The Kosovo Decentralization Briefing Book

Edited by
Robert D. Ebel and Gábor Péteri

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Preface

The seven years of the post-conflict, state-building process in Kosovo have been marked with tremendous challenges to the political, economic, and social reconstruction of the country. In particular, the establishment of responsive democratic governance structures has posed a challenge not only to Kosovars, but also to the international peace-keeping community led by the United Nations Mission in Kosovo (UNMIK). As the Kosovar governance system was being gradually established, the UNMIK-centered governance began to transfer powers to local governance structures.

That decentralization of governance in Kosovo has taken primacy among political development priorities in the first four rounds of the Final Status Talks in Vienna, between Pristina and Belgrade, attests to the importance of the topic of decentralized governance. Under the final status negotiations, decentralization is understood not only as a strategy to improve the delivery of public services, but also as a tool for improving ethnic relations in Kosovo. However, the very term decentralization is largely misunderstood by the majority of Kosovar citizens and is, thus, a much politicized issue. No matter how the decentralization will be decided on the political level, its implementation will be a significantly challenging and long-term process. It will take a few years' time to establish functioning, efficient, accountable, transparent and financially sustainable new municipalities.

In this environment, Forum 2015 noticed that much of the debate revolves largely around whether the government should decentralize or not—which is, indeed, a good and important question—but fails to address the questions of how decentralized government would operate and what fundamental changes it would bring to the Kosovar public sector and, thus, to the relationship between Kosovar citizens and their governments. Accordingly, Forum 2015 decided to start up an initiative in which we have taken a deeper look into the very nature of decentralization, in order to provide better information, not only to the citizens of Kosovo but also to its policymakers and decision-makers, and as such support the ongoing decentralization dialogue.

For this purpose, in Pristina in June 2006, Forum 2015 held an international seminar, "Kosovo Decentralization Dialogue," which brought together citizens, policymakers, practitioners and other experts to discuss the set of key issues and challenges of decentralization that Kosovo, following conclusion of the status talks, will have to face as it embarks on a program of public sector reform. The topics addressed at the seminar have been summarized in the present volume, Kosovo Decentralization Briefing Notes, a selection of essays intended for Kosovar policymakers on the many challenges of the decentralization process. The Briefing Notes has thus been designed to serve as a reference book to all those who have a stake in the decentralization process, or are simply interested to learn what the process is about and what it involves. As such, the publication addresses the fundamentals of decentralization, which are relevant to any society that is committed to governmental reform with a view to improve levels of accountability and transparency, and increase efficiency and effectiveness in responding to citizens' needs.

Forum 2015, the coalition for Euro-Atlantic integration, has undertaken this initiative due to its belief that Europe is a union of minorities/communities where each of its members, independently of size, has the power to speak its voice and influence the decision-making processes that affect all communities. This is the very model that Forum 2015 believes Kosovars should follow on the way to building a European state with full membership in Euro-Atlantic structures. Thus, Forum 2015 is confident that decentralization is an opportunity that deserves serious consideration if we are to build a European future for Kosovo.

Luan Shllaku
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Discussions on the future options for Kosovo's political and fiscal decentralization have been ongoing and fluid over the past six months, especially since the issue of decentralization has been at the forefront of the Kosovo Status Talks in Vienna. As a result, the Editors are highly indebted to the Forum 2015 and all those who mobilized so quickly and professionally to contribute to the timely publication of this volume.

Specifically, the Editors acknowledge the Open Society Institute's Local Government and Public Service Reform Initiative (LGI), and the Kosovo Foundation for Open Society (KFOS) for providing the funding for this project and for constructing the team of experts needed to address the wide array of issues analyzed in this study. At LGI, Ken Davey, Adrian Ionescu and Scott Abrams also contributed to the development and management of this project. At KFOS, Luan Shllaku deserves special mention for first conceiving of this project concept and for ensuring as many local Kosovars were engaged in the expert consultations, drafting and peer-reviewing as possible. Along with Iliriana Kacaniku, who managed most of the local activities related to the development of this volume and without whom this work could never have been completed in a timely manner, the Editors wish to thank them both for their dedication to the success of this project.

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Roland Gjoni and George Guess provided thoughtful and constructive feedback to each author and undoubtedly have ensured the volume in front of you today is in much better shape than when they first received the texts some weeks ago.

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Robert Ebel and Gábor Péteri
Washington, D.C. and Budapest
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Decentralization Framework

1.
Introduction and Scope of the Kosovo Decentralization Briefing Book

Robert D. Ebel and Gábor Péteri

A change of government is not change of a system, merely one of the pre-conditions for it.

— János Kornai, *The Socialist System,* 1992

There are two policy revolutions occurring worldwide. The first is "globalization," the integration of the world's markets and the shrinking role of governments as manipulators of economic affairs. This trend is particularly dramatic in the former Communist countries as new political and economic infrastructure arrangements are being created to provide the foundation for a well-functioning market economy.

The other revolution, equally significant, is "localization"—the decentralization of government itself. This is about pluralism, democracy, and citizens demanding a government system that they can understand and control. And, over the past decade and a half, most of this action has been focused on the decentralization of the socialist state as countries once part of the Soviet sphere have either joined the European Union or are readying themselves as EU accession states.

The issues that each decentralizing system (country, province) faces are at the same time very different and very similar. The differences arise from the diversity in economic and demographic structures, institutions, traditions, geography, and access to new technologies. That there are many differences among the decentralizers makes clear that there is no one "correct" model of intergovernmental reform.

Clearly in many ways Kosovo is different. Its most recent intergovernmental fiscal history has been marked by a formal autonomy established (but, then promptly ignored by the government of Josip Broz Tito) under the Yugoslav Constitution of 1945; a bit of progress toward autonomy in the late 1960s that was dramatized in part by the establishment of an independent University of Pristina; and further decentralization in 1974 when Kosovo gained powers associated with a republic (e.g., a seat on the federal presidency, an assembly). But, then, autonomy began to be inexorably eroded in the 1980s by a police-state. Though during the 1980s autonomy was formally maintained, even that formality disappeared with the July 1990 national referendum.

But, there was also a positive development that made Kosovo unique as some of Kornai's "preconditions" for change began to emerge. Although it may not have been fully recognized at the time as a "positive" (and, of course, in many ways it was surely not), Kosovo took "own local" control—not, as in many countries, in the form of constitutional and legal reforms, but rather, through a system of parallel institutions that, in hindsight, can be argued to be the rejuvenation of a Kosovar tradition of local governance and self-management (Kostovicova 2005). Now Kosovo is engaged in Final Status Talks (Vienna), witnessing the emergence of open society associations, holding public forums focused on EU accession (Forum 2015, 2004), and initiating a dialogue that recognizes that however well intentioned and well designed it may be, the series of intergovernmental rules and practices imposed by the international community are not necessarily those that reflect a process of "home rule".

So there are, indeed, circumstances that make Kosovo different from the other intergovernmental reformers.

But, there are also similarities—and fundamentally important ones. Chief among these are the twin and reinforcing economic developments of globalization and localization that stem from the growing "openness" of the world's economies, to the increasing inability of governments to constrain the flow of goods and services and the movement of capital and labor across their borders.

There are also political similarities. Chief among these is the reaction "from below" to long years of extensive central government command and control policies, and the recognition that if one can come up with a well-designed system of intergovernmental relations and fiscal decentralization, the result is not a "zero sum game" whereby one type of government (e.g., central, provincial) is a "net loser" of political and economic power in favor of another set of governments (e.g., provinces, municipalities, joint service districts).

In addition, Kosovo has a multi-ethnic society, as do many countries in the Balkans. This fact should be acknowledged during the process of elaborating the future status of Kosovo. There are many hidden conflicts and issues that require peaceful solutions and reconciliation. But as it was accepted in a number of countries, including those of the former Yugoslavia, decentralization can be a force for fostering solidarity among different ethnic (and/or religious, linguistic or otherwise diverse) groups (Bird and Ebel 2006).

Indeed, the international practice record is clear that a well-designed intergovernmental system can increase the nation's overall economic welfare relative to what would occur under the old fiscal rules of the game. However, to get to this point of welfare gain, it is important that both the "higher" and "lower" levels of government redefine themselves. Thus for a central government, the days of command and control are, or ought to be, long gone. For "subnational governments" it's time to get down to the difficult business of taking seriously the building of institutions that make them worthy of the term "local self-governments" (Davey and Péteri 2006).

This is not to say the task of decentralizing is simple, quick, and tension-free. Indeed, as the notes in this *Briefing Book* make clear, many of the tasks are complex, will require some time to sort out, and are sure to create a tension among policymakers at different levels of governments—a tension, it should be noted, that is far more likely to be healthy than destructive (much depends on the nature of the newly established intergovernmental institutions and the clarity of the sorting out process of public sector roles and responsibilities).

The "catch" is that all this decentralization can be done very well or very badly. Done well it can lead to the benefits promised by a well-functioning state and local system: better services (e.g., girls' education, clean water, local transportation, and garbage removal); national cohesion; and the creation of a potentially powerful tool for poverty alleviation (the proximity of local governments to the poor and familiarity with the various situations and hostile environs which the poor inhabit in different regions and communities gives well-decentralized governmental systems a distinct advantage in designing and implementing anti-poverty policies).

But if decentralization is done badly, it can lead to a macroeconomic mess, elite capture of the political system, corruption, and collapse of the safety net—the same things that many big central governments have "delivered" so well.

This Kosovo *Briefing Book* provides a series of technical notes designed to help frame the Kosovo decentralization dialogue so that one does the job of intergovernmental reform "right." The book is broadly organized around the five fundamental questions facing any decentralizing society (Bird and Vaillancourt 2006).

- Which type or level of local administration does what (assignment of the expenditure function)?
- Which level levies which revenues (finance or revenue assignment)?
- How can fiscal imbalances and disparities among places be resolved when the case for decentralizing spending is almost always greater than that for decentralizing revenues (a role for intergovernmental transfers)?
- How is the timing of revenues to be managed and monitored (debt and the hard budget constraint)?
- What institutional and capacity building arrangements are required to make it all work?

The five questions frame the intergovernmental system—all pieces of which must fit together. To be sure, there will be a sequencing of reform that is likely to be uneven in its implementation and which will take time. There is also likely to be, and probably should be, some "asymmetry" in how the intergovernmental roles and responsibilities get sorted out (e.g., the same system is not likely to fit both urban and rural areas).

The *Briefing Book* is designed to systematically lay out the framework and issues for a robust and learned Kosovo "decentralization dialogue." To accomplish this, it focuses on principles and lessons learned from Kosovo and elsewhere that can lead to a well-designed, sustainable, decentralized system of governance. Although the authors of this set of twenty-four briefing notes do not shy away from pointing out practices that "work" vs. those that fail, these essays do not provide a set of recommendations.

The book is organized in seven sections. The first sets out the framework and principles for doing decentralization well, and includes a discussion of the stages of post-socialist reform in the region (Central and Eastern Europe). The next two sections (Expenditure Assignment and Service Delivery, Financing Services) address the five questions listed above. Sections four and five (Planning and Accountability, Managing the Reform Process) highlight several key institutional and capacity development realities. The sixth section focuses on Special Topics that will arise as Kosovo embarks on the public sector reform. The final section (Bringing It All Together) summarizes the benefits and costs of fiscal decentralization and suggests some practical "rules" for successful implementation of decentralization.

Intended for citizens, policymakers and practitioners alike, this book can serve either as a quick reference document designed to allow one to quickly go to and focus upon a topic of special interest, and/or, a unified set of chapters that can be approached as one would a research treatise to be read cover to cover.

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2.
Local Government in Kosovo

Gábor Péteri
François Vaillancourt[1]

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1 The current institutional description draws on work by the author following an UNDP mission on decentralization in Kosovo in June 2006; he thanks UNDP Task Team Leader Hélène Genest for her help.

Local Government in Kosovo

An overview of intergovernmental arrangements and local finances in Kosovo.

This briefing note provides an overview of the institutional and financial arrangements of local governance in Kosovo as of mid-2006 and is intended to set the context for the twenty-two briefing notes that follow. The note is divided into four parts: institutions, local government structure, functional responsibilities, and revenues.

The contents of the note reflect several of the issues that are high on the agenda of the Vienna-based Status Talks between Serbia and Kosovo. That decentralization was among the first topics discussed and is a continuing focus of the Vienna talks, demonstrates the importance of decentralization not only in accomplishing the broader economic and financial goals of Kosovo, but also in ensuring social cohesion (Bird and Ebel 2006).

Institutional Context

After the 1999 NATO intervention and the supplanting of Serbian rule, Kosovo came to be ruled by a bifurcated central government composed of the United Nations Mission in Kosovo (UNMIK)—which is headed by the Special Representative of the Secretary General (SRSG) with reserved powers authority (RPA)—and the Kosovo Provisional Institutions of Self-Government (PISG). PISG functions with a directly elected Assembly, which in turn elects the President (chief of state) and the Prime Minister (head of government). The Prime Minister is a member of, and accountable to, the Assembly.

The current constitutional basis of local administration is found in the *Framework for Provisional Self-Government in Kosovo* (UNMIK Regulation No. 2001/9), which states that "Kosovo is composed of municipalities, which are the basic territorial units of local self-government with responsibilities as set forth in UNMIK legislation in force on local self-government and municipalities in Kosovo (Article 1.3)."

It is difficult to overestimate the significance of the outcome of the decentralization dialogue in Kosovo. Decentralization has two main purposes. The first is a theme that flows through all the briefing notes in this volume, to enhance the efficiency and accountability of governance. If this first goal can be accomplished, then so can the second: improvement in the perception of, and trust in, governance—both central and local.

Box 1. Transparency Matters

Promoting honest, non-corrupt and effective management of public finances by local government is essential to a well-functioning democracy. Fiscal transparency, which implies low-cost accessibility to relevant information, allows citizens to act like customers and demand the most value for their money. Transparent operations also make it easier for local governments to deliver such value.

Transparency can be an instrument to improve the quality of public services and the efficiency of government, while also enhancing the effectiveness of public decisions. It is essential to decentralization that

i. politicians and bureaucrats become more accountable to constituencies, which leads to better public decisions;
ii. government decision-making capacity is improved through involvement of all relevant stakeholders in national and local public policy formulation; and
iii. implementation of policies becomes more efficient, as this will reduce corruption.

Kosovo has inherited a formally decentralized local government structure from the prewar period. All government institutions of this period were under the control of the Communist party (Union of Communists). Having been under emergency military rule until the 1950s, Kosovo then obtained the status of an autonomous province in 1960. Throughout the 1960s and 1970s, Yugoslavia allowed more market access and local autonomy than many other Communist countries, but at the same time demands for the expression of ethnic identity increased, particularly in Croatia. In 1987 Slobodan Milosevic, a Serbian nationalist, became president of Yugoslavia and proclaimed the goal of a "Greater Serbia."

Then came the forceful abolition of Kosovo's provincial autonomy in 1989 and the break up of the Socialist Federal Republic of Yugoslavia (SFRY) in 1991–92, which was accompanied by the creation of the newly declared Federal Republic of Yugoslavia (FRY). This was also a period (beginning in 1989) when Albanians were dismissed in mass from state institutions and enterprises, and the development of parallel institutions began in Kosovo (Sevic 2001; Kostovicova 2005). The 1990s were a difficult period for local autonomy, with war breaking out in 1998 and ending with the NATO bombing campaign of March–June 1999. Beginning in June 1999, the United Nations declared that the laws of 22 March 1989—the last date that Kosovo enjoyed autonomy within the SFRY—to be applicable (CEELI 2006). Serbia, however, remained largely centralized (see Box 2).

Box 2. Local Government in Serbia

The scope of decentralization, as measured by local government expenditures, is relatively low in Serbia. In 2001, municipal expenditures were 4% of GDP and municipal revenues were 24% of all budget revenues (Levitas 2004). Local governments were relatively large-size entities (central towns surrounded by villages or a collection of rural settlements). As part of the centralization process, 29 administrative districts (*okrug*) were established (in 1992). The district administration is an extended unit of national government.

Although local governments in Serbia were responsible for a wide range of functions (administration, human and urban services), the national government exercised strict control over these formal municipal functions. Moreover, local governments lost control over municipal property (e.g., communal enterprises, school buildings, facilities) when the Milosevic government "nationalized" local assets. Local public utility services (e.g., water, solid waste management), originally provided by municipal public enterprises, became locally managed state-owned enterprises.

In the 1990s local financing consisted of a clear separation of services. On the one hand, there were services funded by own revenues for which there were no national expenditure appropriations (i.e., municipal public spending), and on the other hand there were the remaining local services, funded by shared taxes and for which expenditure levels were set by "unique objective criteria" (Stipanovic 2004).

Under the Yugoslav system (pre-1998) there was a great variety of own source revenues. Based on the self-management model of some earmarked taxes, charges were linked to specific groups of expenditures (e.g., hotel tax to tourism, parking fees to road maintenance). In addition, self-contributions were collected for specific capital investment projects, approved by referenda. The most significant own source revenues were property-related taxes and fees. Tax revenues were shared with local governments through complicated transfer mechanisms, and local governments received a fixed share of the wage tax, sales tax and property transfer tax. There was also an equalization mechanism supplementing these shared revenues through a "gap filling" method of transfers.

Local Government Structure

Kosovo is divided into thirty municipalities, although an additional de facto municipality can be found in the Serb part of North Mitrovica. There are five regions that are used as deconcentrated units by some central government ministries. In Kosovo there are 1,468 villages, which have local communities or *bashkësia lokale/mesna zajednica* (BL/MZ). The BLs/MZs operate not only in rural municipalities, but also as city districts or neighbourhood units (e.g., there are 21 in Pristina).

Within the Yugoslav model, local communities were the lowest level of self-government, but currently the relationship between the *bashkësia lokale/mesna zajednica* and the elected local governments is not well regulated. BLs/MZs liaise with municipal offices and assist citizens. The typically non-elected village councils are headed by the village chair. Services and funding of local community offices are decided by the municipality.

The concept of social self-management strongly prevails in other spheres of the public sector as well. Various boards (e.g., school boards) and committees (e.g., regulatory bodies) at the local and national level operate according to a social self-management model.

Municipal councils vary in size, starting from a minimum of 17 (in 5 municipalities), to 21 (in 4 municipalities), 31 (in 12 municipalities), 41 (in 8 municipalities), up until a maximum of 51 for Pristina, according to the 2001 population figures.

The 2001 population figures were established on 8 August 2001, using information then available to the UNMIK Department of Local Administration (DLA) and the Central Fiscal Authority (CFA). While the continued use of the 2001 population numbers in municipal administration and financing is often questioned, using these population shares in setting intergovernmental grants to municipalities (see below) may not be such a bad choice. It is plausible that since 2001, due to internal migration, the population shares of municipalities with greater economic activity such as Pristina or Prizen have increased. This means that using the 2001 population figures implicitly equalizes for the fiscal potential of attractive municipalities such as Pristina. Why? Because attractive municipalities, which have greater local tax potential than poorer municipalities, receive less per capita through transfers than they would if the current formula was used with updated population figures. As a result more funding remains for less attractive municipalities.

However, the lack of proper population figures and of relevant socio-demographic information has the following consequences:

- poverty analysis, housing needs analysis, proper planning of public service delivery and measurement of willingness to pay is difficult, if not impossible;
- implementation of proper tax and spending analyses, given the link between demographic forces and tax and spending, is hindered;
- private (market development) economic analysis is difficult since statistical information—a public goods type of input—is lacking;
- finally, accurate population and socio-demographic figures should play a key role in negotiating a proper final status for Kosovo, whatever it may be.

The last valid census took place in 1981. The census data from 1991 are not reliable, as the census was not properly implemented in two municipalities in central Serbia and was boycotted by the Kosovar Albanian population. The 2002 census in Serbia did not cover Kosovo. The presently available estimates on resident population in Kosovo should be verified by a properly managed census. The law creating the legal framework for the Kosovo Census was approved in 2003 and a pilot census (six municipalities) was carried out in October 2005.

Kosovo's overall population is about 2 million. Ethnic Albanians constitute the majority, although there is a sizeable minority of Serbs, and smaller minorities of Roma and Turks, as shown in Table 1. According to 2000 estimates, Kosovo's population has increased by 20% over the past two decades, with the Albanian population accounting for much of the increase (presently 88%). However, the size of ethnic minorities in Kosovo is still significant at 12%. The minority populations are primarily concentrated north of the Ibar River, but also in scattered enclaves in the Eastern and Southern part of Kosovo. The design of intergovernmental fiscal relations must take into consideration the multi-ethnic character of the Kosovo population.

Table 1. Ethnic Composition of Resident Population In Kosovo

	2000	*1991*	*1981*	*1971*
Albanian	88%	82%	78%	74%
Serb	7%	10%	13%	18%
Other	5%	8%	9%	8%
Total	1.9 Million	1,956,196	1,584, 440	1,243,093

Sources: UNFPA 2003; 1991 estimates by the Statistical Office of Kosovo (SOK) Yugoslavia; 1998 and 1971 data from *Kosovo in Figures 2005*.

Kosovo has a relatively young population. One third of its population is below age 14 and the share of elderly is low (6%) (see Table 2). These demographics will have an impact on public services. Provision of education services, for example, will be a major task in the coming years, while public spending on pensions and services for the elderly will not be immediately pressing.

Table 2. Kosovo Population by Age Groups

Years	*2002*	*2001*	*2000*
0-14	32.8%	32.3%	31.5%
15-64	61.0%	61.2%	63.0%
65-	6.2%	6.5%	5.5%

Source: UNFPA 2003: Demographic, social and reproduction situation in Kosovo, Statistical Office of Kosovo (SOK), household survey.

The area of Kosovo is 10,877 km^2. and its population density is 175 inhabitants per km^2, which is higher than the rest of the former Yugoslavia (Bosnia and Herzegovina, 66 inhabitants per km^2; Croatia, 83; Macedonia, 81; Montenegro, 50; or Slovenia, 97) or Albania with 122 inhabitants per km^2, but lower than that of Belgium (337) or the Netherlands (464). Kosovo has a mainly rural population (55%). The per capita GDP is $1,400 (2005 estimates), compared to $5,000 in Serbia. (For a more detailed discussion of how demographic, economic and institutional characteristics impact intergovernmental finances, see briefing note "Fiscal Architecture").

Municipal Elections

The last municipal election in Kosovo took place in 2002 under UNMIK regulation 2002/11. A single multi-member (no wards) proportional system was used with a requirement that at least one third of the candidates be women. Under the regulation, the mayor is elected by and amongst the councillors, and is known as the president of the Municipal Assembly. Forthcoming elections should normally be held in the fall of 2006 (with the passing of the legal four-year interval), but may be delayed as resolution of Kosovo's final status may bring a change in the number of municipalities. A governance system with a chief executive officer, a board of directors, compulsory public hearings, and a tight budget schedule is used to establish spending at the municipal level.

Functional Responsibilities

Responsibilities (competencies) of Kosovo municipalities are set out in UNMIK regulation 2000/45. These responsibilities range from those that municipalities "shall" undertake (e.g., providing conditions for sustainable economic development; licensing and regulating of building and building activity; local public utility services; pre-primary, primary and secondary education; as well as health services), to those that they "may" address (e.g., tourism, cultural and sports activities). In addition, they are mandated to implement central authority regulations, including cadastre records, civil registries, and voter and business registration. Commensurate centrally provided resources are to accompany these mandates.

Of this list of expenditure assignments, three dominate: the specific education (47.6% of total municipal spending) and health (12.4%) assignments, and the general municipal administration assignment (37.7%).

The total 2006 fiscal year budget for Kosovo is € 700 million, with municipal spending representing 24% of total (current and capital) public spending. Table 3 presents the evolution of these amounts over the 2000–2005 period. Expenditures accounted at local government level are roughly 7% of GDP, which is comparable to neighboring countries in the Balkans.

Table 3. Public Expenditures by Budgetary Entities (EUR Million), Kosovo, 2000–2005

	UNMIK	*PISG*	*Municipalities*	*Total*	*% Municipalities in Total*
2000	49.76	152.81	-	202.57	0
2001	70.67	154.27	14.56	239.50	6
2002	144.07	169.02	88.99	402.07	22
2003	138.53	234.56	141.76	514.86	27
2004	167.50	430.83	188.85	786.91	24
2005[a b]		531.61	164.51	696.12	24

Source: Ministry of Finance and Economy

a UNMIK reserved powers do not appear separately in 2005. They are reported as central government expenditures.

b Designated donor grant and privatization grant expenditures are not included.

In terms of total public sector employment in 2006, municipalities employ 41,516 out of 76,717 Full-Time Equivalent Civil Service Employees or 54% of the total. This higher percentage of municipal employment as compared to spending reflects the human capital intensive character of education and other municipal services.

Table 4 shows that wages are the largest outlay for municipalities at about 60% of spending (with operation and maintenance). Wage expenses are greatest in the area of education. Capital expenditures are also managed locally (20% of total expenditures) and primarily comprise spending on roads.

Table 4. Municipal Expenditures by Sector in FY 2006

	Wages and Salaries	Capital Outlays	Other (Goods and Services, Subventions)	Total	Distribution of Total, %
Municipal Administration	15,534,246	32,452,098	14,760,967	62,747,311	37.7
Education	68,126,491	671,516	10,432,435	79, 30 ,442	47.6
Health	14,684,362	765,309	5,200,193	20,649,864	12.4
Total	100,528,654	34,173,453	30,393,595	166,546,990	100.0

Source: Ministry of Finance and Economy, Budget 2006 spreadsheet
Note: The difference between the sum of the three elements in the column rows and the column totals is for activities that are not separately presented here: firefighting, LCO (Local Community Office), ORC (Office of Returns and Communities) and PMU (Pilot Municipal Units).

One should note here that water, sewers and garbage collection services are carried out by publicly owned enterprises (POE) administered by the KTA and financed by fees paid by citizens. Previously the responsibility of the Public Utilities Department (PUD) of the Joint Interim Administrative Structure (JIAS), regulation of the activities of socially/publically owned providers of water, wastewater and solid waste services now falls under the competence of the Water and Waste Regulatory Office (WWRO). The WWRO sets and approves the tariff rate of services. The 14 water and sewage POEs are organized on a regional basis, and thus cannot easily be sold to a specific municipality; the 13 garbage POEs can more easily be municipalized or privatized. Municipalities provide the local infrastructure (local pipes) for water and sewer services.

Fair Share Financing

To ensure equitable distribution of municipal budget expenditures between minority and majority populations, Section 4 of UNMIK Regulation 2003/41 stipulates that municipalities are required to allocate to non-majority communities a proportionate share of their budget with due regard for the principle of "Fair Share" Financing. Twenty-seven municipalities (Regulation 2005/12) are obliged to allocate to resident minority groups a proportion varying from 0.4% to 41.3% of their own source revenues and general grant for education and health. In 2005, total municipal funding allocated to minority groups was €16.1 million. However, it is unclear how municipalities determine which specific expenditures to allocate to minority communities and the process appears open to interpretation.

Local Spending Autonomy

Municipalities are constrained in how they can spend their budget.

- Municipalities cannot choose the number of employees they want to hire. Rather the number of municipal employees is established by budgetary negotiations with the central government, which has the final say on the issue. This constraint is the result of a letter of intent (Memorandum of Economic and Financial Policies)—which is also sometimes referred to as a memorandum of understanding—signed by the SRSG and PISG in November 2005, in which both parties agreed to a 10% reduction in public employment for 2006–2008 (with some protected employment categories, such as teachers and doctors).
- Municipalities cannot set their own pay levels to attract better skilled or better qualified employees.
- Municipalities must respect implicit or explicit central norms in the production of public services.
- Municipalities must respect tendering rules imposed centrally when procuring goods and services with a tender for any spending above €500. The size of a municipality or the types of goods purchased are not taken into account when determining compliance with central tendering rules.
- Municipalities submit a list of capital projects to the central government, which cannot be altered without its permission.

Revenues

Grants

Central government grants are the main source of municipal revenues. Grants represent 80% of total municipal revenues, as shown in Table 5, while municipal own source revenues make up the remaining 20%. Municipalities may not borrow and their funds are held in the Central Government Treasury; they receive no interest on these amounts but are provided with treasury services free of charge.

Table 5. Municipal Revenues Grants and Own Revenues, Kosovo, 2006 Budget (EUR)

	Wages and Salaries	Capital Outlays	Other (Goods and Services, Subventions)	Total	Distribution Of Total, %
Municipal Grant	15.555,598	7,966,338	9,965,879	33,487,815	20.1
Education Grant	68,126,491	631,516	8,325,805	77,083,812	46.3
Health grant	13,258,995	737,595	4,059,400	18,055,990	10.8
Own Source Revenues	1,404,015	24,553,474	8,042,511	34,000,000	20.4
Total	100,528,654	34,173,453	30,393,595	166,546,990	100.0

Source: Ministry of Finance and Economy, Budget 2006, unpublished spreadsheet.
Note: The difference between the sum of the three grant elements, the own source revenues and the total revenues comprise firefighting, LCO, ORC and PMU grants.

This creates a disincentive for municipalities to transform physical capital yielding income (such as shops, housing units) into financial capital by selling it because cash thus obtained would be held by the treasury and would not yield any income. Municipalities use private banks only to collect payments such as property taxes. Some municipalities are reported to have arrears with respect to: (1) utilities; (2) providers of goods and services, and/or (3) capital projects. However, there are no arrears in salaries. Regulations have been introduced to ensure the payment of arrears and to avoid their reoccurrence.

Grants are determined in three steps: Overall Envelope, Specific Envelopes and Distribution. The two envelopes can be considered components of the "distributable pool," as discussed in the briefing note on Intergovernmental Transfers.

Overall Envelope

The current procedure for setting transfers to local governments, as a share of Kosovo generated revenues, was initiated in 2001–2002. Under the procedure, the share (a percentage of central budget revenues) is proposed by the Grants Commission and must be ratified by the Government. The share of forecast central budget revenues was set at around 22% for the 2006–2008 budget cycles.

The Grants Commission was set up in 2003 and consists of seven members: the prime minister, the minister of finance and economy, another minister appointed by the government (in 2006 the minister of local government and administration), the chair of the Budget Committee of the National Assembly, and three representatives of municipalities that are nominated by the Association of Kosovo Municipalities (AKM) and appointed by the central government.

Specific Envelopes

There are currently four envelopes.

1. General Grant
The amount of this grant (about 20% of municipal revenues) is calculated by subtracting from the 22% proportion of forecast central government budgeted revenues allocated to municipalities the amounts allocated for the following three grants: Education Grant (fixed in nominal terms at €75 million in 2006); Health Grant (fixed in nominal terms at €18 million in 2006); and the Property Tax Collection Incentive Grant (set by the Ministry of Finance and Economy at €6 million in 2006).

The General Grant is a two-part grant consisting of (i) a fixed amount of €100,000 per municipality and (ii) the remainder divided up according to 2001 population figures. Allocations of the General Grant to each municipality for FY 2006 must also cover expenditures of local community offices, local returns offices and fire protection services, which levels are set by UNMIK and the Ministry of Internal Affairs.

2. Education Grant
There are four parts to the formula for the Education Grant:

- Teachers Costs: calculated by dividing the number of students in a municipality by the student to teacher ratio. Separate figures are calculated for majority students (using the ratio of 1 teacher to 21.3 students) and minority students (using the ratio of 1 teacher to 14.2 students). The resulting number of teachers is then multiplied by the Kosovo-wide average salary per teacher.
- Non-teaching Personnel Costs: the number of administrative and support staff multiplied by the average salary per administrative and support employee.
- Goods and Services: a fixed amount per school (€500 for each pre-primary and primary school, €1,000 for each secondary school) is added to a fixed amount per student (€18 per Albanian student and €22.5 per student of other ethnic background).
- Capital Outlays: €5 per student is allocated to the municipality.

3. Health Grant
The Health grant is allocated according to 2001 population figures.

4. Property Tax Incentive Grant
The Ministry of Finance and Economy sets a normative target for each municipality and then sets the level of the current year's grant based on a municipality's previous year performance. The distribution of the incentive grant is as follows. Municipalities that meet or exceed their target receive the full grant. Municipalities that miss their target but improve revenue collection, over the 2004 baseline, receive whatever percentage of the grant amount they achieved. Municipalities that fall short of the 2004 baseline receive nothing. All funds that are not distributed go back "into the pot" and are reallocated to the municipalities that exceeded their targets. Municipalities that achieve their targets do well at the expense of those that do not. The extra amount is distributed in proportion to both the amount by which the municipality exceeded its target and its population.

Education and health grants must be spent on education or health. Grants must be spent during the fiscal year or returned to the central government. This creates an incentive to spend all grants in a given year, which may lead to inefficiencies and does not encourage municipal savings. Own source revenues need not be spent during the fiscal year they were collected and can thus be carried over.

Own Revenues

The largest share of local own revenues is from the property tax. The assessment of property taxes is conducted by municipalities using market-influenced administrative prices calculated according to a structure's square metreage. Prices vary by zone and by type of structure. Unbuilt land and agricultural land are not taxed. Municipal assemblies set tax rates annually. Municipal employees collect taxes (with tax bills hand delivered by 31 March) in two instalments payable on 30 June and 31 December via the private banking system. Taxes are owed either by the owner or—if unknown—by the occupant (user) of the property. The first €10,000 of a structure's value is not taxed.

The property tax accounted for about a quarter of municipal revenues in 2005. This was followed by two items, each comprising 15% of municipal revenues: (1) co-payments collected from communities (groupings of residents in rural villages or urban areas) that benefit directly from a specific project, such as the paving of a road; and (2) administrative fees levied by municipalities for various documents. No other item in a list of 58 revenue items has a share above 10%. The revenue items next in importance are construction fees (7%) and licenses for large shops (5%). Thus, the remaining 53 items account for approximately 27% of municipal own source revenues or approximately 5% of total municipal revenues.

Conclusion

Decentralization has three main aspects: political, fiscal and personnel. As is often the case throughout the world, Kosovo has carried out political decentralization but not financial or personnel decentralization. Political decentralization has been achieved by creating independent entities, municipalities, with their own elected autonomous politicians. An important step toward fiscal decentralization has been achieved with the setting of property tax rates by municipal councils. Overall, however, autonomy remains limited as municipalities are neither permitted to manage their financial assets, nor to freely set local spending priorities. Moreover, since the pay scale is set centrally and the number of employees subject to central government constraints, personnel decentralization means simply the power to hire and fire for approved jobs; this is not personnel decentralization.

That said, local governments in Kosovo operate under a unique system of intergovernmental fiscal relations. Some of the Kosovar traditions might influence the future mechanisms of decentralization to be developed: for there is a strong belief in local government and self-management, supported by the period of parallel institutions in the 1990s. Relatively large-size municipalities could serve as a sound basis of decentralization, as they have in the countries of former Yugoslavia. The preservation of large-size municipalities in Kosovo would help to establish rationally sized units for communal service provision.

In addition, local community offices and village councils might play an important role in the future decentralized system of governance and service delivery. Community-based organizations (the BLs/MZs) with greater legitimacy could take over some local government functions and become involved in service provision.

There is also a long tradition of local government property and asset management, so future devolution of assets will improve the efficiency of public service management as well.

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3.
Fiscal Architecture

Robert D. Ebel
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Contents

Fiscal Architecture

Demographic, economic and institutional realties frame the "fiscal sense" of spending and tax policies.

Demographic, economic, and institutional changes/trends that are largely beyond national (as well as regional and municipal) control are constantly occurring. In developing a nation's fiscal policy, rather than ignore these trends, it should be recognized that they define the "fiscal architecture" of the expenditure and revenue pressures facing public sector policymakers and practitioners.[1] As demographic, economic and institutional forces vary not only nationally but also by subnational regions and their geographically smaller jurisdictions (e.g., municipalities), so does the fiscal architecture of regional and municipal expenditures and revenue pressures. The increasing globalization of markets for products and services further magnifies the importance of recognizing these parameters and the opportunities they provide for (and the limitations they place on) policymakers. Understanding how these trends may affect the choice of potential tax bases and the changing spending needs of client populations will enable policymakers to design (and, as circumstances change, redesign) expenditure programs and revenue instruments to stabilize a country's long-term intergovernmental finances—that is, to come up with spending programs and tax systems that make "fiscal sense."

It is easy to identify various elements of a country's fiscal architecture, but more difficult to develop an exhaustive list. Fiscal architecture generally comprises:

- Demographic characteristics, including population growth, age distribution, health status of the population, household composition, fertility rates, and life expectancy.

- Economic characteristics, including the importance of particular sectors (manufacturing agriculture, services) and changes in the importance of these sectors; concentration of natural resources; size and structure of economic base.

- Institutions, including not only institutions of budget and revenue administration, but also the many social systems that make budget polices work, such as a system of postal addresses for tax billing and collection; computerization for tracking budget flows; a telephone or website where one can download budgets, regulations, and tax forms and instructions, and have questions answered; clarity on property rights and rights of different levels of government; a range of tools for holding public officials accountable to their citizen-clients; and a judicial system for dispute resolution among citizens and between citizens and their governments. There are also cultural matters such as the ease at which a census taker may be able to secure a population's cooperation to generate data that can be used systematically to examine a variety of impacts of spending and tax policy on business and households alike.

1 Over the medium and long term, "local" policies may influence these forces at the margin and thereby provide a public sector enabling environment for economic development and improvement in a nation's human development indicators. For example, see briefing note 19 on Local Economic Development.

Expenditures

The methodology for analyzing the impacts of fiscal architecture on governments is based on the relationship between the (above) components and government revenue and expenditures. Thus, the expenditure side of the budget will largely be driven by "needs" as objectively measured, which can be done by estimating a systematic relationship between changes in the population with respect to considerations such as size and composition and the changing relative cost of production of service delivery (growing public sector relative to private production is often a great concern for subnational governments where the delivery of services is often a labor-intensive process not easily amenable to cost containment using technological changes).[2]

Consider, for example, that Kosovo has a particularly young population distribution, with fully a third of the total population of primary school age (0–14 years), and another 61% in the 15–64 year cohort (UNFPA 2003, Table 2.1). For policymakers, this means giving short- as well as medium-term expenditure planning to considerations of not only the operating costs of activities such as public recreation and a teacher core, but also to planning for capital improvements for schools (general as well as vocational), and growth-enabling physical infrastructure. Moreover, given such a young population profile, policymakers are forewarned to now carefully plan a pension system that will be solvent over time.

This youth dominance does not necessarily mean that services traditionally associated with the elderly can be ignored, especially in some municipalities outside of Prishtina where the population may be relatively elderly and in need of health clinics, hospitals and social services. Similarly, once the Status Talks are completed, Kosovo may experience an influx of new residents (or conversely, an emigration). If there is an in-migration, then, for example, the issue of housing may become increasingly important to the budget committees.

Revenues

A similar logic applies to the "fiscal architecture" that frames the revenue side of the budget equation.[3] In this case, the challenge is not only to find the right fit between the general nature of the tax base and external reality, but also between the type of tax and the tax base—to identify the tax that best captures the tax base. A broad measure of taxable income makes sense for an employed labor force. Real property taxes make sense as a sustainable revenue source for land and capital intensive economies. Agricultural income and land taxes are obviously attractive in farm intensive

2 The relationship between changes in public expenditures and changes in demographic factors can be expressed as follows: $\Delta EXPi = \Delta CPOPi * (PXPSi) + \Delta PXPSi * (CPOPi)$, where EXPi is the total expenditure on the ith spending category, CPOPi is the client population of the ith spending category, and PXPSi is the production expense of the ith spending category. In this expression, the left hand side is the change in expenditure for a particular spending category, EXPi, and the right hand side of the equation contains the components of the change in expenditures.

3 An expression for the relationship between changes in public revenues and changes in demographic and economic factors may also be expressed as follows: $\Delta Revi = \Delta TXBASEi * (TXRATEi) + \Delta TXRATEi * (TXBASEi)$ where, Revi is the revenue from source i, TXBASEi is the base for tax source i, and TXRATEi is the tax rate for source i. This equation assumes a given population to pay the tax. Obviously, if the number of taxpayers increases or decreases, this will directly affect the level of collections. For example, if there is a large increase in the labor force participation, we should expect to see an increase in income tax collections. The equation also assumes a given (constant) level of enforcement effort.

areas. Business receipts and consumption taxes such as those on retail sales become increasingly important for communities that experience a shift to services. Excise taxes and doing-business permit fees can work in a sector that is characterized by hard-to-tax small businesses, the self-employed and underground activities. Natural resource taxes can be potentially productive for some countries, but, if they are to be so, one must be ready for a lot of clear-thinking on how to set up a tax system that takes into account the fiscal interests of both a "central" government and the local areas in which mineral mining occurs (Bahl and Tumennasan 2002).[4]

The table below briefly illustrates the way of thinking that fiscal architecture analysis requires. Characteristics of fiscal architecture appear in the first column; examples of changes in these areas appear in the second column; and the implications for expenditure and tax policy follow in the next two columns. In reviewing this table, it is important to keep in mind the intergovernmental nature of both the spending and tax sides of the budget. A fiscally sustainable Kosovo, whether province or nation, will require the reinventing of a new fiscal partnership between central and subnational (e.g., local) governments.

4 Kosovo lists 132 types of extractive natural resources, each of which is subject to some royalty tax or fee.

Table 1. Illustrations of Local Fiscal Architecture and Likely Implications for Spending and Tax Policy

External Reality	Trend /Condition	Spending Implications	Tax Implications
Demographic: Age distribution and family composition	Workforce: disproportionately elderly or young?	Youth: schools, infrastructure of growth, police; for the 15–64 cohorts, higher education; and as society ages, health and hospitals.	For the "end points" of youth and elderly, charges on consumption (fees, charges). As employment grows for the workforce age group, taxes on income.
Economic: Structure of output mix	Home/self-employment	Regulatory systems that enable such work; improvements in broad-band connectivity.	Informal economy that calls for non-tax revenues (license fees) and consumption and excise taxation; income taxes not likely to be feasible.
	Dominated by crop agriculture, both large and small producers' mineral mining (at present, 55% of the Kosovo population is agricultural/rural and 45% urban).	(i) Transportation; (ii) environmental control; (iii) need to develop off-site infrastructure for access to markets.	(i) Suggests a focus on land value (or some proxy) and agricultural income tax; agricultural taxes may complement rather than be integrated with urban property taxation (e.g., use versus highest and best assessment); (ii) environmental damage fees, intergovernmental sharing of a tax base (e.g., royalties).
	Small business	Technical support (e.g., agricultural research services).	Market excise tax on production and/or sales, plus "doing business" fees; presumptive taxation.
Demographic: Spatial distribution of population	Rural dominance	Access to educational facilities	Broad-based land taxation often politically difficult. Per house (communal) tax an option.
	Urban dominance	Increased demands for most infrastructures services—look for economies of scale and use of special (rather than only general purpose) governments.	At first, real estate (commercial & residential) taxation feasible. Perhaps, as a communal levy, but then with progress to modern concept of real estate tax. Low-rate business receipt taxes and market fees/taxes are enforceable.

