepted" spending assignments; spending responsibilities were established (or reestablished) in each annual budget. However, subnational revenue sources were explicitly assigned. As a result, subnational spending decisions were revenue-driven, instead of revenues being expenditure-driven.

The concentration on revenue assignment and the disregard for a clear expenditure assignment has been a common concern of decentralization programs in Latin America and Eastern Europe. Some of these countries committed this fundamental error. Experience shows that assignment of revenues and transfers before expenditures are clearly assigned in the law leads to weak decentralized systems and fiscally overburdened central governments.

Which level of government will deliver which services?

The major question of expenditure assignment is determining which level of government – local, regional or central – should be responsible for delivering specific services. The principles for assignment of services to local governments as developed in the fiscal federalism literature are fairly clear. As a general principle, the idea of "subsidiarity", or devolving power to the lowest possible level of government where it can be exercised efficiently, is widely supported. It puts government decisions closest to the citizens that are affected by them, and thereby encourages the democratic process. It allows government decisions to closely reflect the tastes and values of the local citizenry, and thereby encourages public choices to reflect private preferences. It is technically efficient to assign service provisions to a larger jurisdiction only if cost savings from joint consumption outweigh the potential welfare loss involved in providing the service over a wider jurisdiction, where preferences may be less homogeneous.

¹⁰ Theoretical discussion in this section draws on World Bank Institute's Internet publications on Intergovernmental Fiscal Relations and Local Financial Management Program, www1.worldbank.org/wbiep/decentralization/Library1.htm

Analysis of expenditure assignments in developing countries shows that the responsibilities for delivering services vary from a country to country. For most part, expenditure assignments are the result of tradition and/or inertia rather than best practices. There is, however, no *absolute best way* for deciding which services should be assigned to which level of government, and no “one size fits all” model. The appropriateness of expenditures assignments should and could only be judged against goals or objectives which the government sets for its decentralization reform.

It is worth noting that for the most part, it is not the decentralization of inappropriate services that causes issues, but instead the lack of attention to implementation. Two issues are important in this regard:

Box 8: Assignment of Capital Expenditure

One of the major problems in expenditure assignments is the treatment of capital expenditures for subnational governments. One fundamental mistake which some countries make is maintaining all capital expenditure responsibilities at the central level. This can lead to inefficient decisions with poorly matched needs, as well as a lack of attention from local governments towards the infrastructure which is centrally funded and built. As a rule, local governments should be assigned with capital expenditure. It is however important to empower citizens against short-sighted local politicians who tend to be prone to putting infrastructure maintenance issues on the back burner in order to fund projects with more immediate political appeal.

- First, meaningful decentralization is a process of power re-distribution and no matter what laws are in place, central government agencies will rarely want to decentralize services, especially if the process involves a loss of prestige and resources. Thus, they will often try to slow the reform process.
- Second, local government capacity could be overwhelmed when too many services are assigned to too rapidly. Lack of managerial and technical expertise might constrain efficient service delivery and result in overall dissatisfaction with the course of decentralization reform. In extreme cases, this can become the basis of the central government’s argument for reversing the course of decentralization reform.

Thus, it is important to design the service transfer to be a gradual process. Successful decentralization reforms, such as those in some Balkan countries, show steady transfer of services from central to sub-national governments. Expenditure responsibilities such as education, health, and utilities used to be state-controlled and delivered by the central government only. Gradual transfer of responsibilities to sub-national governments is an increasingly common tendency in the region, as well as a prerequisite of successful implementation of decentralization reform.

Clear Assignment of Responsibilities Among Levels of Government

A more serious issue involves the absence of solid planning in assigning spending responsibilities. If expenditure responsibilities are not clearly assigned, it will be impossible to determine the revenue sufficiency of alternative financing arrangements. The lack of clarity in the definition of sub-national responsibilities has a negative impact on three important respects. First, if the responsibilities are imprecise, the necessary corresponding revenues will remain poorly defined. Second, without clear responsibilities, sub-national government officials might prefer to invest in populist projects which benefit them in the short run rather than in projects with long term impact on a region's economy (such as

infrastructure, education, etc.). Third, there will be confusion whether sub-national expenditures represent local priorities or centrally determined programs.

When expenditures are not explicitly and clearly allocated to particular levels of government, it is impossible to assess the adequacy of the revenue assignment and/or the effectiveness of intergovernmental transfers. As we argued above, clear expenditure assignments need to be the first and fundamental step in the design of intergovernmental reform. An example of non-uniform expenditure assignments and resulting problems with design of equalization formula is presented in Box 10 below.

Box 9: Case of Russia

Both the sub-national and central governments used the ambiguity of expenditure assignments in Russia to their advantage. Sub-national governments used it as an excuse to negotiate a larger share of revenues. The federal government, on the other hand, used the murky expenditure assignments as a mechanism of budget balancing, with service delivery being pushed down to lower-level governments.