Table 1. Illustrations of Local Fiscal Architecture (continued)

External Reality	Trend/Condition	Spending Implications	Tax Implications
Institutional: Progress in scope and quality of social services.	Increase participation in education; distribution of clean water (if not piped to residents and businesses, then, at least, delivered to locations convenient to users).	Water supply (central and regional) and distribution (local). Enabling environment for economic development spending.	Likely to be a measurable willingness to pay for service improvements; demonstrating the service quid pro quo is essential. Up-front external financial, technical, and capacity assistance can play an important role.
Institutional: State of public records; data.	Many localities have no property records; or they are very old (census). In some countries, land ownership is communal and/or nomadic.	General government.	May require presumptive taxation (which must be transparent); nomadic fee charging possible, but politically difficult; taxpayer identification can be a hurdle.
Institutional: Communications infrastructure.	Transportation modes; availability of postal/mail services; IT usage by the public sector.	Highways (regional, national) and roads and streets (local).	Even if assessment possible, how to collect, audit and appeal if system is poorly developed?
Cultural: Ethnic mix; Views on basics such as a census, land tenure, what is a "tax."	In some societies a census taker may be either suspect and/or a family will not allow all members to participate; also concepts of land ownership will vary (which, in turn, undermines getting a taxable base).	Policing, general government to ensure equal access to services; taxpayer services, mechanisms for citizen voice and participation in budget decisions.	For census, sampling and estimating techniques become even more important. The economic vagaries may be easier to address; for example, that of tax-related issues as to what constitutes "rights in land" may be sometimes addressed by distinguishing between land rights, ownership and use.

Source: Wallace 2003; Ebel and Taliercio 2006; Vaillancourt 2006.

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4.
Fiscal Decentralization in Eastern Europe: Stages of Reform

Kenneth Davey

Contents

Fiscal Decentralization in Eastern Europe: Stages of Reform

Summarizing the decentralization experience and record of Kosovo's neighbors.

The financial reforms associated with decentralization in Central and Eastern Europe since 1990 have reached different stages of fruition in individual states. They have, however, pursued at a varied pace certain core objectives. These have aimed to increase local autonomy by

- making the assignment of revenues more transparent and objective and less dependent on political favor;
- improving local governments' capacity to plan the development of services and sustain long-term debt by stabilizing the assignment of revenues;
- removing disincentives to revenue generation; and
- increasing local budget discretion both over the choice of expenditure and the levy of taxes and/or charges.

Revenue Sharing

Assigned shares of state taxes remain the predominant revenue for local governments in most CEE states. However, the following reforms have been widely made.

Rationalizing the Shared Tax Base

In most states tax sharing is now confined to large shares of personal income tax (100% in Bulgaria, Romania, Slovakia and Ukraine). Assignments of shares of corporate profit taxes (CPT) by origin have been largely eliminated, although retained in Poland, while sharing a portion of the tax by formula continues in the Czech Republic. (Sharing CPT by origin is technically difficult since the point of collection does not necessarily coincide with the real incidence and the base is too volatile to finance a large burden of recurrent expenditure reliably). The introduction of VAT has eliminated the sales tax revenues formerly assigned to local budgets, particularly in the former Yugoslav states, although some VAT shares are distributed by formula (e.g., Czech Republic, Macedonia, Romania).

Uniform Assignment Of Tax Shares

The discretionary and variable assignment of tax shares which characterized the Socialist matrix systems has been abandoned in favor of shares fixed and distributed by law to specific tiers or sizes of local government. Initially these shares were prescribed by annual state budget laws, but in at least eight countries (Bulgaria, Croatia, Macedonia, Montenegro, Poland, Romania, Slovakia and Ukraine) they are now set in permanent legislation to facilitate medium-term budget planning and forecasting of debt service capacity.

Sharing by Origin or Formula

Two main patterns of revenue sharing persist:

- Assignment by origin accompanied by formula equalization (through horizontal redistribution in Poland and partially in Albania and Ukraine, otherwise by an additional intergovernmental transfer). Progress has been made in some but not all states in assigning PIT shares to the place where the payers reside rather than work.

- Assignment of a fixed percentage of the nationwide yields by formula (usually and predomi -nantly by population, weighted in favor of larger municipalities to reflect their services to sur rounding areas).

Formula equalization usually takes account of exogenous variations in both expenditure need and local revenue capacity, although dissociating revenue potential from actual levels of collection has proved technically demanding and has not been universally achieved. In some states such as Bulgaria, Moldova and Ukraine equalisation only covers expenditures on delegated competences, chiefly education, health care and social welfare.

Grants

Where grants (as opposed to revenue shares) remain important local budget sources, the following reforms have been in progress:

Reducing Conditionality

It has generally been policy to consolidate a former array of earmarked grants for recurrent services into a single block grant. Although the expenditure demands of individual services may be estimated when calculating the grants, they do not normally determine legally the use to which they may be put by local budgets. In some states such as the Czech Republic and Slovakia a specific grant is still given for the costs of education (or more particularly teaching salaries) but with some flexibility over end use. In some countries local expenditure on social and housing benefits is reimbursed by national government according to actual cost.

Indexation

In some, though only a minority of cases, the aggregate volume of grants is indexed by law to an external factor. In Poland, for example, the general education grant must not fall below 12% of the total state budget.

Calculation by Outputs
The input norms characteristic of Socialist budgeting are being progressively abandoned. It is now regarded as more efficient to estimate aggregate expenditures on local government competences and disaggregate these to individual budgets by calculations of relative spending needs based on exogenous variables such as the client population (e.g.. school age for education, children and the elderly for health services) and population density.

Hard Budget Constraints
It is a general principle that assignments both of grants and tax shares are not subject to variation during the budget year (although the actual receipts of tax shares will depend on yields).

Local Own Revenues

Taxes
Taxes on land and buildings are the most common revenue solely assigned to local government. Individual local authorities are usually given discretion to determine assessment coefficients within prescribed limits, but freedom to set rates is currently confined to Macedonia, Montenegro, Poland, Romania and Slovakia, though more widely recognized as desirable. There is a wide but varying range of local taxes on vehicles, small business profits, inheritance, land transfers and gifts.

In Croatia and Montenegro local governments are permitted to impose surcharges (up to 10%) on the rates of personal income tax paid by their residents.

Hungarian local governments have the right to decide which of five optional taxes to impose locally. This is rare. The Bulgarian Constitution forbids any body except Parliament to determine a tax rate.

Fees and Charges
Local governments generally have far more discretion to determine rates of charges and fees for specific services and administrative transactions and these are widely exploited, particularly where the incidence falls chiefly on businesses rather than voters.

State subsidies to public utility services have been progressively eliminated. This has given rise to substantial increases in the rates of consumer charges, but these have been partially offset by targeted subsidies to keep the net cost of rents and domestic utilities (principally heating) within prescribed percentages of household income (usually around 20%).

Capital Investment Funding

Grants

Most states have allocated grants for the repair and development of infrastructure including roads, water supplies, sewerage and waste disposal, partially funded in some states by environmental penalties. These have been substantially augmented by European Union pre-accession funds in candidate countries and structural funds in the new member states. The distribution of these has become subject to normative criteria in some countries such as Bulgaria, Poland and Ukraine, but they remain more subject to political discretion than in the case of recurrent transfers.

Credit

Most local government legislation now permits local authorities to raise loans or issue bonds to fund capital investment within prescribed limits. Requirements for national government approval have been generally abolished but borrowing power is generally subject to some ratio of debt or debt service to annual revenue.

Budgeting

Budgetary classifications are being widely reformed to disaggregate expenditure by purpose and output in place of, or as well as, inputs (wages, energy, transportation).

In most states, once approved by elected representatives, budgets no longer require external approval. State administration officials may only intervene in local decisions where they consider them illegal and then only by reference to courts. Wider controls pertain to the exercise of delegated functions.

Audit requirements vary and are generally inadequate. In most countries national or regional audit chambers inspect local government accounts, but in some cases their remit only extends to the use of state budget transfers and reports are submitted to parliament rather than the local representative body. In other cases (e.g., Slovakia) local governments are required to appoint external and/or internal auditors. Audit is usually confined to the legality of budget transactions, but in countries like Hungary efficiency is also coming under audit review. Both in Czech Republic and Hungary groups of municipalities have compared unit costs of specific services, while benchmarking initiatives are under way in Romania and Slovakia.

Purchases of goods and services (e.g., refuse collection or construction) generally require public advertisement and competitive tendering.

These reforms have taken place over a period of sixteen years since the fall of the Berlin Wall. Their timing has followed no particular sequence, and has been largely occasioned by exogenous events such as changes in government, negotiations over European Union accession, territorial reform and national tax reform. Certain basic characteristics were defined in the initial legislation creating municipal government in the early 90s, but revenue bases remained subject to frequent ad hoc changes for the rest of the decade. The more permanent definitions of revenue assignment have largely been enacted since the millennium as accession states have "tidied" up their decentralization to comply with the Copenhagen criteria and the former Yugoslav states have adjusted to the substitution of VAT for sales taxes.

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5.
Legal Framework and the European Charter of Local Self-Government

Gérard Marcou

Contents

Legal Framework and the European Charter of Local Self-Government

Legal framework and the European Charter of Local Self-Government for local government in Kosovo.

With the collapse of Communist regimes in Central and Eastern Europe and the former Soviet Union, local self-government has become a key part of the process of institution building to establish democratic republics. In this context, the European Charter of Local Self-Government (hereinafter, the Charter), adopted in 1985, and entered into force in 1988, has rapidly become the common reference for devising a new democratic local self-government system throughout Central and Eastern Europe and Central Asia[1]. A common reference, the Charter can be applied through different systems of intergovernmental (central-provincial-local) relationships. Governments may accede to the Charter with various degrees of acceptance of its provisions, between ratification in full and ratification of a selection of paragraphs, as allowed by Article 12.

Whatever the future status of Kosovo, the question of the assessment of the local self-government system of Kosovo by reference to the Charter is relevant. Until now, Serbia-Montenegro has not ratified the Charter, which therefore is not applicable to Kosovo, as it was not applicable to Montenegro. But Serbia will have to accede to the Charter if the country is willing to achieve its political integration in European institutions. If Kosovo were to become an independent state, as Montenegro has recently, its authorities will face the challenge of complying with European instruments and standards in order to make possible the integration of Kosovo in European institutions. Although Kosovar institutions have repeatedly voiced their commitment to respect the Charter, formal ratification will nevertheless be a key step toward Kosovo's integration with Europe (two of the important documents for the future of local government, the Framework Document for the Reform of Local Self-Government in Kosovo (July 2004) and the Basic Principles of Decentralization (November 2006), expressly affirm that the foundation of local government will be the Charter).

The Impact of the Charter on Local Government Reforms in CEE Countries

For all countries of Central and Eastern Europe, membership in the Council of Europe expresses their commitment to the values codified in the Statute of the Council of Europe (the treaty establishing the Council of Europe) and in the treaties elaborated by the Council of Europe and submitted for signature and ratification to all member states. Two among the Council of Europe treaties have particular importance: the Convention for the Protection of Human Rights and Fundamental Freedoms, including the protocols developed over the past few years and their guarantees, and the conventions regarding local self-government, especially the European Charter of Local Self-Government. Compliance with this legal framework has been a basic condition for later consideration of an application for EC and EU membership.

1 Council of Europe Committee of Ministers, European Charter of Local Self Government, Recommendation No. R (95)19, On the Implementation of the Principle of Subsidiarity, Adopted by the Committee of Ministers on 12 October 1995.

The Charter is of particular importance for the process of institution building. As expressed in the preamble, "local authorities are one of the main foundations of any democratic regime"; "the right of citizens to participate in the conduct of public affairs is one of the democratic principles that are shared by all member States of the Council of Europe"; and "[it] is at the local level that this right can be most directly exercised."

Beginning with Hungary, the following countries have ratified the Charter: 1994, Hungary, Poland; 1995, Bulgaria, Estonia; 1997, Latvia, Macedonia (FYROM), Slovenia; 1998, Croatia, Moldova, Romania, Russia, Ukraine; 1999, Lithuania, Czech Republic; 2000, Albania, Slovakia; 2002, Armenia, Azerbaïdjan, Bosnia and Herzegovina; and 2005, Georgia. Serbia and Montenegro signed the Charter on 24 June 2005, but it had not been ratified before the independence of Montenegro (June 2006).

The Charter has direct influence as a legal framework of reference on the new legislation on local government in these countries. Assistance is given to governments at the time of preparing draft legislation so that it may refer systematically to the provisions of the Charter. The Secretariat General of the Council of Europe then monitors compliance of the legislation and of government practice.

The Charter does not provide a model of local self-government; it is rather a codification of basic principles for a democratic local government system, based on the common but very diverse experience of European countries. As a consequence, very diverse systems of local self-government may comply with the Charter. The Charter's structure is also partly responsible in that it allows countries some flexibility in deciding which principles to observe. In accordance with article 12, all paragraphs are considered individually as optional and signatories to the Charter decide which of the required 20 provisions to bound themselves by. A core set of 14 paragraphs of special importance has been distinguished (part I of the Charter), from which at least half of the required provisions must be chosen.

Several countries decided to adhere to the totality of paragraphs (Hungary, Poland, Russia, Ukraine), or with very few exceptions: for example Bulgaria, Estonia, Georgia (at least for the territories upon which the government has effective jurisdiction), Latvia, Romania, and Slovenia. Provisions most frequently left aside are from articles 4, 7 and 9.[2] The principle of subsidiarity (art. 4.3) has been left aside by Croatia, Georgia, and Slovakia; some paragraphs of article 9 on financial autonomy have been left aside by some countries (Czech Republic: local tax power, equalization, consultation of local authorities on redistributed resources; Slovakia: bound only by the principles of proportionality and sufficiency, local tax power and access to the capital market for financing investments); paragraph 7.2 on compensation for the exercise of the mandate of elected representatives has also been left aside by a number of countries (Armenia, Azerbaijan, Bulgaria, Czech Republic, Georgia, Romania).

This possibility to choose the provisions by which to be bound has certainly facilitated the commitment of transition countries to the Charter. But in the end, this does not seem to be reflected in

2 Article 4—Scope of local self-government; Article 7—Conditions under which responsibilities at the local level are exercised; Article 9—Financial resources of local authorities.

the legislation and in international declarations that, on the contrary, generally reflect a much wider adhesion to the principles codified by the Charter. For example, the *Memorandum of Understanding on Commitment of the Ministers Responsible for Local Government of South-Eastern Europe*, signed in Zagreb on 26 October 2004, reaffirms the "importance of, and the commitment to, fully implementing the principles of the European Charter of Local Self-Government."

Nevertheless, as in the rest of Europe, the legislation on local self-government of Central and Eastern European countries reflects a broad variety of conceptions. This is because the principles of the Charter can be translated into a wide array of institutions and local government systems, including: more or less decentralized, with variations between sectors, with one (Bulgaria), two (Czech Republic, Slovakia, Hungary) or three (Poland) types of local self-government, and with various arrangements regarding the relationships between central and local government.

The Paragraphs Most Relevant for the Local Government Reform in Kosovo

There are eight articles in the Charter that have special relevance to Kosovo (Articles 2, 3, 4, 5, 8, 9, 10 and 11). To summarize the relevant paragraphs:

Article 2: Constitutional and Legal Foundation for Local Self-Government

Article 2 states that the signatories of the Charter agree that "the principle of local self-government shall be recognized in domestic legislation, and where practicable in the constitution." Indeed, the fact that since 1990 all constitutions adopted in Central and Eastern Europe have contained provisions on the recognition and the legal protection of local self-government is probably a major impact of the Charter.

Article 3: The Concept of Local Self-Government

The Charter's concept of local government is based on two ideas: (i) local authorities have to manage a substantial share of public affairs under their own responsibility and in the interests of the local population; and (ii) a right of citizens that is exercised through elected councils or directly through referendums or other forms of citizen participation.

This concept presumes a relatively unified local community. However, in Kosovo, a number of municipalities suffer ethnic divisions. In such a context, pure majority rule may have to be mitigated to safeguard the rights of minorities, whereas referendums and popular initiatives might serve to strengthen ethnic divisions.[3]

3 Such dangers of majority voting could be avoided if a society has a judicial system (e.g., constitution, international conventions, courts, community mediation committees) that ensures minority rights and protections as, for example, currently established for a multiethnic Kosovo under the Constitutional framework 2001: UNMIK 2001/9; and the Framework for the Reform of Local Self-Government in Kosovo, July 2004).

Article 4: The Scope of Local Self-Government

Article 4 is a key article of the Charter. It provides the basic principles for designing the competence (functional assignment and revenue authority) of local authorities, and at the same time provides the criteria against which to assess the compliance of this competence with the Charter. It must be emphasized that competence is a complex concept that does not have exactly the same meaning in all languages, but generally conveys several meanings. This cannot be detailed here, but throughout the rest of this note, the word "responsibility" will be understood as functions, which may be of two types: duties (an obligation) or powers (the function may be exercised or not). However, the word "power" is also used, depending on the context, as the legal act that may be used to exercise a function (Marcou 2006).

Just as the principle of local self-government has to be recognized by legislation, and where "practicable," by the constitution (art. 2), the powers and responsibilities of local authorities have to be prescribed by statute or by the constitution (art. 4, para. 1). The powers and responsibilities of regions may also be stated constitutionally as a matter of guarantee for local authorities that (i) the regional sphere of competence is protected by the law and that (ii) the burden of their tasks cannot be increased by discretionary decisions of central government.

The Charter does not advise that specific responsibilities (competencies) of local authorities be prescribed by the constitution, but rather is permissive in that it allows the policymaker to take the practical and appropriate stance that this is a matter that is best left to statute as provided by the law (art. 4, para. 1) and to practice, as a nation's fiscal architecture is apt to change (See briefing note on "Fiscal Architecture").

The Charter also refers to the distinction between own and delegated powers (art. 4, para. 5). Normally, responsibilities and powers of local authorities are own responsibilities and powers, as reflected in article 3: they have to discharge "a substantial share of public affairs under their own responsibility…." Delegated powers refer to tasks performed by local authorities under the responsibility of central government, although the Charter prescribes that there shall be allowed enough discretion to adapt to local conditions (para. 5). Although not explicitly stated in article 9, it derives from paragraph 2 of this article (resources commensurate with the responsibilities provided by the law), that delegated powers have to be accompanied by the transfer of resources to cover the expenditure they imply.

In several countries having succeeded to former Yugoslavia, large municipalities of the former socialist republic have been split up into more numerous and smaller municipalities, whereas the administrations working at the level of the former large municipalities have become local branches of central government administrations (Slovenia, Croatia, the Former Yugoslav Republic of Macedonia). This organization is compatible with the Charter only as far as new municipalities were devolved enough functions to comply with the concept of local self-government (a substantial share of public affairs under their own responsibility), and that sufficient administrative and financial resources are transferred to them.

In Kosovo, at present, part of the municipal administration is shared between the municipality and the administrator appointed by the Special Representative of the Secretary General (SRSG). In the future, the role of such a central administrator should be reconsidered since the idea of having central government representatives to co-run or supervise local government was rejected during the preparatory work of the *Framework Document for the Reform of Local Self-Government in Kosovo* as unnecessary and expensive and has not been mentioned at all during the final status negotiations by either Kosovo or the Belgrade delegations.

Several paragraphs of article 4 provide basic principles for the legislation of the powers and responsibilities of local authorities. Of particular relevance to Kosovo:

- The general competence clause (para. 2): *Local authorities…have full discretion to exercise their initiative with regard to any matter which is not excluded from their competence nor assigned to any other authority*. This is a freedom clause, much more than a competence clause, and it is therefore a very important principle.

- The principle of subsidiarity (para. 3): *Public responsibilities shall generally be exercised …by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy*. Thus, the principle of subsidiarity may justify the allocation of a task to a local authority, since it is closest to citizens, or justify the allocation of this task to central government, because of the extent or the nature of the task or for reasons of efficiency or economy. The use of the word "allocation" means that the decision on this option belongs to the higher authority, e.g., as a rule to the central government. As a result, the principle of subsidiarity does not simply call for devolving more responsibilities to the local level, but rather involves assessing the relevance of the allocation of tasks among several government levels (see briefing notes on Expenditure Assignment).

- The principle of completeness (para. 4): *Powers given to local authorities shall normally be full and exclusive*. This principle is meant to enable local authorities to exercise powers within their own responsibility; it is assumed that, when powers are not full and exclusive, they are conditioned by the upper authority, at the detriment of local self-government. The principle of completeness is also a prerequisite for sound accountability arrangements: when too many authorities are involved in the same tasks, none of them is really accountable. However, in practice it is very often difficult to adhere to this principle, because several levels of government are involved in all major fields of responsibility, and, even if powers are "full and exclusive," it derives from shared responsibilities that each government is dependent on the others. The lowest are dependent on the upper for rule-making and the upper on the lowest for implementation, but usually the configuration is much more complex.[4] Therefore, the principle of completeness should mainly serve as guidance for legislation and governments, to aim for a clear distribution of powers and to

4 The violation of the principle of completeness is particularly relevant in Kosovo. UNMIK Regulation 2000/45 (Section 41) recognized the right of municipalities to own and manage municipal properties, and Regulation 2002/12 on the Establishment of the Kosovo Trust Agency (KTA) placed all Socially and Publicly Owned Properties under the administration of KTA. This has seriously hampered local government from designing and implementing comprehensive local development plans, urban and spatial plans and has generally prevented municipalities from exercising full and exclusive powers over water supply and sewage systems formerly owned by municipalities, as they are now run by KTA.

develop procedures for shared responsibilities.

- The idea of paragraph 6 is: *local authorities shall be consulted…in the planning and decision-making processes for all matters which concern them directly*. However, this kind of consultation should also be developed in shared fields of responsibility and where local authorities have own powers.

Article 5: Protection of Local Authority Boundaries

This is obviously a burning issue in Kosovo. Article 5 reads: *Changes in local authority boundaries shall not be made without prior consultation of the local communities concerned, possibly by means of a referendum where this is permitted by statute*. The use of the plural leaves open the possibility for determining which communities are to be consulted within the municipalities concerned. On this matter, the Charter pertains to large and small local authorities alike, but in Kosovo this is not only a matter of size.

At present, municipal territories and boundaries are the responsibility of the SRSG, in accordance with UNMIK regulation 2000/45. This should remain a central government responsibility in the future.

As already stated, the *Framework Document for the Reform of Local Self-Government in Kosovo* is contemplating options for a territorial reform: the two options being either to split up existing large municipalities, or to keep them but with additional responsibilities delegated to sub-municipal units. Large municipalities have functional advantages, and sub-municipal units with elected bodies could be vested with significant responsibilities to discharge services that need to be close to citizens and that they can easily access on a daily basis. In large municipalities comprising several communities, this will encourage representatives to work together and build step-by-step the conditions for mutual trust. Sub-municipal units existed in the former Yugoslavia (*mestna zajednica*). Splitting up municipalities into smaller ones would probably create ethnically homogenous municipalities with concentrated minority populations, and make more difficult the institution building of a "multi-ethnic Kosovo" (also see briefing notes "Service Provision in a Decentralized Setting" and "Joint Service Delivery"). [5]

Article 8: Administrative Supervision of Local Authorities' Activities

Article 8 states that administrative supervision is inherent to local self-government, but is at the same time limited by the proper concept of local self-government. Thus, local self-government takes place in the broader system of state organization, but is distinct and separate from the machinery of the executive power which is under the authority of the central government. Local government activities are therefore subject to the law and are involved in the implementation of various public policies and functions for which the central government is responsible. This is the rationale for administrative supervision. However, at the same time, the competence of local self-government is protected by the law; therefore, supervision is not meant to be control at the

5 There are serious concerns this principle of the Charter may be violated by the UN Security Council or other institutions, which will decide on the future status of Kosovo. There is abundant evidence that all parties involved (PISG, UNMIK, UNOSEK, Belgrade, Contact Group) will pursue the territorial division without prior consultation because of the fears that public consultations might prove unsuccessful. Therefore, it is interesting to contemplate whether major political and security concerns may and should prevail over the Charter's principles.

discretion of upper authorities; local authorities are not subordinated to the central government and its agencies.

Accordingly, the norms of article 8 reflect the following restrictions on supervision. Administrative supervision is: (i) to be provided by the law and exercised only according to legal procedures; (ii) aimed at compliance with the law; and (iii) to be kept in proportion with the interests it has to protect. Administrative supervision can be exercised with regard to expediency, as provided by paragraph 2 (2nd sentence), only for the execution of delegated tasks.

On this basis administrative supervision can be organized in very different ways: by sectoral or general authorities of the central government; or by judicial authorities, through prior or *a posteriori* scrutiny of legal acts of local authorities. When supervision is exercised by administrative authorities, supervisory acts have to be subject to judicial review. The intensity of this supervision should be regulated by the principle of proportionality, as stated by article 8, paragraph 3. But this can be, and is, interpreted in very different ways from one country to another, from Eastern to Western Europe. However, the general tendency in Western Europe has been to alleviate administrative supervision.

One problem results from sectoral supervision, because the same authority may supervise the implementation of delegated tasks and the performance of own responsibilities, including those that are duties (mandatory tasks). In that situation, and due to routines established, there is a strong risk that higher authorities operate with an extensive conception of supervision, and that this extensive conception will be accepted by the local administrations. This can be observed in a lot of countries during the transition period, and in particular in countries from the former Yugoslavia, as regards the supervision exercised by the local branches of ministries maintained at the former municipal level. Therefore, the organization of administrative supervision as a specific function of the central government, instead of being simply an extension of the competence of the respective ministries, should contribute to avoid abusive interpretations of supervision and to protect the sphere of local self-government[6].

Article 9: Financial Resources of Local Authorities

Sound local finance is a basic condition of local self-government. At the same time, it depends heavily on the general economic situation of the country, on the situation of public finance as a whole and in particular on the tax system. Article 9 summarizes the basic principles for establishing a sound local finance system. The principles are (i) sufficient resources should be assigned to local authorities within national economic policy, and sufficient discretion be given over use of these resources within the framework of their powers (para. 1); (ii) all financial resources (not only assigned resources) have to be commensurate to responsibilities to be discharged (the principal of sufficiency, para. 2); (iii) own tax power and power to determine charges (para. 3);[7](iv) buoyancy

6 There is also a risk of confusion when many sectoral ministries perform administrative supervision of local governments over same or similar issues.

7 At least part of resources have to derive from these powers; only revenues deriving from own taxes and charges upon which the local authority is, at a minimum, empowered to fix the rates, can be considered as own resources; on the contrary, tax shares (from the national or the local yield) are not own resources, because they reflect no power of local authorities on their resources; tax shares are only assigned resources (see briefing note on Revenue Assignment).

and diversity of resources to ensure that resources of local budgets will evolve with the costs of their tasks (para. 4); and (v) equalization such that the local finance system has to provide for measures designed to correct the unequal geographic/jurisdictional distribution of potential sources of finance (para. 5).

Additional principles of article 9 concern capital expenditure. Grants should not be earmarked for specific projects, the provision of grants should not remove the policy discretion of local authorities in their own jurisdiction (para. 7) and local authorities should have access to the national capital market to borrow (para. 8).

Article 10: Local Authorities' Right to Associate

The right to associate for local authorities consists of three separate aspects: (i) cooperating to discharge functions; (ii) joining together to promote common interests with respect to other authorities, in particular the central government; (iii) favoring the exchange of knowledge and experience, in particular, through participation in international organizations of local authorities, whereby local authorities have access to different approaches and practices of local government in other countries.

The first aspect above is a way to overcome problems of economies of scale and to internalize costs and benefits linked to particular services. If large municipalities are maintained in Kosovo, the scope of this kind of association will remain limited; however, if the decision is made to create smaller and more numerous municipalities, it will be necessary to provide for adequate forms of cooperation. Public law corporations may then offer better conditions in terms of accountability to municipalities, although voluntary cooperation remains an option (see briefing note "Joint Service Delivery"). The second aspect corresponds to the necessity for local authorities to represent their own interests before the central government and to participate in local government reforms. Additionally, such associations can provide services to their members. The last aspect seems particularly important in the case of Kosovo, to give to local councilors and mayors the opportunity to consider local self-government and the performance of local government functions outside of the Kosovar context and its conflicts.

Article 11: Legal Protection of Local Self-Government

Article 11 is about the judicial protection of local self-government rights. Local authorities must have a right of recourse to judicial remedy. The efficiency of judicial remedies depends very much on the capacity of the judiciary to deal with the settlement of legal disputes in general. Several countries have assigned these types of disputes—at least when legislation or government regulations are at stake—to a constitutional court. This option represents an opportunity to transfer this function to a new kind of court, which is much less entangled in the difficulties of a country's judicial organization and therefore should be in a better position to protect self-government rights.

A Strategy for Signing the Charter

At present it is difficult to contemplate a strategy for signing the Charter, since only a state can be party to the treaty, and the future of Kosovo is not settled. A first option could be to pursue the ratification of the Charter by Serbia. Since Serbia has signed the Charter on 24 June 2005, the ratification would bind Kosovo in its status as a province. This would probably be the quickest solution. There would be advantages in the application of the Charter to Serbia too. The questions arise, however, as to (i) whether this would be binding to an independent Kosovo; and (ii) would in the short term open the way for Serbia to force decentralization policies in Kosovo arguing that acceptance of ratification by Serbia may be construed as acceptance of application of the Charter in the whole territory of Serbia including Kosovo. Thus, if the discussions on the future of Kosovo result in the decision to turn Kosovo into a new independent state, it is probable that the ratification of the Charter will take much more time.

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Expenditure Assignment and Service Delivery

6.
Fiscal Autonomy

Robert D. Ebel
and
Serdar Yilmaz

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Fiscal Autonomy

The question of the importance and the fiscal measurement of the concept of "local self-government."

A well-designed intergovernmental fiscal system is characterized by a high degree of subnational (e.g., local) fiscal autonomy. Indeed, the preamble to the European Charter of Local Self-Government recognizes that local governments require a "wide degree of autonomy with regard to their responsibilities and…the resources required for their fulfillment (Council of Europe 1985)." The Charter further provides guarantees of autonomy with respect to the four fiscal pillars: expenditures (Article 4, para. 3); revenues (Article 9, para. 3); the use of intergovernmental transfers (Article 9, para. 7); and borrowing and debt (Article 9, para. 8).[1]

The purpose of this briefing note is threefold. The first is to provide some perspective on how "autonomy" fits within the broader framework of fiscal decentralization. The second is to review what we know about why fiscal autonomy matters—to go beyond the stated objectives of the European Charter and focus on the potential payoffs of autonomy. Finally, the third looks at the question of how to move from goals and objectives to how policymakers should think about implementation of fiscal autonomy. It is one thing for policymakers to promote fiscal autonomy as a statement of principles, and a very different matter to make it work in practice.

Two Points that Provide Perspective

At the outset of a discussion on fiscal autonomy, two general points must be noted. The first relates to terminology, while the second is a comment on the difficulties inherent in measuring decentralization and the degree of fiscal autonomy.

The Three Ds

A brief clarification of terminology is warranted. Decentralization and subnational fiscal autonomy are clearly interrelated concepts, but the term *decentralization* can encompass several distinct governmental arrangements, each of which may be present, and each of which has it place, in a country's public sector system (Bird, Ebel, Wallich 1995):

- *Deconcentration* refers to the placement of the central government ministry offices in local areas (regional offices). *Deconcentration with authority* refers to arrangements whereby regional branches or offices of the central government are vested with some ability to make independent decisions. *Deconcentration without authority* occurs when these regional offices have no independent capacity for decision-making and all deviations from normal practice must be approved by the center.

1 The European Charter contains other provisions guaranteeing local self-government/autonomy with respect to the principle of decentralization (preamble), protection of local authority boundaries (Article 5), administrative structures (Article 6), and rights of association (Article 10). Each of these "non-financial" issues is addressed in other briefing notes of the present volume.

- *Delegation* is a process whereby local governments (not branches of a central ministry) are given responsibility for delivering certain services, but then are subject to more or less detailed supervision by the central government, which also may (and in most cases should) provide some or all of the financing for the services. The design of intergovernmental fiscal transfers and the degree of central monitoring will determine the balance of central and local influence in such delegated areas of responsibility.

- *Devolution* is the most complete form of decentralization and the variant associated with "fiscal autonomy." Independently established subnational governments (SNGs) are given responsibility for the delivery of a set of public services along with the authority to impose taxes and fees to finance the services. Devolved governments have considerable flexibility in selecting the mix and level of services to provide. Some financial support may be provided by the central government (see briefing notes on "Revenue Assignment" and on "Intergovernmental Transfers").

Measurement

There are several good reasons why a public sector should be decentralized, each of which is ultimately tied to the theme that a well-decentralized system is key to accomplishing a society's (nation's) broader economic goals such as improved economic efficiency, enhanced economic growth, and macroeconomic stabilization.

The challenge is: how does one know that decentralization delivers on these promises? The theory makes good sense, but, in fact, the reality of the claims are very hard to measure because the type of data needed to define a country's degree of decentralization (the "decentralization variable") is lacking. At present, the most consistently collected and reliable database is that reported in the *Government Finance Statistics* (GFS) of the International Monetary Fund (Kaiser 2004). Although the GFS series is extremely useful for carrying out a large variety of analytical tasks, it is still focused on the macroeconomic performance of a nation as a whole and not its constituent or decentralized parts. Therefore the GFS series does not easily lend itself to measurement of the degree of fiscal decentralization. Analysts wanting to measure the degree of fiscal autonomy and devolution within a country have to come up with ways to specify the decentralization variable. Fortunately, some very good recent work has been done and we are beginning to get some empirical answers to the question of "why fiscal autonomy matters?" (Jensen 2001; Yilmaz, Hegedus and Bell 2003; Moloche, Vaillancourt and Yilmaz 2004; Bell 2006).[2]

Why Fiscal Autonomy Matters

While acknowledging the difficulty of measuring decentralization, here is what we know empirically about the relationship between decentralized fiscal autonomy (devolution, local self-government) and the accomplishment of a nation's broader economic and fiscal objectives:[3]

2 The Local Government Initiative/Open Society Institute–Budapest, in cooperation with the Organization For Economic Development (Paris), was among the first institutions to initiate this work. See the links to the Fiscal Decentralization Initiative on both the LGI/OSI and OECD websites.
3 This discussion draws on Meloche, Vaillancourt and Yilmaz 2004.

- Developed countries are associated with mature systems of decentralization and varying degrees of fiscal autonomy (e.g., Akai and Sakata 2003). Conversely, the dismal macro-eco nomic record of centralized command and control under Communist regimes in Cetral and Eastern Europe has been well documented (Bird and Banta 1999; Dunn and Wetzel 2002).

- It is expected that if decentralization enhances efficiency in the allocation of public services, this should show up as economic growth. There is some evidence that such a relationship exists with respect to the revenue side of the budget. Martinez-Vazquez and McNab (1997) reach this conclusion with respect to change in per capita income. Ebel and Yilmaz (2003), by defining the "decentralization variable" in terms of both a narrow and broad definition of revenues (the broad definition including unrestricted grants), reach a similar conclusion with respect to the growth rate of real per capita output.[4] A similar finding with respect to revenue autonomy has been reported in Meloche, Vaillancourt and Yilmaz 2004, which concludes that "decentralization of expenditures coming with centrally controlled revenues seems to be an obstruction to economic growth." However, there is less evidence of the role of expenditure decentralization, though in recent research on this topic Imi (2005) concludes that in a mixed pool of developed and transition countries decentralization "particularly on the expenditure side is instrumental to economic growth."[5]

- On the matter of macroeconomic stability, there is evidence that subnational revenue autonomy improves the fiscal position of subnational governments, but that a reliance on intergovernmental transfers may worsen that fiscal position (Ebel and Yilmaz 2003).[6]

- The findings relating to the relationship between fiscal decentralization and public sector size is decidedly mixed, with some studies finding no evidence of a relationship (Oates 1985), and others suggesting that the public sector's expenditure share of national GDP decreases with the increase in subnational tax autonomy (Ebel and Yilmaz 2003).

There is one overarching caveat and three conclusions that can be drawn from the empirical literature on the relationship between fiscal decentralization (fiscal autonomy) and the effect on the overall economic and fiscal performance of the public sector. The caveat is that in examining this relationship between decentralization and economic welfare, it takes considerable time for decentralization to have an impact—that a change in governance is often not a change of systems, but rather one of the pre-conditions for that change (Kornai 1992).

The first conclusion to be drawn from the empirical literature is that care must be taken in interpreting the available data. Second, the emerging research based on improved data and methodology

4 However, no attention is given to the important question of the size of subnational government relative to total government.

5 There is some econometric evidence of a negative relationship between decentralization and economic growth (deMello 2000; Davoodi and Zou 1998), but the findings of this path-breaking econometric work have been largely supplanted because use of GFS data led to the misspecification of the "decentralization variable" (Akai and Sakata 2002; Yilmaz, Hegedus and Bell 2003; Moloche, Vaillancourt and Yilmaz 2004).

6 There is evidence to the contrary, which is not reported here because use of GFS data led to the misspecification of the "decentralization variable." For a review of the issue, see Yilmaz, Hegedus and Bell 2003 and Meloche, Vaillancourt and Yilmaz 2004.

allows us to posit a positive relationship between decentralization and the economic performance of nations. Third—and clearly the most important message for Kosovo (and, for that matter, any newly decentralizing society) — is that *now* is the time to establish an intergovernmental data series for measuring the degree of decentralization. Just what this data series might look like is the topic of the discussion below.

What Makes Subnational Government Fiscally Autonomous?[7]

Revenue Autonomy

Revenue autonomy (or revenue decentralization) can be seen as a continuum of three types of revenues: (a) own source revenues; (b) shared revenues (based on derivation basis, but for autonomous use); and (c) a variety of transfers. For the purposes of this discussion a distinction has been drawn between revenue autonomy (tax and "non-tax" revenues such as charges and fees) and intergovernmental transfers (to be addressed in the following section). Adopting this approach, revenues of SNGs may be divided into categories of decreasing local autonomy (Table 1). If SNGs have total or significant control over a tax, fee or charge as demonstrated by political control over the tax rate (necessary and sufficient) or base, it is a subnational (local) tax. If the SNG does not, at a minimum, have control over the rate of a tax, then the tax is not local. Thus, for example, that the central government may split revenues (tax sharing) with the SNG (where the central tax is collected) does not make it a local tax (Blochliger and King 2006).

7 This discussion draws on the work of Leif Jensen (2001) and Working Party 2 of the Committee on Fiscal Affairs of the Organisation for Economic Cooperation and Development (OECD). The Seminal Work is Paper No. 7 of the OECD Tax Policy Studies series, *Fiscal Design Surveys Across Levels of Governments* (Jensen 2001).

Table 1. Classification of Local Taxes by Degree of Local Autonomy

High Revenue Autonomy	SNG sets tax rate and base.	Highest degree of own source revenues. Most often pertains to fees and charges; refer to Tables 3 and 4.
	SNG sets tax rate only.	Necessary and sufficient condition for categorization as "own revenue" (piggybacking, tax base harmonization/conformity permitted).
	SNG sets tax rate, but only within centrally permissible ranges.	A typical practice is to cap the top rate.
	Tax sharing whereby central/local revenue split can be only changed with consent of SNG.	Can result when a local authority collects the tax and remits to the center
	Revenue sharing with share determined unilaterally by central authority.	100% control by center; this category is a source of much misspecification of what is a central vs. local revenue (GFS includes this category as a local tax).
No Local Autonomy	Central government sets rate and base of "SNG revenue."	May accompany political decentralization.

Source: Adapted from Jensen 2001.

Intergovernmental Grants

Similar to that for taxes and non-tax charges and fees, the framework for classifying grants is structured according to the degree to which SNGs can control the use of funds transferred from the central government. As discussed in the briefing note Intergovernmental Transfers, grants may be either conditional or unconditional, and as with revenues, there is a continuum (Table 2).

Table 2. Classification of Intergovernmental Grants by Degree of Fiscal Autonomy

High Autonomy With Respect to Transfers	Unconditional Grant (which may be formula based or in the form of revenue sharing)	Highest degree. Note that whereas revenue sharing was given low marks in terms of "own" revenue autonomy, if that shared portion is returned to the SNG where is was collected, it takes on the character of a very flexible transfer.
	Conditional Non-Matching	The donor government gives the recipient SNG a sum with the stipulation that funds shall be used for a specific purpose. Given the fungible nature of this grant, it can offer a degree of fiscal autonomy.
	Conditional, open-ended matching	Now, flexibility is diminished due to the matching requirement. Though there is still a degree of flexibility due to fungibility, with the matching requirement it is difficult to say that this form of grant gives an SNG much flexibility (autonomy).
Low or No Local Autonomy	Conditional, closed-ended	This is as specific as a grant is likely to become. The grant is clearly designed to influence the composition of SNG spending. Such specific grants certainly have their merits (e.g., to adjust for net externalities), it is just that they do not add to the degree of SNG fiscal autonomy.

Source: Adapted from Table A-1 from the briefing note "Intergovernmental Transfers"

Expenditures

Just as getting clarity in the sorting out of (or assignment of) expenditures is probably the most difficult intergovernmental design, so too is the expenditure side the most problematic task for determining the degree of subnational fiscal autonomy. As a generalization of that problem, the issue is the degree to which the center "interferes" with and/or "mandates" how local revenues shall be spent. The issue is a most important one since local officials will balk at taking on the political risk of raising revenues unless they can demonstrate to citizens some service delivery *quid pro quo*. A policymaker loaded with central restrictions on the spending of local funds cannot make that service-tax cost link.

An additional challenge on the expenditure side is that autonomy may differ across different functional classifications (e.g., health, education, and infrastructure). Also, developing measures of autonomy over expenditures is difficult because of the many ways central government can control spending by SNGs. For example, in South Africa and Pakistan, local governments have discretion over some expenditure categories, but negotiating wages and work rules with municipal unions is centralized at the national level (Bell 2006). A further problem is that the center may prescribe administrative arrangements for subnational governments; for example, in Pakistan the center prescribes the provincial and local (district, town) organizational charts.

Table 3, which is illustrative, presents a typology for identifying the role of SNGs in service delivery as developed by Bell (2006). The various dimensions of service delivery include policymaking, control of the civil service, standard setting, administration, and monitoring and evaluation. Note that to get a clear sense of the degree of expenditure autonomy, one would have to develop a Table 3 matrix on a sector-by-sector basis.[8]

8 And then develop—or at least have some good sense of—a weighted index of the relative importance of each sector. Thus, for example, a local government might have complete control over expenditure decisions relating to a relatively "small" function such as maintaining local roadways (e.g., which road to repair and when and how to do it), but very little control over a " large" sector that dominates the budget (e.g., the center sets the teacher and staff salaries as well as determines who to hire, promote, and/or fire).