Box 10: Non-Uniform Expenditure Functions in Kyrgyzstan

There is not a clear and consistent assignment of expenditure functions or of revenue sources among levels of government in the Kyrgyz Republic, either in law or in practice. Assignment structures vary from Oblast to Oblast, from Rayon to Rayon within a given Oblast, and even from municipality to municipality within Rayon. Assignments change from year to year as well. This variability in assignments makes it difficult to design a fair and efficient equalization system. Local government assignments vary so widely that “standard” spending responsibilities and revenue sources are hard to identify. Suppose that one municipality is responsible for maintaining its roads but not its water supply, because the Rayon has taken charge of its water delivery. A second municipality is in the opposite situation, responsible for its water supply but not its roads, while a third municipality takes care of both. In this situation, what constitutes a standard group of functions for municipalities? If an equalization formula includes both roads and water supply in the standard group of municipal functions, the first two municipalities will be “overcompensated” because they are not responsible for one of these functions. If the formula incorporates only water supply or only roads, the third municipality will be under-funded.

It is important to note that a meaningful decentralization cannot be achieved without explicitly defined and stable expenditure assignments. Local governments cannot be truly autonomous and independent under conditions of varying expenditure assignments. Providing local governments with clearly assigned revenues and stable transfers will not act as a solution if the higher-level governments can “claw back any additional resources local governments may have been able to generate through the collection of local taxes and fees or even more efficient management of their expenditures.”¹¹

Issues for Iraq

Several issues related to assignment of expenditures in Iraq are identified below as having significant bearing on the outcome of the decentralization process as a whole.

¹¹ Jorge Martinez-Vazquez, Making Fiscal Decentralization Work in Vietnam, Georgia State University, Working Paper 05-13, June 2005.

- Expenditure assignment processes should be complete before the decisions are made on own-source revenues and intergovernmental transfer system. This proposition holds true for Iraq as it holds true for any other country in the world.
- Commitment of Iraq to a decentralization structure is an important step in moving away from the past history of a highly centralized unitary state with autocratic government structures. However, history has played a role. The lack of experience with local self-government and a history of highly centralized administration calls for gradual transfer of expenditure responsibilities to allow the local governments to build necessary managerial and technical capacity to deliver services efficiently.
- Although flexibility and non-uniformity of expenditure assignments is generally denounced by decentralization experts, in a state like Iraq, where the Kurdish area has substantial experience in local self-governance, non-uniformity of expenditure assignments could be a possibility. Ethnical consideration, along with a wide diversity of cultural tastes and approaches, provides room for flexibility in expenditure assignments across the regions. The Kurdish area cannot be treated with the same degree of autonomy as other sub-national units. However, it is important to facilitate decentralization of expenditure assignments in other regions, and to reintegrate Kurdish area into a national structure, especially in the long term.
- Regardless of the number of services or share of expenditures allocated, the clarity and explicitness of expenditure assignments of each government level and each sub-national unit is of paramount importance.

4. REVENUE ASSIGNMENT

Assignment of appropriate revenues to local governments

There are two general principles that determine the assignment of tax resources for local governments: the need to maintain economic and administrative autonomy, and the strategic objective of financial viability of local governments. In order to reach a balance between these two principles, taxes on mobile factors such as individual and corporate income tax, sales taxes such as the value added tax, and taxes on international commerce should be the responsibility of the central government.

For local autonomous governments, it is preferable that their taxes be on fixed factors such as land or real estate property, or sales taxes that tax the same base as the national sales tax. The administration of these taxes should be simple. Simplicity implies that tax forms should be easy for taxpayers and administrators to understand, and that the tax code should clearly specify the base and rate of a given tax and the form and schedule of payments. Simplicity and transparency help expedite administration of taxes as does the introduction of computerization to keep records on collections, and to monitor taxpayers.

For practical purposes, a tax is local when:

- The base and rate of taxation are determined by local governments;
- The taxes are collected by local governments; and
- The funds are managed in accordance with the preferences, needs and priorities determined by local governments.

There are modifications of these three principles, for example:

- Local autonomous governments determine the base and rate of taxation but taxes are collected by the tax administration of the central government and managed according to the preferences, needs and priorities of local governments. In this case, local governments pay, or should pay the central government the costs of administering local taxes. The tax is local even if it is collected at the central level.

- The central government determines the base and rate of taxation. Taxes are collected by the fiscal administration of the central government and are allocated to local governments according to the principal of the “origin” of the tax, the city or district where the taxable transaction occurred. In this case, although the central government determines the base the rate and collects the tax, it is the local government that determines the use of the funds. That is why, in terms of accountability, this tax would be a local one.

Box 11: Growth-Constraining Local Taxation

Local governments in some countries do impose taxes that hinder economic growth. Infamous South Asian octroi (local entry tax) on inter-jurisdictional trade is one example. Octroi is paid to the municipality where one sells the product. Even when public finance experts criticize these taxes they often remain in effect because they are so productive for local governments. The decentralized fiscal system should be designed so that growth-constraining local taxation is prohibited but local governments are provided with feasible alternative revenue sources.

Many developing countries basically follow these principles, with a few famous exceptions, such as the ill-famed South Asian “octroi” (see Box 11). Thus, central governments generally attempt to assign local government revenue bases that are relatively immobile and should, therefore, not lead to serious spatial efficiency effects, not compete seriously with central tax bases, and so on.

Four problems or concerns are worth noting with respect to assignment of own-source revenues.