Table 3. An Illustration of the Elements of Subnational Fiscal Autonomy with Respect to Expenditures

Factor Influencing Degree of Autonomy	Description of the Factor	Central Control and Low Degree of Fiscal Autonomy	High Degree of Subnational Fiscal Autonomy
Broad Control over Policy	Which government sets the main policy guidelines for a service (e.g., free primary education as a national policy)?	Center either makes or has final control over the local budget; and/or can override provisions of the local budget.	Clearly delineated assignment of functions; SNG controls its own budget process and budget execution institutions (accounting systems, treasury operations, internal and external audit).
Civil Service	Control over the level of the wage bill and decisions with respect to hiring, promotion and firing.	Center determines (perhaps through negotiation) the level and structure of civil servant salaries and the conditions of employment.	Local control over civil servants who are engaged in the delivery of local public goods and services. Includes agreements and settlements on wages and employment conditions.
Standards Setting and Regulation	Which government sets the standards for the composition of local public services and the regulations that may accompany SNG spending programs?	(i) Central standardization imposed in circumstances where there are no clear "spillovers." Which unit of government sets the standards? (e.g., national tests of teacher certification may be justified for their externalities; land use zoning and building codes all fail the externalities test and are typically local). (ii) Lack of consultation when there are external effects.	Local control consistent with compliance with the law, constitutional principles and international standards of human rights.
Administration	Administration of service delivery on a day-to-day basis.	Mandating of internal administrative organization and day-to-day expenditure management (e.g., procurement practices).	Local authorities determine their own internal administrative structures in order to adapt them to local needs and ensure effective management (see European Charter 1985).
Monitoring and Evaluation	Which government monitors and evaluates SNG performance.	The center has an appropriate and important role in monitoring fiscal flows (spending and revenues). But monitoring shall not be confused with control.	Clarity in revenue and expenditure assignments is achieved and a responsibility to report fiscal flows, including flows from external (foreign) sources, is accepted and practiced.

Borrowing and Debt

In principle, there is no reason that an SNG should not borrow. Indeed, as long as the SNG is subject to a clear set of rules that establish accountability and lead to a hard budget constraint, borrowing to finance capital expenditures promotes efficiency and equity. Because capital (investment) expenditures provide a flow of current benefits over time (the life of the project), it is efficient to spread the capital cost recovery process over that same time period. Moreover, using "other peoples' money" provides fiscal space for economic development spending. Equity is satisfied by spreading out the payment of the capital costs over successive generations that benefit from the subsequent year-to-year flow of services of the initial investment year. Repayment may be based on revenues from the investment itself (for example if user charges are imposed on a market) or from general taxes.

For fully advanced countries in which subnational governance and capital markets are well developed, there is little, if any, reason for a "higher" level of government to legally constrain SNG borrowing since the capital markets become the agent for enforcing financial discipline through bond rating mechanisms and the understanding that a profligate local government will be allowed to fail. However, the typical practice, in developed and developing countries alike, is to establish a rule-base system that is designed to insure accountability and fiscal discipline. Thus, in some countries the central government imposes strict administrative controls (e.g., local authority borrowing is subject to approval by the central government in Ireland, Japan, Korea and the United Kingdom). Other countries rely on mechanisms for formal cooperation and coordination. For example, in Germany, the Financial Planning Council establishes an intergovernmental (central, lander, and municipal) debt strategy, whereas in the Netherlands regular meetings are held between the central authority and the association of municipalities. Several countries employ a balanced budget requirement monitored by the center (Ireland and Spain). There are also limitation arrangements as in Poland whereby subnational governments are subject to specific limits on debt and debt service. And, as in Egypt, many states enact "golden rule" laws or regulations designed to insure that borrowing is for long-term investment only.

Enforcement procedures are coupled with these *ex-ante* fiscal discipline mechanisms. In Poland the Regional Clearing Chamber may require a subnational authority to amend its budget. And, in Brazil, the Fiscal Responsibility Law and its companion legislation allows states and municipalities to borrow under the conditions that they maintain debt stocks below specified ceilings and establish annual targets for revenues, expenditures, and the balance and changes in the stock of debt. SNGs failing to comply with these rules will face sanctions, including the nullification of contracts and fines. And, for governors and mayors who are chronic rule breakers, there is the threat of impeachment and imprisonment.

Drawing on Joumard and Kongsrud 2003, Table 4 illustrates the degrees of subnational fiscal autonomy with respect to the revenue source of "using other people's money" to pursue economic development objectives (borrowing and debt).

Table 4. Classification of Borrowing and Debt Authority by Degree of Local Autonomy

High Revenue Autonomy	Market Discipline (Australia, the states of the United States, Canadian provincial and territorial governments, Czech Republic).	SNGs borrow on their own account, from internal and external country sources alike. This requires that the market assess the creditworthiness of the borrower. There's a clear understanding that subnational borrowing shall not be guaranteed by the central/state government; however, there may, and should be, a default/bankruptcy "work-out" procedure codified in the law.
	Cooperative Approach I (Germany)	The Landers agree to the "golden rule" of borrowing for only capital investment expenditure. The same is true for municipalities but their borrowing is subject to regional approval. Peer pressure to comply is introduced by the Financial Planning Council, which monitors fiscal flows and may make recommendations for restoring fiscal discipline as required.
	Cooperative Approach II (Austria)	Municipalities as a group agree to balance their budgets, with the possibility of providing deficits/surplus rights to other governments. Governments failing to meet their targets are subject to fines and sanctions by an intergovernmental commission. The fine may be refundable if fiscal discipline is restored. There is an "escape clause" in case of serious economic downturn.
	Cooperative Approach III (Netherlands)	Subnational governments are free to borrow as long as they run balanced budgets. Regular meetings are held between central authorities and the Dutch Association of Municipalities on financial issues. Provinces are responsible for errant municipalities, and the center will intervene to bail out in exchange for loss of SNG financial independence.
	Fiscal Rules without sanctions (Finland municipalities)	Law requires SNGs to achieve a balanced budget as well as make plans on how to cover any deficit. Borrowing is coordinated by the municipalities' organization. There is no central guarantee.
	Fiscal Rule With Sanctions (Brazil)	The Fiscal Responsibility Law requires states and municipalities to establish agreed upon annual targets for taxing, spending, stock of debt. States are free to borrow as long as they comply with the targets. SNGs failing to comply are subject to a number of financial sanctions (e.g., nullification of contracts made). At the extreme governors and mayors risk impeachment and imprisonment
No Local Autonomy	Fiscal Rule With Central Intervention (Norway)	Whereas there are no explicit restrictions on SNG borrowing, if an SNG runs a deficit over two years, the central government intervenes with the power to approve borrowing.
	No SNG Autonomy (Greece, Iceland, Luxembourg, UK)	SNGs must submit their budgets for central approval; borrowing is subject to central approval (either all borrowing or borrowing within certain limits such as some percent of current revenues and/or debt service).

Source: Adapted from Joumard and Kongsrud 2003.

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7.
Intergovernmental Assignment of Expenditure Responsibility

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Contents

Intergovernmental Assignment of Expenditure Responsibility

Addressing the question of which government shall be responsible for which set of public services in a decentralized system.

The first and most difficult of the five fundamental questions facing any intergovernmental society is the question of assigning expenditure responsibilities; that is, which government shall provide which set of public functions? The question's difficulty stems from a combination of factors ranging from the economic "openness" of subnational (e.g., local) jurisdictions (unlike a central government, subnational units cannot effectively constrain the flow of good and services or the factors of production across their borders) to the shared or partnership nature of much public expenditure. Indeed, depending on a variety of circumstances (e.g., the nature of the production process, geographic dispersion of users, degree of own revenue autonomy of local governments, language and/or ethnicity of the population), what is largely a "local" service in one country or region may be more centralized in another. Thus, there cannot be said to be one correct answer to the "which-government-does-what" question. There are however some principles and guidelines that should frame the policy debate. The purpose of this essay is to systematically lay out these principles and guidelines in a manner useful to the policy practitioner.

In order to accomplish this goal, this note begins with a brief commentary on two threshold topics that are often ignored in the expenditure discussion: (1) what justifies public expenditures in the first place? Or, its converse, why not let the private sector do all the spending? And (2) what are the forms that spending may take? From here the essay moves directly to the two facets of expenditure decentralization: (i) the nature of the normative framework that public finance economists describe as the "branches" of the public sector budget; and (ii) the application of a set of objective principles that allows policymakers, central and local, to get down to the practical business of the intergovernmental sorting out of expenditure (functional) responsibilities.

Two Threshold Topics

Public vs. Private

The economically successful society—which uses its scarce economic resources of people, capital and land to maximize total economic welfare—must have a mix of expenditures on privately and publicly provided goods and services (Samuelson 1954). Therefore, the first question public policymakers, central and local (e.g., provincial, municipal) must address is just what is that mix? That is, what makes one type of spending a private sector function and another a public responsibility? The normative response to this question is based on the concept of "market failure"—a circumstance where the pursuit of private interest does not lead to an efficient use of society's resources or to a fair distribution of those resources (e.g., certain goods that citizens demand but cannot be priced; the existence of net negative or positive externalities; over consumption of common property resources such as air and water; monopoly power). But it is also true that there can be "government failure" when collective decisions undermine social welfare (e.g., influence of organized "rent seeking" in the form of restricting competition to the interest of special benefits; limited information on the implementation and/or consequences of bureaucratic actions; failure to recognize how markets will work to circumvent government action; nontransparent and/or elite capture of the electoral process and/or electoral funding). The role of government has been adequately discussed elsewhere and needs no further elaboration here.[1] Suffice it to say that this question of "what is and what is not a proper role for public intervention?" is important for central and local policymakers alike and should be the first test of any public decision to undertake a spending activity.

Forms of Spending

Governments have three mechanisms with which to carry out their expenditure responsibilities: (1) "functional" spending made through the budgetary process; (2) regulation of private activities; and (3) tax expenditures. Of these three responsibilities, this essay focuses on the assignment of functions through the typical process of the functional budget, the cost and accounting financial plan that implements a government's spending choices. [2]

Regulations are both complements and substitutes to budgetary spending and typically involve mandating private agents to spend on tasks that the government would otherwise carry out. For example, business firms are often required to dispose of their solid waste, with such regulations accompanied by fines for noncompliance. Similarly, there can be regulations relating to health and sanitation, environmental control, and building and land use practices (for household and businesses alike). The use of such regulation to impose costs on households or firms cannot be justified on the basis that it reduces budgetary government spending, or worse, as a technique to hide the costs to society of governmental decisions. Regulation can, however, be appropriate if it is designed to "internalize" what are appropriately private sector costs of production and/or privately generated external costs to society as a whole.[3]

A third, and often much less transparent, way of spending is by the use of tax expenditures. Tax expenditures are revenue losses resulting from provisions that grant special tax relief designed to encourage certain kinds of taxpayer behavior and/or to aid taxpayers in special circumstances. They may take one of several forms; can be hard to measure; and are typically not given the periodic budget review required for good public financial management.[4]

1 E.g., for further discussion, see Musgrave 1959; Mikesell 2003; Weimer and Vining 2005; Bird and Vaillancourt 2006.

2 The related technical issues of "off" vs. "on" budgeting and extra-budgetary accounts is not discussed here. For more on these issues, see Wong with Gooptu and Martinez-Vazquez 2002.

3 Whenever one economic actor (a firm or individual) undertakes an action that incurs a (net) added value or cost to another economic actor, there is an externality. If these added values (positive externalities) are not paid for by the recipient or net costs (negative externalities) are not paid for by the first actor, the result is inefficient resource allocation.

4 Gravelle 2005 identifies four variants: (i) exclusions, exemptions, and deductions, which reduce taxable income; (ii) preferential rates, which apply lower rates to part or all of a taxpayer's income; (iii) credits subtracted from taxes and ordinarily computed; and (iv) deferrals of tax, which result from delayed recognition of income by allowing deductions in the current year that are properly attributable to a future year.

Normative Framework

Once it has been decided that there is a case for public intervention, the next step—the economics of fiscal decentralization—involves two facets (Dafflon 2006). The first facet is to lay out the normative framework that identifies the broad functions of the public sector in an intergovernmental (multi-tier) context. There are three such roles or branches of the public sector budget: (i) macroeconomic stabilization; (ii) making adjustments in the overall distribution of income and wealth; and (iii) the allocation function of commandeering private resources for public use (Musgrave 1959). The third facet (to be discussed in the following section) involves establishing criteria, according to a set of principles and objectives, for sorting out which government does what with respect to the allocation function.

To summarize, the three broad roles of the public sector:

- Responsibility for stabilization. The maintenance of high employment and price stability should be assigned to the central government.[5] This is true for two reasons. First, the economically and fiscally open character of economies in subnational jurisdictions prevents subnational governments from effectively addressing macroeconomic concerns such as employment and price levels. For example, a successful employment program will likely attract job-seeking in-migrants from other jurisdictions, thereby dampening the employment effect for local residents.[6] Second, the institutional economic reality is that one of the basic tools of stabilization policy—control over the money supply through a monetary authority—rests with a central bank (or, which may be, as in the case of Kosovo, a supra-national authority, i.e. the European Central Bank).[7]

- For much the same reason, because subnational economies are "open," securing equity in the distribution of income and wealth should largely be a central responsibility. A local government policy of "pro-poor" tax and transfer entitlements runs the risk of attracting the poor to the jurisdiction, while at the same time providing an incentive for high and middle income families to relocate to another jurisdiction and/or move their capital out of the redistributing district. Indeed, the outcome of an aggressive local policy to redistribute income and wealth from rich to poor may result in a perverse equality—everyone will be poor (Oates 1972). Now, the mobility of factors such as labor and capital will vary according to socio-economic factors. For example, if the borders of local jurisdictions coincide with those of traditional ethnic, linguistic, or religious groupings, then redistributive policies carried out locally may be less likely to induce migration. Under these circumstances, at least in the short to medium term, subnational local policies may have some latitude to redistribute income. But regardless of the degree of such mobility (of

5 This is also becoming the case across nations, thus calling for international coordination of macro policies.

6 There are two different stabilization issues: (i) whether the aggregate fiscal position (taxes and spending) of the subnational sector influences the overall national economy; and (ii) whether subnational fiscal changes during economic recessions or expansions might contribute to (pro-cyclical), or dampen (countercyclical) the recession. For example, a subnational sector would be countercyclical if in economic expansions subnational governments would tend to build up reserves thereby dampening effective demand; and, in recessions, tend to spend from reserves, thereby minimizing the dampening effect.

7 Kosovo has adopted the Euro as its medium of exchange; however, it is not one of the 12 states that is a formal "participating" member of the Euro Area.

labor and/or capital), in the longer term what matters most for an effective income- and wealth-enhancing policy is for all types of governments to coordinate an anti-poverty strategy. And, in this respect policies that promote education and provide for equal opportunities for all in the market place are most likely to be successful.

- This leaves the efficiency argument—i.e., allocation policy—as the raison d'être for a subnational role. Allocation focuses on two topics: (i) the manner in which the public sector intervenes in how an economy uses (allocates) its scarce resources by collectively purchasing not only final goods but also the services of the factors of production (labor, capital and land), and (ii) the determination of which type or level of government shall be responsible for which purchases.

Principles for Assigning Expenditure Responsibility

Once it is decided that a certain set of goods and services are appropriately public, the key question arises: which government shall provide which of the goods and service? There are five distinct, but reinforcing, principles (e.g., Oates 1972; Hermann et al. 1997; Dafflon 2006) that serve as a guide in assigning expenditures.

- Functions should be assigned to that government whose jurisdiction most closely approximates the geographical area of benefits provided by the function. For example, fire protection services benefit only the residents of the community located near the relevant facilities; while air or water pollution prevention activities benefit larger regions or even a nation (also see the essay on Revenue Assignment).

- Closely related to the question of "who benefits?" is the principle that takes into account the heterogeneity of preferences that persons or groups living in different parts of a country may display for different amounts (more or less) of certain services, a different quality of service (for a given amount), and/or a different approach to delivering public services. Under such circumstances, local governments can be the appropriate service provider if the border of the locality matches that of the social preference function. Thus, around the globe one observes the local public production of activities such as cultural heritage, language, and preservation of historic structures—even to the point where the freedom to provide a different mix of services becomes a "glue" rather than a "solvent" for national cohesion (Bird and Ebel 2006). Where this heterogeneity of preference rationale crosses the line from acceptable to unacceptable is when it violates protections of human rights, civil liberties, the right of people and governments to freely associate, and equal access to jobs and justice.

- Public goods and services should be provided by the government that can best realize economies of scale in production of the good or service. Economies of scale refer to the unit cost of production. For any good or service, increasing the amount produced may result in increasing, decreasing, or constant unit costs. Other things being the same, the type of government that can deliver a good or service at the lowest possible cost should provide that service. Economies of scale generally accrue when a capital intensive enterprise can spread the high cost of capital over a large number of customers. For example, building a sewage treatment plant that services a larger region may be more cost effective than having each local jurisdiction build its own capital intensive treatment plant (See essays on Service Delivery and on Joint Service Delivery).

- If an activity of one local government has an important external effect whereby its actions create added value (positive externalities) or costs (negative externalities) for individuals or businesses located in another jurisdiction, then the responsibilities for providing (or, in the case of negative externalities, limiting or compensating for) these services should be coordinated intergovernmentally. Mechanisms for such intergovernmental cooperation range from the establishment of special purpose (e.g., joint service delivery) district governments to institutionalizing regional (and/or central) coordinating bodies.

- Functions should be assigned to governments that can effectively manage that function. Specifically, the government should have adequate legal authority and management capacity to perform its assigned functions and be willing to pursue intergovernmental policies for promoting inter-jurisdictional cooperation. The notion that local government may be better able than a regional or central government to determine how a service is to be organized or delivered is a key part of this management principle. This can also help insure that best practices can be identified through experimentation and then adopted by other jurisdictions.[8]

Implementation

The application of the principles put forward above does not always yield an unequivocal answer to the “right” pattern of expenditure assignment. Consider, for example, primary education. It is not uncommon to see a report on decentralization present a general assignment matrix according to whether a function belongs to a central, intermediate (e.g., provincial), or local (e.g., municipal) general purpose government, and then assign primary education to the subnational (e.g., local) governments. Indeed, this essay provides just that sort of matrix (Table 1, below). Now, at first glance that makes a lot of sense—local schools for local children. Why should a provincial (or national?) legislative body have anything to say about schooling in a municipality or village? Well, for the most part, the answer is that it should not. But, then, when one takes a closer look, things can get more complex. For a start, a nation or province as a whole has a strong interest in a well-educated population, so now there is a broader-than-local benefit. Indeed, when one applies the five principles presented above, it turns out that education can be broken into several sub-functions; for example, setting the curricula (a role for a national “core” curriculum supplemented by local options); teacher certification (the center or province may wish to set minimum standards); staff hiring, firing, and salary determination (local); and textbook selection (a mix).

Similarly, consider public health services. In the case of vaccinations against diseases such as polio

8 This criterion of effective management does not refer to the notion of an “adequate” fiscal capacity, which, though certainly critical to the sustainability of a system of subnational governments, is a separate matter. See the essays on Revenue Assignment and on Intergovernmental Transfers.

and hepatitis, the benefits and externality arguments converge to make the case for a supra-local (indeed, even global) role. However, what about a situation where a municipality has failed to maintain its sewer system to the point that it is causing illnesses in some of its neighborhoods? Bad government, for sure; but this is not necessarily a provincial or national responsibility. Now if the consequences of this health problem spill over to other communities in the form of negative externalities (e.g., contaminating the rivers or groundwater) and the offending local government does not act to address these costs, then regional and/or central intervention will be required—perhaps even to the point of some temporary central takeover of the local Department of Sanitation.

What does one do where there is no clear "bright line" to assignment of a function? In the case of Europe, there is the generally accepted "overarching" guideline of Subsidiarity as embodied in the Council of Europe's European Charter on Local Self Government, which is a presumption in favor of having responsibilities carried out by the authority that is "closest to the citizen" (European Charter of Local Self-Government, Article 4, para. 32). That is, unless there is a clear efficiency case to do otherwise, the "higher" (e.g., central) level of government should have a subsidiary role to the "lower" level of government with respect to expenditure assignment (see the essay on the Legal Framework)[9].

Illustrations

The two tables presented below pull together this discussion of the intergovernmental assignment of expenditure responsibilities. Though illustrative, both are useful. Table 1, which presents the conventional "expenditure assignment" matrix that is found in many country studies, has the merit of providing policymakers with an framework for initially thinking through expenditure assignment vis-à-vis the guiding principles laid out above. But, as briefly discussed above, it quickly becomes clear that, as one takes a closer look at the delivery of a service as complex as primary education, one cannot think in terms of a single function that calls for a single jurisdictional assignment (and, indeed, some newly decentralizing societies make just this mistake—and at a high cost to child education), but rather as a set of several different functions that come together as complementary and/or concurrent intergovernmental competencies. Table 2 picks up on this point of complexity and, again using the illustration of primary education, reveals the intergovernmental nature of the service. For purposes of this illustration, Table 2 provides four groups of competencies (though other groupings are certainly possible): organization of instruction (which students shall attend which schools, instruction time, and teaching methods); personnel management (the critical issues of civil service arrangements with respect to hiring, firing and credentialing); planning and structure (consisting of number and types of schools, curriculum and content); and financing (including matters of budget process and execution). Table 1 adopts a three-tier model of decentralized governance for three types of governments: central, regional or provincial, and local.[10] Table 2 adds Schools as a fourth type.

9 See the essay on Kosovo for a description of the responsibilities of Kosovo municipalities.

10 All governments should consider the option of setting-up intergovernmental compacts and special purpose governments (see note on Joint Service Delivery).

Final Comment: Beyond Assignment to Accountability

If fiscal decentralization is to achieve its intended efficiency goals, it must be accompanied by policies that will insure transparency in the local budget, decision-making and institutions to further insure political accountability—the explicit linking of legislative decisions to decision-makers. The more the responsibility for fiscal decisions is obscured by hidden or complex institutional arrangements, the less accountable the system of public service delivery. With respect to the expenditure assignment decision, there are at least four barriers to accountability: (i) central hiring of personnel to perform services that are locally provided and managed (e.g., central hiring of, and wage determination for, local school teachers); (ii) unfunded mandates and preemptions of local authority (e.g., central orders to local governments to perform services for which they are not cost-reimbursed); (iii) lack of local budgetary certainty (e.g., central withholding of agreed upon central transfers); and (iv) centrally set local expenditure norms (e.g., a mandate whereby the central government details cost and capacity specifications to be used in local service provision).

Table 1. Illustrative Intergovernmental Assignment of Functions

Expenditure Function	Concept	Rationale for Assignment and Comments
Defense, Foreign Affairs, Trade	C	Benefit and costs are national in scope
Post and telegraph	C	Economies of Scale
Monetary policy, currency, banking; fiscal policy	C	The institutional reality is that the center must control the central bank or currency board. Benefits of monetary stability are national in scope.
Water and air ports	C, R, L	Often special purpose public authorities; and may be sub-central. There are numerous examples of sub-central units managing ports. Clearly, however, some national coordination is needed, especially if ports are few. Customs entry is surely national.
Transfer payments to persons (Pensions, large anti-poverty programs)	C	Redistribution. In many countries emergency safety net programs are local and may reflect local preferences.
Immigration	C	Benefits and costs are national in scope and thus this is a typical central matter (also have foreign policy implications); but there are exceptions of practice: Switzerland Cantons (regional/intermediate governments) and UAE Emirates have decision control over immigration.
Expenditure Function	Concept	Rationale for Assignment and Comments

Table 1. Illustrative Intergovernmental Assignment of Functions (continued)

Environment	C, L	Economies of scale suggest that the center would responsible for activities such as geological surveys and ensuring clean air and water; but the benefits and preferences arguments suggest a regional or even local role for activities such as irrigation and land reclamation. In the case of deterioration of a local environment due to mining operations—the goal is to internalize the costs of clean-up/control to the mining operations. This may require central and local regulation and taxation.
Land use planning, zoning, licensing and regulating of building, residential occupancy permits; managing municipal property , fairs and local markets	L	Depends on the benefits area; but the principle is that local (e.g., urban) planning and zoning is a local affair.
Capital Investment Planning	R, L	Depends on benefits area; but except for very large infrastructure projects having significant economies of scale and/or national benefits, the capital investment decision is usually subnational.
Primary and Secondary education, Literacy	C, R, L	A classic case of the need for intergovernmental partnership due to differing benefit areas (Literacy is surely a national goal but the operation of a school is local—indeed, may even be at the school level). Differences in local preferences require local provision. See Table 2 below.
Health: Dispensaries and local hospitals	R, L	Benefits argues municipal (local); but there may be a regional role (economies of scale).
Community Fire Protection	R, L	Primarily local benefits; Police are central; Fire Services are a local responsibility. Unless there is a clear externalities argument (e.g., local police are corrupt, the center is not), there is no good justification for any central role in community policing (beyond, perhaps, information sharing).
Community policing	C, L	Applying the benefits rule, there is a case for special policing for provincial or central activities (e.g., inter-municipal and inter-provincial highway control), but the benefits rule also argues that community police matters are a local issue. Of course, there should be intergovernmental police coordination.
Water supply and distribution	L	Water supply tends to have a regional character (to manage watersheds that cross over municipal boundaries); however, the responsibility of getting water to home and businesses has a large local/municipal character (benefits, preferences, management).
Parks and recreation	C,R, L	Primarily local responsibility, but some "heritage" parks may be national.
Roads Interstate	C	Internal common market
Interregional	C, R	Interregional benefits and costs
Local roads and streets	L	Includes street lighting

Table Notes. * All these functions will have a private as well as public sector character. Activities denoted with a double asterisk (**) in the table are predominantly private sector functions in many developed federations. ***Center, Regional, and sometimes local governments have a regulatory role (e.g., sanitation). The designations are C: Central ; R a regional or intermediate tier of government that is sub-central and yet overlaps municipal/local/village boundaries; L, Local (e.g., municipal, special district).

Table 2. Further Detail to Illustrate Expenditure Assignment Among Governments: Primary Education

Decision Category	Function/Component	Lead/Joint Responsibility for	Principles Arguing for the Assignment in the Previous Column	Selected Comments
Organization of Instruction	Which school shall children attend?	L, S (often consultative)	B, H, Mgt	Jordan, Thailand, India, CZ, Hungary, Philippines, US, UK
	Instruction time	R, L	H, Mgt	Developed countries, typically school or local; Unitary developing, often central
	Choice of textbooks and how to buy them	S, L, R	H, Mgt, Es	Economies of Scale (in purchasing) for a core curriculum argue provincial (or perhaps for a small country, even central) role in textbook selection and purchasing
	How to group students (e.g., tracking?)	S	B, H, Mgt.	School typical in developing and developed countries
	Teaching methods	S, R	H, Mgt, Es	School typical; India is the intermediate. Training is appropriately provincial or central well as school and local
	Assessing student work	S ,R C	Mgt.	School typical; India intermediate; Jordan central; End of level testing is often centralized
	Teaching techniques (e.g., F2F vs. DL)	S	Mgt, H,	School in developing and developed countries; India is intermediate; Jordan, Central

Table 2. Further Detail to Illustrate Expenditure Assignment Among Governments: Primary Education (continued)

Decision Category	Function/Component	Lead/Joint Responsibility for	Principles Arguing for the Assignment in the Previous Column	Selected Comments
Personnel Management	Hiring /Firing the Principal and the teaching staff	S. L	B, Mgt	A pattern of what is typical emerges: the less developed, the more likely central control (Turkey, Malaysia, Jordan, Thailand plus France); Developed countries tend to be more S & L (US, UK, NL, Sweden, Hungary)
	Fixing of teacher salary scales	S, L	B, Mgt., H	A "golden" devolution rule is for school / local control (US, Hungary, Sweden, Chile, Finland); yet typically a central matter in many developing countries; Intermediate in Denmark, India, Argentina, Spain).
	Duties of service for teachers & staff	S, L	B, Mgt., H	A similar pattern as for setting salary scales
	Career planning for principal and teachers	S, L	B, Mgt	Some countries give this to the center
	Credentialing of teachers	R, L, S	B	Typically central or intermediate in developing countries. Also central in some developed countries (N. Zealand, Hungary, Ireland). US is local and intermediate.

Table 2. Further Detail to Illustrate Expenditure Assignment Among Governments: Primary Education (continued)

Decision Category	Function/Component	Lead/Joint Responsibility for	Principles Arguing for the Assignment in the Previous Column	Selected Comments
Planning and Structures	Creation./closure of a School	L, may have overlaps for R	B, Mgt, Es	Consultation with S system important; in developing countries often a central or intermediate function (Turkey, India) though also in developed systems (Austria)
	Curriculum and content	S,L, some core courses @ R	B	Unitary developing countries, central (Turkey, Jordan, Denmark, PRC). School in US, CZ, Hungary, NL; Sweden , Spain, UK, Chile
	Integrating boys and girls education	C	B	This is about equal (or intentionally unequal) access. If center opts for unequal, a case is made for a Provincial or Local authority to expand options for equal. National Benefits
	Setting graduation standards	L, R	B, Mgt.	Though local is some places(US, Thailand, UK/Scotland), the typical is P or C
Financing	Current vs. capital budget planning	S,L,R	Mgt., B	Capital budget should be S/L; Now the grant system is fundamental to the system
	Allocation to schools of teaching staff	L, R	Mgt.	The practice reflects the twin (and interrelated) issue of "who pays". If the local and school systems are tax and transfer dependent on the Province, the Province will generally control. Until localities have and then use the authority to mobilize significant own revenues, the province will control this "local" decision
	Allocation for other current spending	L, R	Mgt. H, B, Ex	
	Allocation for Capital budget	S, L	Mgt. B, H,	Developed countries typically S, L; developing typically central or intermediate
	Whether to set school fees	S, L	Mgt, H,	Must integrate this matter with the broader issue of the intergovernmental grants
	How to pay for off-site infrastructure	L, R	Ex., Es	Externalities argue for government "above" the school system

Government: C: Central ; R : Regional, Provincial); :L Local (e.g., municipal); S: School. **Principles**: Benefits (B), Heterogeneous Preferences (H); Existence of Economies of Scale (Es), Presence of Externalities (Ex), Management Capacity (Mgt). This table expands on Gershberg 2006.

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8.
Service Provision in a Decentralized Setting

Gábor Péteri

Contents

Service Provision in a Decentralized Setting

A key argument of a well-designed intergovernmental system goes to the merits of responsiveness and efficiency in local service delivery.

Getting the expenditure assignment question "right" does not guarantee that decentralized services will be delivered efficiently and effectively. There are several additional considerations for the government (with the assigned responsibility), if it is to ensure that services are delivered by effective service mechanisms. This is especially true in Kosovo, where local public services are provided by highly controlled, centrally owned and managed service organizations.

The present forms of municipal service delivery should be changed as the decentralization process further develops, in parallel with the transformation of international organizations and the provisional government.

For designing effective and efficient local services three aspects of public service provision will be discussed here:

(i) how the market mechanisms influence the public sector;
(ii) what type of new relationships emerge between various actors in service provision; and
(iii) how proper regulatory functions of the national and local governments should be devel oped in a market environment.

Transformation of the Public Sector

Organizational forms and financing methods of public services are influenced by the private sector, leading to changes in governance methods and public management techniques.

Public Sector Reform: Impact of the Market

In the field of public services, modification of state and public functions can be characterized by two major sets of changes. The first set of changes is the establishment of enabling and facilitating roles of the state, both at the national and local level.

In transition countries, the most critical element of these changes were the new forms of ownership. Abolition of state-owned property and decentralization of public assets established new relationships between governments and service organizations. Corporatization of state assets, privatization and transfer of public property to local governments led to the separation of service providers and producers. Consequently, governments' political and legal responsibility for public service provision does not necessarily require services to be delivered by these public entities. Separation of service producers supported the use of market-based techniques, like economic incentives, performance measurement, greater management flexibility, and customer orientation.

Obviously, the social consequences of introducing market-based techniques require compensation and corrections mechanisms. So, the second major change was the development of state regulatory functions. Regulation in a broader sense comprises the legal environment for entering the market (e.g., licensing, supervision, audit), and the setting of service performance standards and enforcement of competition rules.

New Public Management

Market mechanisms had an impact on governance methods as well. During the past two decades, the concept and techniques of good governance were developed parallel to changes in public service delivery in Europe. The objectives of good governance are to improve accountability, achieve better representation, create transparent procedures and make professional decisions. All these factors aim to improve the effectiveness of the public sector through better-informed decision-makers, and to increase efficiency by facing the real costs of public services.

"New Public Management" characterizes the transformation of the public sector in service delivery and governance methods. It aims to diminish the state's direct influence by making it smaller (through privatization and decentralization) and by improving its performance. New public management is built on entrepreneurial and managerial approaches of the private sector. Both at governments and at public service organizations, it focuses on decision-making (planning, policy analysis, evaluation), and management practices (by promoting the "3 Es": Economy, Effectiveness, Efficiency; and client and customer orientation).

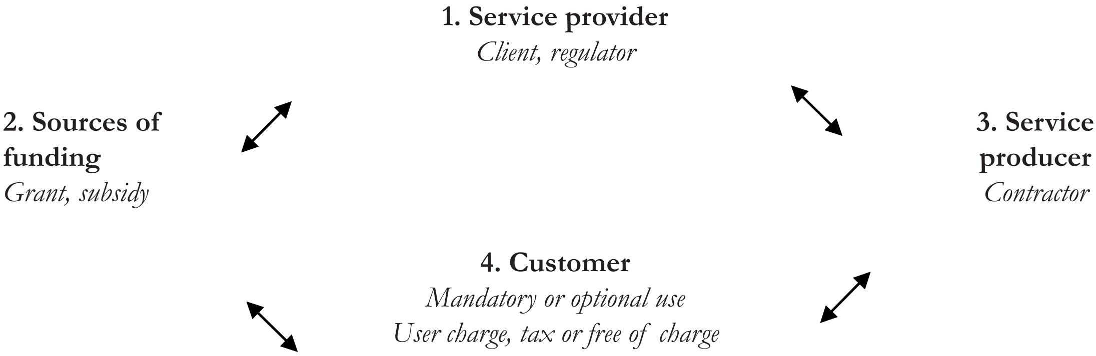
Client-Contractor Split

Public sector reforms aiming to introduce new public management techniques focus on the four main actors of service provision. The (i) national government's devolution and privatization policies set the scene for municipalities and service organizations. The (ii) local governments ensure a balance between citizens' needs and services produced by various organizations. These (iii) service organizations operate in a regulatory environment set by general (national) legislation and local rules or compacts. Evidently, (iv) citizens as clients are able to influence the other three actors through elections, participation and other direct forms of client power (paying user charges, raising complaints, using customer protection mechanisms).

Development of these institutions and establishment of procedures is a long-term process. Within this framework, perhaps the most critical condition for initiating changes in local public service delivery is the separation of the two service functions:

(i) provision or ultimate responsibility for a public function, and
(ii) production or the actual delivery of goods and services. By making this shift the roles of the key actor, the service provider, become clearer: the service provider works as a client and as a regulator. In this scheme financing of service provision is a regulatory means. The contractor, as the actual producer of the service, is primarily linked to the client, but obviously to the customers as well (see Figure 1).

Figure 1. Separation of Roles and Functions in Public Service Provision



The client-contractor split is based on the legislation, the available organizational forms and the financial incentives set for the contractors. Service producers might be budgetary organizations, entities under company law or other organizations (e.g., NGOs). Efficient service provision very much depends on the selection process of these partners (whether it is competitive or not; how targets are formulated), contract specification, monitoring and enforcement practices.

Customers of public services are voters, influencing municipal (client's) decisions and they have direct impact on service producers. If they are obliged to use the selected contractor's services, then they can affect the service organization through financing (user charges, taxes) and complaint mechanisms.

Source of funding is usually a mixture of public (national, local budgets) and private finances. Various grant schemes, subsidies, and national and local user-charge policies aim to balance incentives for efficient operation of service producers and to ensure equitable services and access to a minimum level of public services. Private financing can also be involved in public service provision, as there is usually excess capital available on the market. However, the various public-private partnership mechanisms require a developed legal environment (e.g. on concessions, public procurement), and managerial and regulatory capacity of governments.

This separation of roles and functions supports policymakers by making clearer the motivations behind the various actors. Moreover, it helps to understand the conflicting roles of local governments as owners of service organizations, primary sources of funding and entities representing customers. The separation of roles might also help to better target various regulatory techniques and to separate economic and social objectives in service provision.

Developing the Regulatory Framework for Effective Service Provision

Components of Regulation

Most municipal public services are regulated in four major areas:

(i) institutional and organizational forms;
(ii) service performance, content, strategies;
(iii) finances; and
(iv) management, in a broad sense, including tendering and contracting, users' involvement, and customer protection.

Institutional and Organizational Forms (i):

(a) local government institutions, in the forms of budgetary or contributory organizations;
(b) "municipal enterprises," mixed forms of public sector entities with characteristics of businesses, and
(c) business entities under company or not-for-profit organization law. These three groups of service organizations operate under different taxation (VAT, profit tax) and accounting rules (e.g., depreciation rates).

For providing local public services, they should go through a licensing process. Permissions are issued if the service organizations meet technical standards, environmental protection requirements, employment rules and other pieces of sectoral regulation.

Organizational forms can be more diverse when there is a similar demand for services that are easy to monitor (e.g., road maintenance), or when the need for services varies but both users and governments are able to control service performance (e.g., special public education courses, some communal services). A homogenous institutional setting is typical when options for service monitoring are limited (e.g., primary public education) or public control of service performance is highly technical.

Service Performance, Content, Strategies (ii): One of the most critical elements of regulation on municipal services is to guarantee minimum services set by national standards and to balance them with local autonomy. Control over service performance and equal access to public services can be ensured primarily in two ways: influencing inputs, or setting output and outcome requirements.

Input based regulations are traditionally used in the public sector, through which, *inter alia*, staffing levels, operational and management costs, curricula, and available technologies are set. When outputs can be measured (e.g. pupils trained, water produced, heat supplied, customers served), or results as outcomes are identifiable (e.g. level of poverty or unemployment, safe public transportation), then regulation will be more indirect. It allows greater flexibility in management and consequently leads to better services. These performance objectives are also influenced by sectoral plans and strategies.

Finances (iii): Finances indirectly influence public services through transfer schemes for current expenditures, capital investment funds, price setting rules and financial management regulations. This area of regulation is typically dominated by the general rules of intergovernmental finances.

Managment (iv): The operational and managerial framework in a broad sense covers all the issues of personnel (employment, salary, and training), competition and contracting rules, customer involvement in decisions, conflict of interest, and consumer protection. These rules gradually evolve with public sector reform and decentralization. They are critical elements of regulation because they specify the competencies in detail and define local autonomy in managing services.

Stages of Developing Regulation on Public Services

These four major areas of regulation on public services are usually developed over a long period of time. They are the most complicated and time-consuming to change, as they are deeply embedded in the organizational and institutional setting of a country. The experience of transition countries has showed that, after the first constitutional changes are made and basic local government and public finance laws are passed, it could then take another three to five years until the supporting regulatory framework becomes effective. Under unfavorable political conditions it might take even longer (e.g., in Slovakia) or the positive trends could even reverse (e.g., in Bulgaria from the mid-1990s).

However, major discrepancies in developing the regulatory environment might endanger the transformation and could create a regulatory "vacuum." Unlike in established market economies, restructuring and privatization of public services in transition countries often takes place in an incomplete regulatory environment. This delay in establishing new regulations for example in local utility services might increase the chances of creating monopolies.

In the field of communal and urban services, some generally accepted international principles shape regulatory reforms. First of all, regulation should ensure open access to networks. It should be followed by "unbundling," that is, separation of various components of service delivery (e.g., generation, transmission, and distribution in the energy sector) and their allocation to different organizations. This will also prevent cross-financing of loss making activities from profitable ones, consequently decisions on privatization and subsidies will be more transparent and rational. Privatization of utility services should prohibit "creaming off"; that is, when only the most lucrative parts of the services are put out for tender and the least efficient ones remain in the public realm. The most important lesson to be learned from the transformation of urban services in transition countries is that the regulatory environment should be developed before or in parallel with the privatization of communal or urban services.

Table 1. Stages of Transformation in Public Utility and Communal Services in Transition Countries

	Public Utilities (natural monopolies)	Communal Services (mixed goods and services)
First Stage RESTRUCTURING "communalization" "corporatization"	• Modest breakup of state-owned monopolies (devolution of assets) • Modest unbundling • Establishment of independent regulatory authority	• Rationalization • Establishment of competitive environment
Second stage PRIVATIZATION with REGULATION	• Privatization of competitive assets (de-monopolization) • Development of regulatory function • Market liberalization	• De-monopolization • Management of public shares • Privatization

Source: Péteri and Horváth 2004.

Within the European Union the classic principles of regulation are put into the framework of "services of general public interest." This principle would evaluate the economic performance of service producers in a broader framework, incorporating other aspects, like affordability and equal access to services. It gives greater power to local governments in appointing service organizations and could limit the use of market and competition in public services.

Examples of Public Education and Water Services

Tables 2 and 3 below summarize the main characteristics of basic local government services (public education and water management) along three dimensions of regulation:

(i) assignment of major regulatory functions by levels of government;
(ii) transparency and customer orientation in service management; and
(iii) accountability and customer protection.

In the area of public education almost all countries foresee certain roles for local governments in the management of education services, with the exception of Spain. In almost all the countries analyzed, except for Denmark (which is highly decentralized), the state enacts rules and legislation in areas such as curricula, personnel status and training, standards for quality monitoring and private provision of education services.

Local governments are responsible for the functioning of schools and maintenance of school infrastructure. In the case of Lithuania local governments are in charge of financial planning, even though the state holds control over municipal tax revenue. In the case of Denmark the system is financed mostly by municipal own resources. In Spain funds are allocated both by the state and the regional administration.

Water services are mostly provided by locally owned enterprises (in the Spanish case also by regionally owned enterprises). The state controls legislation and implementation of water-resources management and planning; regulation on the modes and instruments for private participation in the provision of water-related services; and financial resources of local administration.

In the countries analyzed public-private partnerships for service provision is not a very extensive practice, but contracting out is used in Poland. In the case of Lithuania the practice of leasing public assets is widespread. Local governments are usually responsible for capital investments. This increases their dependence on economic resources from the central budget, since user charge revenues are not sufficient for funding large capital schemes.