- Assigned own-source revenues are usually inadequate in comparison with assigned expenditures. To fill this void, an intergovernmental transfer system must be designed.
- Local governments often impose too many unproductive taxes that do not provide for the cost of administration and collection (see Box 12 as an example).
- Lack of attention to implementation in relation to service decentralization plagues the revenue side.
- Own-source revenues often have serious design problems, including such issues as static bases and overly complex structures. Ineffective collection mechanisms are sometimes due to inappropriate revenue administration design.

One of the most critical international lessons of intergovernmental reform on the revenue side is that local governments should concentrate their energies and often scarce managerial and administrative resources “on a few local sources of revenue that can provide substantial yields” and pay “less attention to the many minor taxes that they typically have access to.”¹² Local governments are better off when they concentrate on property taxes and user fees – the two significant sources of revenue that local governments might use effectively. We discuss each of these own-source revenues below.

Box 12: Local Taxes in Bosnia and Herzegovina

At present, municipalities in Bosnia and Herzegovina (BiH) punish the commercial sector with a dizzying array of unproductive taxes and fees, including 160 different taxes and fees currently levied. Many of these tax types receive scant effort in administration or collection, bring in little revenue, and contribute to the public disillusionment with the scheme of taxation.

¹² Ibid 5.

Property Tax

Property tax is considered to be one of the most appropriate sources of own-source revenues for local government. There can be however serious local political problems with adopting and enforcing it. The first challenge is to draft adequate legislation. The implementing legislation must establish the basis for the tax (market-value), specify and limit the number of exemptions, set the limits of the tax rate, provide for sufficient enforcement powers, and give the central authorities the responsibility for oversight to ensure uniformity and to certify or decertify municipalities to administer the property tax.

Once the law is drafted, the next step is obtaining the political buy-in of local government units. Implementation of such a major reform cannot take place without a strong commitment from the local governments to set up property tax departments, hire additional staff to survey the thousands of pieces of real estate and enter their property characteristics and owner/occupier information in a database, as well as commit other significant resources to the reform. The IT solution must be designed such that it is customized and appropriate for the country context, robust enough to store and analyze vast quantities of data, can generate various management reports, and can accommodate additional upgrades to last far into the future.

A substantial taxpayer education and public relations effort is vital to communicate the reform to the citizens before the survey takes place so the people understand why the surveyors are visiting their property. Political leaders must enter into a dialogue with

taxpayers so they understand how the property tax works and its link to improvements in the community. Taxpayer education must be an ongoing, never-ending activity in order to maintain voluntary compliance with the tax.

Even if these elements (adequate enforcement mechanisms and communication with taxpayers) are in place, it is likely local governments will be reticent to collect a

significant amount of own-source revenues. Local government leaders have little experience collecting revenue from their neighbors and fellow townsfolk and politicians believe it is safer to rely on intergovernmental transfers, even if they fail to cover all of their obligations, than to raise tax rates and enforce collection. Box 13 shows how this tendency was successfully counteracted in Kosovo.

Box 13: Property Tax Incentive Grant in Kosovo

Kosovo recently implemented a Property Tax Incentive Grant which has, thus far, been very successful. Although it was implemented at the end of 2005, the increased revenue effort of the municipalities is directly responsible for at least an additional €600,000 in total collections. In general, the Incentive Grant groups municipalities into one of three categories – (a) those that have above average tax rates and collection rates; (b) those that have average collection rates and average tax rates; and, (c) those that have below average collection rates and average tax rates. It then applies an annual growth rate to each of these categories to determine a revenue target for each municipality. Category A is expected to increase property tax revenue by 10% each year, category B by 20%, and category C by 40%. The amount of money available to the 30 municipalities under the Incentive Grant is €6 million, set aside from the General Grant and allocated according to the same formula. Municipalities that fail to achieve their revenue targets but still increase revenue over the 2004 base year receive a partial grant. Municipalities that fail to increase revenue over even the 2004 base year are ineligible for the grant. Instead, their allocation is divided amongst the municipalities that exceeded their targets.

Two other issues with property tax implementation are worth noting:

- Some countries overtax business property through higher assessments and higher tax rates with the objective of protecting residents. However, this usually results in a shift of the tax burden back to residents through higher prices of goods and services. The solution is in eliminating differentials in tax rates for business and residential property.
- Valuation procedures tend to be so complex that the tax base stagnates for long periods of time. The solution is to simplify assessment procedures.

Box 13: Property Tax in Armenia

The “cadastral evaluation” in Armenia, used as the basis on which the property tax is imposed, bears no relation to market value. For example, the tax bill of generally poor agricultural land owners is higher than dictated by the market value of their land. On the other hand, the tax bill of well-off owners of desirably located property in downtown Yerevan (capital of the country) is reduced because their property is assessed at lower than the market value. The lack of coordination between local communities and the State Cadastre Committee resulted in registries for buildings and land that did not reflect the fact that some buildings were abandoned and some land was unused.

Property tax reform processes that have worked in other countries may not be fully applicable in Iraq’s conditions, but the general strategies and principles can guide Iraqi policy-makers in designing the property tax for the country.

User Fees¹³

A second important aspect of own-source revenues for local governments is user fees. There are several arguments both in support and opposition of such fees. The proponents highlight the close connection between consumption and cost; ease of collection due to the direct nature of charges; and ease of non-payers’ punishment by means of exclusion from service delivery. The opponents argue that serious problems exist with instituting and increasing user fees for public services, including political sensitivity, equity concerns about the effects of charges on the poor, unproductiveness of some service charges in relation to the cost of administration and collection.

Several principles in implementation of service charges could be suggested.

- People usually don’t mind to pay for services when adequate quality and reliability is provided;
- A taxpayer education and public relations campaigns are required to make people accept new and/or increased user fees;
- Gradual implementation helps avoiding administrative and political resistance;
- It is easier to charge service fees when non-payers can be easily excluded from consumption;
- Equity consideration should be taken into account.

¹³ Ibid 5.

Issues for Iraq

Two issues are particularly relevant in Iraq:

Capacity to Pay. The most efficiently and elegantly designed revenue system will not yield the expected results if it ignores local economic conditions. Iraq's transitional state has been difficult and painful to its citizens. That is why it is pertinent to point out the socio-economic context of the country and to keep this context in mind when discussing how to restructure local finances in Iraq. While there are urban-rural and region-to-region differences, consideration of the general socio-economic situation of Iraq injects a dose of realism, when it comes to restructuring local public finances. Collecting more taxes may be difficult. Local governments are likely to suffer more than the central government from this poverty-related inability to pay taxes. People have more discretion over whether or not to pay their local government tax obligations (property taxes, for example). Even if they avoid paying these taxes, they still occupy the property – enforcement mechanisms with respect to property are very difficult to put in place.

Avoid “localization” of natural resource taxes. Although Iraq is rich in oil, it is concentrated primarily in the north and partly in the south. Interregional balance could be substantially distorted as the natural resource taxes are localized. If the situation is not addressed through a carefully designed equalization transfer system it will “create disparities between regions based on wealth” and might lead to internal migration in the long-run. “Areas that do not have access to this revenue resource will experience population outflows and those with access will experience population inflows. Given the demographic concentration of ethnic and religious populations, this internal migration could destabilize the wealthier regions in the long run through significant immigration of minorities either ethnically or religiously different into the oil rich regions.”¹⁴

¹⁴ Bruce Hutchins, Local Government Revenue Sources, USAID/Iraq Economic Governance II Project, April 2005.

5. INTERGOVERNMENTAL TRANSFER MECHANISM

In countries with multiple levels of government, it is rare that each level is able to finance its spending from revenues it collects on its own. More often, governments at one level (typically regional or local) rely on transfers from those at another level (usually central) for a portion of their revenue. This section deals with these intergovernmental transfers, including why intergovernmental transfers are considered to be not only necessary, but also desirable.

Arguments for intergovernmental transfers

Public sector finance experts note that if allocation of expenditure and revenue responsibilities is done in the theoretically prescribed manner, lower level governments will be given more spending responsibilities than they have available revenue means. An imbalance, or *fiscal gap*, will emerge and intergovernmental transfers will be required. Transfers allow countries to fill this fiscal gap while still respecting sound principles in parcelling out expenditure responsibilities and assigning revenue sources. If it weren't for intergovernmental transfers, countries attempting to keep local governments solvent would be obliged to allocate fewer expenditure responsibilities or more revenue sources than theory would dictate.

A fiscal gap is not the only justification for intergovernmental transfers. Additional arguments for intergovernmental transfers include the following:

- **Spillovers:** A local government may undersupply certain public services if a portion of the benefits go to people who live outside its jurisdiction. Local leaders are, after all, elected to serve local interests. For example, sewage treatment helps not only residents of a community, but also those living downstream from it. In deciding how much to spend on sewage treatment, a local government may not devote enough because it does not take fully into account the benefit accruing to non-residents. However, if the central government provides a transfer payment to help local governments pay for sewage treatment, communities may spend more on it.
- **Harmonization:** Just as transfers can induce local governments to take spillovers into account in deciding how much to spend, and on what, they can influence local governments in deciding how to spend and how to tax. The central government can provide transfers to local governments that harmonize their standards, rules and administrative requirements, and program design. This harmonization can involve expenditure programs in areas such as road design, eligibility for social programs, or occupational licensing.
- **Regional equity:** A particular assignment of spending responsibilities and revenue sources to local governments will leave some communities in a stronger budgetary position than others. For example, a community that is home to a productive mine or factory will be able to extract more revenue per resident than a community less blessed. Even if communities had similar abilities to raise revenue, they might not be in an equivalent position to provide a uniform level of public services. Some communities will have to spend more than others because of cost and need factors. For example, it costs more to build a kilometer of road in mountainous terrain than in flat areas. Intergovernmental transfers can be designed to compensate for such differences in revenue capacity and spending requirements – to equalize the position of different communities at least as far as their ability to provide public services is concerned.

- **Regional efficiency:** Equalization payments make for fairer treatment of a country's residents, regardless of where they live. No resident is condemned to second-rate public services just because he or she lives in a particular community. But the rationale for equalization payments goes beyond fairness. Equalization payments can contribute to greater economic efficiency as well by giving individuals and businesses an incentive to locate where it makes economic sense, not simply where local taxes are lowest or local public services are best. Suppose communities had to finance their operations entirely out of own-source revenues. Communities with strong tax bases due perhaps to wealthy residents, or communities with low public service demands, thanks maybe to few children and few elderly residents, could afford to have either lower tax rates, superior public services, or both. These advantages would attract individuals and businesses to those favored locations, even if the purely economic return might be higher from locating elsewhere. With equalization payments, local taxes and public services can be more uniform across the country. Thus, they are less likely to distort market signals regarding where to locate.