Lessons for Kosovo

1. Future devolution of public functions should be accompanied with the transformation of regulatory mechanisms at national level. The central regulatory schemes should target service performance and quality, ensure diversity of service organization and management practices, guarantee sector-neutral transfers and matching funds for capital investments, regulate price-setting mechanisms and separate social compensation schemes from user charges.
2. Municipal public service provision is a joint responsibility of national and local governments. Funding schemes should guarantee a minimum level of services and allow local autonomy in developing local policies. Indirect forms of national-level supervision focusing on service outputs should be developed.
3. Devolution of state property is a basic condition for establishing autonomous local governments. Municipalities responsible for service provision have to be in a controlling position over the local service organizations.
4. Large regional service organizations should be kept in the area of public utilities, but those local governments which are served by these companies should have an increased influence over the service producers.
5. Diversity in forms of service organizations should be legislated by allowing the use of non-profit organizations in human service delivery and opening up the market for private investors in utility and urban services.
6. Legal framework of private sector involvement should be developed through competition rules, licensing, consumer protection and funding regulations.

Table 2. Intergovernmental Relations and Education in Comparative Perspective[1]

	Intergovernmental Relations and Regulatory Instruments	Transparency of the System	Accountability and Consumer Protection
Poland	Mixed structure. The state enacts laws and regulations in the following areas: finances, curricula and personnel status and training. Management of schools and quality control is decentralized at the local level. Education is funded by national transfers, managed at local level. Local authorities can complement national budget grants with their own resources.	State has a strong hold on education policy, through fiscal and regulatory instruments. Concentration of most decision capacities in state hands reduces uncertainty.	Parents have input in the management of schools. Parents associations hold school managerial structures and teachers accountable. Consumers have limited input and control over the legislative process, which usually takes place at the national level.
Lithuania	Mixed structure, but municipalities hold financial and managerial control of the education system. Municipalities are in charge of school management (including personnel) and financial planning. The state retains major normative and management capacities in the following areas: personnel training, student curriculum, publishing of textbooks, regulation of private schools and municipal tax revenue.	Clear division of functions among tiers of government. State retains general normative capacities, as well as coordination capacities in areas of general interest, such as student curriculum, training of academic personnel and regulation of private schools. Municipalities are mostly visible in the implementation phase (i.e. school and personnel management) and in financial planning.	Parents have input in the management of schools, holding school managerial structures and teachers accountable. Parents have less input and control capacities on decisions concerning the structure of the curriculum.
Denmark	Highly decentralized structure. Municipalities hold general normative, managerial and financial capacities within the education system. Schools are owned and managed by municipalities; schools and municipalities determine curriculum. The state administration establishes general policy outcome standards. It has financial capacities to compensate for territorial economic inequalities.	The system is highly transparent because most decisions are taken by local authorities together with school management boards and parents. Decentralization is understood as getting decisions closer to citizens rather than inter-institutional relations.	Parents have a strong input in the management of schools and also in decisions affecting the functioning of the education system. Since most decisions are taken jointly by schools and local institutions, parents associations have access to the decision-making process.

1 Summary tables were prepared by Carlos Hernandez Ferreiro.

Table 2. Intergovernmental Relations and Education in Comparative Perspective (continued)

	Intergovernmental Relations and Regulatory Instruments	Transparency of the System	Accountability and Consumer Protection
Spain	Education system has recently been fully decentralized at the regional level. Municipalities are not considered to be administrations in the education system. The state and the regional administration share financial responsibilities. State retains general normative and coordination capacities in the following areas: curriculum, training, regulation of private education and quality standards. Regional administration is in charge of management and have normative and implementation capacities in all areas.	Recent decentralization of education system at the regional level has introduced certain levels of uncertainty. The limits of the capacities of each tier of government are not always clear. Especially important for financial issues.	Parents have strong input in the functioning of the system. At the school level, parents associations have input in decisions concerning school functioning, as well as in the control of teachers' activities. At the national level, parents associations have gained visibility in the context of recent debates on the new National Education Law. Yet, it is not clear to what extent parents are able to control the normative process at the regional level.
Slovenia	Centralized education system. State controls almost all economic and normative resources. Participation of municipalities is limited to maintenance of school infrastructure and control over school management.	The system is transparent to the extent to which almost all decisions in the provision of education are taken at the same tier of government.	Parents associations participate in school life and can control school activities. Parents associations have had traditionally very little participation in the legislative process at the national level.
Bosnia and Herzegovina	Education system is highly fractionalized along ethnic boundaries. System is different for both entities. In the Federal Republic of Bosnia education is controlled by cantons. Lack of a coordinated education policy beyond ethnic boundaries. In the Republic of Srpska, system is highly centralized in the hands of the central administration.	In the Federal Republic of Bosnia education system is opaque. Fractionalization along ethnic boundaries leads to lack of coordination instruments and over complexity of the educational structures. In Serbo-Bosniak cantons de facto two separated education systems coexist. In the Republic of Srpska, centralization leads to clearer lines of command.	Parents have very limited input in the education system.

Table 3. Intergovernmental Relations and Water Management in Comparative Perspective

	Intergovernmental Relations and Regulatory Instruments	Transparency of the System	Accountability and Consumer Protection
Poland	Decentralized water system. Local governments provide water supply and sewage through budgetary enterprises and companies. They have powers in financing capital investments. The state has a general normative capacity on water management issues and planning (together with counties) the use of water resources. The state establishes the conditions for public-private partnerships, permits and licenses. Special state agencies are in charge of regulating river basins and the use of water resources.	Variety of actors involved: budgetary institutions, enterprises and companies, a few examples of public-private partnerships. State-owned enterprises have very little share in service provision. Politicization of managerial structures in public companies. Decision-making structure is not very transparent. Price-setting rules do not ensure an adequate level of resources to cover for capital investments. There is lack of coordination between provision of water-related services and management of water resources.	Accountability is limited by the lack of transparency in decision-making, this is particularly true for decisions concerning prices and consumer rights.
Lithuania	Local governments provide water supply and sewage services through local public companies. They can lease public assets, under state regulatory control. Municipalities are in charge of capital investments. The state retains normative capacity in the area of water resources management. The state regulates public-private partnerships and licenses.	Governance of water supply is not transparent. Leasing to private investors is a widespread practice. State's legislation on leasing favors redundancy of management structures and lack of clarity. Decision-making structures and service provision structures are not clear.	There are no clear mechanisms for accountability and consumer protection. Leasing practices in a legal environment that does not favor flexibility in the governance structures of water supply results in a highly opaque and expensive system. Customers face high prices and redundant managerial structures that make it more difficult to establish accountability mechanisms.

Table 3. Intergovernmental Relations and Water Management in Comparative Perspective (continued)

	Intergovernmental Relations and Regulatory Instruments	Transparency of the System	Accountability and Consumer Protection
Denmark	Local governments are in charge of the provision of water and sewage services. Local authorities employ municipally owned enterprises and public works. All relevant decisions concerning service provision are allocated at the local level. The state has normative capacities concerning management of water resources and planning, particularly, in the area of environmental protection.	The system is highly transparent. Governance is concentrated in a single tier of government. Decision-making rules and processes are particularly clear when it comes to incorporating European or national environmental protection standards that have an impact on the price of the service.	The system is highly accountable and transparent. Decision-making capacities are allocated at the local level, thus citizens can have an input on the decision-making process. This is particularly important in the context of price setting.
Spain	Municipal governments are responsible for water provision including capital investments. Regional governments have normative competency in the management of water resources within their territory. The state has legislative capacities in the areas of management of water resources, planning, and the regulation of conditions for public-private partnerships in service provision.	Water supply and sewage in urban areas is carried out either by municipally or regionally owned enterprises. Most decisions concerning water-related services are taken at a single governmental level. The planned incorporation of private actors could introduce new elements of complexity in the delivery of public services.	Accountable system of public provision of water-related services. Developed system of consumer associations and adequate administrative procedures ensure protection against arbitrary administrative acts. The introduction of private actors can result in a drastic reduction of the effectiveness of accountability mechanisms.

Bosnia and Herzegovina	Two legal systems of water management co-exist in Bosnia and Herzegovina. Both the Federal Republic of Bosnia and the Srpska Republic passed legislation on water management. There are prospects for a new Water Law (sponsored by the EU) in Bosnia and Herzegovina, binding for both entities. The new law tries to implement a river basin approach to water resource management and protection as well as rationalize the system of water provision.	–	–

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9.
Joint Service Delivery

Gábor Péteri

Contents

Joint Service Delivery

The right of association among governments provides opportunities for improved delivery of local public goods through cooperation.

Kosovo: The Starting Point

Kosovo has relatively large-sized municipalities in the countryside with populations above fifty thousand. These local governments comprise different discrete geographical units (towns and villages) and, under the present local government system, basic human services such as education are organized along these municipal units. Urban services are provided by a smaller number of water and municipal solid waste companies for groups of local governments on a regional basis. These communal companies are governed by management boards, where the majority of board members represents the central authority (Kosovo Trust Agency, PISG).

Despite the large municipal entities and the centralized delivery of public utility services, with further decentralization a need will arise for cooperation among municipalities. Large, multi-ethnic municipalities may be fragmented for political reasons—as was claimed during the Vienna status talks. The example of Macedonia demonstrated a similar trend, as local governments first broke up and later were amalgamated again into larger units on a new basis.

Future devolution of public functions will raise the need for cooperation in public service provision (administrative services, local public utilities, human services) and in strategic planning. Of the latter, even the present large-sized municipalities will be required to cooperate in designing regional and urban development strategies and promoting local economic development.

Why Cooperation?

General-purpose local governments might enter special cooperation agreements for primarily economic reasons. There is fiscal pressure for efficient provision of municipal services, which are typically organized by political-administrative entities; however the boundaries of local governments are not always drawn to allow for efficient public service management. Public services provided by central towns might spill over to neighboring municipalities, who benefit from these services without contributing to their funding (common examples are education and health care services). The other typical case involves small municipalities who aim to achieve economies of scale in the provision of local services (for example when catchment areas of utility services are different from the administrative borders).

The rational size for efficient municipal service provision varies by type of public service. In the case of capital-intensive public services, like water or solid waste management, unit costs of services decline with the increase of facility size. This is not necessarily the case with human services, like education, or with administrative services. According to international examples, the unit cost curve of these services is typically u-shaped, which means that unit costs of service entities start to increase again as the entity exceeds an optimum size, primarily due to the more complicated management system and the need for coordination mechanisms.

In a democratic and decentralized local government system, financial and managerial decisions should be harmonized with political decision-making mechanisms. That is, political entities should be adjusted to the boundaries of municipal service units. This allows the internalization of costs and revenues related to municipal services. Political decision-making can be harmonized with financial and managerial decision-making in basically two ways: (i) by creating large general-purpose local governments or (ii) through horizontal cooperation among municipal units. Amalgamation, exemplified by reforms in Skandinavia, creates permanent administrative and political structures, to which service delivery mechanisms are adjusted. Cooperation, on the other hand, follows the bottom-up approach, when politically autonomous municipalities establish flexible forms of service provision.

Models of Municipal Cooperation in Europe

As the forms of joint service provision follow the constitutional, political, administrative and management traditions of a country, different approaches towards municipal cooperation exist. Three basic alternatives for municipal cooperation, briefly discussed below, serve as potential models for reforms in Kosovo. Examples of other transition countries (e.g., Hungary and Poland) have shown that lessons from these models might be combined in a selective way and can be adjusted to local conditions.

1. The *contract-based model* of cooperation follows the new public management concept, developed in the Anglo-Saxon countries and in Scandinavia. Various types of local services can be provided within this form of cooperation: public education, water, solid waste management or administrative services. Based on private sector rules and practices, different forms and levels of government cooperate by establishing agreements on service performance, funding rules and forms of management decisions.

The legal forms of cooperation are adjusted to the nature of services provided (e.g., by council, committee, foundation, company). Sometimes the contracted services initiate cooperation and define the forms it assumes among municipalities. Local governments—and not individual citizens—develop these contract-based forms of cooperation. Therefore this type of cooperation differs from the American "special districts," which may be run by elected governing boards, who have taxing power or levy charges, and are accountable directly to service users.

2. The *German model* of government cooperation ("Zweckverbände") has many variations in the regions of the federation. Compared to the Anglo-Saxon contract-based model, this form of association establishes administrative-legal relations between various municipalities or even governments at different levels. This form of municipal cooperation is based on the adaptation of private sector management practices in the area of public administration and public service management.

The purpose of municipal cooperation is similar to the contract-based models: its objective is to harmonize political, administrative and service units of governments with the economic area (or fiscal base) of the local government. The municipalities establishing the associations are equals and are not subordinated to the association, despite the fact that the association provides the linkages to upper-level state administration. The associations usually provide regional services (e.g., water management, secondary education, fire protection). They are funded by shared taxes that are set by the association. The municipal property of common services is transferred to the association. There is a permanent consultation between municipal leaders and the head of the association.

3. *Administrative cooperation*, developed in France, takes various legal forms (syndicates and authorities, *communautés*). Local governments of different types and sizes establish these forms of cooperation under public law, thus preserving the legal autonomy of all members. The syndicates are voluntary single- or multi-purpose organizations. A local government might join several syndicates. All syndicate members enjoy equal rights. The syndicates are funded through the shared revenues and contributions of local governments.

The public authorities are organized for management of specific local government functions (e.g., fire protection, urban planning, environmental protection, housing, public transportation). Local governments are obliged to participate in these metropolitan or regional authorities; however, the rules and procedures of cooperation are set by the members of the public authority. Specific local tax revenues are assigned to these forms of cooperation, which are administered by the unified national tax authority.

For cooperation with the private sector, local governments might establish mixed public companies, which operate under private law, but are entirely controlled by the founding municipal bodies, who should be majority shareholders.

Critical Issues of Cooperation

These international examples demonstrate that, regardless of their size and scope, elected local governments are able to establish various forms of cooperation. The models presented here also show that organizational forms and management practices very much depend on the legal environment and traditions. But all types of cooperation are aimed at creating rational units of public service management for efficient use of public resources.

As effective and efficient service provision is the basic goal of decentralization also in Kosovo, the following points should be taken into consideration when designing regulation on joint service provision.

(i) *Legal and administrative rules of cooperation*:

- Establishment of joint service organizations and participation in cooperation is voluntary (optional) or mandatory for their members.
- Forms of representation should ensure legitimacy and effective decision-making.

- Boundaries of municipal cooperation should allow flexibility for creating administrative units adjusted to service catchment areas.

(ii) *Institutional setting and forms of administration:*

- Forms of decision-making should be designed to address inequalities between entities. The interests of small municipalities should be protected through consensus building.
- Separate administration of municipal cooperation is needed in order to improve its management capacity.
- Joint service organizations should be subject to municipal supervision and reviewed in local government audits.

(iii) *Financial incentives for cooperation:*

- Intergovernmental fiscal relations should create incentives for cooperation; for example, more grants should be allocated by objective criteria (e.g. school age population), instead of by institutional capacity (e.g., number of pupils enrolled).
- Balancing revenues shared by member municipalities with own source revenue-raising authority of the municipal cooperation.

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Financing Services

10.
Revenue Assignment, Mobilization and Administration

Robert D. Ebel

Contents

Revenue Assignment, Mobilization and Administration

Guidelines and criteria for determining which set of revenue tools shall be assigned centrally vs. locally; and once the local assignment is made, the nature of the policy tradeoffs among tax choices and the challenge of policy implementation.

Debate on revenue policy seldom makes clear the basis for sorting out the authority to assign types of revenues among governments. Several factors may be at work to discourage explicit statements, including lack of data on the economic effects of public revenue, uncertainty on who will bear the tax burden, and the complexity of the interplay of a multiplicity of taxes. That said, there are principles, guidelines, and criteria for "getting right" intergovernmental assignment, mobilization and administration of revenues. The assignment issue is addressed below in the form of three questions: Why local taxation matters? What normative guidelines frame the "assignment" decision? And, what set of criteria can be applied to weigh the policy tradeoffs of "which" provincial or local tax? Once these questions are addressed, a discussion follows on the "next steps" of revenue mobilization and administration.

Why Local Tax Policy Matters

For a country to become a member of the European Union, it must agree to most, but not all, of the eighteen articles of the European Charter of Local Self-Government (see "Legal Framework," this volume). A key article is Article 9 that addresses the financial resources of local authorities: inter alia (i) "Local authorities shall be entitled…to adequate resources of their own, of which they may dispose freely within the framework of their powers"; and (ii) "...financial resources shall be commensurate with the responsibilities provided for by the constitution and the law." That principles of granting local governments "own revenue" taxing powers are fundamental to a system of local self-government apply to any decentralizing country, not just to Europeans (OECD 2002; Ebel and Taliercio 2005).

This question of "why" local taxes matter goes to the point that far from being a purely local matter, a well-designed intergovernmental system is key to a nation's broader reform goals. This follows from what is labeled the "decentralization theorem," that the set of governments closest to citizens can adjust budgets to local preferences in a manner that best leads to the delivery of a set of public services that reflect community preferences (Oates 1972).

The focus is now on improving efficiency in the use of a society's resources of people, land, and capital. With respect to private goods and services, the market-price system accomplishes that goal. But, when the private market fails in this objective (pure public goods, externalities, and monopoly), there is a case for the collective (public sector) commandeering of resources to supply the activity. Once the public sector intervenes, the efficiency logic is in favor of some form of fiscal decentralization. The argument is that, because of spatial considerations, local governments are best situated to become the conduit for setting up a system of budgets that best match the benefits and costs of local goods and services. In technical jargon, this is the "benefit model" (or "matching principle") of public finance. To satisfy those conditions, subnational (local) governments must be allowed to exercise own source taxation and be in a financial position to do so. That is the essence of decentralization. And, this is why subnational local tax policy design matters.[1]

What Normative Guidelines Frame the "Assignment" Decision?

The question now becomes, "which taxes should be assigned for local use?" There are two guiding principles: benefits received and tax base immobility (Table 1).

Benefits received. To achieve the economic efficiency gains promised by fiscal decentralization it is desirable that those who benefit from local government expenditure should also pay for it. In its most strict interpretation, this argument dictates a reliance on "non-tax" revenues—user charges and fees—that one pays for the receipt of *specific service benefits* such as for *direct use* of a facility or consumption of a service; *license fees* paid for the privilege of an activity; and *betterment levies* to pay for local infrastructure. Where it is impractical to impose specific fees or levy user charges, local services should then be financed by the taxes levied on local residents (and, here, a "resident" may be an individual, household and/or a business) to the extent there can still be demonstrated a logical link between taxes paid and the benefits of services rendered. Such *generalized benefit* taxes include broad based taxation of the business enterprise on income or receipts as well as the subnational use of a personal income tax if it can be determined that the benefits of local government spending are related to one's improvement in production (income earned) and/or the ability to consume (income spent). "Local taxes" in this sense are those over which local authorities have some control; for example, they can set the rate or determine the tax base in addition to receiving the revenue. Note that such taxes need not be administered locally, and thus in some countries the revenue administration of local taxes may be carried out by another government (e.g., in many countries the central or provincial government is responsible for assessment and collection of the municipal property tax).

Tax base immobility. One must be candid to acknowledge that the search for local revenues also has a fiscal expediency character. Accordingly, the guideline that a "good" tax to assign locally is one that attaches to a relatively immobile tax base (e.g., real estate) often complements the benefits principle. The concept is straightforward: because, by their nature, they cannot (as easily as can a central authority) control the flow of economic factors (labor, capital) and goods across their borders, subnational governments run the danger of over-taxing a highly mobile factor (e.g., capital, some types of sales, where income is reported) and thereby lose some of its tax base to a lower-taxing neighbor jurisdiction.

Given these two guiding principles, which types of revenues are likely to be more suitable for central/provincial rather than local use? There are several. For example, as Table 1 suggests, in order to minimize potential tax distortions, make manageable revenue administration and promote tax-

1 To get a bit more technical: An efficient solution maximizes social welfare subject to a given flow of land, labor, and capital resources. The rule for achieving an efficient allocation of resources is to supply a service until at the margin—for the last "unit" of the service supplied, the welfare benefit to society just matches its cost. Note that this efficiency requirement does not require that local governments tax at levels high enough to pay for the entire cost of local public goods and services.

payer compliance, a high degree of national uniformity seems desirable with respect to the taxes on corporate net income and value added. A well-administered corporate net income tax requires a complex set of income sourcing and tax base apportionment rules, especially for multinational firms. When as in Kosovo a value added tax is imposed as a tax on the "destination" of where a product or service is consumed (as all European Union value added taxes are), one must deal with issues such as the implementation of the border-control rules that accompany VAT administration.[2]

Other tax designs best left "off the local tax table" include those intended to add a significant degree of vertical equity in the overall national tax system; e.g., a progressive income tax. The danger here is that if a local government were to seriously pursue a policy to redistribute after-tax income from rich to poor, over time the rich may move out of that jurisdiction with the result that everyone in the "progressive" locality will be poor. This is by no means an argument against local use of a tax on personal income (or, some variant, such as wages); rather, the point is that using the tax system to redistribute income (or wealth) is something a central government should take on so as to minimize the unintended consequence of inducing people to change residential locations.

The taxation of natural resources presents a special case. Since natural resources (e.g., nickel, copper) are completely location-specific, they satisfy the tax base immobility guideline. However, other considerations argue for national taxation. There are three. First, natural resources revenues are notoriously volatile, thereby making it just the wrong revenue to rely upon for local government that must have tax certainty to pay for the "necessary" local public goods such as water distribution, heath clinics, and preschool and primary education. Second, because the local government cannot take on debt to the extent that the center can, a locality is not in a position to deficit finance once there is a downturn in global prices of the natural resources and revenues plummet. Third, the equity argument against local taxation of natural resources is a powerful one. Since natural resources are typically unevenly distributed across regions, assigning natural resources to local governments would generate subnational differences in fiscal capacities among jurisdictions. The two cases for some special local taxation of natural resources arise to cover the costs of (i) local environmental degradation and (ii) off-site local infrastructure costs incurred as a result of a mining operation. However, these two circumstances do not change the fundamental national character of a tax on natural resources.

2 In large countries and federations, some "intermediate" governments such as provinces, oblasts, and states do have the administrative capacity to utilize such taxes (Bird 1999).

What Are the Criteria for Selecting One Local Tax Option Over Another?

The next policy questions that arise are (i) among the set of conventional taxes, which make "local revenue sense?" and, of that set, (ii) how does one judge which ones are better than others? Here, there are two responses. The answer to the first question is to identify the jurisdiction's "fiscal (tax) architecture" (see note on Fiscal Architecture). The second response is that given the revenue options consistent with the fiscal architecture, there then can be applied normative criteria for selecting one revenue source over another. Table 1 below presents six generally agreed-on criteria that are accompanied by a checklist of which revenue sources satisfy the objectives laid out. Two points are apparent. First, in selecting or modifying one tax or set of taxes, it is inevitable that trade-offs must be made among the criteria. No one revenue tool meets all the objectives of a "good" tax, and some taxes may satisfy one criterion and violate another. Second, for a subnational revenue system to work well, it is desirable to use a mix of taxes. All revenue sources have inherent structural inequalities, and if any one revenue source is used too intensively those defects can become intolerable. That calls for using a mix of taxes (for a given yield, lower rates), as well as for fostering broad-based sources of taxation.

Table 1. Criteria for Making Subnational Tax Choices

Criteria/Objective	Comment	Taxes that Satisfy the Objective	…And Those that Fail
Accountability: Local policymakers responsive to citizen preferences. Those taxed have political redress.	Local officials determine "own" tax rates; tax burdens borne locally; transparency.	Local Personal Income Taxes (may conform to higher level tax base with rate set locally). User Charges	General Business taxes Visitor (tourist) Natural resource taxes (petroleum, minerals)
Revenue Productivity: Taxes that help promote the EU Charter (Art. 9) call for financial resources commensurate with spending responsibilities.	As a system, recognizes a balance between bases responsive to changes in economic conditions, growth (elasticity or buoyancy) and stability (certainty).	Ad valorem property tax (distinguish between land and improvements) & or Area-base property tax Personal Income Tax General Broad Based Business Tax (e.g., gross receipts/turnover) Single stage sales taxes Some market excise taxes	Corporate profits, natural resources (both highly volatile) Many user charges
Tax Price: To extent possible taxes should function as a payment for the flow of services that accrue to the taxpayer/citizen.	Taxes set to perform a *quid pro quo* function and may be tailored to local and regional variations and benefit areas. Service spillovers (whether positive or negative) may call for special purpose districts and/or inter-local cooperation and revenue harmonization.	User fees and charges; Visitor taxes Moderate tax rates on business enterprises (generalized benefits; e.g., gross receipts)	Non-resident based income tax (assumes non-residents are subject to alternative taxes for services received: e.g., user charges, sales taxes, visitor taxes, general business tax)

Table 1. Criteria for Making Subnational Tax Choices (continued)

Criteria/Objective	Comment	Taxes that Satisfy the Objective	…And Those that Fail
Non-Distortion: taxes should not unintentionally interfere with private decisions of consumers, factor suppliers and producers; they should be "neutral."	Variability in tax rates possible; Immobile tax bases work well here as do taxes on commodities that exhibit a relatively high inelasticity of demand. Providing for taxpayer certainty in making tax rate and base policy is desirable.	Taxes on immoveable property Land value tax plus charges User Charges Resident based Personal Income Sumptuary Taxes Taxation of "bads" Poll and communal taxes	Non-resident based income tax Gross receipts taxes Severance Taxes (if high rate)
Tax Equity: Tax burden should be reasonable and fair	Vertical equity (differential treatment unequal as usually measured by income or wealth—"gressivity"); Horizontal (equal treatment of those in equal circumstances as measured by income, consumption, or wealth).	Progressive Resident Personal Income Taxes Ad valorem property taxes Some local sales taxes; excises	Poll and communal taxes Area-based property taxes Gross receipts taxes
Simplicity: administration & compliance.	Citizens should be able to understand and control the system; cash flow preferable to accruals; standardized tax bases.	Piggyback Personal income Single stage sales and excise (market tax) Wage taxes Turnover/receipts taxes Some user charges Market taxes	Multi-rate taxes Potentially broad based taxes narrowed by exemptions, deductions & tax preferences Property tax

Source: Ebel and Taliercio 2005.

From Revenue Assignment to Revenue Mobilization and Administration

Getting revenue assignment "right" is a most important first step—but it is only the first step. The next task is to move from concept to implementation; that is, from intergovernmental assignment to revenue mobilization and administration.

Revenue Mobilization

In the aggregate Kosovo's public finances fit within the range of the region's ratio of government spending to GDP. Kosovo's ratio of 39.5% is the same as the Former Yugoslav Republic of Macedonia, about the same as Bulgaria (37.1%), above that of Romania (33.1%) and Albania (25.3%), and below Bosnia and Herzegovina (50.3%) and Croatia (47.2%) (World Bank 2006)[3]. This spending is being paid for largely by domestic tax and non-tax revenues (estimated at 28.1% and 4.1% of GDP in 2004, respectively), and interest income and other fees.

What is of concern is that a close look at the composition of the revenue stream reveals: not only are nearly 70% of total Kosovo own revenues generated by taxes on international transactions (a typical number for the region is in the 3–5% range), but also the contribution of municipal revenues to total government revenue (4%) is quite small (placing Kosovo at the low end of the 5% to 22% range for the region).[4] This central/provincial reliance on border taxes is unsustainable in an era of globalization and reduction of trading barriers; so the "center"—particularly if Kosovo is to achieve independence as a nation—must focus both on making a heavier reliance on the more conventional national revenue sources (refer back to Table 1) and on providing the fiscal space for local governments to carry a larger share of the total cost of paying for public services (which, in turn, requires a serious effort at expenditure and revenue decentralization).

In this context, the present Kosovo municipal revenue system needs attention—and will even more so if, as is contemplated by the Provisional Institutions of Self-Government in Kosovo (PISG), a second tier of subnational (local) government is introduced. Of € 26.5 million of estimated "own" revenues in Fiscal Year 2005, about three fourths is derived from a set of narrowly based fees and licenses and the other fourth from the broader based property tax on houses.[5] The policy questions that arise are whether this is the right mix of narrow and broad based tax reliance, or are there other revenue sources that can be mobilized in a manner that can both (i) further the goals of resource efficiency (refer back to the introduction of this note) and (ii) take some of the pressure off the central government to use its revenues to support municipal services through the grant system.
In order to embark on a program of intergovernmental revenue (tax) reform for the new Kosovo,

3 The data are for 2002; however, the estimated ratio for Kosovo in 2004 is also 39.5% (World Bank 2006, data are preliminary).

4 But these regional comparison numbers must be used with great care and caution as they are taken from the International Monetary Fund's Government Finance Statistics (GFS), which, though the only available consistent source of such country revenue comparisons, is recognized (by the IMF as well) as being a data overstatement. For a discussion, see Ebel and Yilmaz 2003. The numbers reported here are from World Bank 2004.

5 For which a low compliance rate is reported (UNDP May 2006).

there is what one can call a "way of thinking" about how to organize the reform dialogue and reform process:

determine revenue assignment and normative framework → tax principles→
fiscal (tax) architecture →
country starting point → analysis of the "own" source revenue options (including a local willingness to pay for public services) → implementation and administration[6]

Revenue Administration

As noted, the above tax policy sequence is a way of thinking logically about how to go about the job of improving local resource mobilization—which is to say, the sequence is not a rigid sequence. So, as the process begins, it is not too early to be simultaneously thinking about the question of which government, central or subnational (e.g., municipal) should administer the subnational revenue system.

There is no consensus on the principles of devolved administration. Local governments need not, in theory, have direct control over all tax administration functions as long as local governments are in control of how those functions are administered. There is an argument that collection authority should be devolved to the government with the lowest collection and enforcement costs; however, that recommendation ignores the intergovernmental perspective that overall administrative and compliance costs for the entire national and subnational system should be considered when designing the level of administrative devolution (Mikesell 2002). Revisiting the definition of own source revenues, one could make the case at the extreme that, because there are functions of tax administration that effectively control marginal revenues, control over some aspects of tax administration must be part of the definition of an own source revenue.

Suffice it to say that there are several options that would guarantee local autonomy while improving efficiency. Four traditional models for tax administration in decentralized policies may be identified: (a) central government tax administration with sharing of revenues; (b) central government tax administration with assignment of taxing powers to different levels of government; (c) multi-level administration with revenue sharing; and (d) self-administration by each level of government (Vehorn and Ahmad 1997). For all four approaches, there are two cross-cutting dimensions of administration: contracting out to the private sector (also known as "tax farming") and the extent to which national and subnational authorities cooperate through intergovernmental agreements such as tax compacts, exchange of information, cooperative taxpayer assistance, and collaborative training (Duncan and McLure Jr. 2005).

6 And there often is a citizen "willingness to pay." See Gulyani 2005 and UNDP May 2006 (p.46–47) discussion of the property tax.

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11.
Intergovernmental Transfers

Robert D. Ebel
and
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Contents

Intergovernmental Transfers

Payments made from one type of government to another in order to address fiscal imbalances that are inherent in a system of fiscal decentralization.

Once Kosovar policymakers sort out expenditure roles and responsibilities for the different types of government and the revenue authority to be assigned to each, all but the richest subnational governments will almost surely experience a fiscal imbalance. The imbalance occurs as the Euro sum of a "well-designed" expenditure assignment exceeds the "own" source revenues that can be generated within the system of revenue assignment. Such imbalances are not the result of poor management by local officials (though that can certainly contribute to the problem), but rather the reality is that there is no *a priori* reason to expect a Euro equality between expenditure and revenue assignments, which are driven by very different factors of demographic, economic, and institutional trends.

Two types of fiscal imbalances will occur (Bird and Tarasov 2002). The first is a *vertical* imbalance between expenditures and revenues among different types of government. As a practical matter, in almost every case,[1] this vertical imbalance reflects the fiscal reality that central governments have control of the nation's most productive tax bases and are therefore in a position to capture most of a country's tax capacity, while a country's "allocation branch" expenditure responsibilities fall largely on local governments (see briefing note on Expenditure Assignment).[2] The second type of imbalance is a *horizontal* imbalance which occurs when the differences in expenditure needs and revenue-generating ability vary across similar types of subnational governments, as some jurisdictions are more tax-base rich and/or less need impacted than others.

Thus is the case made for intergovernmental transfers in the form of fiscal flows between types of governments. In practice, these flows almost always move from "higher" to "lower" tiers of government.

As with any fiscal policy, intergovernmental transfer systems differ in quality of their design. If designed poorly, the system will not only fail to address imbalances, but will create additional problems. One such problem is what economists refer to as a "soft budget constraint," whereby central and subnational governments engage in negotiating ad hoc "gap-filling" spending at the end of a fiscal year—a practice that overtime will cause subnational governments to become permanently transfer-dependent and will undercut the political and fiscal accountability link between policymakers and the citizenry. However, if done well, a transfer system can not only enhance the overall efficiency of the public sector and ensure that even the poorest of local jurisdictions are able to finance a minimum standard of services, but can also serve as "fiscal glue" for national cohesion through intergovernmental partnership.

1 In some petroleum producing nations, it is the provincial government that may garner much of the tax wealth (Davis, Ossowski, and Fedelino 2003) .

2 This discussion is presented largely in terms of the relationship between the central government and its subnational (e.g., provincial, municipal) units. However, the same principles apply to the provincial-municipal fiscal relationship.

Objectives of Intergovernmental Transfers

The term *transfers* refers to a number of different kinds of public financing instruments: grants, shared revenues, subsidies and subventions are but a few (Bahl 1999; UNDP 2006). Well-designed transfers typically have three basic objectives:

- providing incentives for efficient spending and utilization of the municipal revenue base;
- guaranteeing sufficient funds for managing local functions; and/or
- supporting regional equalization of communities.

The above objectives and their intended impact on local expenditures and revenues are summarized in Table 1 below.

Table 1. Objectives, Methods and Incentives of Intergovernmental Fiscal Transfers

	Interplay with the Expenditure and the Revenue sides of the Local Budget	
	Expenditure	*Revenue*
1. Providing incentives to localities	(i) Promote efficiency in local service provision; (ii) stimulate local spending on public goods having positive externalities.	Promote (or at least not discourage) own source revenue-raising "tax effort."
2. Guarantee a minimum level of services (for *different* types of local governments)	(i) Transfers that are conditional on promoting certain types of spending (e.g., pro-poor, growth enabling); (ii) ensure citizen access to basic services (e.g., education, housing, safety net); (iii) recognizing objective differences in unit costs of producing a public service (e.g., geographic isolation).	Grants for equalizing differences in local revenue-raising potential.
3. Horizontal equalization	Grants designed to recognize both the (objectively measured) variations in expenditure needs (e.g., for a given quality of public service as measured by "workload" factors such as number of children of school age, poverty levels) and unequal distribution of revenue bases.	

Factors Influencing the Structure and Amounts of Transfer

Decisions on the level and distribution of grants are political; however it is also true that the organization of an intergovernmental system has an influence on these decisions (a feature that serves to once again illustrate the partnership character and fiscal interplay of a well-designed system of fiscal decentralized governance). There are three such structural factors that will influence the structure and level of transfers.

The first factor is the *type of functions* assigned to general purpose local governments. The broader the set of functions of a generalized benefit nature, the more likely considerations such as the cost of ensuring a citizen access to an agreed upon (most likely donor-government determined) minimum level of services will arise. However, if a locality has a narrower set of functions that happen to be in the form of a flow of specific benefits (e.g., utility services), for which costs can be largely recovered through direct user charges, then the need for broad-based grant finance may be reduced.

The *size of local government* may also influence the amount of a transfer. Thus, in post-socialist Central and Eastern Europe, a problem that arose in some countries (e.g., Hungary) was what became known as the "fragmentation" problem of too many small governments (e.g., in the early 1990s, Hungary, a country of 10 million, created 3,148 municipalities with an average population of 2,600 residents, whereas Poland, a country of 39 million, created 2,948 or 20 percent fewer municipalities, with an average population of 16,000).[3] In Hungary's case, the problem is that some governments are simply too small to efficiently provide all the public services that have been (theoretically) assigned to them. In contrast, the larger Polish municipalities are better able to capture larger portions of the local tax base. Fragmentation may place government closer to the people, but it also complicates intergovernmental relations, particularly with respect to intergovernmental transfers (see the related briefing note on Large City Administration).

A third factor (closely related to the fragmentation problem) is the *number of subnational government tiers* and their relationship. With the elimination of (or at least the power-stripping of) intermediate governments in favor of a system characterized by a large number of general purpose local governments, it can be very difficult for the central authority to maintain direct bilateral relationships with the many units. Not only is this inefficient, but it can also lead to unintended political outcomes, as extensive fragmentation may reduce the political voice of local governments as a whole. There are solutions, however. One is to reform and/or reestablish the intermediate tier and empower that tier to become the conduit for national-to-municipal grants (e.g., the Romanian *judet* and the Pakistani province).[4] Another model is the municipal federation in the Nordic countries whereby localities organize on a voluntary basis to provide certain local services such as transportation for commuters, planning and education. A third solution is joint service delivery/special government (see briefing notes on Service Delivery). Each of these arrangements has the potential to make more efficient both the spending and revenue-generating sides of the subnational budget, thereby reducing the need for transfer reliance.

The Two Steps in Grant Design

Given the above set of considerations, the focus of the remainder of this essay is on the design of intergovernmental grants. There are two steps to the designing of grants. First, the amount of the grant must be determined; that is, the total amount to be transferred amongst the subnational governments must be determined. This is referred to as determining the "distributable pool." The second step is that of determining how the pool shall then be distributed between the different subnational governments.

3 The reason for this fragmentation was quite understandable as Hungarians (as well as most early post-socialist countries) associated the intermediate tier with the former control economy, and so there was a political imperative to eliminate it (Bird, Ebel, Wallich 2005).

4 The related topic of the institutional systems for managing grant systems (e.g., grants commissions) is not discussed here. See Yilmaz and Bindebir 2003 and Martinez-Vazquez and Searle 2006.

Determining the Distributable Pool

There are three ways to determine the *total amount* to be transferred: (1) as a fixed share of national government revenues; (2) as part of the annual budget decision; (3) as a proportion of approved specific local expenditures to be reimbursed. A stable transfer system promotes good planning and efficient service delivery effort, which further encourages recipient governments to follow good budgeting practices and face hard budget constraints (Ahmad 1997, Yilmaz and Bindebir 2003).

Establishing a fixed percentage of total national revenues to be transferred is the best way of providing some degree of stability and transparency. However, some governments prefer to decide the total amount in the distributable pool in accordance with budgetary priorities as part of the annual budget decision. With this system, the central government exercises a significant amount of control over subnational governments and determination of the pool becomes an ad hoc exercise. Furthermore, in the event of a national recession or decrease in central revenues, subnational governments will face big revenue cuts.

There are various methods for determining the distributable pool where reimbursement of certain expenditure items (cost reimbursement) is opted for. This third type of transfer system is always closed-ended[5] because the central government decides what kind of expenditure items are eligible for reimbursement. Consequently, in such cost reimbursement type of transfer schemes, the decisions tend to be ad hoc (Table A-2).

Distribution of the Pool among Subnational Governments

There are three basic models for allocating the total amount of transfers from national to local government budgets. These methods generate different types of incentives for local governments (see Table 2):

- *Gap-filling model*: the grant for a municipality is equal to the difference between estimated level of expenditure and the planned local revenues, thus (E-R=G). The resulting incentive is for continued transfer dependence and reduced accountability of local officials for their spending and taxing decisions.

- *Local government respects hard budget constraint*: whereby government spending is equal to the sum of own source revenues and grants made available for the locality, (R+G=E). Here the incentive could be for increased revenue effort and/or spending discipline (depending in part on donor-determined size of the grant). Of course localities may lobby separately and/or collectively with respect to the size of the distributable pool (grant level).

- *Fiscal capacity based methods*: a formula-based grant is made to each recipient government based on a calculated estimate of the difference between the summed amount of a (nationally) standardized set of expenditure functions and the recipient governments ability to mobilize own source revenues from a (nationally) standardized set of revenue bases. ($E_{\text{estimated needs}}$-$R_{\text{potential}}$ =$G_{\text{calculated,}}$).[6]

5 A *closed-ended* grant places a limit on the total amount of grant funds. In contrast, an *open-ended* grant provides grant funds (entitlements) as long as certain conditions for distribution are met by the recipient government. See Table A-1.

6 Measuring fiscal capacity requires constructing an estimate for revenues and expenditures that each subnational unit would have

Table 2. Alternative Methods of Grant Allocation

Types of transfers	Expenditure	Revenue	Transfers
1. Gap-Filling	Individual decision on appropriations ($EI_{estimate}$)	Individual revenue assessment ($RI_{planned}$)	Individual bargaining ($EI_{estimate}$-$RI_{planned}$)
2. General Grant influences the tightness of the Budget Constraint	Local decision on expenditure levels (E=R+G)	Local authority to generate revenue (R)	General grant (G) determined by the donor government; distinct from gap-filling since the donor controls the transfer amount at the outset and (presumably) does not negotiate local deficit situations.
3. Fiscal Capacity	Accepted expenditure levels based on objective (policy neutral) measures of "needs" ($E_{estimated}$)	Potential revenue at standardized revenue bases subject to nationally average tax rates and revenue charges. ($R_{required}$)	Calculated grant ($G_{calculated}$=$E_{estiamted\ needs}$-$R_{potential}$)

The gap-filling model is the *most centralizing* form of grant allocation, where both municipal budget expenditure for particular services and total local government revenue, including own source revenue, are estimated for each local government. Transfers are then calculated as the difference between these individual levels of municipal expenditure and total anticipated revenue. This method, which characterized the intergovernmental fiscal arrangements under Communism, led to the "soft budget constraint" system of unaccountable (to citizens) transfer-dependent local governments—an outcome that some argue was one of the most serious of Communism's fiscal flaws (Kornai 1986). Under gap-filling arrangements, there is little or no incentive to raise own source revenues, because transfers are automatically decreased by the amount of any surplus above the planned own revenue appropriations. As of today, most of the post-socialist CEE countries have tried to abandon gap-filling although others have attempted instead to refine the approach by standardizing the expenditure side of the formula (e.g., Bulgaria, Slovenia).

The second model, used for calculating *general grants*, provides greater autonomy in deciding municipal expenditure and creates incentives for own source revenue-raising. Under this model the national budget grants are calculated by formulae and carry with them a high degree of userfiscal flexibility and autonomy (see Table A-1). Methods used for distributing general grants include population size, and number of users of municipal services (e.g., students, elderly in health care facilities, welfare assistance).[7] This approach is widely used in the Czech Republic, Hungary, and

recorded had it followed tax and expenditure policies that prevail across the nation. This estimate is to be designed independent of its current tax and expenditure policies (Yilmaz and Bindebir 2003).