Bad justification for intergovernmental transfers

While the above discussion dealt with positive justifications for intergovernmental transfers, experience shows that developing countries often have negative reasons for justifying their introduction. Some of these negative factors are listed below:

- Transfers are sometimes introduced to discourage local government autonomy. If the central government does not want to give up control over revenue-raising powers to local governments, it introduces intergovernmental transfers as an alternative source of local government revenue.
- The central government could resist or fear diversity in terms of expenditure mix or revenue structure. It then uses the intergovernmental transfers in an attempt to maintain or enforce uniformity.
- The central government could resist the shift of responsibilities to the local governments thinking that the local governments are more corrupt than the center, and therefore, a shift of responsibility to sub-national governments would lead to a wasting of revenues.
- A transfer system may be put in place as part of a strategy to offload the central government's budget deficit on to local governments.¹⁵

Box 15: Case of Russia

In 1992 some of the national investment responsibilities (e.g. highways) were transferred to sub-national governments in order to balance the central government budget. This created serious budgetary pressures on some local governments, crowding out the most important social responsibilities in the areas of health and education.

Transfer Taxonomy

It is clear why countries with multiple levels of government should most often have, and benefit from having, intergovernmental transfer systems. However, it is also important to determine what sort of a transfer system should be used. Key characteristics that distinguish different types of transfer payments are outlined below:

¹⁵ Draws on discussion in Roy Bahl, Jamie Boex and Jorge Martinez-Vazquez, "The Design and Implementation of Intergovernmental Fiscal Transfers," September 2001

- **Conditional Transfer:** Funds are transferred from one level of government to another only if the spending satisfies a condition - that they be spent on a particular program, for a specified purpose or perhaps in a particular way. For example, to be eligible for a conditional health transfer, the recipient government might have to agree to spend the money only on health services and those services might have to be made available to all citizens on an equal basis. *Unconditional* or *General* Transfers are the opposite of conditional transfers.
- **Matching Transfer:** When making conditional transfers, the granting government may agree to *match*, in a certain proportion, the amount a recipient government spends on the identified program or purpose. The matching ratio is one of the parameters of such a transfer, with the granting government transferring an amount equal to a specified proportion of what the recipient government spends (e.g. 1-for-1, 2-for-1, etc.).
- **Capped Transfer:** A granting government is financially exposed under a matching transfer since its expenditure on the transfer is determined by how much the receiving government spends on the designated program or purpose. In order to limit or *cap* its financial exposure, the granting government can establish a maximum amount it will transfer, either to an individual recipient government, or to all recipient governments combined. Transfers without such a maximum are known as *Open-Ended* Transfers.

Transfers vs. Revenue Sharing

An alternative method for a central government to fill its fiscal gaps to local governments is to share the proceeds of a tax. For example, the central government might collect income taxes throughout the country and return a percentage of what it collects in each locality to the locality's government. There are numerous variations on revenue sharing. The central government can control all the levers by defining the tax base (what is subject to taxation), setting the tax rate, and carrying out the collection and auditing function. Or the central government might define the base and allow each community to set its own rate. The essential feature is that both levels of government derive revenue from the tax and that each local government's revenue is dependent on the amount collected from taxpayers within its jurisdiction.

Box 16: "Shared" Taxes in Kyrgyzstan

In Kyrgyzstan the proceeds of a number of taxes (e.g. profit, income, excise) are "shared" among the Republic and the various levels of local government, with no rules governing the sharing proportions among local governments. Oblasts take their cut first, then Rayons and what remains goes to the municipalities. Thus, it is difficult to identify a standard municipal tax rate or tax base. One municipality may receive a large share of the income tax collected from its residents while another receives little or none at all. It is impossible to compute a "standard" amount of revenue to attribute to a municipality. Suppose the standard revenue assignment used in the equalization formula assumes that each municipality receives 40 percent of the land tax collectible on its territory. In fact, one municipality receives 90 percent and another receives none.

Revenue sharing has a number of desirable features. It gives communities autonomy by providing them with a revenue source for which they are not beholden to the central government. Unlike a system that keeps central and local revenue sources separate and distinct, revenue sharing helps harmonize tax rules across localities and permits a single efficient administrative apparatus.

Yet revenue sharing suffers from an intrinsic flaw if the equalization objective is overly important (see Box 17). In such cases, the money is sent back to where it was raised, and thus, does nothing to help balance inter-community differences in the provision of comparable levels of public services at comparable tax rates.

Transfer Design Principles

Continuing with the discussion of conceptual foundations of transfer payments, it is useful to consider what makes for a good system. Widely acknowledged characteristics of good intergovernmental transfers include:¹⁶

- Transfers should be determined as objectively and openly as possible, ideally by some well-established formula, enshrined in law and respected by all levels of government. They should not be influenced by behind-closed-doors political negotiation (see Box 18).
- Transfers should be relatively stable from year to year to permit rational sub-national budgeting. At the same time they should be sufficiently flexible to ensure that national budgetary objectives are not thwarted by sub-national finances. To keep this feature in perspective, one might add that transfers should not be so stable as to be unresponsive to changing sub-national conditions. If transfers are not stable, they should at least be predictable.
- The formulae should be transparent and simple, based on readily available and verifiable factors.
- Transfers should provide recipient governments with appropriate incentives. Recipient governments should not be penalized financially through the transfer arrangement for raising money themselves, for rooting out inefficiencies in their delivery of public services, or for prudent budgetary behaviour.
- Wherever possible, transfers should be unconditional and non-matching. The benefits of decentralization accrue only if lower-level governments are free to make their own spending decisions. Conditional, matching grants can undermine the achievement of this independent decision making objective.
- Nevertheless, there are situations where conditional, matching transfers may be appropriate - when inter jurisdictional spillovers are important, when harmonization considerations are significant, or when some overarching national goal prevails. In such cases, good financial stewardship requires that the central government be held accountable for how it spends taxpayers' money. Such accountability is lacking with unconditional transfers.

Box 17: Case of Armenia

In 1998 and 1999 revenue sharing for community budgets had been introduced at 15% of income tax. But in 2000, this arrangement was abrogated by the central government. Instead the size of intergovernmental transfers was significantly increased. One of the reasons for this change was that shared revenue from income tax was mostly transferred to Yerevan's districts, as many industrial enterprises located in outlying communities were registered in Yerevan. Even if the income tax revenue had gone back to the community where the income was generated, the bulk of it would still have gone to the capital. Rural communities, which hardly generated any income tax, would have had inadequate fiscal means to deliver essential public services. It was therefore considered more reasonable to let the central government collect income tax revenues and then reallocate revenues to local governments through a subsidy system.

Box 18: Case of Kazakhstan

At present, the Government of Kazakhstan uses a system of subvention and withdrawal to equalize disparity between its regions. The system is based on revenue and expenditure projections. If projected expenditures exceed projected revenues, subventions fill the gap. In cases where projected revenues are higher than expenditures, withdrawals are administered. *Theoretically*, estimation of revenues is based on "tax potential," whereas expenditures are calculated based on service norms. *In practice*, however, estimation of both revenues and expenditures is based on historical trends and is, in fact, determined as a result of negotiations between the head of the Oblast (akim) and the Ministry of Economy and Budget Planning. Kazakhstan is currently moving to a formula-based intergovernmental system where each tier is provided with a stable and transparent revenue source.

¹⁶ Draws from the World Bank website devoted to the topic of government decentralization -- <http://www.worldbank.org/publicsector/decentralization/transfers.htm>.

Equalization Transfers

There are many examples of equalization systems designed with transition economies in mind.¹⁷ In fact, most have a significant number of elements in common. The aim of these systems is to provide each local government with the financial means to deliver a comparable package of services to its residents while imposing a comparable tax burden. To determine the amount of money required for this purpose, the cost the local government would incur in providing a standard group of services is assessed (*expenditure need*), along with the funds it would derive from applying a standard group of revenue-raising measures (*potential revenue*). Since this transfer of financial means allows all sub-national governments, rich or poor, to provide equivalent services to their residents, they are said to “equalize” them.

A formula-based system is one that calculates the payment going to each recipient government with a mathematical representation of their expenditure needs and their revenue-raising capacities. Statistical indicators measure these needs and capacities. This mathematical approach removes a good deal of the discretion from the determination of “who gets what.” It makes the process transparent and subject to rational debate over how factors are measured and how much weight they should receive. It limits the role of back-room bargaining and regional or political favoritism.

As a rule, equalization payments come with “no strings attached.” The recipient government can spend these general-purpose transfers as it wishes, either to increase spending where it sees fit or to reduce taxes. This is in contrast to dedicated transfers that must be spent for a particular purpose or matching grants that require the recipient government to commit some of its own funds to an identified objective in order to qualify for the payment.

To say that an equalization system should be formula-based does not necessarily imply that the identical formula and parameters must be used to compute transfers for each and every recipient government at a particular level. In a country where different local governments take on different sets of functions, a transfer system could have one equalization calculation procedure for local governments that are responsible for water supply and another calculation for those that are not, one for those that receive a large share of income tax revenue and another for those that receive a small share. Box 19 presents a case of the Kyrgyz Republic where such an approach cannot work because of changeability of expenditure assignments from year-to-year and from one sub-national government unit to another.

Calculating equalization transfers using a formula determines not only the amount each community will receive, but also the total amount the State will pay. This may present a problem, for the central government may not wish to tie its hands in budgetary matters by committing itself to spend whatever amount the formula churns out. This reluctance is

¹⁷ Some of these are,

- Bahl, Roy, *Intergovernmental Fiscal Transfers in Developing and Transition Countries: Principles and Practices*, Part of the World Bank Institute Course on Fiscal Decentralization, presented in Caracas, Venezuela: 6-17 June 1999.
- Nikolayenko, Irene, “Methodology of Allocating Transfers from the Fund for Financial Support of the Regions (FFSR) in the Year 2000” (Russian Federation, 1999)
- “Options for Equalization Transfer Mechanism”, Kazakhstan Public Expenditure Review: Volume III, Annex IV.3, June 27 2000.
- Yilmaz, Serdar, “Equalization Across Subnational Governments: Fiscal Capacity”, (World Bank Institute, May 2002.)

understandable, since central government budget-makers consistently face a long list of worthy candidates for spending. Local governments represent only one of these candidates. Setting one of these expenditures on “automatic pilot” by using a formula may upset a carefully achieved balance among competing claims.