7 Note that benchmarks such as students, elderly in health facilities, and number of hospital beds give numbers that reflect a government's policy decisions and, thus, are not "policy neutral." In contrast, alternative "workload" measures such as the number of children of school age, number of elderly in the population, and poverty tend to be more policy neutral and therefore serve as "objective" measures of spending need.

Poland, with the complexity of the allocation formulae marking the difference between the systems in the three countries.

Finally, the most "policy neutral" model for grant allocation is built on the *difference* between expenditure *needs* and own source revenue *capacity*. This method calculates local expenditure through formulae, and at the same time, takes into account standardized estimates of potential revenues that a subnational government could mobilize if it applied average national tax rates (and revenue charges) to its available revenue bases. Consequently, methods of transfer serve equalization purposes (municipalities with low revenue potential and/or higher expenditure needs receive higher grants) without destroying local incentives for own source revenue efforts (local governments get no compensation for uncollected revenue below the average level, and the surplus in own revenue does not automatically decrease the transfers). In Central and Eastern Europe (CEE) only Hungary and Poland have tried to standardize the *revenue* side of the grant allocation formula. There has been little work to set up standardized measures for both revenues and expenditures (but it is certainly possible, see Table A-3).

Final Comment: Need for Reliable Information

The complex grant allocation formulae require proper statistical and fiscal information; otherwise there would be no way to ensure objectivity in grant allocation. Detailed data is needed for measuring outputs and the capacity of service organizations in a timely manner. This information is not always available at the early stages of annual budgeting, in which case fiscal planning is necessarily based on estimates and projections.

Appendix

Table A-1. Taxonomy of Intergovernmental Grants

	Conditional, Open-Ended, Matching	**Conditional, Closed-Ended**	**Non-Matching**	**Unconditional**
Description	For every Euro the subnational government (SNG) receives, the recipient must spend some own funds in order to receive the grant. With an "open-ended" grant there is no cap on amount of funds. Thus, the cost of the grant depends on recipient behavior.	Conditional grant but with a ceiling on the cost.	The center transfers a fixed sum of money with the only stipulation that it be spent on a specified activity. There is no percentage share requirement ("match") placed on the SNG.	Provided for equalization purposes or basic functional areas (e.g., the decision to give governorates some flexibility in investment fund spending).
Purpose of Grant	Encourage spending on production of good or service having positive social and/or interjurisdictional externalities.	Same as open-ended.	Restriction on its use differentiates it from unconditional grant.	Increases overall capacity to spend. May have specific equalization goal (horizontal imbalance) and/or be a way to correct vertical imbalance.
Illustration	There is no cut off (or cap) on the amount of funds received as long as the SNG meets the need conditions for receiving the transfer. Thus, this type of grant becomes an "entitlement." Grants for housing for the poor, access to education, and the safety net are often structured in this manner.	Most categorical grants (environmental management, housing, substance abuse treatment) have some limit on donor cost (close-ended).	Community development, job training, transportation, capital/operating assistance.	An equalization grant is designed to address horizontal imbalance of recipient. Sector "block" grants have a designated purpose, broadly defined.

Table A-1. Taxonomy of Intergovernmental Grants (continued)

	Conditional, Open-Ended, Matching	Conditional, Closed-Ended	Non-Matching	Unconditional
Effect on Governmental Spending	The center determines the amount of spending.	Effect on Spending is shared by donor and recipient (but this all ends when cap is reached). The cap (total Euro limit to be spent) is a way the center can control its own budget. That is, at some point the SNG is no longer entitled to the grant.	Donor gives recipient a fixed amount of a grant with stipulation on its use. If the community wanted to consume less of the public good then the grant condition affects behavior. Otherwise this looks like an unconditional grant.	The donor will cap the amount of the grant. As long as the community wants to consume at least an amount of the public good equal to the amount of the grant, then the fact that the grant is conditional or unconditional is irrelevant.
Fungibility	Fungibility means that money can be used for more than a designated purpose; or it "frees up" other funds that would be used for a restricted purpose for other uses, including tax reduction.	Yes	Yes	Yes
Degree of Fiscal Autonomy	Moderate	Low	High—similar in effect to an unrestricted grant.	High

Source: Robert Ebel and Adrian Ionescu, Central European University, Masters of Public Policy Course (2005).

Table A-2. Determination of the Distributable Pool in Selected Countries

Country	Sources of Funds for Transfers	Description
Turkey	**Fixed share of national revenues** 6 percent of national tax revenues	Central government provides additional support for certain projects in the form of cost reimbursement from different funds; such as Local Authorities Fund, Municipalities Fund, Traffic Services Development Fund, Tourism Development Fund.
Jordan	**Fixed share of national revenues** 6 percent of fuel tax	The "fuel tax" refers to a pool of shared taxes set aside to help finance local governments. Revenue in the pool is drawn from an earmarked portion of customs duties, vehicle licenses, excise taxes on fuel products, and traffic violation fines.
Colombia	**Fixed share of national revenues** 24.5 percent of national revenues to departmental governments (second tier); 22 percent of national revenues to municipal governments (third tier).	There are three components of the transfer system: the situado fiscal (SF), the participaciones municipals (PM) and the sistema nacional de cofinanciacion (SNC). The SF consists of 24.5 percent of national current revenues; it is transferred to departments to finance education and health expenditures. The PM consists of a percentage of national current revenues, increasing annually to a scheduled maximum of 22 percent; it is transferred to municipalities for "social investments." The SNC finances specified subnational projects on a matching basis.
Japan	**Fixed share of national revenues** LAT: Fixed percentages of 5 taxes	The main source of transfer pool is local allocation tax (LAT)—an unconditional transfer system that is a tax-sharing arrangement. LAT is distributed according to a uniform formula based on basic financial need and basic financial capacity of subnational governments. It is paid annually to subnational governments and varies across them inversely with their local fiscal capacity. LAT is not a traditional transfer but a shared-tax system that is similar to surtax on the national income tax base. Approximately 60 percent of prefectural and 40 percent of municipal tax revenues are from the LAT.
Belgium	**Fixed share of national revenues**	• The full proceeds of radio-television fee collected by the federal government; • A share of personal income tax (apportioned according to a historic break down of the amounts and indexed according to the GNP); • A share of VAT
Spain	**Fixed share of national revenues**	The major unconditional transfer source is the central government's general revenues and PIT collected in each subnational government jurisdiction.
United States	**Annual Budget/ Cost Reimbursement**	There are more than 600 different federal transfer programs to state and local governments, most of which are conditional transfers. The largest portion of the amounts of federal transfers is used to fund healthcare programs administered by the states.

Source: Serdar Yilmaz and Serap Bindebir 2003.

Table A-3. Equalization and Intergovernmental Transfers, Selected Countries

Indonesian transfers are designed to empower district governments: The equalization grant pool, the dana alokasi unum (DAU), is a fixed percent (25%) of central resources (in practice, budgeted rather than actual resources) after tax sharing with the regions. The central government distributes the pool on a formula that takes into account both revenue capacity and expenditure needs. Revenue capacity is estimated as standardized own revenues plus tax sharing receipts plus 75% of share of natural resource receipts. Expenditure needs reflect population, poverty rate, land area, and a construction cost index. Recognizing that the district is the primary unit of decentralized service delivery, 90% of the grant goes to districts, and 10% to provinces. The grant finances 70% of total district spending and 50% of provincial expenditure. There is also a new earmarked grant system (DAK, accounts for only 3% of total grants) that builds in some equalization. Regions with low fiscal capacity pay only 10% in matching funds whereby those with high fiscal capacity pay up to a 50% match.
China is ever so slowly experimenting with a "robin hood" system of using a transfer system to channel funds from its relatively rich, largely Eastern and costal provinces to its poor Western region. The Peoples Republic relies largely on earmarked grants, which account for 95% of all grants, two-thirds of which consist of revenue sharing on a derivation basis (similar to Egypt). Thus there is no equalizing element. A small equalization grant does exist (3% of total grants). The pool is determined annually during budget preparation (thus ad hoc, uncertain); however it is formula based, derived from regression analysis of a "standard budget" and relies on variables such as provincial GDP, student-teacher ratios, number of civil servants and population density.
The Philippines provides an example of a multi-SNG distribution of the transfer pool. Under the Local Government Code (LGU), local governments receive a fixed share of central tax revenues through the Internal Revenue Allotment (IRA). The pool is equal to 40% of average internal tax collections three years prior. The IRA pool is first divided among types of SNGs: provinces (23%), cities (23%), municipalities (34%), and barangays (20%). The distribution formula allocates based on pollution (50%); land area (25%), and sharing across provinces.
Hungary, like many regimes of the Soviet sphere, has systematically moved from revenue sharing to equalization grants. The typical Soviet sphere socialist country of Central and Eastern Europe was not dissimilar to current-day Egypt in that it financed local administration through a combination of tax sharing on a derivation basis and an intergovernmental formula grant designed to fund the expenditure capacity (not needs) requirements of centrally set, socialist, service delivery "normatives." At first (1991) 100% of the centrally levied and administered personal income tax was returned to municipalities on a derivation basis. Over the decade Hungary systematically reduced that percent from 100% to 50% to 35% to, presently, 5%. And, in doing so, also systematically moved these central funds into an intergovernmental grant pool to be distributed according to needs. The result: from derivation to equalization.
Canada equalizes on the basis of potential revenue capacity of its provinces. The goal of the Canadian system is to equalize tax bases. To accomplish this, the central government calculates a per capita provincial standard tax rate and applies that to the potential tax base of each province (the standard rate is the average per capita tax base of five middle income provinces). The central government then calculates the revenues that would result from applying the (implicit) "average" tax rate to each province. The center then calculates two numbers: the amount of tax revenues that a province would generate if it received own revenues equal to the average per capita tax collection of the five provinces, and the potential yield it can generate by applying the five-provincial average tax rate to its actual base (a "representative" yield). The amount of the transfer is then based on the difference of the two numbers. Note that because for a poor province the lower number is based on potential revenue, the transfer is neutral with respect to actual tax effort. That is, a poor province is not penalized if it makes an actual per capita "tax effort" greater than its "representative" potential tax effort. The Canadian transfer pool is funded from general tax revenues.

Table A-3. Equalization and Intergovernmental Transfers, Selected Countries (continued)

	Australia is designed to measure relative "fiscal capacity"—the relationship between equalized tax revenues and representative (equalized) spending needs. The distributive pool is broadly defined for central taxes (personal income, corporate net income, value added, and excises). Then, formula is a three-step calculation: First, the revenue capacity of each state is calculated in a manner similar to Canada's method. This give a measure of the ability of each state to generate so many Aus. dollar revenues from a "representative" tax base multiplied by statewide average tax rate ("representative tax rate"). A similar "representative' method is applied to estimate expenditure needs on a state-by-state basis. Expenditure needs are calculated on the basis of separate sets of indicators for each of 41 expenditure categories assigned to subnational governments (e.g., medical services are based on population adjusted for age and sex, health on infant mortality). Each of these indicators is assigned a weight, which is then used to aggregate the relative expenditure needs of each state. The indictor of expenditure needs less the indicator of revenue raising capacity determines the relative expenditure gap of each jurisdiction.

Source: Amin and Ebel 2006; Dillinger 2005, Yilmaz and Bindebir 2003; Bird and Tarasov 2002.

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12.
Local Borrowing and Municipal Debt

Paweł Swianiewicz

Contents

Local Borrowing and Municiptal Debt

Using "other peoples' money" to finance capital expenditures for development.

There are several recurrent policy issues within the context of designing an intergovernmental fiscal system. One such issue for newly decentralizing countries is whether a subnational government (e.g., province, municipality) should be allowed to take on debt. A typical argument against borrowing is that the subnational unit does not have the institutional and administrative "capacity" to manage debt. This argument presents often a paternalist attitude towards local governments (with a doubtful assumption that capacity of central level bureaucracy in transition countries is usually higher than in case of local administrations) and in practice it is often used as an excuse to block fiscal decentralization. It should be noticed however, that the issue of local capacity to manage debt policy may become more salient in countries with territorially fragmented systems, in which there are plentiful very small subnational units (see essay on Territorial Organization). A second argument, and one that had particular merit for some countries in the early days (the 1990s) when countries were making the transition from heavy socialist centralization to decentralization, was that the "transition" country had inherited a precarious macroeconomic situation (Bird, Ebel, Wallich 1995).

But for a country to develop, a good case can be made for permitting subnational governments to borrow as long as the "golden rule" of debt finance is followed: that subnational governments borrow only for financing capital (investment) expenditures such as those for infrastructure improvements, which provide a flow of benefits over time.[1] When this rule is followed, borrowing then not only becomes a viable alternative to other sources of financing (e.g., so-called pay-as-you-go schemes, whereby only current revenues are used to pay for capital investments), but, in fact, becomes a tool for the achievement of the goals of fiscal equity and efficiency. Indeed, borrowing—using "other peoples' money"—provides fiscal space for economic development planning. Thus, one observes that in developed economies of the world, local governments have developed a range of borrowing strategies and tools—strategies and tools, it must be noted, that are often accompanied by some rules-based mechanisms for fiscal discipline (see briefing note "Subnational Fiscal Autonomy").

The Arguments for Borrowing

The main arguments for using borrowed money for capital projects may be summarized as follows:

- *Efficiency*. Because capital (investment) expenditures provide a flow of current benefits over time (the life of the project), it is efficient to spread the capital cost recovery process over that same time period.

- *Equity*. Equity or fiscal "fairness" is enhanced by spreading out the payment of the capital

1 The one exception to this rule is the use of short-term loans to address temporary cash-flow problems; but such loans should be repaid during the same budget year

costs over successive generations that benefit from the subsequent year-to-year flow of services.

- *Timing*. Borrowing allows for faster implementation of projects and benefits deriving from investments can be enjoyed earlier. Indeed, in some cases earlier completion of a project may generate additional revenues or reduce current expenditures (e.g., new, more efficient lighting or heating systems). Moreover, faster implementation often reduces the total cost of an investment project.

- *Practicality*. Borrowing often enables use of external grants that require pre-financing.

- *Politics*. Recognizing the merits of these first four arguments, it is to be noted that the ability of local governments to borrow is one of the tenets of the European Charter of Local Self-Government, which in article 9, calls for the right to borrow by subnational entities in order to finance investment projects.

Clearly, borrowing does not increase the pool of financial resources ("servicing the debt" by a schedule of repayment of principal and interest is required); rather what it does is change the timing of the financial resources. It also raises the question of borrowing limits, which help to (i) assure that debt does not exceed a level which cannot be repaid and (ii) minimize the risk of not being able to service a debt, a circumstance that if widespread could lead to macro-economic instability (see further discussion below). However, as European practice suggests, subnational debt usually constitutes only a very small fraction of the total public debt, and its macroeconomic consequences are negligible (Swianiewicz 2004). Indeed, there is an emerging body of evidence that suggests that a well-designed system of fiscal decentralization enhances macro-stability and growth (see briefing note "Subnational Fiscal Autonomy").

Forms of Borrowing

Borrowing by subnational governments takes several forms, with the practices of various countries representing different models (King 1984). The focus of this essay is on long-term borrowing, i.e. going beyond the current budget year.

- **Intergovernmental loans**. In some countries, especially those in Eastern Europe, there is an arrangement where an upper tier government's budgets may provide loans for lower tier governments. Many analyses suggest that this form is rarely effective in promoting optimal use of borrowed funds. Within this arrangement decisions relating to loans are often made on the basis of political rather than economic criteria, and the administration is not prepared to assess the risk and feasibility of financed projects. In some countries intergovernmental loans are used to support local governments with excessive indebtedness (that have problems servicing their debt). Such a solution may produce a "moral hazard" problem, encouraging both lenders and financial institutions to underestimate the risk related to borrowing.

- **Special credit lines or special funds offering preferential loans**. It is quite common to offer special credit lines to local governments; for example, for investments that support environmental protection. Due to the ability to secure lower interest rates, such loans are often cheaper than commercial loans. In some countries there are special environmental protection funds that subsidize loans by drawing on own revenues from fees and fines imposed for polluting the environment. And, in several European countries there has been a trend to establish special financial institutions that focus predominantly or exclusively on financing local government investments. Establishment of communal banks is one available option. However, the experience in many cases has been that these institutions, which lend predominately to local governments, often do not support optimal credit decisions; and, thus, the recent trend in several West European countries has been to withdraw from such special programs and rely instead on the commercial credit market. On the other hand, the experience of some East European counties has been that special environment funds have played a clearly positive role in promoting desired investments as well as serving as a tool for teaching local governments the basic rules related to behavior on the capital market (Swianiewicz 2004).

- **Commercial bank credit**. Credit from commercial banks is probably the most popular way of subnational borrowing in Europe. In many countries banks are very keen to lend money to subnational governments, since they judge the risk of the lending to be very low. Indeed, there is often competition among different banks that offer products and services to local governments.

- **Municipal bonds.** Borrowing from the private capital markets—the "municipal bond market"—is common practice in some non-European countries, such as the United States, Canada and Australia.[2] It is also promoted through some technical assistance programs, such as those funded by United States Agency for International Development and the World Bank. The practice is now becoming more frequent in Europe, although due to constant costs related to the issue, they tend to be largely utilized by regions and big cities rather than by small local governments. For large issues, the cost of the loan may be lower in the case of bonds than for commercial credit. When bonds are issued in Europe the vast majority of issues are purchased by a small number of investors such as banks. pension and investment funds; the role of individual private investors is very limited.

- **Leasing, BOT.** The above items describe "conventional" forms of borrowing. There are also alternative forms such as leasing or some forms of Public-Private Partnership—which are, in fact, a form of borrowing (e.g., the essence of the Build-Operate-Transfer, BOT, mechanism is borrowing).

- **Guarantees issued by local governments (e.g. for credit received by local companies)**. Although guarantees are not a debt incurred by local government, they may become part of a local government's financial obligation. In some countries (e.g. Poland) guarantees are reported together with other types of municipal debt, and they count against legal limits on debt size.

2 The term "municipal bond market" is broadly used to describe subnational borrowing by not only local (e.g., municipal) governments, but also by other local governments and provinces.

Quite another form of local debt is related to *arrears* in payment. Contrary to the forms of borrowing discussed above, which are often required and serve to support local development, arrears are a clear sign that the local financial system is in poor health. Although it is a fundamentally different type of debt from those previously discussed, in some transition countries it plays an important role in many local governments.

Regulatory Framework

An efficiently functioning capital market requires a regulatory framework. For a number of reasons, market mechanisms cannot provide sufficient regulation in this respect. Therefore it is necessary to provide clear rules and controlling/monitoring mechanisms. In nearly all European countries, the borrowing power of local governments is limited by various rules-based regulations (Joumard and Kongsrud 2003).

First of all, in most (but not all) countries local governments are allowed to borrow only to cover investment spending, but must not borrow to cover a gap in their operating budgets. There are two modes of local borrowing regulations in European countries:

- *ex ante* borrowing controls, including individual borrowing limits and permissions;
- *ex post* control of the level of indebtedness and control of the current budget, which needs to include resources for servicing debt on capital projects.

Although there is no EU law directly related to levels of local debt, Maastricht treaty criteria indirectly limit local borrowing by requiring total public debt to be kept below 60% of GDP.

Countries usually apply limits on debt at the level of individual subnational governments. There used to be some countries (Czech Republic, Slovakia) that did not apply limits on individual municipalities, but the practical experience of less than prudent local policies forced them to eventually introduce some limits. The most frequent limitation is on the level of debt service, usually expressed as a percentage of the annual budget revenues. Sometimes there is also a limit on total indebtedness. In general, limits on local government borrowing can be set in three different ways:

a) *annual debt service* as a percentage of local government revenues;
b) ratio of *total annual new borrowing* as a percentage of annual revenues; and
c) *stock of debt.*

Sometimes these limits are criticized for being inflexible and not reflecting the real financial standing of a local government. Thus, for some local governments it can be very difficult to repay a debt that is a small fraction of their annual budget, while for others too strict a limit on borrowing may act as an unnecessary barrier to the expansion of their development program. An alternative approach is to relate an allowed level of debt to the actual and projected level of operating surplus (difference between current revenues and amount spent on current operation of local government), but such a regulation does not provide macroeconomic security of the debt level. Another important issue is regulation of local governments who have problems servicing their debt. In some countries (Hungary, Switzerland), there are laws and regulations to address local financial emergencies (e.g., threats of or actual default, bankruptcy) that are designed to secure the ongoing delivery of basic local public services to local communities as well as to discourage irresponsible behavior on the local borrowing market.

Implementation of borrowing regulations requires an effective monitoring system, i.e. reporting requirements and a system of collecting and presenting relevant information (Dafflon 2002). Monitoring is often a problematic issue in the transition countries of Eastern Europe. In constructing such a monitoring system, borrowing by communal entities (such as companies that are separate legal entities, but owned by local governments) needs to be accounted for.

Policies to Support Development of Local Borrowing

Central governments may support development of the local borrowing market not only through building a regulatory framework and providing special credit arrangements, but also—and much more importantly so—by carrying out their own policies that enable local governments deemed to be creditworthy to have access to debt funds.[3] The following are examples of policies that may support local borrowing:

1. Stabilization and diversity of the banking system as a necessary precondition for development of the local borrowing market.
2. Training programs for bank and local government officials. Effective local borrowing policies require sophisticated skills that are not everywhere available, especially (but not only) in smaller local governments.
3. Transparency of the financial reporting system. Such a system supports control by local communities (and their elected representatives), but also enables better access to information by potential lenders (banks, private investors).
4. Promoting a clear separation of the current and capital budgets of local governments. This enables imposition of the "golden rule of the balanced budget" and allows for borrowing for capital projects only.
5. Stability of the local government system. Multi-year financial planning, a precondition for taking on long-term debt, is possible only within a stable local financial system. It is also important that local governments have a considerable amount of control over their budget revenues, so in this way development of local borrowing is interrelated with other aspects of fiscal decentralization.
6. Developing regulations on borrowing that are predictable and stable.

3 That bond issuing requires knowledge of procedures that are often quite complex and thereby require a high degree of technical expertise; small local governments may have limited administrative capacity to work through the process. Thus, such tools become an important vehicle to allow small jurisdictions to have access to debt finance.

In sum, the ability of subnational (e.g., local) governments to borrow and to take on and manage debt is a key tool for local as well as national economic development. But, to make it work, there must be an intergovernmental partnership—partnership whereby not only does the central authority understand it is in the national interest to enable (and regulate, and monitor) local borrowing, but also one in which local governments take on the responsibility to become creditworthy.

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13.
Property Devolution and Local Government Asset Management

Gábor Péteri
and
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Property Devolution and Local Government Asset Management

Local governments should have ownership of assets related to devolved public functions, and they develop effective methods of municipal property management.

In many countries, local governments own a vast array of assets including public housing projects, water and sewerage distribution systems, roads, office buildings, and numerous infrastructure facilities. Management of public infrastructure assets, however, may be fragmented with various categories of assets falling within a different jurisdiction, or bureaucracy. As a result, it is essential that all governments, no matter what their stage of development, properly devolve public assets by implementing more effective legislation on commercial entities; provide clear rules and options for local governments with respect to the management of public assets; and develop more effective zoning and urban planning systems to enable local governments to prudently manage public assets.

The future of publicly and socially owned assets is critical for the future decentralization and modernization of public services in Kosovo. According to the present regulations all municipal assets are owned nationally and they are managed by the Kosovo Trust Agency. However, there is a tradition of local asset management and autonomy in working with locally owned communal enterprises.

This briefing note provides the essential ingredients necessary for effective management of local public assets by : (i) reviewing what steps are essential to the successful devolution of public assets; (ii) providing a framework as to why local government asset management is important; and (iii) presenting a brief description of the fixed asset cycle

Property Devolution

Public sector reforms in transition countries have revolved around three interrelated issues: (i) political decentralization; (ii) reassignment of public functions and their funding; and (iii) transfer of state-owned assets. Devolution of public property is justified, because real local governments need a sound economic base and the transferred assets, accompanying assigned services, are managed more efficiently.

The counterarguments against substantial devolution of public assets usually emphasize that it will: (i) lead to the loss of national property; (ii) increase differences among local governments; and (iii) lead to inefficient property management practices.

These political debates can be resolved if the transfer of ownership is properly managed. The most critical issues related to property devolution are as follows:

- how the scope of devolved assets is defined;
- what are the methods of property transfer; and
- how the accompanying legal rules and regulations are developed.

A principle behind property devolution is the *functional approach*, according to which all the assets connected to assigned local government functions should be transferred to local governments. Property devolution might also be implemented at different speeds, according to the rules of decentralization in specific service areas. CEE transition countries, in their experience with wide-scale devolution of state assets, encountered three related problems that had to be solved during the property transfer:

a. Whether former owners had the *right of compensation* for the loss of their private assets with nationalization.
b. What *reference date* was to be used to establish the starting day of public ownership?
c. Transferred assets were severely deteriorated (e.g., social housing stock). Many of the new owners were *obliged to accept* these liabilities.

The actual transfer of property in CEE countries followed the physical location of the assets. Typically, the following groups of property were devolved: land and public spaces, natural water-flows, service organizations and urban infrastructure, social housing stock, financial and intangible assets. Transfer of state-owned enterprises (SOEs) was determined mainly by the privatization practices. Often small services, manufacturing companies and some shares of incorporated SOEs became municipal assets.

Local government ownership of assets must be legislated. Table 1 below presents in tabular form the experiences of local governments in Central and Eastern Europe. Real municipal ownership may be limited by assigning only the “right to administer” (e.g., Slovakia in the early 1990s) or by separating non-negotiable core property (roads, city parks) from those which can be alienated (e.g., Hungary). The actual transfer of property was implemented in two ways: (i) by virtue of law or (ii) through property transfer committees/commissions.

[1]**Table 1. Real Property Owned by Local Governments in Transition**

Country	Does municipal property (MP) exist as a legally established form of property or ownership? (yes/no) Law's name (the highest law)	To which degree has practical transfer of built-up properties under local governments' (LGs') control happened? (high / partial / initial)	To which degree has practical transfer of land (vacant or farm) under LGs' control happened? (high / partial / initial)	Is registration of MP in a cadastre/ registration system required by law? (yes / no)	To which degree is registration of MP completed (%,built-up properties / vacant or farm land)	Comments
Albania	Yes; Law on the Transfer of Immovable State Public Properties to Local Governments	Initial	Initial	Yes	Close to 0% / 0%	Law # 8744 of 22 February 2001
Bosnia	No	Not available	Not available	No	Not applicable	
Bulgaria	Yes; Constitution	High	High	Yes	Close to 100% / 100%	
Czech Republic	Yes; Act #172/1991	High	High	Yes	Varies by city; close to 100% / 100%	
Croatia	Yes; Law on Ownership	High	High	Yes	Varies by city, in some close to 100% / Not available	Incomplete registration is often related to properties under restitution.
Estonia	Yes, municipality is just one type of owner; Civil Code, Law on Land Registry	High	High	Yes	90%	Incomplete registration is mainly related to legal litigations.
Hungary	Yes;Constitution, Law on Local Governments	High/completed	High	Yes	High / varies by city	Act LXV of 1990
Macedonia	Yes; Law on Local Government	Initial (decentralization has not been started, except in the urban services)	Partial (more lease type of arrangements)	Yes	Not available	

1 Extracts from Kaganova and McKellar 2006.

Table 1. Real Property Owned by Local Governments in Transition (continued)

Country	Does municipal property (MP) exist as a legally established form of property or ownership? (yes/no) Law's name (the highest law)	To which degree has practical transfer of built-up properties under local governments' (LGs') control happened? (high / partial / initial)	To which degree has practical transfer of land (vacant or farm) under LGs' control happened? (high / partial / initial)	Is registration of MP in a cadastre/ registration system required by law? (yes / no)	To which degree is registration of MP completed (%,built-up properties / vacant or farm land)	Comments
Moldova	Yes; Law on Public Ownership of Administrative and Territorial Units and Law on Public Land and its Division	High	High	Yes	Close to 0% / 0%	• Property rights of LGs are severely limited by a number of laws. • Division of public property among governments of various levels was completed in 2002, and registration of municipal property in territorial cadastre offices started in 2004.
Montene-gro	No (municipal property is part of state property); Law on Property	Initial	Initial	N/A	N/A	The state holds the titles to property; however, local government may purchase and sell public properties without the approval of state agencies.
Poland	Yes; Law on Local Government	High	Partial	Yes (in registration books managed by court)	Varies by city; in some close to 100% / 100%	
Romania	Yes;Law on Public Administration (2001) Law on Public Property (1998)	High	High	Yes	Varies by city; in some cases, the process is just beginning.	
Slovenia	Yes;Law on Local Government	High	High	Yes	Not available	

Notes: LG = local government; MP = municipal property.

There are several conditions for establishing an efficient and transparent system of local asset management. However, the most critical conditions for creating an enabling environment for efficient local management of new asset portfolios are the following:
a. Legislation on commercial entities within the public and private sector (a Company Act) should clarify the basic rules of operation for businesses.

b. The privatization process should make it clear from the very beginning what options are available to local governments, as new owners of former state-owned companies.

c. As local governments become owners of urban land and begin operating in a market environment, land use (zoning) regulations and the urban planning system should be adjusted to these new conditions.

d. Fiscal regulations need to be adjusted to the new environment; local governments should enjoy high autonomy in setting user charges and levying property-related local taxes.

Why Is Local Government Asset Management Important?

In many instances, management of public infrastructure assets is fragmented with various categories of assets falling within a different jurisdiction, or bureaucracy. In almost all countries, different classes of assets are managed according to their own rules, often adhering to traditional asset management practices rather than developing an approach that defines the most appropriate asset management practice.

The need for better management of locally owned public assets has been highlighted on a global scale by the widespread decentralization initiatives that have devolved huge asset portfolios from central to local governments. Many regional or local governments appear to be unprepared to deal with the multiple issues related to being the owners and managers of public assets.

New Public Management[2]

Reforms in local government asset management belong to the various public policies associated with "New Public Management." In brief, new public management seeks to:

- Improve public sector performance supported by performance monitoring and incentives;
- Separate policymaking and service delivery functions;
- Decentralize or devolve service responsibilities from higher to lower levels of government;
- Provide for greater managerial flexibility in financial management; and,
- Enhance or provide for greater accountability and transparency in local government operations.

Much of the impetus for new public management reforms stems from the recognition of the substantial amounts of wealth tied to local government fixed and property assets and the potential

2 This section is largely derived from Kaganova and McKellar 2006.

income or cost-savings to be obtained by changing asset management practices.

The reform of accounting practices includes the shift to accrual-based accounts. Budget constraints, while prompting cost-cutting measures, have also accelerated approaches to manage local government assets better and initiated the search to raise additional revenues from such assets. In many countries, the budget constraint may result from the fact that local authorities have very limited flexibility to raise local tax rates or to impose new local taxes. The primary options for raising revenues involve charging for the use of public assets or selling assets. A deliberate downloading of programs and services from higher level governments, as part of decentralization initiatives has taken place in numerous countries, often without adequate sources of funds to pay for the devolved programs.

Accounting Reforms Accelerate Improvements in Asset Management[3]

The reform of accounting practices in the government sector has strongly influenced local government asset management practices. The move toward accrual accounting and generally accepted accounting principles (GAAP) has made inroads with respect to local governments managing their financial assets more appropriately. These accounting changes can have dramatic impacts on the way that fixed and other local government property assets are accounted for, and the kind of information flows that are needed to comply with newly adopted accounting standards. From a local public finance point of view, local governments in many other parts of the world have traditionally operated via annual budget requests and annual appropriations assigned on the basis of these budget requests. This approach typically eliminates the need for any type of balance sheet since all transactions are annual cash transactions with carry-over provisions. Capital assets are written off in the year completed. The value of these assets is not accounted for in public ledgers. This implies that local government assets are, in an accounting sense, considered to be nonproductive or a free good.

Accrual accounting has prompted controversial changes in public sector asset management. In accrual accounting for government, financial statements should report all assets, liabilities, revenues, expenses, gains and losses. For capital assets, accrual accounting shows asset values and related debt. This implies that governments should identify and record all their assets, attach a value to each asset, and then re-evaluate these assets later.

Accrual accounting also matches a revenue stream to offset the annual charge associated with amortizing capital cost. For example, if a fixed asset is amortized over twenty years as an expense, a corresponding revenue stream is shown on the other side of the ledger. This revenue stream is derived from a capital charge. This may either be an imputed charge or an actual payment and is introduced as the primary means to force users to recognize the true cost of using and consuming the asset.

3 For more on government accounting, see Gauthier 2001.

A problem arises with depreciation. Some charge(s) can be assessed on the expense side for depreciation, usually as a percentage of the capital cost. Without a corresponding entry on the revenue side to match this liability, the balance sheet rapidly accumulates an amount of deferred maintenance. This deferred maintenance, if allowed to persist, has a significant impact on the net worth of the total portfolio.

Fragmented Management of Public Assets

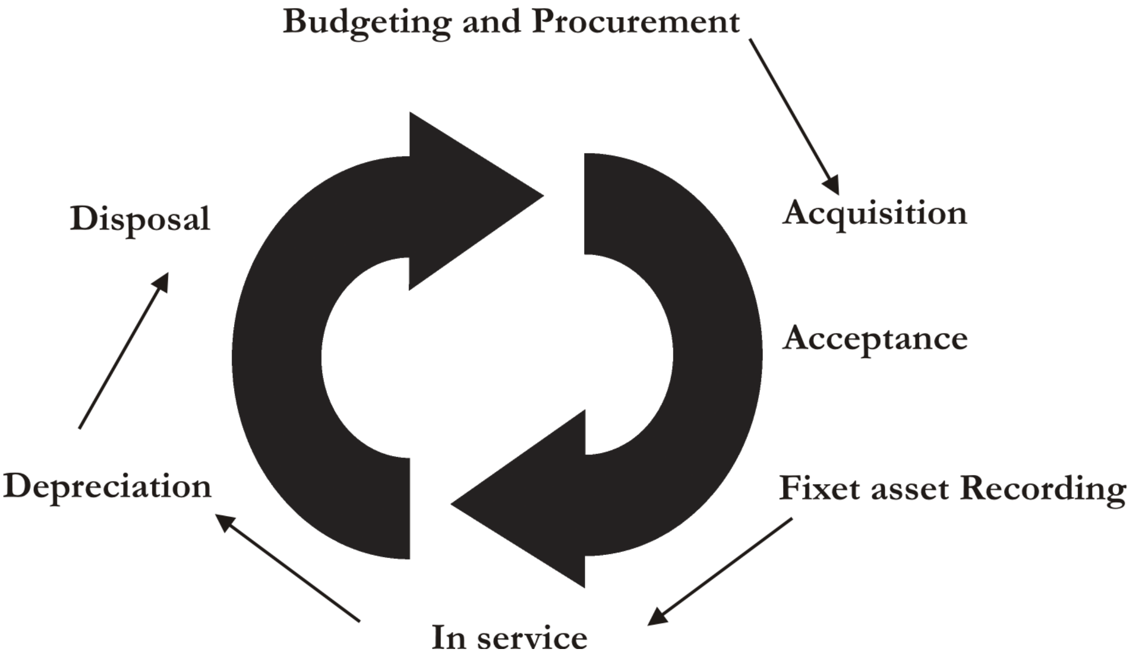
When many government agencies, departments, government-owned companies, or special purpose entities may become involved in managing, financing, and using an asset class, the management of these public assets may become fragmented. A lack of government-wide strategies, policies, and rules dealing with asset management practices may exacerbate the management fragmentation of public assets. It is essential that uniform policies, procedures and rules be introduced with respect to the management of public sector assets.

Until very recently, information about fixed assets and other real property has generally been an issue with respect to local governments. In addition, reliable financial information regarding local government assets is also often missing. Bookkeeping values are often so outdated as to be meaningless.

The Fixed Asset Cycle

The fixed asset cycle is the accounting cycle relating to the ownership of an asset (see Chart 1). This cycle is composed of the budgeting, procurement, acquisition, recording, accounting, reporting and disposal of an asset. Each of these steps has its own specific functions and traits, but each of these traits interrelates with one or more of the other items. In addition, each stage of an asset's life has different accounting, reporting, and management responsibilities. These stages run from the initial acquisition of the asset to the ultimate disposition of the asset.

Figure 1: The Fixed Asset Cycle



The asset management cycle can be briefly described as follows:

- **Acquisition.** Acquisition is defined as the obtaining of the fixed asset by the local government. This acquisition can be done as, but is not restricted to, a cash purchase, receipt of donation, construction, lease purchase, or eminent domain.
- **Acceptance.** The process of receiving the fixed asset for use by the local government.
- **Fixed Asset Recording**. Recording is the act of entering a newly acquired asset on the fixed asset subsystem.

Depreciation

The usefulness of most assets, other than land, declines over time and some type of write-down or write-off cost is needed to indicate that the usefulness of an asset has declined. Depreciation is the term most often used to indicate that intangible assets have declined in service potential. The cost of fixed assets will be allocated to the periods benefited through depreciation.

The method of depreciation chosen must result in the systematic and rational allocation of the cost of the asset (less its residual value) over the asset's expected useful life. Most communities use the straight-line method of depreciation, which presumes that the same economic value is obtained from the use of the asset in each period.

Residual value

Residual value is often not material and in practice is frequently based on a predetermined percentage of the initial acquisition value. If the historical cost is used, residual value is defined as the expected worth of the asset, in present currency (i.e., without any consideration of the impact of future inflation), at the end of its useful life. Residual value should, however, be net of any expected costs of disposition. In the case of water utilities, residual values are very difficult to determine since most fixed assets are unique and are rarely sold in the market. Since it is rarely used in practice, not using a residual value is a viable approach since it all too often generates unreliable estimates.

Disposition of Fixed Assets

Regardless of the time of disposal, depreciation expenses for fixed assets should be taken up to the date of disposition and all amounts related to the retired asset should be removed from the accounts. Ideally, the book value of the specific asset should be equal to its disposal value. However, this is generally not the case, and a resulting gain or loss occurs. Gains or losses on the retirement of assets should be shown in the income statements along with other non-operating revenues/expenses that arise from ordinary business activities.

Conclusion

This paper focused on the search for common rules, and institutional and accounting arrangements to improve the efficiency and public usefulness of government-owned (fixed) assets and real property. Government assets are crucial to financing government operations. These assets in some instances can be used to collateralize borrowing and are essential to effective public service delivery.

Public asset accountability involves the overall stewardship of assets. The importance of public sector assets implies that it is essential to inventory, catalog, and account for these assets in a systematic manner. Installing (accrual) fixed asset recording accounting systems is a crucial initial step to establishing effective mechanisms to measure results that will drive asset creation or divestiture decision-making. Local governments must be able to hold asset managers accountable for the assets in their custody and be assured that these assets are serving their intended purposes and achieving targeted results.

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Planning and Accountability

14.
Budgeting: Methods, Process and Execution

Zsuzsanna Kassó

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Budgeting: Methods, Process and Execution

Putting together the political document that specifies the expenditure program.

A budget serves as both a financial plan and, if so designed, a statement of the purpose and performance of public spending.[1] When budget allocation methods are designed in accordance with the legal and constitutional framework of the country there is an intentional and sometimes seemingly arbitrary decision to set the level of public services. In this case, the budget serves as the synthesis of all laws in force, and of all policies, strategies and other short-term plans. The challenge is to find a format that transmits the above content, while at the same time serves as the basis of accountability and the ability to be held accountable. Being able to put together a budget and to get it "right" on both its operating and capital (investment) components is a key indicator of a municipality's capacity to govern.

Budgeting Process and Methods
Budgeting Procedures

Budgeting is a four-stage process, with special roles and actors.

1. Executive *formulates* the budget proposal.
2. Legislature debates and *approves* it.
3. Executive *implements* the budget.
4. After implementation, executive reports on its activities, and a supreme audit institutio conducts *an audit, evaluates* and certifies its quality.

A budgeting system comprises all the activities, procedures, and incentives for each of the four stages. However, the substantives of the budgeting system are different in each stage, depending on the budgeting approach that is followed.

1 This essay focuses on the expenditure side of the expenditure and revenue "budget equation."

Which Type of Budgeting Approach Better Serves Citizens' Needs?

Traditional (Input Based) Methodology

Until recently, the traditional approach to budgeting was marked by two main characteristics:

Annuality: The budget period was usually a single year. Although longer-term projections of public expenditure were prepared, the planning of public expenditure focused only on the upcoming financial year.

Incremental: Under incremental budgeting, new budget is prepared by beginning with previous year's numbers (expenditures plus or minus some percentage).

The traditional approach is often criticized for the second characteristic of its incremental nature. Because the current budget reflects the priorities and inputs of the previous year (or, if this is always the way the process works, year*s*), it fails to take into account the changing needs and collective preferences of the community. Moreover, if the revenue-driven budget constraint changes (as it almost certainly will from year to year), the result can be a very ad hoc "across the board" increase or decrease in spending—an increase or decrease that may have very little relevance to, and therefore distort, the next several years (the "out years") of budgets.

These are valid criticisms. But, in defense of incremental budgeting, it has the merit of allowing one to contend with an often very difficult and complex process. This is particularly true for the newly decentralizing system such as Kosovo will likely soon address. Incrementalism also allows one, at least in the short run, to avoid setting off political battles over spending priorities (although some may rightly not consider this a "merit").

Recognizing these merits, the theme of this briefing note is to combine the best of the traditional approach with a process that incorporates both the tests of service delivery performance and that of responsiveness to changing fiscal architecture and citizen preferences.

Measurement and Performance Budgeting

The objective of "budget reforms" is typically to institutionalize a government's ability to be aware of, and to adjust to, service delivery performance (OECD 2002a, 2002b). Such *performance budgeting* thus shifts attention from control *ex ante* on budgetary inputs to accountability *ex post* on the basis of results (IMF 2001). With performance budgeting, decision-makers try to choose outputs that will lead to desired policy outcomes; that is, they seek improved performance. With the traditional approach to budgeting, appropriations focus largely on inputs and decision-makers have little incentive to strive for better performance.[2]

In a performance-based system, there is a need to monitor the quantity and quality of outputs, and to measure the result (or outcomes) of delivering these outputs. Data and reporting requirements

2 There may be some non-input related drivers of spending, such as a law requiring a certain percent of the budget be earmarked for a program (e.g., an earmark for provincial-to-local transfers or other "mandatory" spending).

are needed to enable monitoring (Allen and Tommasi 2001). There is a sequence to budget reform (see Box 1).

Strategic Planning

Improvement of the efficiency and effectiveness of governance involves another essential management tool: strategic planning. Strategic planning is also an effective tool to support the allocation exercise of budgeting.