Even if one accepts this point of view, a formula approach need not be abandoned. The formula results may be used to determine the relative rather than the absolute amount of payments to be made to each community. This leaves the central government free to establish the total amount to be paid. Under such a “constrained formula” approach, each community’s formula-determined payment is adjusted by a factor that measures the overall payment the central government feels it can afford as a proportion of the total unconstrained formula-determined transfers for all communities. For example, if the central government feels it can dedicate 9 “units of local currency” to equalization transfers, but the unconstrained formula generates total payments of 10 “units of local currency”, each community will receive a constrained-formula payment equal to nine-tenths of the unconstrained formula amount allocated to it.

Box 19: Case of Kyrgyzstan

Given the degree of expenditure assignment variability among Kyrgyz local governments and the fact that the assignments changes from year to year, this approach could easily degenerate into a unique equalization calculation for practically every local government. Such a “system” where, in the limit, each recipient is subject to a different set of rules soon begins to resemble the existing “no rules” approach to equalization.

Transfer formulas should be fairly straightforward, being based on simple factors like student population, number of population over 75, major variables determining climate (latitude and elevation), population density, etc. In order to support institutionalization of democracy, transfer allocation formulas should be clearly understandable to the general population, not just a select minority of experts. The main characteristics of good objective factors for equalization grants are these:

- They should be client-focused. A client-focused formula for elementary education would allocate most resources on the basis of numbers of students, not
 - numbers of teachers,
 - numbers of school buildings, or
 - numbers of classes;
- they should be quantifiable;
- they should be clearly and precisely defined;
- they should be auditable, or their validity should be verifiable by a source other than the local government to which they apply; and
- the value the factor takes should not be a function of decisions made by a local government, a ministry, or parliament.

For example: factors like “number of elementary schools”, “number of elementary school classes”, or “number of elementary school teachers” would not, for purposes of determining fair and efficient allocation formulas, be considered “objective factors”. The values that these factors take on for specific localities are the result of political or bureaucratic decisions. Administrators or politicians who scream the loudest, or persistently threaten, cajole, or lobby, end up getting the most through personal contact. Over time, putting emphasis on

these types of factors will simply serve to drive up costs, particularly as communities that did not receive favorable treatment find out what the “most favored” have received.

Allocation factors should have clear incentives for operating efficiently; they should provide incentives for local governments to cooperate. Formulas based on number of classes, number of buildings (or schools), or number of teachers have much different incentives than formulas based on number of students. If a significant portion of funding is based on numbers of teachers employed, and the public or school administrators know they will lose funds if they employ fewer teachers, they will have no incentive to reduce the number of teachers and spend more, for example, on computers or books. If some funds are based on the number of buildings or institutions, and closure of a building or institution will result in fund loss, local governments will have no incentive to close facilities and cooperate with neighbors to provide a service more efficiently.

Analysis of the Expenditure side

To provide a representative quantity and quality of public services to its residents, a local government must undertake a certain level of spending. The size of that expenditure will depend on both the *amount* of services needed to achieve that representative level, and the *cost per unit* of services supplied. Both can vary from community to community, as noted.

Amount of Services: The amount of local government services per capita required to bring a community’s residents up to the level established for transfer purposes can vary from municipality to municipality for a variety of reasons. Three of these are identified here, along with an examples based on a study undertaken by BearingPoint in Armenia.

Demographic:

Example: In Armenia, local governments are required to provide kindergarten education. Communities differ with respect to the proportion of their population that is of kindergarten age. A community with many young children will have to spend more if it is to provide a representative level of kindergarten service, e.g. places available for all children within the target age group. Therefore, the amount of kindergarten services needed (i.e. the number of places to be made available) will depend on the demographic make-up of the community.

Economic

Example: Armenian local governments are supposed to ensure delivery of water service. Low-income households may be unable to pay their full water bills. The local government may thus have to subsidize water services for some residents. A town with many low-income households must spend more to provide water service comparable to other communities e.g. a minimum supply to all residents. Therefore, the amount of spending required will depend in part on a community’s economic make-up, particularly on the share of the population with low incomes.

Geographic

Example: Maintenance of community roads is a local government responsibility in Armenia. Communities that cover large areas often have long stretches of roads to maintain, and will need to spend more if they are to keep them at a representative state. Therefore, the amount of road maintenance required will depend on the geographic characteristics of the community.

Cost per Unit of Service: A second influence on the resources required by local governments to deliver a representative set of services is the cost per unit of services delivered. This can also differ from community to community for a variety of reasons.

Labor costs

Example: The typical wage that must be paid to workers, including local government employees, may be higher in some parts of the country than in others. A capital of a country may be a special case due to the need to compensate employees for the higher cost of living in the capital. Therefore, the unit cost of delivering local government services will vary with prevailing wage rates in the community.

Transportation costs

Example: Local governments in isolated communities must pay more to have the goods they require shipped to them, including the goods used by local governments. Therefore, the unit cost of delivering local government services will vary with the accessibility of the community.