In parliamentary democracies, the election programs of political parties can sometimes be regarded as some sort of a comprehensive strategic concept, which serve in the election period to guide the development of strategies (much may depend on the representative nature of the election process—see note "Achieving Decentralized Accountability").

When formulating strategies, with the analysis of external and internal information, it is necessary to first identify the position of the public service or organization. By considering this position, the status intended to be reached at the end of the planning period should be designed.

Box 1. Sequence and Principles of Budget Reform

1. Foster an environment that supports and demands performance before introduction of performance or outcome budgeting.
2. Control inputs before seeking to control outputs.
3. Account for cash before accounting for accruals.
4. Establish external control before introducing internal controls.
5. Establish internal controls before introducing managerial accountability.
6. Operate a reliable accounting system before installing an integrated financial management system.
7. Budget for work to be done before budgeting for results to be achieved.
8. Enforce formal contracts in the market sector before introducing performance contracts in the public sector.
9. Have effective financial auditing before moving to performance auditing.
10. Adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them.

Source: Schick 1999.

The Main Objectives of a Budgeting System

It is generally accepted that all budgeting systems need to achieve the following three basic objectives:

(i) To maintain aggregate fiscal discipline.

Fiscal discipline pertains to effective control of the budget totals, by setting ceilings on expenditure that are binding both at the aggregate level and on individual spending entities. Control of the totals is the first purpose of every budgeting system. There would be no need for budgeting if the totals were permitted to float upward to satisfy all demands.

(ii) To allocate resources in accord with government priorities.

Allocative efficiency is the capacity to establish priorities within the budget, to distribute resources based on the government's priorities and program effectiveness and to shift resources from old priorities to new ones.

(iii) To promote the efficient delivery of services.

Technical or operational efficiency in the use of budgeted resources refers to the capacity to implement programs and deliver services at the lowest cost.

Table 1. below shows how these principles are enforceable in the two basic budgeting approaches:

Table 1. Traditional vs. Performance-Oriented Budgeting

Main Objectives	Traditional, Input-based System	Performance-Oriented System
To maintain aggregate fiscal discipline.	Only outlays may be decreased, there is no opportunity to adjust service levels. In the absence of information decision-makers are not able to classify demands and they increase the public debt.	Based on the draft justification of appropriations, decision-makers are better able to decide which service or program would provide better public outcomes, and can discontinue the less important ones. With the added information, it is easier to determine whether to provide a particular service and increase public debt, or cut the service and save future money.

Table1. Traditional vs. Performance-Oriented Budgeting (continued)

Main Objectives	Traditional, Input-based System	Performance-Oriented System
To allocate resources in accordance with government priorities.	Allocation mechanism linked to the operational or capital investment expenditures level. The government objectives are to increase or decrease them, without any special requirements.	Based on the information on service delivery, strategic objectives and priorities, some programs receive additional resources, while others are discontinued or reduced in scope.
To promote the efficient delivery of services.	As efficiency is not measured, improving it is only rhetoric.	If appropriations are linked to performance requirements, to obtain public money is the main incentive.

The Role of Accountability and Fiscal Transparency

The current wave of civil society advocacy is underpinned by a global public management revolution that promotes greater public participation in governance and highlights the need for greater transparency and accountability in public management.

Accountability refers to the way in which government exercises responsibility in making known how it intends to make decisions or take action, the actual decisions made and action taken, as well as the result or outcome of such decisions and action.

The concept of *accountability* as applied to budgeting has three dimensions:

Effectiveness—to use money prudently.
Responsiveness—to achieve the promised payoff in efficiency gains of a decentralized system of governance, as embodied in the principle of "subsidiarity" of the European Charter of Local Self-Government (see the briefing note on Legal Framework).
Performance—to accomplish something.

Transparency refers to the low cost availability of information on all government decisions and activities. As a government responsibility, transparency requires government, to make information accessible to, the general public in a manner that is easily understood (see "Achieving Decentralized Accountability" in this volume).

As also noted in the briefing note "Achieving Decentralized Accountability," transparency underpins accountability. Fiscal and financial information—made fully available on a regular, timely and low cost of accessibility basis—is an important ingredient of an informed executive, legislature, and public. Competent legislative staff and independent public media are essential to processing and disseminating this information. Thus, both the International Monetary Fund (IMF) and the Chartered Institute of Public Finance and Accountancy (CIPFA) emphasize the importance of clear fiscal roles and responsibilities and transparency (IMF 2005; CIPFA 2004).

Classification, Fiscal Information and Accounting

Classifying expenditures is important for formulating policy and measuring the allocation of resources among sectors. An expenditure classification system provides a normative framework for decisions on policy and accountability.

According to the different needs of policy formulation, reporting, and budget management, public expenditures are generally classified according to the following categories:

a) *Function*, for historical and policy analysis.
b) *Organization*, for accountability and administering the budget.
c) *Fund,* for administering the budget.
d) *Economic categorie*s, for statistical reporting and aggregate fiscal control.
e) *Line-item (or object),* for compliance controls and internal management.
f) *Program*, for policy formulation and performance accountability.

From the above list, the functional classification requires some explanation (IMF 2001). It classifies government activities according to their purposes (e.g. education, social security, and housing) and is independent of the government organizational structure. Moreover, a stable functional classification is required to produce historical surveys and analyses of government spending and to compare data from different sectors and different fiscal years.

The accounting system should apply the features of the expenditure classification system. Each transaction entering the accounting system should be coded according to the above six classification types.

The Importance of Auditing in a Budgeting System

International standards define two main types of audit (see also the briefing note "Achieving Decentralized Accountability"). The *external audit* makes an important contribution to the stewardship of public resources and corporate governance of public services. Furthermore, it is necessary for the segregation of state powers, wherein decision-makers are accountable to citizens and the administrators of the executive are accountable to decision-makers. For this reason, governments need an independent external audit body that can evaluate financial records, that is independent from the executive level, and that reports to decision-makers.

The *internal audit* has different roles and priorities from the external audit, but there is a lot of overlap in what both types of auditors do, and why they do it. The main role of the internal audit is to support management in improving its activity and control system. External auditors look at internal control systems to determine whether they prevent or decrease the risk of errors, while internal auditors seek to make ongoing improvements in these systems.

Mastering the Transformation of Kosovo's Budgeting System

The pace and direction of reform should be defined according to each country's context and priorities. Nonetheless, there are some basic principles that should be incorporated into every budgeting system.

The following section contains lessons learned by Eastern European countries in the reform of their own budgeting systems, which may be of value to those leading reforms in Kosovo.

Consider Moving Towards a Performance-Oriented Budgeting Approach

Broadly, the concept of a performance-oriented system is designed to result in public organizations that are better aligned with the government's objectives and to improve the development of civil servants and the public service culture.

The need for performance measurement and reporting for the diverse variety of state and municipal programs is a continuing challenge. Citizens, elected officials, and managers are often frustrated by the lack of information that would enable them to assess whether public services are operating effectively and efficiently, and how to improve unsatisfactory performance.

As Kosovo considers whether or not to apply some features of performance budgeting, it is worth bearing in mind that performance budgeting can enrich policy debates and help identify and prioritize desired outcomes, especially when embedded in a broader strategy of managing for results.

Improve Technical Support for Budgeting Procedure and Budget Implementation

Having a proper expenditure classification and coding system is the most important requirement of any reform.

When reforming an expenditure classification system, changes in the organization of the accounting systems should focus on what is required to identify all transactions properly. If budget preparation and execution is fully computerized, it is easy enough to code each item.

For budget preparation, a unified and computerized coding system of budget classification categories at all levels of governance are required if cross-referencing is to be possible. Cross-referencing amongst the different dimensions provided by budget classification categories is a very useful tool for analyzing the budget, which helps to understand what room there is for changes. In the absence of a proper IT system, this type of cross-referencing of budget dimensions is limited, which will act as a constraint on reforms.

It is clear that Kosovo will undergo numerous policy changes and a permanent transition. In the absence of the information provided by different budget classification categories and cross-referencing of budget dimensions, policy changes are unlikely to be systemic or lasting. In the case of Kosovo, the functional classification would play an important role, as far as only this classification makes it possible to follow, measure and compare budget expenditures apart from organizational structure.

Switch from Annual Planning to Strategic Approach

Strategic planning looks ahead toward goals to be accomplished, while performance measurement looks back to see what was achieved. When used together they form a continuous process. In essence, strategic planning defines the performance to be measured, while performance measurement provides the feedback loop that keeps the target in focus.

The concept-flow behind strategic planning and performance measurement is the same for all levels of governance, only the actors and the level of details are different:

- Develop a strategic framework that identifies key results (outcomes)—strategic planning.
- Devise measures that explain achievement in a succinct, measurable way.[3]
- Agree on "expected results," "planned performance expectations" or targets.[4]
- Identify and effectively report targets that are achieved.
- Identify and effectively report the contributions to public outcomes (effect).
- Use the above information to inform management decision-making.

Use the Budget as a Transparency and Accountability Mechanism

The preparation of the budget is a multi-phase procedure, in which expenditure requirements and the needs of public services gradually approximate existing revenue constraints. The last phase of the budgeting process is the presentation of the budget to politicians for a final decision. When reviewing the draft budget, politicians should understand:

- How the budget links to strategic objectives?
- What is the cost of maintaining the existing level of services?
- What are the service implications of reducing costs?
- What are the service implications of growth proposals and what are their costs?

3 The EU term is Operational Programs.
4 The EU term is Program Complement Document

The functions of the budget are diverse. The budget

- mediates the planned policies;
- obtains the support of politicians for planned policies, as it is a plan for execution;
- divides the policies into budget programs; that is, it gets decision-makers approval for the execution of planned "individual" projects or programs;
- serves as a guide for execution and as the basis of follow-up reports;
- determines the subjects on which decision-makers retain the right of approval and thus limits the scope of actions of the executive level.

When the budget document—supported by the appropriate procedure—answers the above questions and discharges the above listed functions, it serves to inform citizens and politicians about the core budget decisions, so it is likely to be transparent and provide accountability.

Use the Budget as an Effective Resource (Re-)Allocation Tool

Two broad approaches exist for allocating resources and drafting a budget:

The *top-down approach* allocates resources to sectors, sub-systems, and main objectives, as constrained by revenue levels worked out by the Ministry of Finance. The Ministry of Finance has information about the whole scale of resources and takes into consideration government-level priorities.

The *bottom-up approach* allocates resources according to the detailed needs and requirements of service delivery units—which calculate their own revenue needs. In practice, a mixture of both approaches is always used, but currently there is too much emphasis on bottom-up bidding and too little on top-down strategy. The budgeting process tends to begin with bottom-up bids which often prove to be a waste of time, as a top-down analysis would clarify the need for cutbacks.

More emphasis on using a top-down strategy to allocate resources between sectors (main public service lines) with a view to resource constraints would be progress. The top-down approach needs to be accompanied by performance standards and targets.

Link Budget Appropriations and Performance

An ideal budget document would paint a clear picture of what resources are being used and what is being achieved by expending them. (See Gomez 2006 for the key types of budget documents that not only support budget preparation, but also its implementation).

The central and local budget documents should contain most or all of the following information:

- Medium-term macroeconomic and fiscal projections.
- A statement of budget policies and fiscal policy objectives.
- Revenue and expenditure estimates, measured in gross terms even when appropriations

are calculated on a net basis. These estimates should cover all revenues and expenditures, including special funds and accounts, if any.

- Authorizations for forward commitments, if any.
- Financing from external sources, grants and loans.
- A statement of contingent liabilities resulting from state guarantees of third party debts and an estimate of payments likely to be required under those guarantees during the budget year.
- A statement of major identifiable fiscal risks.
- A statement of tax expenditures.
- Narrative statements explaining the sectoral activities to be funded, their objectives and expected results.

The last element of the list establishes the base for accountability in the public sector and is the element that marks the main difference between a traditional and a performance-oriented system.

The crucial issue is how to link performance and the allocation of resources. The narrative statements in a traditional budgeting system are expressed only in general terms; namely, to meet demands to the extent possible. In the performance-oriented system the link between appropriations and output is transparent, and resources are made available only for declared outputs against which the government can be held accountable.

Consider Involving Citizens in Planning and Budgeting Processes

Budget advocacy is opening up a traditionally elitist political exercise that in the past has led to social inequity. As such, the model of civic engagement generates strong public interest and, in the process, pressures governance to be more transparent about the way it allocates people's money. However, before working to build better relations with citizens, decision-makers must understand that citizen input should not be the sole decision-making criterion; rather it should be a supplement to technical analyses of the issues.

Never Ignore the Cultural Context

There is no inherent relationship between a particular budget approach or institutional arrangement, and budget outcomes. The relevance and effectiveness of budget management systems depend on the country context. Hence, any instrument for public expenditure management originating from another country must be carefully analyzed in the light of the local context and rejected, adopted, or adapted as needed. If budget reforms are designed without considering key local traditional rules and behaviors, they are likely to fail.

Establish the Framework of Sound Financial Management

The internal control system is the whole framework of controls, both financial and managerial, established by the management in order to carry on the business of public bodies in an orderly and efficient manner, ensure adherence to management policies, safeguard assets, and secure the completeness and accuracy of the records. Strong internal controls prevent poor decisions and make it easier for top managers to delegate decisions. A government with weak internal controls is prone to fraud or corruption.

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15.
Achieving Decentralized Accountability

Michael Schaeffer

Contents

Achieving Decentralized Accountability

Establishing relationships whereby governments that are responsible for providing local goods and services are politically and fiscally answerable to their citizens, who, in turn, are ultimately responsible for the consequences of tax and spending decisions.

Introduction: Governance, Accountability and Development

The case for decentralization is fundamentally an argument about improving the process of governance that matches collective (e.g., public) decision-making with respect to subnational (e.g., local) tax and spending decisions to local preferences. As the previous briefing notes make clear, the "best" solution is one of an intergovernmental partnership that builds on the platform of fiscally strong local, provincial, and central governments. To make this all work there must be *accountability*; that is, mechanisms (formal systems, institutions, laws, regulations, as well as the informal day-to-day practice of government) must be put in place such that two things occur: political leaders and bureaucrats become answerable to the citizenry for their actions and the citizenry takes on and accepts responsibility for the collective actions that governments make on their behalf.

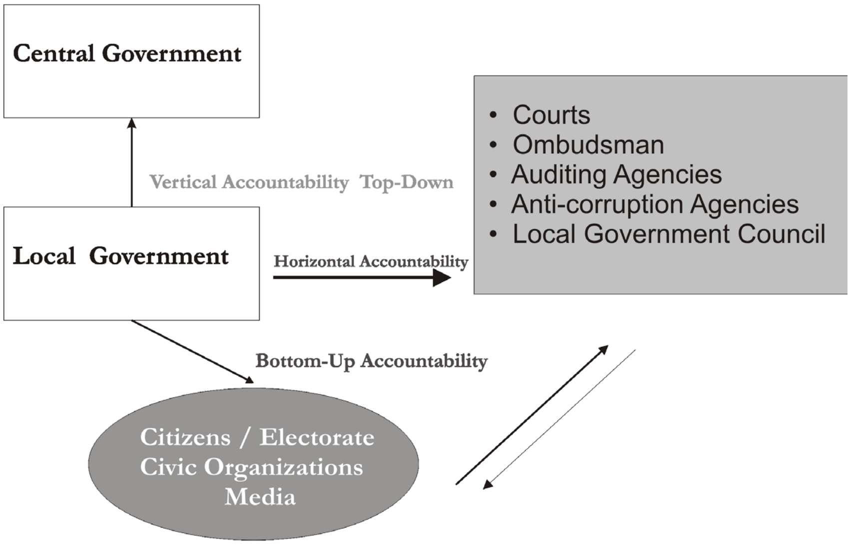
Such "good local (intergovernmental) governance" rests upon three pillars: transparency, predictability and participation. *Transparency* implies that there is low-cost accessibility to relevant information. *Predictability* results primarily from laws and regulations that are clear, known in advance, and that are enforced in an even-handed, uniform, and certain manner. And, *citizen participation* is needed to supply reliable information and to provide for a way of monitoring public sector performance (Schavio-Campo 1999).

Accountability Links and Mechanisms

In an intergovernmental system accountability takes the form of a triad. Accountability may be *bottom-up* whereby local government is answerable to citizens; *horizontal,* whereby government is answerable to certain public agencies institutionalized to monitor government performance; and *vertical,* with answerability to certain central governmental instrumentalities that monitor the system as a whole.

Bottom-up accountability includes citizens acting through the electoral process and indirectly through civil society organizations (e.g., honest brokering "think tanks" such as Forum 2015, KFOS and Riinvest; civic organizations such as neighborhood organizations; citizen "watch-dog" NGOs; and an independent media). *Horizontal* and *vertical* accountability involve a range of public and quasi-public entities entrusted to minimize government abuses and promote reform (e.g., municipal associations, electoral commissions, local government councils, courts, ombudsman or public complaints agencies, and various auditing agencies) (see Figure 1).

Figure 1. Accountability Linkages



For newly (or even poorly developed) decentralizing systems of governance, the quest to build vertical and horizontal accountability can be hindered by a variety of factors, including poor salaries, weak morale, weak oversight institutions, poorly drafted laws, and/or the absence of effective local public sector management practices (Allen and Tommasi 2001). An important barrier to achieving bottom-up accountability will occur if elections are unrepresentative, gerrymandered and/or dominated by political elites, and/or if the electorate has few other ways to register its views on the quality of governance (Mair and Katz 1997; Mungui-Ppidi 2003). This is especially true under systems that operate with a closed-list proportional system that allows central party functionaries and/or public officials to dominate local councils and impede citizen access to the electoral process (a problem that some argue is one Kosovo must address).

To help establish as well as strengthen the accountability triad, there must also be a set of mechanisms (systems, strategies, institutions), formal and informal, that become a "way of doing" government. These mechanisms can be divided into four categories and are illustrated in Table 1: information; consultation and oversight; community participation and the independent media. The challenge in implementing these mechanisms for public sector accountability lies in creating an enabling political context where such mechanisms can be introduced and be sustained.

Table 1. Mechanisms for Advancing Public Sector Accountability[1]

Accountability Mechanisms	Task	Method
Information	Provision of Information	Mandatory provision of information by the government (e.g., public hearings, annual reports, brochures, newsletters); citizen-led sources such as service delivery "scorecard" surveys.
	Financial Disclosure	Timely accounting and budget information (e.g., quarterly reports followed by audited financial reports).
	Financial Management Systems	Use of financial management information systems (which, for example, can provide citizens on-line access to key indicators of performance).
	Competitive Procurement	Local government procurement processes must be transparent, open, and, for larger projects, competitive.
Consultation/ Oversight	Notice and Comment on Rule-making	Requirement that draft normative acts be published in public forums prior to their enactment.
	Public hearings	Public hearings may be required by law whenever laws and implementing rules and regulations are developed.
	Administrative Procedure Systems	Administrative procedures should require that citizens receive notice prior to any change in legislation or other action.
	Advisory Committees	Permanent or ad hoc bodies that provide input to government in various policy areas (e.g., a broadly representative Advisory Commission on Intergovernmental Relations).
Active Participation	Right to Petition	The public has the right to propose the adoption, amendment or repeal of a normative act.
	Consensus/Negotiated Rulemaking	Councils that consult with groups (e.g., interest groups or civic organizations) must reach consensus with respect to policy initiatives.
Media—Right to Know	Non-governmentally controlled media (print and electronic, including access to the Internet)	Require government to inform the independent press of its activities, from procurement practices to budget reports (Reinikka and Svensson 2004).

1 This table draws on Malcolm Russell-Einhorn 2004.

Policy Considerations

Improving public sector accountability requires an approach that recognizes the diverse factors underlying the persistence of weak governance. Creating interventions that improve local government accountability generally requires a tailor-made strategy that takes into consideration the particular contours of the problem in different circumstances, local, provincial and/or national. Actions to improve governance, public financial management and accountability need to be taken on numerous fronts, of which five are identified below.

The Local-Central Government Relationship

A first issue to arise is that of the appropriate role of central government in promoting and ensuring the vertical accountability of local governments. This can be a tricky matter since the very way the issue is phrased as the "role of the central government" not only presumes a hierarchy among governments, but also that the central authority has the capacity to be intergovernmental and the integrity to be in a position to appropriately monitor "its" subnational governments. Assuming that there is a well-functioning central authority—again, an overly confident assumption in some countries—if the foundations of vertical accountability are to be established than sufficient fiscal autonomy must be guaranteed to the local level of government. There are three dimensions to the issue: (1) local governments must be effectively empowered to carry out services in accordance with their assignment of powers and functions; (2) sufficient local resources must be ensured to carry out the assigned expenditure tasks; and (3) local governments must have sufficient discretion over these resources within the framework of their powers (see briefing notes "Fiscal Autonomy" and "Legal Framework and the European Charter of Local Self-Government").

The three dimensions can lead to the creation of some tension between the various levels of government—a tension, that one should note can be either "healthy" or destructive to an intergovernmental system. To illustrate, while recognizing that a central government has the important role of monitoring local performance and collecting intergovernmental (including provincial and local) data—and that it is incumbent on the subnational governments to cooperate on this matter—if the center seizes upon this monitoring as a justification for interfering with what is a subnational/local competency, then the tension represents a destructive rather than positive or "healthy" sign of robust intergovernmental relations.[2] Such interference typically arises when the parliament devolves expenditure assignments to local governments, but then at the same time attaches various conditions and/or unfunded mandates that do not fit local citizen preferences and constrain local decision-making. It can also occur when a ministry or other central instrumentality undertakes various administrative and regulatory actions.

Now, two things can happen: one positive, one negative. The negative outcome, which is repeated in many newly decentralizing countries, is that the give-and-take ends up in the creation of a soft budget constraint "deal" where the center ends up bailing out or paying for the mandate or condition. Such a practice leads not only to a loss of local autonomy and accountability, but, if the practice is widespread, macroeconomic instability for the nation as a whole.

2 If there is a local "financial emergency" such as a financial default or bankruptcy, there can, and should, be legislation on how this situation is to be addressed. See Jókay, Szepesi and Szmetana 2004.

But, too, there can be very positive outcomes from a "healthy" intergovernmental tension—and, thus, to continue with the illustration, the local jurisdiction can learn the lesson that acquiring local fiscal autonomy means getting serious about matters such as own source revenue mobilization and local control over decisions regarding the mix of local public goods. But getting "local control" can be difficult without political support; and the support that can come from the local citizenry. How does the local government obtain the "grassroots" political support it needs to make this work? By institutionalizing systems of accountability: transparency, predictability and participation so that the citizens have a stake in local autonomy (for a case study of Kosovo's regional neighbor, Hungary, see Pallai 2003).

Consultation and Participation…and Corruption

Local governments can also present an uncertain terrain for good governance and effective accountability efforts, particularly where they are established in an environment characterized by low levels of political and social organization, a poorly developed legal framework, and centrally controlled (e.g., non-elected) municipal councils. Under these circumstances, the concern arises—and it is legitimate—that "good governance" will give way to elite capture and corruption. There is, however, growing evidence about the positive impact of consultative and participatory mechanisms in improving local service delivery (Fisman and Gatti 1998, World Bank 2001) For example, in their empirical work designed to identify major drivers of corruption in order to isolate the role of centralized decision-making, Grugru and Shah (2002) find that lack of service orientation in the public sector, weak democratic institutions, economic isolation (closed economy), a colonial past, internal bureaucratic controls and centralized decision-making are major causes of local corruption. From this they conclude that, when well-designed, accountable decentralization enhances public sector performance and reduces corruption. Suffice it to note here that in order to advance this anti-corruption outcome, multiple mechanisms of organizational and institutional capacity building may need to take root in order for local government accountability to prove effective (Blair 2000; Kobonbaev 2006).

Evaluating Accountability

Within this context of decentralized governance, there are three useful criteria for evaluating accountability mechanisms *vis-à-vis* local circumstances (Russell-Einhorn 2004):

- *degree of visibility*: governments whose policies are put in question in a very public forum find it more difficult to obfuscate their intentions;
- *simplicity*: high costs of obtaining information undermine the goal for a decentralized government to be "close to the people"; and
- *direct access*: recognizing that developing government accountability is a long-term process, success depends on the citizen's ability to influence policy relatively quickly.

Even when all three criteria are met by a government, the development of homegrown grassroots movements (NGOs, interest groups, civic initiatives) remains essential to the effectiveness of accountability mechanisms. And here, one may note that the dominance of "supply side" international NGOs and donor-driven citizen participation projects often has very little impact on citizens' ability to influence policy decisions. Rather, the payoff comes in working on the "demand side" by increasing local public awareness and institutionalization of the available transparency mechanisms.

Institutional Controls

Inadequate accountability mechanisms within the local civil service can be minimized with appropriate institutional controls. The most effective controls generally reside inside institutions. This implies that there is honest and effective supervision, auditing oversight and control, and an awareness and internalization of the standards of ethical behavior. Thus, for example, some municipalities have created ethics commissions and/or offices of the Ombudsman. To be effective, these offices must be independent from the political establishment, have ample personnel and financial resources, and have high standards. In some cases, ethics commissions must also have the power to enforce penalties and be able to make reports without political clearances from an interested government or government body. And, clearly, a free press increases the impact of this process—and to development as a whole (World Bank 2002; Islam 2006).

Transparency of Rules, Regulations, Laws and Processes

The lack of transparency in rules, laws, and processes in many countries lessens local government accountability. Rules dealing with government procurement processes, financial management and accounting are often confusing. Even if an individual exercises some initiative and tries to understand the rules, the documents specifying these rules may not be publicly available. Furthermore, many organizational rules may be changed without public announcements to that effect. Indeed, in some instances, regulations and laws are written so that only trained lawyers or financial experts can understand their true impact. This problem may be compounded by the lack of an independent and competent judicial process that can interpret the law and a supreme (high) court that is trusted to give a final judgment if such is required.

The Audit Function

Management controls are the policies and procedures put in place by the managers of an (government) entity to ensure its proper and effective operation, and key among these are the audit functions. Developing an effective system of controls requires, first, a careful assessment of the risks confronting the organization. Policies and procedures can then be selected to control those risks effectively and at reasonable cost. No system of controls can provide an absolute guarantee against the occurrence of fraud, abuse, inefficiency, and human error. However, a well-designed system of controls can give reasonable assurance that significant irregularities can be detected.

There are two types of audit procedures:

Internal audit is part of an organization's management control structure. The internal audit office audits lower-level units on behalf of management. Among its most important functions, internal audits test the management controls and assist senior management in assessing risks and in developing more cost-effective controls. Here, it is important to emphasize that effective internal auditing critically depends on independence of auditors from undue interference by senior local government officials. There is abundant anecdotal evidence that in many Kosovar municipalities, where auditors are appointed or their job performance is conducted by chief of personnel or CEOs in municipalities, internal auditing has become an insignificant process.

External audit of government operations is typically performed by a supreme audit institution (SAI) or an independent external auditing firm. External auditors typically perform compliance/regulatory audits, financial assurance audits, and value-for-money (efficiency) audits.

To be effective, external audit staff must have the professional skills required for the audits being performed. The external audit function can only be effective when a method for communicating audit results to law enforcement agencies (e.g., anti-corruption agencies, the courts) is combined with an approach for encouraging appropriate corrective action. In Kosovo, the General Auditor reports the findings of financial controls to the UN office of the head Special Representative of the Secretary General, but, then, is not required to refer the serious violations of the financial management or procurement laws to the Kosovo Anti-Corruption Agency for further investigation. There is also no direct referral mechanism between the General Auditor and law enforcement authorities or the Office of the Public Prosecutor of Kosovo. As a result, many alleged bribery and corruption cases are simply labeled as "financial mismanagement" because the cases are not referred by the external auditor to law enforcement bodies. The creation of a system to ensure that offenses involving violation of official duty for financial rewards do not go unpunished, requires that information about alleged corruption offenses can be received from any citizen or organization and that a specialized financial auditing is conducted. The reports can then be referred to prosecutors for review of whether further action (e.g., criminal indictment) is appropriate.

Good governance and effective local government accountability play a critical role in determining whether fiscal decentralization will deliver on the promise of improved service delivery and honest government. To accomplish this objective, a newly decentralizing Kosovo will have to direct a good deal of attention to getting "right" the mechanisms for promoting accountability, transparency, strategic prioritization, and citizen participation.

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Managing the Reform Process

16.
Sequencing Fiscal Decentralization Reform

Roy Bahl
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Contents

Sequencing Fiscal Decentralization Reform

Drawing on international experience, a set of process steps a newly decentralizing country may consider as it implements a plan for public sector reform.

While there is extensive knowledge about how to design fiscal decentralization policies, considerably less is understood about how a decentralization program should be sequenced and implemented. Countries embarking on decentralization often struggle with decisions about its essential components, the order of introduction of decentralization policies and activities, the number of years necessary to fully implement a program, and the components of the transition strategy. This note argues that the sequencing of decentralization is an important determinant of its success. The consequences of a poorly sequenced decentralization program can range from minor delays and complications to macroeconomic instability, and, even, to chaotic situations with failed public services.

If sequencing matters, what is the best way to proceed? While it is recognized here that no one process or model fits all decentralizing systems, by drawing on the experiences of other places that have undertaken fiscal decentralization reform one can develop a stylized approach to sequencing decentralization (Bahl and Martinez-Vazquez 2005). Such an approach serves as a reasonable baseline against which to compare the ideal sequence to that of real world practice where politics and administrative constraints matter and change final outcomes. This briefing note lays out six identifiable steps (Figure 1).

Step 1: National Dialogue

Ideally, the fiscal decentralization process begins with a national dialogue involving key stakeholders. This debate might be in the context of an election cycle or part of a discussion led by an appointed, broadly representative commission to consider a change in the pattern of governance. The momentum for decentralization may originate from the "bottom up" such as a citizens-movement, or from a centrally led "top-down" initiative; or, from both directions (e.g., the Japanese "integrationist approach" as discussed in Iqbal, Muramatsu and Kume 2001). Regardless of where the pressure originates, some form of discussion about the desirability of decentralization is an important first step. This process is already underway in Kosovo and serves as the context for these briefing notes. The national discussion should focus on the basic goals of the decentralization program and the options available for structuring decentralization. It should not, however, dwell on details. The reason that the decentralization dialogue is important is that for decentralization to be sustainable, key political and administrative stakeholders and citizens alike must buy into the desirability and general outlines of the strategy.[1] Ideally, this national debate will involve the

[1] "Sustainability" here refers to political consensus and sustainability. This concept is different from, but complementary and reinforcing of, the conditions for achieving fiscal sustainability. See Bird, 2003.

main political parties, will have some degree of formality (as in the case of a national commission), and will be transparent. A further important ingredient for the success of fiscal decentralization is a coalition of strong advocates. These advocates will keep decentralization in the center of the national debate and work to develop the coalitions necessary to effect a decentralization policy.

Step 2: Design of the Fiscal Decentralization Program

The design of the fiscal decentralization program should culminate in a *comprehensive policy paper* that lays out the framework for the fiscal decentralization. While the national consensus might be centered on the broad idea of bringing government closer to the people, the "white paper" would lay out the plan for accomplishing this. It would outline the main components of the fiscal decentralization program, provide a timetable for implementation, and serve as the basis for writing the law(s). Fiscal decentralization is a policy that is designed to achieve certain objectives, and therefore, it is critical that the objectives be clearly specified before the program is designed. This policy framework paper must be specific enough, and comprehensive enough, to guide the development of the law and the implementation. At the same time, it must also be recognized that, for example, as the country's fiscal architecture changes (see briefing note on Fiscal Architecture) what was the "right design" in the first year of the program, over time, may no longer fit changing circumstances—thus the argument for establishing a continuing policy development and research process, along with institutions, public and private, to support that process (Yilmaz, Hegedus, Bell 2003). The design phase must follow the national discussion that gives the mandate for decentralization policy.

What if decentralization goes forward without such a policy paper? Two major problems are almost certain to occur. First, without a roadmap for the decentralization strategy, government policymakers will "make it up as they go." This can lead to a fragmented decentralization strategy, pieces of which do not fit together. The other problem with not having a documented framework is that changes to policy in the years that follow may not be consistent with the overall goals of the fiscal decentralization program.

Figure 1. Sequencing Fiscal Decentralization: A Normative Approach

Step 3: Draft and Pass the Decentralization Law(s)

The drafting and passing of the decentralization law naturally follows from the national mandate and from the policy framework paper, and gives legal standing to the implementation of the fiscal decentralization measures. The laws must be clear and true to the policy design. The decentralization laws might stand alone, or some elements of the decentralization program might be introduced into the constitution (Basta Fleiner 2002).[2]

On this matter, there are two further comments. First, there may be (should be) more than one law. For example, Hungary has enacted not only a general Law on Local Self-Government that lays out the basic structure for intergovernmental reform (See the note, “Legal Framework and the European Charter,” and also Peteri 2002), but also supporting laws on local elections, the sorting out of intergovernmental functional responsibilities, regulations on service delivery revenues, borrowing, debt and bankruptcy, asset management, and the capital city (Pallai 2003). Second, recognizing that there is great merit in providing constitutional protections for decentralization and local governance, it is also true that great care must be taken to keep constitutional language broad—that is, to draw a bright line between ensuring protections vs. loading down a constitution

2 It is most important that Constitutions address broad principles and not become cluttered up with details that are appropriately statutory and regulatory. Constitutions are difficult to change and thus do not readily fit the chaining economic, demographic and institutional realities of governance (see briefing note on Fiscal Architecture)

with what is properly a matter of statute and might prevent future reforms.

Recognizing that the "right mix" of laws and constitutional protections may vary from country to country (and/or province to province since just as there are national constitutions there may also be provincial constitutions), a most important factor in getting a successful decentralization in place is to include in the law key elements of the policy design. These key elements include that of: (i) expenditure assignment and authority; (ii) revenue assignment and authority; (iii) design of the intergovernmental transfer system; and (iv) provisions for fiscal discipline. To summarize:

Expenditures: finance follows function. It is important to get correct the order of reform as regards how much should be spent by subnational governments, and how much revenue should be given to subnational governments. There is a conventional wisdom to the ordering. First comes the assignment of expenditure responsibility to subnational governments, after which the assignment of revenue-raising powers and central government revenue shares is determined. The logic behind this finance-follows-function rule is straightforward: one cannot establish the required level of subnational revenues independent of having a reasonably clear sense of the bundle of services one expects a local government to deliver and then pay for. With that said, it is also true that to argue that finance follows function should not be taken as counsel for delaying a policy of mobilizing local "own" revenues. Recent empirical evidence indicates that simultaneous decentralization of tax and spending powers reduces the overall size of the public sector (Ehadie 1994) and improves overall macroeconomic performance (Ebel and Yilmaz 2003).

The significance of local revenue autonomy. It is important to a complete decentralization that subnational governments have independent sources of revenue. If all financing is from revenue sharing and other forms of transfers from higher-level governments, there is a danger that the lower-level government will become a spending agent for the center, with little accountability and operational efficiency (Martinez-Vazquez and McNab 1997).

Design of the intergovernmental transfer system. An important sequencing question has to do with the design and implementation of intergovernmental transfers. The correct order of policy formulation is to first ask which of the many possible objectives should the intergovernmental transfer system accomplish, and only then design the reformed system. The major issue is that different types of transfers have different objectives, and it is important to sequence grant design according to these objectives. One goal is to reconcile the difference between the assignment of expenditure responsibility and the assignment of revenue-raising powers. This goal of vertical balance is arguably the first task to tackle in designing the transfer system. The second step in grant system design is to implement conditional grants for those functions of national/regional importance where it is feared that without central assistance under-provision might occur. Finally, equalization grants should be designed to address the horizontal imbalances that result after designing the first two components of the transfer system (see briefing note on Intergovernmental Transfers).

Subnational governments must face a hard budget constraint. Fiscal discipline, a key element of a successful decentralization strategy, should be introduced at the start of the program. If subnational governments are not forced to operate with balanced budgets, they become accustomed to looking to higher-level governments to cover their shortfalls. A hard budget constraint implies that those local governments that are given autonomy will be asked to balance their budgets without recourse to any end-of-year assistance from the central government. Without a hard budget constraint, the moral hazard is that subnational governments will consciously overspend knowing that their losses will be made good. Furthermore, a soft budget constraint will tend to discourage own tax effort and encourage inefficient and even wasteful spending. As many countries have learned, it is difficult to break the culture of soft budget constraint (see briefing note on Subnational Borrowing).

Step 4: Adopting a Set of Implementing Regulations

In the disucssion above, is was recommended that the dialogue of Step 1 be broad and avoid becoming bogged down in details. But, of course, details matter, and thus it becomes important to develop implementing regulations that spell out how the fiscal decentralization will be put in place. Thus, for example, whereas the policy framework paper and the law on decentralization might call for the transfer of civil servants from central to subnational governments, the implementing regulations would address the detail of this transfer of how government officials, central and local, put the new system in place. It is in this step that one distinguishes between the content of laws and regulations. The law should include those things that are understood to be relatively long term as decentralization policy. For example, provisions for the election of local officials, basic expenditure and revenue assignments, the fundamental structure of the equalization grant, and the civil service status of local and central government employees are not likely to change over time—or at least should not change frequently—and, therefore, properly belong in the law. However, other factors, such as the weighting parameters in the intergovernmental grant formula, provisions for revenue-sharing rates, and administrative arrangements may change with economic development and other variable circumstances, and belong with the implementing regulations rather than the law.

Getting the implementing regulations out of sequence can be quite disruptive of the decentralization program. If these are written before the policy framework paper is completed, then the regulations themselves become an important part of the decentralization policy. This is the "make it up as you go" approach, which was cautioned against earlier. The implementing regulations in this case would be written by different government ministries following more or less their own preferences and the different pieces are unlikely to fit any unified strategy.

Step 5: Taking on the Set of Implementation Tasks

Implementation of a decentralization program involves more than simply passing a set of laws with respect to the intergovernmental fiscal relationship. It also involves developing a strategy for implementation and a significant amount of planning and fail-safe provisions in order to accommodate any failures in the early stages of decentralization. This planning is part of the design phase of the sequencing. Actual implementation comes after the implementing regulations are complete. Several issues need to be considered:

Using asymmetric decentralization. Uniformity is not a necessary condition for effective decentralization. In fact, a better route may be to begin fiscal decentralization with larger local government units and to let the smaller ones "grow into it." Subnational governments have very different capabilities to deliver and finance services. Accordingly, it may be necessary to set up a system where these differences are explicitly recognized, i.e., where different local governments are given different financing powers and arrangements as well as differing expenditure responsibilities (Bird and Ebel 2006).

Building capacity. An often important constraint to the implementation of a newly decentralized system of government is lack of administrative capacity of local governments. When decentralization takes place and the administrative capacity is not in place, what may follow is poor performance in service delivery with all sorts of inefficiencies, waste, corruption, and lack of accountability. Systemic failure of local governments to deliver services is in the long term the worst enemy of decentralized governance—sooner or later the "solution" found will be to recentralize the public finances. That said, the lack of subnational administrative capacity should not be allowed to become an excuse for delay of the decentralization strategy. Governments, central and subnational, must be allowed to build capacity in a "learning-by-doing" manner.

Contingency funds. Like most other government policies, decentralization policy is designed and implemented in a context of limited information and therefore there is always the risk that things may not turn out as expected. For this reason, it is important to provide the implementation process with contingency funds to cover unforeseen circumstances.

"Big bang" versus gradual implementation. A gradual implementation of reform is thought by many to be more desirable than a hurried "big bang" approach. There are two good reasons why this might be preferred: (a) limited available information does not allow for predictions on how reform will work out in comparison to how it was planned and (b) the cost of reform can be substantial, and gradual approaches allow this to be spread out over a number of years (IMF 2000). In short, gradual approaches carry much less risk, and thus it is probably best to argue in favor of gradualism in its implementation. However, the type of gradualism being proposed here must not be seen as a substitute for a comprehensive blueprint for decentralization reform. A gradual implementation approach should be based on an explicit plan with goals and the institutional changes necessary to achieve them.

Transition measures: hold harmless versus "cold turkey." Many forms of fiscal decentralization reform imply that there will be winners and losers among the subnational governments. Sometimes, politically and/or economically powerful subnational governments may effectively veto the reform unless their concerns about the losers under the new system are taken into account. Usually, neither the local government service delivery system nor the local political system can withstand large one-time shocks without causing turmoil in the delivery of essential services. Some form of phase-in of the new system is called for.

Step 6: Monitoring and Evaluation

The final step in the sequencing consists of a well-designed and operational system of monitoring and evaluation by the central (state) government and a well-designed accountability system across all governments. Many developing and transition countries may be characterized as having very centralized systems of government, which are likely to remain centralized for quite some time. A plausible scenario in such countries is that fiscal decentralization will be to a large degree controlled and regulated from the center.

In some cases, the control will reflect hesitancy on the part of the higher-level government to relinquish powers to a new group of bureaucrats. But in other cases, regulation and oversight can be seen as a needed feature of the fiscal decentralization structure. The following are some examples of the latter: As subnational governments move toward debt financing of capital improvements, central governments will be called on to establish disclosure requirements and enforce borrowing limits. The center must monitor the fiscal performance of local governments and identify those in financial difficulties as well as those exerting weak revenue mobilization efforts. The success of central government financing instruments (transfers, subsidies, local taxes) should be monitored annually and fine-tuned periodically. Another example is the need for the center to ensure compliance with the terms of conditional grants, expenditure mandates and taxing limits. Moreover, there is need for the center to provide technical assistance to local governments in several areas. Smaller local governments, especially, require assistance in areas such as accounting, treasury, tax administration, data processing, and project evaluation.

The steps outlined above might be thought of as a normative approach to ordering the elements of a sustainable fiscal decentralization strategy. This sequencing allows each step to build on the necessary prerequisites, and therefore could minimize the chances for failure of the system to accomplish its objectives. In the real world, however, there are important constraints that steer countries away from such an optimal sequencing. And sometimes, these departures are in the best interests of getting the job done. But clearly, while some departures may be admissible in terms of the costs and disruption involved in the decentralization process (for example, getting the implementation started without complete implementing regulations), some other departures may be too costly (for example, decentralizing borrowing powers without providing for a hard budget constraint for subnational governments).

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17.

Building the Capacity to Govern

György Hajnal

Contents

Building the Capacity to Govern

Improvement in governments' political, administrative and fiscal capacity to implement reforms requires human resource development, organizational strengthening and institutional change.

What Is State Capacity? [1]

The Origins of the Concept

The concept of state capacity—whether at national, regional, or local level—originally emerged in the context of developing countries. The purpose of its use was twofold. It was used to explain

- why the efforts of some developing countries (e.g., Japan and South Korea) to "catch up" to the West in terms of economic and social development succeeded, while others failed; and

- why international (Western) technical/development assistance was effective and useful in some recipient countries, while completely obsolete in others.

These differences amongst countries shed light on the problem of (lacking) state, or governmental, capacity. In the post-communist countries, after the initial years of transition, the problem of state capacity yielded a new dimension: as many post-communist states were unable to adequately fulfill even basic functions, capacity building became a real "growth industry."

The Concept of State Capacity

In its simplest form, state capacity can be defined as "the ability to translate concern into policy" (VanDeVeer and Dabelko 2001, 20). Based on another markedly different value content, a World Bank paper defined state capacity as "the ability of the state to undertake collective actions at the least cost to society....[State capacity] encompasses administrative capacity of state officials...and the deeper institutional mechanisms" (World Bank 1997, 77).

State capacity has two major components: political capacity and administrative capacity.

(a) Political capacity refers to the existence of effective and sustainable political institutions and mechanisms to ensure that policies reflecting the country's needs are formulated and that implementing apparatuses are held accountable.
(b) Administrative capacity on the other hand refers to having adequate organizational resources to enable the effective preparation, implementation, and monitoring of government policies.

1 Comments received from György Gajduschek (MKI/Hungarian Institute of Public Administration) are gratefully acknowledged

State capacity is often analyzed by means of so-called governance indicators, such as those compiled by Freedom House, the World Bank Institute, the European Bank for Reconstruction and Development (EBRD), and Bertellsmann. Broadly speaking, these indicators are numeric measures of the capacity of various countries to conduct "good government." They are composed of a detailed hierarchy of sub-indicators, which in turn, are measured *via* expert polls, macroeconomic indicators, and/or secondary data published by other organizations. Nevertheless, one has to bear in mind that while most governance indicators are primarily oriented to measuring either the outputs/results or the processes of government, "capacity" mainly refers to its input side (e.g. human, organizational, institutional, and cultural resources).

Capacity Building

Capacity building is a term encompassing all conscious efforts to increase state capacity. Capacity building programs can be run by domestic governments as well as by international entities such as multilateral donor organizations or foreign governments. However, in transition countries the term most often emerges in the context of Western technical assistance.

Capacity building can have a broad spectrum of specific target areas:

- governmental entities, including both political and administrative;
- NGOs, trade unions, and political parties;
- expert organizations (think tanks, scientific and technical facilities or communities); and
- the broader public.

Whatever the actual target areas of a capacity building intervention, its immediate objective is to enhance one or more of the three fundamental prerequisites of a capable government. These are summarized in the below table.

Table 1. Elements of State Capacity: Possible Objectives of Capacity Building Efforts

Objective of Capacity Building Effort	Examples of Specific Activities
Development of human resources: enhance the supply of professional personnel (either its quality or its quantity).	Provision of training for civil servants Elaboration of training curricula and materials, training of trainers Development of civil service training organizations/systems Technical assistance to improve the legislative framework of public service
Strengthening of organizations: improve organizational structures and management processes to ensure better organizational performance.	Redesigning/restructuring central government ministries Introduction of new management or budget mechanisms in a local government
Institutional reform: create and/or modify (political or social) system-level institutions determining the "rules of the game" in the economic and political fields.	Constitutional reform changing basic elements of the political system Overarching policy/legislative change effecting broad sectors of the society

Source: VanDeveer and Dabelko 2001, 21.

Past Experience Regarding Capacity Building

The "Third World" Experience

A major lesson drawn from administrative development efforts of earlier decades is that a highly autonomous, neo-Weberian *"developmental state"* seems to be a prerequisite of successful development. That is, a strong state capable of

(a) avoiding attempts by strong interest groups to gain control over national government policies and activities (e.g., large national or multinational monopolies' efforts to circumvent national labour and environmental protection, or tax regimes—cf. "banana republics," or the capturing of government policies by powerful regional/ethnic minorities or local strongmen);
(b) effectively countering national and regional security risks and exerting effective physical control over the country's territory.

Such a "developmental state" ideally rests on a highly committed, disciplined, and professional civil service (often integrated by some "universalistic," as opposed to subnational or clan-centered, ideology). Its motto could be "enlightened state versus backward society and particularistic groups."

Subsequent experience, however, has shown that in many cases the strong isolation of government from other societal actors leads to the incapacitation of government policies. In other words, while the strong and unilateral influence of a few interest groups is highly detrimental to capacity building efforts, the presence of a broad spectrum of relatively empowered societal players can be highly conducive of state capacity.

The Experience of Transition Countries

For the past fifteen years, capacity building has been the most permanent and emphatic element of Western technical assistance to transition countries. Most often, capacity building efforts consist of two components:

(a) The preparation of some kind of advice; for example, the elaboration of draft legislation, or an action plan for changing organizational (structural) arrangements or management processes within the government machinery; and
(b) The delivery of some form of training, provided either directly to the final beneficiaries, or indirectly, through the creation of training resources (e.g., compilation of training materials and "train-the-trainers" programs).

Additionally, capacity building programs sometimes have (usually minor) investment components such as the construction of office space or the purchase of equipment. While these capacity building programs have definitely had certain positive effects, they have also had some important drawbacks. On a technical level, the planning, organizational and implementation arrangements systematically produced certain dysfunctions, of which some examples are:

- Many of the projects seem to be very expensive. For example, in the field of civil service training—training unit costs being directly comparable—donor-funded activities were, on the average, 20 to 50 times more expensive than locally run training activities.

- Most of the capacity building efforts utilized a project-type implementation framework; that is, implementing organizations and experts were contracted for the duration of the given project, usually a period of one to three years. Individual- and organizational-level learning was often minimal for two reasons: (i) in the project startup phase newcomers have to learn everything anew, and (ii) knowledge gathered throughout the project can disappear if the project organization ceases to exist and the experts involved leave the project setting (or even the country).

- Another problem with the project-type implementation framework seems to have been that while project plans/Terms of References are, naturally, difficult to change in the implementation phases, they often prove to be either unfounded or outdated as a consequence of important changes in the project's context.

Cultural and management problems were often pervasive. In the interest of brevity, I will highlight only a few problem areas.

- Decision-makers benefiting from capacity building measures (i.e., local participants from the recipient country) lacked sufficient assertiveness vis-à-vis the donor and implementing organizations, which often led to the simple omission of their insights and intentions from the project design.

- This was often exacerbated by a host of skill-, knowledge- and management-related insufficiencies which together led to a surprising lack of coherent and rational/goal-oriented thinking and action on the side of the recipient country. An obvious aspect of this problem was a complete lack of effective coordination of capacity building projects on the recipient side. Especially in the earlier years of transition, practically no recipient country managed to set up a central coordination unit responsible for "channeling in" assistance efforts/resources.

- Finally, an important problem was the often mechanical and senseless copying of institutional and procedural models, and/or the related rhetorical universe, of certain Western countries (cf. "international best practice" as the *ultima ratio* of administrative modernization debates!). Formulating problems and relevant solutions as "agencialization," "citizen participation," or—for the sake of example—"gender issues," in a context where often the very basic prerequisites of state (or even economic and societal) functioning are missing can be highly misguided and even destructive.

Subnational Capacity

Most of the systematized and published evidence on capacity building is related to central government capacity. The available knowledge related specifically to capacity building issues in the field of decentralization is relatively scarce. On the basis of what limited information is available, the following observations seem justified:

(a) A strong version of decentralization might, in some cases, weaken the institutional and material resources of local government capacity building because the central government's policy on capacity building may become too narrowly focused on central government organizations, and thereby "leave local governments on their own." For example, the—often legally/constitutionally guaranteed—autonomy of local governments in setting up and managing their own organization, or setting up and implementing training policies, might prevent central government from designing and implementing adequate measures to ensure that

   - adequate organizational and management standards are in place and minimum requirements enforced;
   - effective policies and measures for training local government personnel are elaborated;
   - sufficient organizational and material resources to implement local government training are in place (including the institutional infrastructure of training as well as the necessary budgetary resources for training).

(b) Another aspect of the above problem is related to the mechanisms of organizational and policy learning across local governments. In the absence of a carefully designed and maintained institutional mechanism ensuring the exchange of experience among local governments many of the capacity building opportunities will fail to be utilized. This can be a very serious problem, since in many cases the most useful and relevant resource for capacity building is the experience of similar local governments within the same country. Actually, *national (as opposed to international!) best practices are the most important domestic resources* for local government capacity building.

Guidelines

General Objective of Capacity Building

Guideline 1. Strengthen state autonomy in relation to powerful domestic and international actors. One of the key factors limiting state capacity is that powerful national or foreign actors—such as large business corporations or regional strongmen—"capture" government policies and programs. Therefore a central objective of capacity building is ensuring government's autonomy vis-à-vis such powerful actors. This requires the creation of a committed, professional and disciplined civil service exhibiting the virtues of classic bureaucracy—as opposed to the often-cited recommendations of New Public Management to "let managers manage."

Guideline 2. Strengthen a broad spectrum of societal partners in a balanced, proportionate way. At the same time, "getting close" to those governed is also important. Therefore the *proportional and balanced* development of a broad spectrum of societal partners—such as NGOs, advocacy groups, think tanks, and the broader public—should be included among the objectives of capacity building policy.

Resources of Capacity Building

In the initial phase(s) of administrative transformation/decentralization, capacity building is mostly driven by external assistance (including technical assistance). From the outset, however, much emphasis has to be put on the long-term creation and utilization of domestic resources. Therefore:

Guideline 3. "Don't leave local governments on their own": make sure that an effective general framework for local government operations exists. Ensure that "strong decentralization" doesn't translate into "leaving local governments on their own." It is not possible to establish a capable local government system without the carefully designed, decidedly implemented and long-term involvement of central authorities. Such central government involvement is necessary, for example, in (i) setting and enforcing organizational and management standards in local government administrations, and (ii) creating and maintaining training infrastructure and training programs for local government employees.

Guideline 4. Create institutions for enabling local governments to learn from one another. In the long run, one of the most important and relevant resources of local government capacity building is policy and organizational learning across domestic local government organizations and practitioners. To make such learning happen, adequate forums for the exchange of experience and knowledge should be created and maintained, and their use encouraged.

Designing and Managing Foreign Assistance for Capacity Building

Guideline 5. Assertively follow your own agenda in "hosting" Western assistance. In the course of designing assistance programs, those involved in providing technical assistance (including donor organizations, implementing organizations, as well as their experts) tend, naturally, to push their own agenda. In order to ensure the relevance of capacity building efforts, however, the recipient side should be able to assertively put forward issues or solutions relevant for the domestic context and—if necessary—refuse those pushed by the donor side. Moreover, instead of opportunistically accepting the donors' view of the problem, strive to identify and formulate those issues/solutions in a way that is relevant and meaningful in the domestic reality of decentralization.

Guideline 6. Give preference to permanent organizations over temporal ones. Instead of relying exclusively on temporal, project-type organizational arrangements in the course of implementing capacity building measures, try to promote the creation/utilization of permanent structures and organizations. This is likely to enhance the sustainability of results as well as to increase the opportunities for organizational learning.

Guideline 7. Use domestic expertise more extensively. In the design and implementation phase of assistance projects promote—if necessary, even by risking conflict with the donor—the use of domestic experts. The possible inferiority of the technical quality or analytical strength of their work is often effectively counterbalanced by their much closer familiarity with problems and the resulting relevance of their conclusions—not to mention their command of the local language, which so often acts a barrier and severely limits the work of foreign consultants.

Guideline 8. Coordinate foreign assistance centrally. Set up a strong central coordinating unit, directly responsible for providing political leadership and coordinating foreign aid in the field of capacity building.

Building the capacity to govern is one of the most urgent and critical matters facing a newly decentralizing, intergovernmental society. Indeed, capacity development it is at the heart of the successful implementation of all the several reform policies addressed in the other briefing notes that accompany this volume. Weak organizations, institutions, and human resource capabilities will undermine the state as guarantor of public welfare and security and the enabling of civil society to hold government accountable for its actions and to fight corruption (OECD 2006). Weak capacity also has a negative impact on the ability to use international assistance in an effective and sustainable manner. That capacity building for both central and subnational governments is a challenging and complex matter is as clear as is the reality that there are many examples of a society's failure to address this challenge and complexity. But, what is equally clear is that many places have been most successful in "developing and unleashing capacity" (OECD 2006). A careful consideration of capacity development issues exposed above can contribute to making Kosovo one of these places.

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18.
Policy Process and Policy Development Capacity

Arta Rama

Contents

Policy Process and Policy Development Capacity in Kosovo

For supporting decentralization sound policy design and implementation capacity has to be developed in Kosovo.

How Policies Are Perceived in Postwar Kosovo

Kosovo is struggling to become an example of a success story of democratic reforms in the region. It has undertaken serious commitments that hopefully in the near future will support its move toward EU integration. However, partly due to such ambitions, the government's commitments tend to be of a more long-term character, rather than immediate solutions that can be implemented with present capacities. Moreover, with the powerful support of the international civil administration Kosovo is undergoing transition at a more rapid pace than other similar post-conflict and post-communist societies.

For more than two years, UNMIK[1] was the only authority in Kosovo that initiated, developed and implemented policies at all levels of governance. On 14 January 2000, Special Representative of the Secretary General passed Regulation No. 2000/1 on the establishment of the Joint Interim Administrative Structure[2] (JIAS) as a temporary local governmental structure. JIAS functioned until the first free and democratic elections, but had no decision-making role and therefore mainly served as a structure for incorporation of local leadership in Kosovo's administration.[3]

At the municipal levels as well, international administrators were responsible for the functioning of municipalities and local services, and performed their duties jointly with administrative councils representing municipal institutions and parties, and administrative boards.[4] Therefore, at both levels in the joint administrative institutions, real policymaking, decision-making, and control belonged to international representatives.

Even with the first elections and the establishment of the Provisional Institutions of Self-Government (PISG), there was little or no improvement in the domestic capacity to develop and make

1 UNSC Resolution 1244 vested UNMIK *inter alia* with the authority to perform basic civilian administrative functions, as well as to organize and oversee the development of provisional institutions for democratic and autonomous self-government. The full text of the resolution is available at http://www.un.org/Docs/scres/1999/sc99.htm.

2 JIAS was composed of: the Interim Administrative Council (IAC), the Kosovo Transitional Council (KTC), administrative departments, municipal councils and boards.

3 The establishment of JIAS served as an argument for dissolution of all parallel structures that by the end of the war either claimed or attempted to exercise various forms of public authority in Kosovo. The parallel structures consisted of the "Provisional Government of Kosovo," the "Presidency of the Republic of Kosovo" and the "Parliament of the Republic of Kosovo." However, neither the JIAS nor the establishment of PISG after the elections was able to achieve the dissolution of parallel structures that were organized, supported and directed by Belgrade, and which continue even today to operate in Serbian communities of Kosovo.

4 Regulation No. 2000/1 on the JIAS, foresaw that the Municipal Administrative Board would, as its name suggests, be responsible for municipal administration. The Board was chaired by the International Administrator of the Municipality (appointed by the SRSG) who monitored the work of the Board and had the authority to appoint and remove other members. As for Municipal Councils, its members represented the citizens of a municipality and were appointed by the Municipal Administrator. The Municipal Council was a consultative body and made recommendations to the International Municipal Administrator on any matter within his or her authority.

policy in Kosovo. Due to lack of local capacities in the newly created government, and also due to UNMIK's standing (as the main public authority aiming at gradual transfer of powers to PISG), governmental policies in Kosovo were driven by an international presence that even today is the main source of analyses, policy development and, together with PISG, policy implementation.

Within this arrangement, policies were mostly either imposed on the Kosovar government or given ready for approval, and while the government wished to prove zealous, particularly toward policies aimed at improving communities, most often it did not question the process by which such policies had been created. Moreover, the government committed itself to the implementation of policies without any prior assessment of the capacities required for their implementation.

In addition, even when the policymaking process was handled within PISG, policy advice and analyses came mostly from foreign experts who were either employed for this purpose within PISG on different supporting projects, or at international organizations—and local officials had little idea how to use the policy advice and analyses. Often, such advice and analyses were not authentic, but were simply borrowed and with a few changes adapted to Kosovo without taking into consideration unique aspects of the local situation; thus ultimately the policies were not relevant. It is unavoidable that policies should reflect the traditions, culture, history and values of the public that they will affect.

Decentralization Policy: The Existing Obstacles

For more than six years Kosovo has been an oasis where many donor countries, international governmental and non-governmental organizations, and other actors have offered assistance in the policy development process. Yet little progress has been made in building local capacities, with the result that the local level is unable to absorb the full range of assistance on offer. Further, the lack of local ownership over the policy process has proved to be a main obstacle toward the realization of policies, for without a sense of ownership policies have simply been accepted without prior assessment. The imposition of the decentralization policy in Kosovo by UNMIK and the international community within a very short period of time is the most striking example.

Decentralization policy in Kosovo—which was initiated by UNMIK as a tool for convincing the Serbian community of the need for their integration into Kosovo's public life—is primarily based on ideological goals rather than on analysis or assessment of actual needs on the ground. Thus far, decentralization policy has not resulted in much improvement of the situation, and only in a few limited cases has it enhanced the efficiency of self-governance. The limited success of decentralization policy is mainly due to a lack of authority, insufficient budgetary resources, and lack of capacity to undertake new responsibilities at the subnational level.

Therefore, as practice has shown in many countries, if the decentralization process is not implemented properly, distribution of powers to a secondary level of government may contribute to further aggravation of the existing situation. The approach taken by the Kosovar government and UNMIK is that the present form of decentralization is experimental until 2008, when a decision will be made on whether it is compatible for Kosovo.

For places like Kosovo, decentralization can aid the democratic transition by increasing local participation in public decision-making and administration, empowering communities, and encouraging transparent and accountable local governance. But decentralization needs to be addressed cautiously in highly sensitive environments like Kosovo—which is not only a postwar territory but strives to establish the rule of law, fight corruption and organized crime, and build upon weak managerial traditions.

The process of decentralization in Kosovo has been highly politicized and exclusive, proceeding without the participation of most social groups. The lack of transparency has resulted in dissatisfaction and a misconception of the nature and purpose of decentralization among the wider population.[5] Moreover, unequal development of institutional, infrastructural and human capacities between existing municipalities and new ones to be established under the decentralization policy, increases the risk of an asymmetric decentralization in Kosovo that will further deepen horizontal inequalities.

An appropriate legislative framework is also a priority for Kosovo. In some areas Kosovo clearly lacks a sufficient number of laws and regulations, while in others it suffers from the existence of several sets of laws regulating the same issue. The Kosovar government is trying to build a legal framework from scratch by approving new laws that conform with international and EU standards, while continuing to apply two sets of former Yugoslav laws[6] in addition to UNMIK regulations. The uncertain nature of the legal framework has a deleterious effect on the policymaking community (analysts, researchers and policymakers) and on policy implementation.

Lack of a permanent mechanism for assessing the compatibility of different laws precludes an assessment of the impact of legal regulations prior to their adoption. Therefore, taking into consideration that the Constitutional Framework of Kosovo does not allow for the establishment of such mechanisms, it is of crucial importance for Kosovo to create them within the government administration. But merely establishing mechanisms for the impact assessment of laws is not enough, concrete steps must be taken in order to make them functional and capable of identifying the best options for society.

Finally, in Kosovo one of the most serious impediments to sound policy development is the lack of credible and valid data. In the absence of appropriate data it is impossible for policy researchers and analysts to evaluate potential future impacts of policies.

5 In a survey conducted by the author between June–October 2005 with citizens, only 18% of respondents could state the aims of decentralization in Kosovo, while 82% reported hearing about the process but couldn't recall its exact aim.

6 According to Regulation 199/24 on Applicable Law in Kosovo, among others applicable laws include: legislation that was applicable in Kosovo before 22 March 1989 and laws applicable in Kosovo after 22 March 1989 that are not of discriminatory nature.

Building Policy Development Capacities: What Should Be Done?

Like any other government in the world, Kosovo needs to develop sound public policies in all segments of life that will aim at improving overall social and economic conditions. Considering that successful decentralization is the main test for Kosovo in front of the international community to prove its full commitment for functioning democracy, it is crucial to develop a strategy for sustainable organization and management of policy design and development in the field of decentralization.

Decentralization Is Part of Good Governance

Kosovo clearly needs to develop policies that would present decentralization as an integral and necessary part of good governance, as well as to build better partnership with civil society organizations and media for promotion of citizens' participation and inclusion in policy design at all levels. It should be noted that while strides have been made, several areas that collectively contribute to good governance are lacking, among which most notable is transparency and accountability.

Capacity for Policy Analysis and Design

While external assistance that was given until now to Kosovo is still needed and helpful, the government and civil society have to generate their own policy analysis and research, as well. In most transition countries where public sector wages are uncompetitive, substantive expertise remain outside the government structures, thus making it difficult for governments to obtain permanent expertise (Verheijen 2005). Therefore, developing a strategy for offering competitive conditions for attracting experts within governmental structures might be a way to improve existing policy capacities in Kosovo.

Professional Civil Service

In this regard, it is necessary for Kosovo to build a professional civil service with strong policy analysis skills that is able to provide credible and useful solutions for policymakers. The government of Kosovo is undergoing a difficult process of consolidating the civil service capacities and due to budget constraints is often forced to limit hiring sufficient number of staff for conducting even regular administrative functions within ministries and municipal authorities.

In postwar Kosovo, the need for training of government officials was understood more as a need for training central government officials, rather than municipal ones. However, recent developments of the decentralization policies have been accompanied by acknowledgement of the importance of training for municipal staff.

Within municipal government it is important for policy practitioners to learn about the role of policies in each society, their influence and their efficient use. Therefore, it is crucial for them to understand and learn properly the processes how policies are made, and especially to understand the importance of the transparent policy development.

Parallel System of Policy Design

Different organizations operating in Kosovo within the last six years have helped directly in building capacities within PISG. They also empowered many local NGOs in becoming important factors in the policy development and decision-making process in Kosovo. Organizations such as KFOS, UNDP, EAR, USAID, in consultation with PISG, have developed numerous projects for development of policy design capacities, either by offering research fellowships in this regard, or by providing foreign or local consultants. Practice showed that due to lack of experience and knowledge in the field of policy development, these supporting consultants in most cases had to take upon the responsibility for developing policies, while governmental officials served more as technical support for them and less as partners in producing actual policies.

In the future attention should be given to strengthening policy capacities within central and local government, that will be able to properly handle policy development in different fields. Like in many countries in transition availability of foreign funding for supporting different civil society groups led to development of a parallel system for policymaking. This shortened the government's possible civil service capacities.

While there is a need to continue the provision of foreign and local experts to the Kosovar government, the approach should unquestionably be changed. The practice of involving governmental officials more intensively in the policymaking process is crucial. This could be done through involving them in the process more actively from the earlier phases of developing ideas, writing, analyzing and lobbying a particular policy within the government. The working strategy for external experts should be mainly offering consultations, feedback and training to local officials, who in turn would be doing the main work. Thus, such a strategy would enable establishment of sustainable capacities within the government of Kosovo.

Another way to improve the policy capacities in Kosovo is to follow the trend of some transition countries, where leading universities are occupying the policy and consulting market niche (Livny 2005). Typically the university faculties and academic institutions were engaged in the policymaking process through projects supported by different donor organizations. A sustainable cooperation should be established, where master, doctoral and other students would conduct different research in the field of decentralization. In addition, research institutions could be established within universities, where faculties would conduct different policy analyses and research, that would enable the government to strengthen capacities. In future they might provide qualitative and policy relevant analyses for the government.

Transparent and Inclusive Policy Development

Policy advices that are produced by different social actors, representing interests of various groups, are crucial for developing policies that deal with the core issues of society. Therefore, Kosovo should avoid becoming a society where policy advices are not needed and decisions are mainly based on authoritarian central and local authorities.

The previous practice of PISG and UNMIK in developing the general framework for decentralization in Kosovo was to carry out policy preparation behind closed doors. Usually, once they were framed by the international community and gained the support of the local leadership, these policies were brought to public as already agreed decisions. In most cases the public never learned how or why a policy was designed in a particular way.

Therefore, it is very important for Kosovo to establish the practice where public opinion will have an impact on future decisions. This could be achieved through organization of regular public debates and public consultations, which would be held prior to decisions by authorities; where the public could give its opinion and express views on whether a policy would improve people's life, or whether there are other greater policy priorities. Once a policy has been developed, and before being presented in its final version, a similar public debate should be organized. This time the public consultation would be aimed at confirming whether the developed policy is in conformity with the public's requirements and actual needs. Transparency and increased public participation in policy-making would give policies greater legitimacy, and bode better for their future implementation.

For successful implementation of policies, nowadays it is imperative to get the media's support. The influence of the media has become so great that it can steer the public's attention toward different issues. It is not uncommon in many countries for the media to remain highly politicized and influenced by the government, even though democracy requires an independent media that serves the interest of the general public.

So far in the process of developing decentralization in Kosovo, PISG and UNMIK have not co-operated with the media at a satisfying level. It has often happened that the media, through different channels, found out and published information on many decentralization policies that would otherwise not have been made available to the public. In order to earn back the trust of the public in the process of decentralization, it is imperative for the government and UNMIK to change their approach toward the media and increase transparency in this regard. The attention of the media should be captured not only by releasing much more information on government activities, but by establishing regular contacts that will help build a circle of trust between media, citizens and government.

However, improved communication should extend not only to the government but also to external policy analysts. There are many ways that different policymakers can develop better cooperation with the media and better publicize their activities; e.g., by regularly providing tip sheets, journalism forums, source directories, and surveys (Popper 2005).

On the other hand, especially in newly created municipalities, the public should be informed about how services are provided and about the responsibilities of government representatives toward them. Thus, establishing a program that would promote cooperation and exchange of information, including good and bad practices regarding the decentralization in Kosovo, could significantly improve the level and quality of transparency.

Role of the Civil Sector in Policy Development

Practices of countries in transition have shown that non-governmental stakeholders are not usually welcome to participate in decision-making processes relating to highly politicized issues such as decentralization, judiciary reform, and administrative reform (Kourylev and Evenson 2005). However, EU standards encourage development of effective mechanisms that enable active cooperation between governmental and non-governmental sectors.

With some exceptional cases, the practice in Kosovo has shown that civil society has not been active in producing policy analysis. This is so because Kosovo still does not have a strong and sustainable civil society; it is still highly dependant on foreign funding and support.[7] Therefore, Kosovo needs to strengthen policy capacities within different civil society groups, interest groups and think tanks, that can contribute to broader encouragement for public involvement in coordinating and producing policies, both at national and municipal level. In this regard, it is important to organize trainings for civic actors that would teach them how to do policy research and analyses.

In Kosovo the lack of capacity is such that, without the assistance of different foreign donor organizations, the government is incapable of producing policy analyses to inform future decisions. The trend so far has been that as foreign donations targeting domestic policy capacities are reduced, the government of Kosovo will need to turn to policy consultants in different spheres. Therefore, the government will undoubtedly need external policy advice in the relatively near future, so it should take steps to strengthening policy institutes, think tanks, consultancy groups or companies that are most likely to provide them with policy analyses and research.

How to Make Policies Successful?

The most important component of any successful policy is the appropriate communication and advocacy for the ideas expressed. Therefore, communicative capacities should be developed in tandem with policymaking capacities.

It is crucial that the political will for reforms exist and that the government shows a readiness for accepting internal and external policy advice, as the basis for future decisions. Moreover, it is important to develop policies that are relevant for and can be implemented in a particular context, given available capacity and resources.

It is very important that policy options provided through analysis are in accordance with existing budgetary constraints and political feasibility (Young and Quinn 2005). In Kosovo, particular attention should be given to such factors, since practice has showed that there is often insufficient financial means for the realization of approved policies. The decentralization policies in Kosovo

7 In postwar Kosovo, only a small number of registered NGOs has managed to build reputations that enable them to operate continuously without experiencing the serious funding shortages that most organizations face.

have proved to be very unsuitable for implementation, as the present political situation in particular regions has not been taken into account.

Above all, it is imperative for all stakeholders to develop a sense of ownership and responsibility toward policy development and implementation. This can be done only through a combination of all the above-mentioned elements that are necessary for developing successful policies.

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Special Topics

19.
Local Economic Development in a Post-UNMIK Kosovo

Scott Abrams

Contents

Local Economic Development in a Post-UNMIK Kosovo

The role of local governments in promoting a friendly public sector environment enables economic development.

The question of Kosovo's political status will be decided soon, but for many issues and long-term concerns, such as the creation of a viable and sustainable economy, the final decision regarding status will be just the starting point on a long road of urgently needed reform and investment at both national and local levels. This statement is in no way intended to belittle the question of status; in fact, all twelve of the Kosovar municipalities that have developed comprehensive local economic development (LED) strategies since 2002[1] cited the omnipresent status question as a major threat to their development. Nevertheless, despite potentially inflated local expectations, there is no evidence that the resolution of the status question will automatically usher in a wave of investment and economic growth. This means that like everywhere else in the region, both national and local authorities, in conjunction with the private sector, will need to carefully strategize about how to improve their business climates and how to maximize their economic strengths and opportunities, while minimizing their weaknesses and threats.

This briefing note focuses on the continued need to improve Kosovo's business enabling environment and to encourage local economic strategic planning in the post-status period. It also highlights some of the salient issues that Kosovar municipalities will need to contend with, and elucidates international good practices and lessons learned that may be utilized to overcome existing economic or administrative hurdles.

Kosovo's Business Enabling Environment

Kosovo's postwar economy has been characterized by a reliance on financial transfers from international donors and the diaspora. Today, with the postwar construction boom largely over and negligible production or export taking place, most business in Kosovo revolves around small-scale trade (European Stability Initiative 2004). Much of that trade and associated labor take place outside the formal economy, helping to explain why most of Kosovo's budget revenues still derive from import duties collected along its boundaries (European Stability Initiative 2004). In a region where high unemployment rates plague most every economy, Kosovo stands out with an unemployment rate approaching 45 percent (World Bank 2005). Add to this equation the fact that Kosovo's population is the youngest and among the fastest growing in Europe and it becomes evident that unless large numbers of meaningful and productive jobs are created in the near to medium term, Kosovar stability and democracy will remain tenuous.

1 The strategies have been developed under the Developing Economies Locally Through Action and Alliance (DELTA) program implemented by Riinvest Institute and financed by the World Bank and the Local Government and Public Service Reform Initiative (Open Society Institute–Budapest). The 12 municipalities are: Drenas, Ferizaj, Gjilan, Istog, Kacanik, Klina, Lipjan, Peje, Podujeva, Prizren, Viti, and Vushtrri. The Research Triangle Institute, sponsored by USAID, has been doing follow-up work with a number of these cities on concrete action plans and spatial analysis for encouraging LED.

The above macroeconomic considerations notwithstanding, there are reasons for optimism. A 2005 study on business conditions in Kosovo concluded that "Kosovo proved to have a far more business friendly environment than any other member of the Yugoslav Federation and even outperformed some of the recent entrants to the European Union in some areas (USAID 2005)." Areas in which Kosovo fared strongly in this regard were: (i) number of procedures (5) and time needed (23 days) to start a new business; (ii) time needed (9 months) to dissolve a business; and (iii) labor market flexibility. These strengths are extremely important and bode well for the entrepreneurs needed to drive economic growth.

Less favorable however are other indicators highlighted in the same study. These include: (1) capital requirements needed to establish a business; (2) access to credit; and (3) contract enforcement, particularly with regard to debt collection (USAID 2005). So while processes may be relatively simple and straightforward when it comes to starting a business, costs may be prohibitively expensive. For example, the minimum capital requirement needed to establish an enterprise is roughly three times the monthly per capita income of €130 (USAID 2005; World Bank 2006). Also discouraging is the €220 charge for registering collateral in order to try and access the credit market. These factors may to some extent help explain the bloated informal economy despite the relative *procedural* ease of starting a business.

While it may be relatively easy to reduce some of the above costs, there are additional, more fundamental domestic inhibitors of economic growth that need addressing, particularly for Kosovo's municipalities. Not least of these is the impact of UNMIK's Kosovo Trust Agency (KTA), which is responsible for managing all "socially owned property." A review of twelve municipal economic strategies carried out in the summer of 2005 notes, "the KTA is an anomaly that was most likely created with the best of intentions, but which now seems to be a principal barrier to the [economic] growth of the municipalities (Budds 2005)." If municipalities are unable to manage a large portion of their local properties and assets, they lose a vital tool in helping to attract investment, retain businesses and generate direct incomes/rents to fund local services.

Although according to the above-mentioned USAID report the business registration process is highly efficient, if not exactly affordable, there is a growing sense in Kosovo that it is overly centralized. In the past, business registration took place at the municipal level. Now entrepreneurs can register only at the Ministry of Trade and Industry in Pristina or at one of its regional offices. Municipalities have noted that it is often difficult to get information from the ministry offices, particularly if their local political party differs from the one in power centrally (Budds 2005). With only partial or delayed information on local businesses, municipalities have a reduced ability to develop and conduct proactive business development, training and/or retention programs; and are similarly constrained in the elaboration of comprehensive local economic development plans.

The list of obstacles cited above is in no way meant to be exhaustive, but simply reflects some of the problems most frequently cited by municipalities with regard to economic development. Addressing these issues, of course, will shape the platform from which Kosovo's private sector will either grow or contract.

Local Economic Development Strategy-Making

Strategy development for local economic development is an essential tool that municipalities can use to generate private-sector growth. A favorable business climate and a local economic development (LED) strategy for economic growth are mutually reinforcing. A friendly enabling environment should foster the successful implementation of a strategy, while a strategy should highlight areas where the business enabling environment can be improved.

LED strategic planning is essentially about maximizing the potential of a range of factors including location, physical infrastructure, human resources, capital and finance, knowledge and technology, industrial structure, quality of life, investment climate, institutional capacity and community (Wong 2002). LED strategies administered and implemented at the local level can increase the potential of employers to generate jobs (Abrams and Murphy 2005).

By actively reviewing its economic base, a municipality or community can develop an understanding of the opportunities for, and obstacles to, growth and investment. At the municipal level, businesses both large and small often choose to locate or develop in an area because of agglomeration economies, that is, the benefits derived from sharing markets, infrastructure, labour pools and information with other firms. The economic advantage of an area therefore depends on the quality of governance and management, and on the policies affecting the availability, or lack of, business infrastructure such as electricity, transport, telecommunications, sanitation and developable land. Factors affecting worker productivity in the local economy can include the availability and quality of housing, health and education services, skills, security, training opportunities and public transport. These *hard* and *soft* infrastructure factors are major determinants of a community's relative advantage, and the quality and provision of *hard* and *soft* infrastructure forms the cornerstone of a successful local economy. The vast majority of businesses in a municipality are, after all, small and local, and reliant on the effective functioning of the municipality (Abrams and Murphy 2005).

Ideally, an LED strategy will form a component of a broader strategic development plan that includes social and environmental components. The LED strategy provides a focus for strengthening the local economy and building local capacity. The timeframe for an LED strategy is typically three to eight years and should include annual implementation plans which are directly linked to the municipality's budget.[2]

The recent introduction of a modern property tax system in Kosovo is a promising development for linking local revenue generation with improved local public services. Property tax collections rose to 25 percent of total municipal own source revenues during the first half of 2005, increasing roughly 14 percent over the same period in 2004. Revenues generated locally from property taxes and license fees can only be invested in hard infrastructure projects such as roads, water supply, waste collection, etc.[3] These investments are critical for laying the foundation for economic development.

2 For more information on the World Bank and Open Society Institute methodologies for LED strategy development, based on OECD good practice, see World Bank 2004.

3 This short overview of recent changes in tax legislation is provided by Sejdi Osmani, Director of Administration, Riinvest Institute.

Twelve of Kosovo's thirty municipalities have undertaken comprehensive LED strategic planning efforts sponsored by the World Bank and the Open Society Institute in the past four years. Six additional cities—Dardana, Kastriot, Malisheva, Sharr, Shtime and Gjakove[4]—have recently embarked to do the same. That leaves nearly half of Kosovo's municipalities, including the cities of Pristina and Mitrovica, without a commitment to comprehensive LED planning. The final status agreement may also see the creation of new municipalities which will need to develop such a strategy. Furthermore, municipalities that have already developed strategies should continue to review and revise them on a periodic basis, and may need technical assistance in doing so. Finally, recognizing that when it comes to Mitrovica a political settlement will need to be in place before LED strategic planning can truly take place, *inclusive* LED strategy-making may act as a bridge and help foster Albanian-Serbian dialogue on some areas of common interest.

Having all this in mind, a number of policy options are offered below regarding the business environment in Kosovo and the importance of LED strategic planning. Following which, a number of specific suggestions are made to help ensure that LED strategy development is done in the most optimal way possible.

Policy Options

1) The post-UNMIK central government (whatever form that may take) could reduce the costs associated with registering a business and collateral. The medium-term rewards from having tax-paying businesses and improved employment rates will outweigh the need for high cash payments to open an enterprise and provide access to the capital markets.

2) The Kosovo Trust Agency's responsibilities concerning the management of municipal land might be transferred to Kosovo's municipalities, not the central government. Strong regulations would then need to be put in place to make sure, especially in the case of ethnically mixed municipalities, that a representative committee works together to make decisions on properties and/or assets of common interest.

3) The business registration process could be devolved back to the municipal level, along with performance indicators for efficiency and transparency which would need to be met by all municipalities. A joint *and public* database of registered businesses could be created that would allow both local and central authorities to access the information.

4) The central and municipal governments could publicize the positive findings of the business environment survey and get the message out that it is simple to start a legitimate business in Kosovo. If costs could be reduced in the near-term, and once a final status is agreed upon, the government might choose to legitimately advertise itself as the "friendliest business environment in the region."

5) An economic development officer could be appointed in each municipality with the specific responsibility to push for the implementation of the economic strategic plan. This

4 The Gjakove plan is sponsored by UNDP.

should involve facilitating partnerships between the different levels of government, the private sector and the donor community to realize specified goals and objectives. The LED officer should take the lead in ensuring the business administrative and regulatory environments are running as smoothly as possible under the existing legislative framework. Even if municipal governments are unable to hire additional personnel to play this crucial role, the position may be created by shifting existing personnel around. Ideally this person would also have been intimately involved in the development of their municipality's plan for economic growth. If no such plan exists, they can take the lead in organizing the effort (or submitting a proposal to a donor to help with the financing and technical assistance). Donors interested in sustainable economic development in Kosovo may undertake to provide comprehensive training to these local development officers (and potentially their teams).

Finally, the following points provide a concise overview of some of the critical lessons learned in Central, East and South-East Europe over the past decade of LED strategy development efforts.[5]

Planning Insights

- **Strategy objectives and projects are often not prioritized**. By default this means that everything is a priority, which unequivocally translates to nothing is a priority. Without a clear indication of what the most pressing needs are, and in what order to address them, the municipality will find itself back where it started.

- **Strategic goals are often vague and generic**. If LED goals are not well defined from the outset, or do not adequately reflect identified municipal assests, the LED strategy is inherently weakened. Every municipality has unique, positive characteristics that can be exploited and maximized.

- **Lack of political agreement and support from all sections of the community can seriously hinder LED efforts**. Any LED strategy that seeks to improve the local economy will require broad and continuing support across the political spectrum throughout the timeframe of the straregy. It is all too evident that unless political "buy-in" and agreement has occurred, a change in the political composition of a municipality will result in the LED strategy being ignored or usurped in favour of more politically expedient programs.

- **Strategies should be locally written**. Where a municipal LED strategy is devised and compiled by an individual or team of external consultants, the strategy itself is unlikely to be implemented with the enthusiasm, commitment or conviction that a locally written strategy would be. In building local capacity to take responsibility for implementing the LED strategy, it is better to have an imperfect locally produced strategy that is owned by

5 This list derives from an unpublished LGI study led by Pawel Swianiewicz entitled "Local Governments and Development—What Works and What Does Not?" and the operational LED programs that LGI and the World Bank have supported in Albania and Kosovo. The Swianiewicz reports can be viewed at: http://lgi.osi.hu/documents.php?m_id=98. For a full list of these recommendations, see Abrams and Murphy 2005.

the community than a strategy that has been produced externally (but might look fancier).

- **Private sector engagement is essential**. Economic development is led by private sector growth. It is the business community that best understands the obstacles impeding local economic development and their input is critical in addressing those impediments. Business representatives bring capital and entrepreneurial resources to the process, resources that can be harnessed in a variety of partnership initiatives to spur development. Businesses operate under the guidelines, rules and regulations of the local economy, and are best positioned to suggest changes to the regulations that shape the local business environment.

- **Mayors and municipal assemblies should sign a commitment to the process,** with identified performance targets and personnel allocations.

Implemenatation Insights

- **Unclear action plans and/or weak monitoring systems reduce strategy impact**. Strategy goals and projects not only need to be prioritized but the priorities need to have detailed and feasible action plans. Project descriptions should serve as blueprints for activity. They should include a list of contributors (specifically naming what each group can and will assist with), a timetable, a realistic budget, risks to be mitigated, and clear ways to monitor and evaluate the progression and impact of the project. The blueprint will allow anyone in the municipality, since staffs change, to pick up and manage the project at any time. The monitoring and evaluation mechanism (that is, a clear set of measurable indicators) is intended to ensure that the project is adapted if needed to increase its impact, or cancelled if it turns out to be a net loss initiative.

- **Too great a focus on external (i.e. state and donor) funds is commonplace**. The principal rationale for the strategy should be to more efficiently manage self-generated and existing resources, as well as to create a more favorable investment environment via internal reforms. While external funds are of natural importance, municipalities have less control over this domain and therefore may end up with strategy components that cannot be implemented. Often a strategic plan has been a precondition for donors to "invest" in a municipality. While this approach clearly makes sense, one must also avoid a situation where the municipality sees the strategy foremost as a way to leverage external funds rather than as a tool for better allocating own source revenues.

- **Weak link between strategy and municipal budgeting process**. This point relates to the one above. The strategy should serve as a guide to the annual budgeting process. Priorities identified should be matched to existing resources, with co-funding and private sector contributions (and partnerships) sought whenever possible.

- **Local strategies should be integrated into their respective regional or national economic strategies**. The adoption of new programs or the introduction of new policies at higher levels may be of great use to the municipalities.

- **For sustained success, strategies should be reviewed annually to adjust to changing environments**. New opportunities arise; new threats emerge. One cannot expect the same policy to be successful year after year without modification.

- **Quality of life factors enhance economic development**. Green spaces, cultural attractions, sports facilities, cleanliness and other quality of life attributes can advance economic development. A city that is pleasant to live in is one that is more likely to retain local businesses and attract new ones.