Climate

Example: Communities in mountainous regions must spend more to maintain roads on steep grades or subject to heavy snowfalls, and may incur higher costs for heating publicly-owned buildings due to the severe climate at higher elevations. Therefore, the unit cost of delivering local government services will vary with the climate of the community.

Assessment of Revenue-Raising Capacity

A frequently uttered warning in constructing the revenue component of an equalization formula is to avoid measuring what different governments *do* collect, and instead measure what they *could* collect, if each imposed a uniform tax regime (same tax base, same tax rates, and same efforts at collection). Equalization systems should avoid using actual revenues because a local government would have an incentive to make itself look poor by purposely not taxing its residents too heavily or not trying to collect revenue. But if the equalization formula relies instead on some measure of what the local government could collect (its revenue potential or revenue capacity), the transfer-driven incentive to extend only a low “tax effort” would disappear.

Measuring revenue capacity is more difficult than measuring actual revenue and generally leads to a more complicated equalization formula. Nevertheless, it is usually good advice to use revenue capacity rather than actual revenues in a formula because it rids the system of perverse incentives.

Limitations on Data Availability

Limitation of data availability is an added challenge which developing countries must face when designing their transfer systems. The absence of the necessary data on local fiscal, demographic, and socio-economic variables hinders the possibility of adequately quantifying local expenditure needs and fiscal capacity. A good equalization system needs a detailed and trusted database to underpin its calculations. In computing how much each local government must spend to deliver a standard set of services, it is necessary to know the number and needs

of its residents, as well as the unit cost of providing the specific service in that location. For example, if a standard local government function is to make adequate pure water available to each household, it is necessary to know the number of households in each community, the number of liters of water a typical household in that community requires per day, and the cost of acquiring/purifying/transporting a liter of water in that community. In order to effectively design a system of intergovernmental transfers, the availability and quality of a comprehensive database for every level of government is essential. The development of fiscal, demographic and socio-economic databases allow for design of a transfer system that can correct horizontal and fiscal imbalances.

Issues for Iraq

An efficient intergovernmental transfer system can mitigate substantial regional disparities existing in Iraq and serve as an instrument for holding the ethnically and religiously fragmented nation together. In building a successful intergovernmental transfer system, attention should be paid to the following issues:

- The transfer system has to have a sound legal basis. The structure of the equalization subsidy should be included in the law so citizens can see how entitlements are determined. When transfers are instead determined through more arbitrary administrative or political means, not only is confidence in the fairness of the system undermined, but local government effort is directed at influencing the transfer allocation decision rather than at managing the community.
- The transfer system should have good incentive effects. The amount of equalization subsidy a community receives should be based on its capacity to raise funds from its revenue bases, not on the amount of revenue it chooses to raise. A community with a weak revenue base receives more than one with a strong revenue base that opts not to use it (i.e. one that displays a low “tax effort”). This gives local governments with a decent fiscal capacity a financial incentive to go after their own-source revenue.
- Proper technical base must be built. Data availability and data quality are important, as well as availability and usability of analytical and simulation models. Such analytical tools must be developed to facilitate experimentation with alternative transfer designs and help Iraqi policy-makers in making rational choices in developing the intergovernmental system.

Box 20: Database Development in Armenia

In Armenia, BearingPoint has developed a comprehensive database of economic, demographic and fiscal data for local government units. The database contains economic, social, demographic and fiscal information for each of the 930 communities and is used for determination of transfer allocation and assessment of other fiscal policy alternatives. Based on the database, a user-friendly software package was created for user-defined data search, data-extraction, and creation of customized reports. The software and the database significantly increased the capacity of the Ministry of Territorial Administration and the Ministry of Finance and Economy. Based on the database, a simulation model was developed by BearingPoint to analyze of alternative intergovernmental fiscal arrangements and their effects on the central and local governments.

6. CONCLUSION

The following points highlight the most important issues addressed in this paper:

- When decentralization reform is designed, introduced and implemented as a result of a politically-negotiated process, it has much greater prospects for success.
- Lack of managerial and technical expertise can limit the efficiency of service delivery and undermine the process of intergovernmental reform. Capacity and institution building are of great importance for any country involved in decentralization.
- The balance should be struck between capacity building and devolution of power.
- In politically unstable environments, such as the one existing in Iraq today, legislative efforts should come first in order to build the framework for implementation of decentralization.
- When deciding on the number and size of local jurisdictions in Iraq, the economically optimal size for the provision of public goods or services should be weighed against the size that will most effectively mitigate existing ethnic and religious tensions.
- Expenditure assignment processes should be complete before decisions are made on own-source revenues and intergovernmental transfer systems. Clarity and explicitness of expenditure assignments at each government level and each subnational unit is of paramount importance.
- Socio-economic context of the country should be considered when discussing how to restructure local finances in Iraq. Poverty-related inability to pay taxes should also be taken into account.
- Interregional balance could be substantially distorted if natural resource taxes are localized in Iraq.
- The intergovernmental transfer system has to have a sound legal basis and good incentive effects to be efficient.
- Availability of data and analytical tools facilitate experimentation with alternative transfer designs and help in making rational choices when the intergovernmental system is designed.