- **Municipalities can strengthen their positions through horizontal collaboration**. As highlighted earlier, detriments to economic growth are often external factors, ranging from macroeconomic state policies to national tax rates to centralized processing of business-related matters. When municipalities are faced with the same barriers, horizontal networking—via associations of municipalities or through informal ad hoc structures—can result in a strengthened position vis-à-vis the central government.

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20.
Territorial and Administrative Structures

Paweł Swianiewicz

Contents

Territorial and Administrative Structures

Local government systems with large-or small-size municipalities can be managed efficiently under different political, service delivery and administrative structures.

European Models of Territorial Organization

Throughout Europe tremendous variation can be observed in territorial organization at local level. Consequently, there is no single model of territorial organization. England sits at one extreme, with an average local government of over 120,000 inhabitants, and France at the other, with over 30,000 communes and an average size well below 2,000 residents. Territorially consolidated municipalities tend to prevail in Northern Europe (Sweden, Denmark, Netherlands), while fragmentation is more typical of Southern Europe (Italy, Spain, France). Similar variation can be found among local governments in the post-communist countries of Central and Eastern Europe, here we find large local governments in Lithuania, Bulgaria, Poland or (former) Serbia and Montenegro, and fragmentation of municipalities in the Czech Republic, Slovakia, Hungary, Ukraine, and to a somewhat lesser extent, in Latvia and Estonia. In the fragmented model, well over 50% of municipalities have less than 1,000 residents, with extreme lows falling to below 100 or even 50.

Historically, two major waves of territorial reforms can be observed in European countries. The territorial consolidation reforms of the 1950s, and later in the 1960s and 1970s, were inspired by the desire to accrue economies of scale in the delivery of local services. Of the countries that underwent reform during this period, many were West European (England, Netherlands, and Scandinavian countries) and several were Central East European (Poland, Czechoslovakia, Bulgaria, and Hungary).

The fall of the Socialist regimes in 1990 saw a reversing of the trend toward consolidation, and several countries of Central and Eastern Europe—Czech Republic, Slovakia, Hungary, Ukraine, and some countries of South-Eastern Europe—initiated reforms of territorial fragmentation. Although there was no similar trend in Western Europe, still there too one could hear voices arguing that the benefits of territorial consolidation had earlier been overestimated.

This diversified and dynamic picture suggests that the choice of territorial model is not an obvious one, and requires balancing the advantages and disadvantages of various solutions.

Arguments For and Against Territorial Consolidation

Although theoretical discussions and results of empirical studies on the impact of the size of municipalities on local government functioning are quite complex and often conflicting, the dominant tone of conclusions drawn might be summarized as follows:

- Territorial consolidation makes more radical decentralization of functions feasible. Very small local governments are unable to take on responsibility for several important functions, such as primary schools or solid waste disposal.

- Some functions benefit from economies of scale (with the result that unit costs of goods and services are lower in larger local governments). The best documented in several countries is economy of scale in administrative services.

- Larger local governments can hire professional administrative staff more easily.

- In territorially consolidated systems there is less pressure for equalization mechanisms, as there is usually less variation among revenues from own sources.

- In consolidated systems it is easier to minimize the "free rider" effect; namely, when consumers from one local government benefit from services financed and delivered by another. In larger local government units spillovers are more manageable: external costs can be internalized.

- Larger local governments can usually better influence local economic development because they can better mobilize resources for crucial projects and have more coherent land-use planning. (Although some authors argue that territorial fragmentation supports economic development by stimulating competition between local governments.)

- Territorial fragmentation supports direct forms of local democracy. Citizens in small jurisdictions are usually more interested in and satisfied with local government functioning, and feel (and actually are) better informed.

- Larger municipalities require a different type of representation in which political parties and institutions matter more; direct participation is more complicated.

- In ethnically mixed territories, there is an additional argument related to the autonomy of communities with a strong feeling of distinctiveness, which in some cases may lead to the creation of smaller local governments

As we can see from above, there are a number of arguments in favor of both consolidation and fragmentation. Ultimately, the choice of systems depends on which values of local government we want to promote.

Table 1. Territorial Organization and Service Delivery Options

	Size of Municipal Governments	How Most Local Functions are Provided	Risks
1	Small	Narrow scope of functions for local governments; most services delivered by the state administration.	Limited decentralization; central provision often less effective than provision by democratic local governments.
2	Small	Narrow functions of villages and small towns; larger towns deliver several services for surrounding settlement units (formally separate local governments).	Accountability and financing problems in delivery of services for small local governments.
3	Small	Wide scope of functions for local governments. Several services delivered through contractual arrangements: by "contracting out" (buying services from the private sector) or "buying in" (small local governments purchase services from a larger town nearby).	Difficult to implement in countries with weak market of private providers. Local governments reluctant to enter "buy in" agreements.
4	Small, with middle tier	Narrow functions for basic tier governments; upper tier responsible for majority of vital functions.	Not applicable for small countries.
5	Small	Wide scope of functions delivered through voluntary cooperation of local governments.	Political and administrative costs of cooperation. Accountability and transparency problems.
6	Large	Wide scope of functions delivered by consolidated (amalgamated) local governments.	Small communities risk losing identity. Fear of domination by the main settlement units. "Distance" to decision-making and administration is great.

The last two options (5 and 6) appear to be the most viable for Kosovo and are briefly discussed in following sections. Taking into account the size of Kosovo, it is reasonable to focus on territorial organization at the municipal level, leaving aside the issues of number of tiers and/or size of regional level governments.

Cooperation of Local Governments: Remedy for Weaknesses of the Fragmented System?

In a situation in which individual local governments are too small to provide some functions effectively, voluntary cooperation with neighboring municipalities is often seen as the solution. This is frequently seen as an alternative to the creation of large local government units through the amalgamation process. Moreover, such a solution allows residents to benefit from the more direct local democracy of small local units.

However, in practice, the experience of voluntary cooperation is not always positive, and empirical research provides examples of both success and failure in this respect. First of all, local governments are often reluctant to cooperate—even if cooperation is a logical and effective solution. Second, if and when they cooperate, local governments often enter into conflicts which detract from the benefits of cooperation.

Cooperation among local governments also has its political and economic costs, which are sometimes difficult to accept. Cooperation impinges on the political ambitions of local leaders, who are forced to concede some of their power. Moreover, it incurs transaction costs associated with more complicated organizational-managerial settings. Finally, cooperation produces transparency and legitimacy problems in a situation where authorities of the "cooperative arrangement body" are not directly elected and their decisions are not transparent to local communities.

Numerous empirical studies have concluded that effective cooperation of local governments requires the following preconditions:

- Strong incentives for cooperation provided by central government and/or by another tier's authorities (international projects, such as those sponsored by the EU may play a role). These incentives might have a dual character: (i) financial—in which cooperating authorities are rewarded by a system of special grants or other form of financial support; (ii) functional—in which cooperative agreements may result in transfer of additional competencies to local governments. The French experience with cooperative agreements among very small local governments (especially in the metropolitan and agglomeration areas) provides a very good example of the practical impact of such incentives.

- Cooperative political culture among local elites. In general, chances for effective cooperation is higher in societies characterized by higher levels of interpersonal trust or other features associated with high social capital.

- Strong leadership. Cooperation is more frequent in areas where there is a strong, widely accepted political leader, who may be an engine of joint activities.

Other solutions which are sometimes discussed for territorially fragmented systems are less likely to be viable in Kosovo. They include contracting out services to private sector entities (which requires a developed market of private providers, as well as an administration which is skilled enough to handle complex contractual arrangements) and purchase of services by small local governments from their larger neighbors (which is perhaps even more difficult than voluntary cooperation in joint delivery of services).

Guidelines for Amalgamation Reforms

Territorially consolidated systems have many advantages but also incur a number of risks. The most common arguments raised against amalgamation reforms (or more generally, against territorially consolidated systems) in various countries are presented below:

- **Amalgamation may lead to ethnic tensions.** In countries with a diversified ethnic structure, amalgamation may lead to the merging of villages inhabited by different ethnic groups into a single local government unit. One group might feel dominated by or, in fact, be dominated by another. This issue should be kept in mind when drawing up a map of territorial organization.

- **Access to local (administrative) services.** The distance to the central town or village in the municipality may be significantly greater than before amalgamation reform. This is one of the typical arguments raise by opponents of territorial reforms. The increased distance may be a real issue, especially in countries where roads are underdeveloped, the public transportation system is not very good, and in rural areas where access to private cars may be limited.

  There are several solutions to reduce the effects of this problem. Municipal (communal) administrations may establish local branches in individual villages, so amalgamation does not result in more difficult access for individual citizens. Such branches do not need to open on a daily basis, but should be accessible frequently enough to serve the needs of local citizens. This solution is technically easier nowadays, due to the widespread availability of the Internet and other computer technologies. Original documents kept in the "central communal office" may be made available for use in "village branches" as well.

- **Protecting interests of small villages that are part of amalgamated communes or municipalities**. The typical fear of amalgamation is related to the possible domination of the largest settlement unit; and such a fear is not only psychological, domination by the "communal center" over the "communal periphery" is a very real possibility. There are examples of municipalities in Bulgaria where ninety percent of councilors are recruited from the largest town, leaving citizens of small villages greatly under-represented. This creates obvious problems for local democracy and democratic accountability, but also creates a risk of biased policies. For example, the vast majority of investment funds may be concentrated in the central town, while small villages remain underinvested. Such inequity leads to the frustration of village communities but is also harmful to the interest of the country as a whole.

A partial solution may be found in the electoral system. If the system is proportional, with all councilors elected within one ward, strong domination by the largest settlement unit in the council is quite probable, even if the population of the town is similar to the aggregate population of all villages. The danger nearly disappears in majority systems, in which the municipality is divided into as many wards as the number of councilors elected. Such a system ensures that no part of the municipality will be without representation, and that none of the settlement units can dominate within the council or during local decision-making. The issue is even more controversial when the mayor is directly elected by all citizens. In such an instance, the more or less balanced geographical representation of the local council plays a crucial role, and the council has to have the power to control major decisions taken by the mayor.

- **Amalgamation is dangerous for local democracy**. As mentioned above, in small municipalities councilors are closer to citizens and are better informed about public preferences, and as a result, they can more easily formulate and implement policies that are closer to citizens' preferences (also because small communities are more homogenous). In small municipalities citizens are usually better informed about local public issues; there is more trust in public authorities; and citizens are more satisfied with their local politicians. It is difficult to refute these arguments. But one may try to minimize the disadvantages associated with large municipalities, and as mentioned above, institute a simple majority system of election with one-councilor wards which may help to maintain links between voters and local representatives in enlarged local governments.

- **Local identity of villages**. The choice of territorial organization is not only a matter of access to services or representation of interests, but other concerns such as citizens' pride of their "small homelands" and identification with smaller territorial communities are values worthy of protection. If a territorially consolidated system is in place, it is worthwhile to consider strengthening village governments and, especially, the position of village leader (village head). Further, responsibility for decisions on some functions can perhaps be delegated to villages. There are many international examples of solutions going in that direction (decentralization within Scandinavian local governments; English parishes; and some positive examples of rural local governments in Central-East European countries, such as Poland or Bulgaria).

One must not forget about requirements formulated in the European Charter of Local Self-Government concerning changes to municipal boundaries. In each case, the change of boundaries (or annexation of one local government by another) requires public consultations; although the consultations are not necessarily binding for decision-makers, they must be conducted in accordance with Council of Europe standards.

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21.
Large City Administration

József Hegedüs

Contents

Large City Administration

In transition countries capital cities, as concentrations of economic, administrative and political power follow specific models of decentralization to utilize the benefits of coordinated policies and to ensure accountability.

Statement of the Issue

Urbanization and the Need for Metropolitan Governments

In 1950 45% of the population of Southern Europe lived in urban areas, whereas by 1980 it had increased by more than a third (62%). Today it is 66% (UNDP 2005). The United Nations estimates that by 2015 it will stand at 70%.[1] At present, Kosovo is 45 percent urban.[2] As a consequence of this rapid urbanization, the urban built-up area extended in a process of agglomeration. New urban clusters were formed in which individual cities or towns were connected by continuous built-up development, and each city or town continued to act autonomously. Lack of coordination and cooperation between individual municipalities in adjacent urban areas created a need for a new form of government.

One simple solution was the territorial expansion of the central city by annexation and the formulation of a consolidated (one-tier) government, like with the creation of Greater Berlin in 1920, or the amalgamation of Antwerp with seven adjacent municipalities in 1983. However, because many municipalities resisted annexation, a new form of government emerged, the *metropolitan government*. Under this form, individual cities retained their limited autonomy, but area-wide functions (transportation, water service, etc.) were transferred to a new broader level of government made up of representatives of the newly formed area, who were either directly elected by their constituency or indirectly through representatives of the individual municipalities involved. The creation of Metropolitan Toronto, in 1953, was the first important example of this approach. In this case the province federated the city of Toronto and its twelve suburbs as a metropolitan corporation.

In the United States, a similar structure was introduced in Miami-Dade County, which has had a "two-tier federation" (city and county) since 1957. Cities are the "lower tier" of local government providing police and fire protection, zoning and code enforcement, and other typical city services within their jurisdictions; these services are paid for by city taxes. The county is the "upper tier," and it provides services of a metropolitan nature, such as emergency management, air and sea port operations, public housing and health care services, transportation, environmental protection, solid waste disposal, etc. These services are funded by county taxes assessed on all incorporated and unincorporated areas.

However, unlike Miami-Dade County, the majority of US urban areas found the metropolitan gov-

1 Southern Europe includes Albania, Andofra, Bosnia and Herzegovina, Croatia, Gibraltar, Greece, Holy See, Italy, Malta, Portugal, San Marino, Serbia and Montenegro. Slovenia, Spain, and TFYR Macedonia. Since these latest estimates are for 2005, there are no UN-comparable data for Kosovo. UNDP 2005.

2 Thus, Kosovo is less urban than the former Serbia and Montenegro, which is 52. UNDP 2005.

ernment structure politically unacceptable because of the limitation it places on local autonomy. Instead, cooperation among municipalities was achieved with the creation of special-purpose districts that provide specialized services (transportation, sewerage, electricity, etc.) to more than one municipality and are empowered to tax residents of the district for services provided.

Decentralization and Large City Governments

After the transition of the 1990s, large cities represented another type of problem for countries of Central Eastern Europe and the former Soviet Union. Large cities were part of the centralized, multi-layer public administration (oblast, rayon, micro-rayon). With the collapse of the Socialist political system, large cities (especially capital cities) constituted a special political and administrative problem depending on how committed the new political leadership was toward real decentralization. The concern was that autonomous large cities, with their concentrations of economic, administrative and political power, might play a destabilizing political role in an immature democratic system.

The political weight of large cities has greatly increased in the countries of the Baltic, the former republic of Yugoslavia and the Caucasus, as the share of the population living in the capital cities of these newly formed countries typically exceeds 20%, but in some cases even 30% (32% in Riga, Latvia; 39% in Tallinn, Estonia; 40% in Tirana, Albania).

Capital Cities: Special Laws

Capital cities, as centers of political power and administrative authority, are special cases that require special legislation. A country's economic power is frequently concentrated in its capital city, which simultaneously serves as the core of its political identity and legitimacy. Most of the countries in the region introduced special legislation related to capital (and large) cities, not merely because of their special political and economic role, but also because of the overlapping responsibilities of government and capital cities. The laws on capital cities define the political and administrative structure of the capitals, and their relation to higher levels of government (regional and central).

Decentralized City Structure: Arguments For and Against

There are very strong *arguments for decentralized* governing structures in large cities. Large cities are composed of urban (and sometimes rural/suburban) areas with different social, economic and residential character, thus local preferences can be very different across the various parts of the city. The suburban districts in Belgrade or the outer districts of Budapest struggle with very different problems than their inner district counterparts. The subdivision of large cities into units with direct political representation (own local governments) allows for more emphasis to be given to the unique features or particular needs of different urban neighborhoods and—according to the public choice theory—could lead to better solutions in public service provision.

In a decentralized system, individual districts based on local self-government will compete with one another in a sense to provide the best local services at the lowest local rate of taxes. Within a fair regulatory framework, this competition will result in better services for the entire city. In Budapest, different inner districts have developed different rehabilitation strategies—an example of districts competing and learning from one another.

This competition between districts has lowered the risk of reform failure that a one-program-for-all solution always presents. In the same way, decentralized systems have more room for innovative solutions than the typically more bureaucratic organization of a unitary large city. An additional argument in favor of decentralized systems is that smaller sub-units of a city have greater political legitimacy and increase accountability of the leadership to their constituency.

Decentralization, however, could *lead to a fragmented city structure*, in which citizens living in different parts of the city do not have the same access to public services. Citizens of a large city expect the same standards for basic services (such as water, electricity, education, social services, etc.), and large differences in the quality of and/or access to services would be politically unacceptable. Broad autonomy for districts of large cities could easily result in such inequalities in service delivery, which are caused partly by different management approaches and partly by the economic and social composition of the sub-city units.

A fragmented city structure could increase the social polarization of the city, with the poor segregated in the worse part of the city. One extreme illustration of such polarization, the practice of some wealthy districts in Budapest, is for district authorities to offer housing in other less affluent districts to poor or problematic residents.

However, the strongest argument against decentralization is that the provision of most area-wide services is much more efficient in a unitary city (economies of scale). Water services, sewerage, public transportation, etc., can be much more easily provided in a one-tier government than in a multilevel government structure.

There is no perfect solution, as the appropriate governing structure of large cities will depend on several specific factors: the nature of public services, the size and location of the city, the history of cooperation among municipalities, and other factors.

Models, Differences in Approaches, Variants

The experiences of many countries with the organization of local self-governments in large cities suggest three predominant models:

1. *The polycentric model* is composed of different numbers of independent municipalities which have the same rights and duties. There is no central authority; the cooperation between municipalities is voluntary. Cities organized according to the polycentric model have difficulty providing basic services of equal quality at an equal price. Planning, especially of the infrastructure, is very difficult, and rivalries between the municipalities may

develop.

2. *The unitary model* is "traditional" and composed of a single authority. There are no municipalities below the city level. Cities organized according to the traditional unitary model, through annexation, lose sight of the particular interests of the city's particular parts. As the city encompasses surrounding municipalities, its administration is increased and thus a greater centralization of power occurs.

3. *The two-level model* is a combination of the above two models and is composed of one central authority and a various number of sub-systems, often referred to as blocks. The two-level model, theoretically at least, offers the advantages of the polycentric and unitary models without their disadvantages by having one main municipality with several blocks subordinated to it. However, in practice, their cooperation is frequently called into question due to lack of clearly defined and assigned competences.

While the conceptual differences are clear between these ideal types, in reality the actual models are not easy to categorize. The governing structures of large cities in CEE/fSU countries tend to move towards a certain type of two-level model. Nearly every capital city in the region has a second level of government, the second or district level, which is vested with certain rights and represents a form of *administrative decentralization or sub-city government*.

Tallinn, a capital city of 438,000, is a good example of *administrative decentralization*. Tallinn has eight districts with very limited autonomy that serve as local decentralized units of the central city administration. The districts have indirectly elected councils. The Tallinn Statute regulates the relationship between the city government and its districts. It is very significant that the districts' budgets are part of the city budget, as with any other city-level budgetary department. However, the districts have quite broad responsibilities, in the areas of education, culture and public maintenance, and are also responsible for central city services in communal and social areas (i.e. street maintenance, water issues, local business promotion, etc.). The district authorities organize and collect taxes (advertisement tax) on outdoor media in their districts. They also have to organize and maintain parks and other green areas in their district.

Budapest is a good illustration of the *sub-municipality model* of two-level government. The capital city has 1.7 million inhabitants and 23 district governments that enjoy the same status and rights as other local governments in Hungary. The city government has different responsibilities (city-wide services such as public transportation, district heating, water, etc.) than the districts (housing, basic health services, education, etc.), and there is no hierarchical relation between the city and district governments. Districts have their own budgets and own revenues (including certain local taxes). A revenue-sharing scheme radically diminishes the horizontal inequality among the districts. The districts have their own directly elected mayors and councils, who enjoy sound legitimacy.

The *Law on the City of Skopje* was passed in 2005, after four years of preparation. A major debate prior to the passing of the law was whether districts in Skopje have the same rights as municipalities in Macedonia, which was one interpretation of the Constitution. The law on Skopje defined the special status of the ten districts and conferred upon them rather broad responsibilities, including elementary education, social services, local roads and parks, etc. The districts have own revenues (local taxes and user charges), which they must share with the city government. Mayors and council members are directly elected. A coordinating body comprised of mayors helps to encourage cooperation between districts and the city government.

In the 1980s, after a wave of creating metropolitan governments, the trend towards decentralization intensified. There was a demand to strengthen the local *representation of neighborhoods*, which are typically smaller than districts. The starting point in Europe was the need for public participation in urban rehabilitation programs, which led to the formation of the sub-municipality structure. There are two types of approaches to neighborhoods: (1) the neighborhood initiated organization and (2) the city initiated organization.

In 1999, for example, Los Angeles approved the concept of *neighborhood councils*. Neighborhood councils are designed to give community members a forum for addressing issues in their neighborhood, as well as the capacity to improve their neighborhoods. A special department, the Department of Neighborhood Empowerment, helps the work of the spontaneously formed neighborhood councils. In Europe, Amsterdam's first neighborhoods were established in the early 1980s. Amsterdam-Noord and Osdorp were the first to have their own authorities with extensive independent powers, with their own budget and team of civil servants. The idea was that neighborhood authorities like these would contribute to more efficient and effective decision-making, and that people would be more involved in local government. The experiment in Amsterdam-Noord and Osdorp went well and in the years that followed the number of neighborhood councils increased to sixteen.

Several countries now make it possible for large cities to set up *sub-district units* of government, which can guarantee a higher level of local participation and legitimacy. In Hungary, for example, the sub-local governments in Budapest typically represent homogeneous residential areas having a common history. Their operation (scope of responsibility and financing) depend entirely on local council decision. The sub-municipalities of ethnic and national minorities are organized under local governments but not on a residential basis.

The governing structure of large cities in the CEE/fSU region has been continuously changing because of macroeconomic and sectoral changes. The importance of *intergovernmental (city–region –country) cooperation and public-private partnerships* has increased, especially in the EU accession countries. New models of cooperation are typically sector-specific. Efficient public transportation, for example, requires the cooperation of the typically state-owned railway, long-distance bus company, and city-controlled local public transportation companies. In the case of privatization, this model has to have a PPP element as well.

In Budapest, after fifteen years of transition, the Budapest Transportation Association is only now in its first stage of development as transport conditions are standardized in different segments. The Parking Association is another example of intergovernmental (city and district) cooperation in Budapest, which aims to offer a standardized parking services and fee system, and sharing of revenues among participating district local governments.

A new element in intergovernmental relations is the *emergence of regions* in CEE/fSU countries. The relation between region and large city is a key question, which mirrors the problem of relations between the government structure of a large city and its adjacent urban/rural areas. Typically, large cities have the same rights as regions, as in Warsaw, Prague, and (federation) Moscow, although some are part of a region, which again raises the issue of cooperation between the region (not including the large city) and the large city. Some form of metropolitan government can help to integrate the municipal governments of the region.

Regional governments have been criticized for their large size and, as cities have less influence over the decision-making process, a new form of government, the *city region*, has been proffered to replace the dominance of the region. The city region encompasses the administrative area of a city (conurbation) and its hinterland. The extent of a city region is usually proportional to the intensity of activity in and around the main city center. In a German context, the Lander of Berlin, Bremen and Hamburg qualify as city regions because of their historical and constitutional status as "free cities." In the United Kingdom, city regions have been offered as an alternative to regional assemblies. In the East Midlands, the three major cities of Nottingham, Leicester and Derby with their connected hinterlands form a city region of 2.6 million people, which has established a partnership including the Government Office of the East Midlands and the East Midland Development Agency with several sub-regional programs.

Assessment of Options

There is no real unidirectional trend in the governance of large cites, as economic and political efficiency can be reached under different governing structures. The basic choice facing decision-makers is whether sub-city units will have the same legal status as local governments in the country, or will their existence depend exclusively on the law of the city. Warsaw (before 2002) and Budapest are examples of the first option, while Tallinn and Prague are examples of the second.

In the first option, the operation of government can be complex and costly, and may involve the risk of political conflict between the tiers. Thus voluntary cooperation between the two tiers becomes crucial, and the risk of reforms failing due to non-cooperative behavior is high. However, with their incentive structure and closer relation to the voters, local (district-level) solutions are more radical and more efficient. Horizontal inequality among districts has to be diminished by a well-designed equalization grant.

In the second option, the level of decentralization depends on the special design of the sub-city units. The districts have dual accountability (both to the city government, on whom their responsibilities and revenues depend, and to their constituencies). The advantage is political and administrative simplicity, which is guaranteed by the fact that city governments (through financial incentives) can enforce cooperation among district governments. The disadvantage is the dual accountability, and specifically, the weakness of local participation.

An evaluation of the policy options should take into consideration the actual expenditure and revenue assignments of the different levels with special emphasis on how much autonomy the decision-making bodies have. The crucial question on the revenue side is whether the district government has local tax revenues (or user charges) that could contribute to the political accountability of decision-makers, and prevent a one-sided rent-seeking attitude. On the expenditure side, property management is a key issue; namely, whether the district government has autonomy over property management (and at least partly enjoys the revenue from it), or not.

Lessons from Transition and Developing Countries

Large city administration in CEE/fSU countries displays wide variation, but in individual cases three factors play a very important role in the formation of the governing structure of large cities.

The first factor is the political choice in relation to the political decentralization of the large cities and their sub-city districts. In some cities in the region, mayors are not directly elected, and the government retains some degree of discretion over the political control of the large (especially capital) city. However, a basic political question independent of the chosen model is the territorial structure of the city. Territorial changes (number of districts, change of border, etc.) typically require changes to the Constitution.

The second factor concerns the existing institutions and institutional solutions. In the decentralization process, it is very rare that new institutions are built up from scratch: the typical solution is the step-by-step modification of the existing system. Therefore, the development of systems is mostly pragmatic and evolutionary. And in this respect, sometimes the law or the implementation of the law changes the institutional structure.

The third factor is the sector-by-sector structural changes made in response to the challenges of transition, accession to the EU, and globalization trends. Sectoral changes influence decentralization by redefining the role of the different levels of government and the private sector. For example, the privatization of the primary health sector (GP) in Hungary practically eliminated the role of local governments in this area.

On the basis of experience, the reform of large city administration should follow these steps:

1. Make the basic policy choice on the political structure of the city (territorial consideration, region-city-district relation).

2. Define the tasks (on the basis of analyses of the different sectors of the city) that can be transferred to the lowest level of government (proposal should be pragmatic and evolutionary).

3. Define the revenue assignment of the city and districts (based on the law on local government finance). Consider giving some revenue autonomy to the lowest level without

risking the creation of high inequity in the city.

4. Design a budget system that includes an equalization element.
5. Consider the possibility of the neighborhood association as a sub-district unit with limited local responsibility.

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22.
NGO and Government Partnership

Gjylieta Mushkolaj

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NGO and Government Partnership

Under the existing legal and financial regulations in Kosovo, municipalities have to develop better cooperation with non-governmental organizations at local level.

Role of Non-Governmental Organizations

Non-governmental organizations (NGOs) play a significant role in every country. They perform multiple functions, and fulfill the vacuum left by other sectors of society:

a) NGOs deliver a variety of human services, from health care and education to social services and community development. They are well known for identifying and addressing unmet needs, for innovating, for delivering services of exceptional quality, and for serving those in greatest need.

b) NGOs have indispensable capacity in identifying unaddressed problems and bringing them to public attention, in protecting basic human rights, and in giving voice to a wide assortment of social, political, environmental, ethnic, and community interests and concerns. NGOs are key players to push for changes in government policy or in societal conditions. Their advocacy role is vital, as they are in a position to serve as a link between individuals and the broader political process, providing a way to bring group concerns to broader public attention and to push for policy or broader social change. In this direction, NGOs are crucial mechanisms for providing space and tools to the minorities in the decision-making process.

c) NGOs do community building, in creating what scholars are increasingly coming to call "social capital," those bonds of trust and reciprocity that seem to be crucial for a democratic polity and a market economy to function effectively. By establishing connections among individuals, involvement in associations teaches norms of cooperation that carry over into political and economic life. NGOs also perform a broader expressive function, providing the vehicles through which an enormous variety of other sentiments and impulses—artistic, religious, cultural, ethnic, social, recreational—also find expression.

An essential condition for the emergence and development of effective NGOs and a dynamic civil society is a legal framework that guarantees free association and assembly. These freedoms are already fundamental components of many liberal constitutions in countries in all regions of the world.

Legal Framework of the NGO Sector

The basic legal document that regulates registration and operation of NGOs in Kosovo is UNMIK Regulation 1999/22 on the Registration and Operation of Non-Governmental Organizations. With the term "non-governmental organization," the regulation refers to an association, society, foundation, charitable trust, non-profit corporation, or other juridical person that is not regarded as part of government and that is not operated for profit—viz., if any profits are earned, they are not and cannot be distributed as such. The regulation's definition of non-governmental organization does not include trade unions, political parties, profit-distributing cooperatives, or churches.

The regulation fully recognizes the right of individuals to associate and work together for a common interest and public good. If an association wishes to form a legal entity separate from the legal personality of its members, the regulation provides simple procedures to do so. For example, only three persons are required to register an association, whereas one person is needed for a foundation.

Other positive features of the NGO regulation are that both physical and legal persons have the right to form non-governmental organizations, and that it recognizes foreign and international NGOs and regulates their registration and operation in Kosovo.

Under the regulation, the government has very limited powers to deny registration of an NGO, as the reasons for denying registration are clearly enumerated. Moreover, the regulation does not require NGOs to register; NGOs need only register if they wish to operate as legal entities. A further stipulation requires that the registration authority issue a registration certificate—or if registration is denied then an explanation for the denial—within 60 working days of receipt of an application to register. One of the weaknesses of the NGO registration system is that inactive NGOs are not automatically removed from the registry.

The NGO regulation acknowledges the registration of two types of organizations: (1) NGOs whose purpose is for public benefit; and (2) NGOs such as professional associations that are formed for the mutual benefit. In general, NGO founders have significant freedom to decide on their organization's governing structure. NGOs that obtain public benefit status are released from paying tax on custom duties, as well as from other tax and fiscal obligations.

Finally, the regulation gives NGOs the right to engage in economic activities that support the organization's goals. NGOs are permitted to generate income from any lawful activity, and to manage their own property in furtherance of their statutory purposes.

NGOs and Churches

Religious groups have the right to establish themselves as NGOs. Most of the newly registered religious groups in Kosovo are registered as NGOs, in order to operate as legal entities. The more traditional religious communities in Kosovo, such as the Islamic Community, Orthodox Church, and Catholic Church, tend to operate as legal entities based on the former Yugoslav legislation. However, PISG and UNMIK are currently working for adoption of the new law on religious communities that would strengthen religious freedom, and prepare a more favorable legal environment for more active involvement of religious organizations in society. However, even now, religious organizations as legal entities have the right to establish NGOs, and engage in all kinds of lawful activities.

Tax Regulations Affecting NGOs

Tax Exemptions. Registered NGOs with public benefit status are exempt from the profit tax to the extent that the income is used exclusively to further the organization's public benefit purposes (Section 5(a), Profit Tax Regulation). This includes income derived from foreign grants and donations.

Deductibility of Charitable Contributions. Donations by legal entities and individuals made for humanitarian, health, educational, religious, scientific, cultural, environmental protection, and sports purposes may be deducted from income up to a maximum of 5% of taxable income (Section 9, Corporate Income Tax Regulation; Section 16, Personal Income Tax Regulation). The donation must be made to an NGO that has received and maintained public benefit status or to "any other non-commercial organizations that directly perform activities in the public interest and not-for-profit," including medical, educational, and other specified types of institutions (Section 9.2, Corporate Income Tax Regulation; Section 16.2, Personal Income Tax Regulation).

Deductions are not allowed if a contribution directly benefits a person related to the donor. An NGO is prohibited from accepting more than €1,000 from a single source per day, unless it receives a written exemption. An NGO is required to disclose in its annual report any source of contribution that exceeds €5,000 per year (Sections 4.1, 4.3, and 4.6, Regulation 2004/2 on the Deterrence of Money Laundering and Related Criminal Offences).

Value Added and Turnover Taxes. The standard VAT rate is 15%. NGOs with public benefit status do not have preferential status under VAT regulation.

Property Tax. A tax is levied on all immovable property in Kosovo. Municipal assemblies annually set the rate of the property tax, which can vary between .05% and 1% of the market value of immovable property. NGOs with public benefit status are exempt from property tax, provided that they use the property exclusively for their stated public benefit purposes. Exemption is also extended to foreign donor agencies carrying on work in the fields of humanitarian aid, reconstruction, civil administration, or technical assistance, as well as religious institutions approved by the municipalities in agreement with the Tax Administration, if their property is used for religious purposes.

Size of NGO Sector

A favorable legal environment for registration of NGOs and the affluence of international donor funding after the war resulted in rapid growth of the NGO sector. There are today over 2,500 registered NGOs in Kosovo, although it is estimated that only 10% are active. Many experts hold the number of registered NGOs in Kosovo to be quite high, but in comparison with other CEE countries this does not appear to be the case—the Czech Republic, with a population of 10 million, has over 95,000 registered NGOs.

The NGO community in Kosovo is quite diverse. NGOs provide a variety of services, especially basic services such as health care, education, relief, housing, water and energy. In other areas such as economic development, environmental protection and governance, the number of non-governmental service providers is small but growing. The advocacy role of NGOs in Kosovo is also expanding.

Forms of Cooperation between Government and NGOs

Government support. In Western European countries direct government financing is an important source of income for the non-profit sector, on average government financing in these countries constitutes 40–60% of the sector's total income.

Central and local governments in Kosovo do provide support to NGOs, but unfortunately data is unavailable on the level or extent of support provided. However, information from organizations working with local governments—such as Mercy Corps International, Community Development Fund (CDF), Kosovo Foundation for Open Society, and the World Bank—indicates that local governments are indeed financially supporting these community groups (NGOs), especially in building and repairing infrastructure.

The activities of formal NGOs in Kosovo are mostly funded by international donors; although, over the past few years both central and local governments have begun distributing small grants. NGOs more often receive in-kind support from municipalities, usually in the form of free-of-charge premises belonging to municipalities. The Multi-ethnic Children and Youth Peace Centre in Mitrovica and the Roma Women's Center in Prizren, for example, receive office space free of charge from their respective municipalities.

Government contracting. Through this type of cooperation, an NGO obtains the right and obligation to perform activities (tasks and services) that traditionally fall within the competence of the state. The assignor (a central or local authority) provides financial support to the assignee (an NGO) as a subsidy or as a consideration under the contract. As an alternative, the government can provide in-kind assistance, such as premises or other support in its capacity of a contracting party. Cooperation is of particular importance in providing social services.

For two years now, beginning with the enactment of the Law on Public Procurement, NGOs in Kosovo are in a better position to compete for government contracts to provide goods and services. The number of NGOs receiving grants and contracts from the government has increased accordingly.

NGO participation in local government decision-making. UNMIK Regulation 2000/45 on Self-Government of Municipalities in Kosovo provides a progressive framework for public participation at municipal level. It establishes a number of requirements for public involvement in the local decision-making process and stipulates that municipalities adopt implementing legislation.

The UNMIK regulation on self-government requires municipalities to observe several minimal requirements regarding public involvement in municipal decision-making:

- Meetings of the municipal assembly and its committees must be open to the public, including representatives of the press.
- Persons must be allowed to inspect documents held by the municipality.
- A municipality must hold at least two public meetings each year. The date and place of the meeting is to be publicized at least two weeks in advance.
- A right to petition the municipal assembly about any matter within the powers and responsibilities of the municipality must be guaranteed.

Importantly, under the regulation on self-government, municipal assemblies (the highest representative bodies of municipalities) must adopt a statute that regulates the implementation of the responsibilities established by the regulation. The statute, among other things, must provide that municipal regulations are adopted only after publication of draft regulations and public consultations.

Municipalities may provide for additional mechanisms of public participation by regulation or statute. The municipalities of Gjakova, Deçan, and Vitia, for example, have adopted municipal regulations that provide several mechanisms for promoting public participation. The statutes go some way towards expanding upon the requirements set forth in the regulation on self-government, but fail to provide clear guidelines on how citizens may take advantage of various opportunities to participate.

The statutes provide that the municipality may use several different enumerated types of public consultation, as well as any others that may be appropriate in a given context. The municipality must provide a reasoned justification of the choice of public consultation. It must allow adequate time for participation and, before making any final decision, must take into account and make public the outcome of the consultation or participation. The president of the municipality and all committees of the municipal assembly have authority to arrange for public consultations on matters within their competencies, and must publicize the form of consultation at least fourteen days in advance and allow adequate time for public comment.

The regulation on self government also provides that municipalities must use at least four separate types of public consultation before adopting a municipal regulation: (1) information campaigns; (2) contacts with focus groups and interested parties; (3) public notice and comment period; and (4) impact assessment studies.

Despite a forward-looking legal framework that's favorable toward public participation, a lack of understanding prevails among municipal officials, civil society groups and the public in general of the opportunities available for participating in municipal decision-making processes in Kosovo. Only three of the thirty municipalities in Kosovo have established proper rules, procedures, and guidelines for public consultation and participation—and even these are not applied with sufficient frequency.

Main Obstacles to Local Social Partnership

Taking into account the capacities of the NGO sector, the tradition of civic participation built during the 1990s, and the favorable legal basis, we cannot be very satisfied with the level of social partnership at local level in Kosovo. There are a number of different explanations, of which the most acute are:

- Low level of NGO accountability. (Although many well-known NGOs that receive funding from international donors have learned what it means to be accountable to donors.)
- Insufficient development of mechanisms for outsourcing services to the NGO sector.
- Absence of legal recognition of sub-municipal units of government.
- Lack of conformity between laws and regulations governing NGOs with public benefit status and tax laws; implementation is especially inconsistent.
- Unsatisfactory use of the work of volunteers, caused by (1) absence of legal recognition of volunteer work, and (2) inadequate incentives provided by NGOs for encouraging people to volunteer.

Lacking a Sub-municipal Level

Over half the population of Kosovo lives in villages. Unfortunately, due to the election rules, and the formal absence of sub-municipal units of government, much of this population is not properly represented and does not receive services to which it is entitled. Many village representatives report that their villages are neglected by larger settlements, which are responsible for many aspects of their service delivery.

Many villages in Kosovo have no voice in municipal assemblies, as they have no representatives elected to the assemblies. Indeed, in many municipalities there are more villages than assembly members; while in other municipalities some villages may have three representatives and other villages none.

Such a state of affairs is especially unacceptable in Kosovo, as it has a long tradition of sub-municipal structures called *bashkësia lokale/mesna zajednica* (BL), by which citizens were able to satisfy most of their basic needs (culture, education, local development).

After the abolition of Kosovo's autonomy in 1998, the Albanians developed parallel social structures (education, culture, social welfare), which were not part of government institutions. In this context, an informal local NGO sector developed very rapidly, and replaced public functions. The NGO sector was very active and mostly financed from local sources until the beginning of the war in Kosovo. Although most of the NGOs were ethnically Albanian, they were oriented toward helping the whole of society in the area of social services, human rights, and gender issues.

During those years, volunteerism flourished, and nearly every adult Kosovar was engaged in a volunteer activity. The tradition of BL grew, and Kosovo developed very early strong partnership with those sub-municipal structures. It would be difficult to imagine the operation of the Mother Theresa Society network without the strong support of BL activists, or the presence of the Council for the Defense of Human Rights and Freedoms in every village in Kosovo without the active use of BL resources, the basic units of the government that it managed to retain.

Conclusion

Kosovo is in a favorable position as far as the tradition and the newly established legal environment for NGOs is concerned. The public in general appreciates the work of NGOs, especially taking into account the fact that we as a nation were able to survive the Milosevic regime with the smart and prompt development of the NGO sector. Nearly all inhabitants have had some kind of experience with the nonprofit sector, including present governmental officers, and there is a friendly environment for building strong partnership between the NGO sector and government.

A proper relationship with the NGO sector requires proper organization of local democracy. In this regard, we are in an advantageous position, with a rich tradition of BL (sub-municipal structures) and a favorable legal basis. The UNMIK Regulation 2000/45 on Self-Government of Municipalities in Kosovo (Section 5) provides the legal basis for municipalities to establish cooperation with villages, settlements, and urban quarters. This provision is quite broad and could be interpreted as allowing municipalities to establish sub-municipal structures for carrying out activities within the sphere of municipal responsibilities. Section 6 of the same regulation provides for municipal cooperation with NGOs that provide services in areas within the general responsibility of the municipality.

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23.
Local Government and the Right to Freedom of Association

Gjylieta Mushkolaj

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Local Government and the Right to Freedom of Association

Association of local governments in Kosovo is critical for effective advocacy and efficient service provision.

The right of municipalities to association and mutual cooperation is vital to the integrity and effective operation of local governments. In this briefing note, the terms *association* and *cooperation* are used to refer to two types of associations of local governments:

1. Political associations of municipalities established for advocacy purposes, representing and defending interests of municipalities, and also for providing services to their members (e.g. information, training); and
2. Technical, service-oriented associations for delivery of public services.

European Charter of Local Self-Government

The European Charter of Local Self-Government of 1985,[1] of the Council of Europe, demonstrates the far-reaching consensus of European states on the importance of local self-government. Article 10 of the charter, on Local Authorities' Right to Associate, recognizes the right of local authorities to cooperate and to associate with other local authorities of the same or another state. The right to associate is an important aspect of the development of local autonomy; and the independence of associations of local authorities from state influence strengthens local government.

The first paragraph of Article 10 is a broad guarantee of local authorities right to association. Paragraph 1 reads: *Local authorities shall be entitled, in exercising their powers, to cooperate and, within the framework of the law, to form consortia with other local authorities in order to carry out tasks of common interest.* This paragraph provides for cooperation between local authorities on a functional basis, and therefore, under this provision local authorities may, through joint projects with other municipalities, seek greater efficiency or perform tasks that are beyond the capacity of a single authority. Such cooperation may take the form of the creation of consortia or other kinds of partnership of self-government authorities.

In order to facilitate the right of local authorities to association, states ratifying the Charter are encouraged to develop an enabling legal framework. The right in most countries is codified in laws (Belgium, Spain, France) and sometimes even in constitutions (Greece, Poland, Portugal).

Paragraph 2 of Article 10 states: *The entitlement of local authorities to belong to an association for the protection and promotion of their common interests and to belong to an international association of local authorities shall be recognized by each State*. The creation of associations of local authorities, as provided by paragraph 2, is decided for general purposes and not on a functional basis.

1 The full text of the Charter is available at http://conventions.coe.int/Treaty/EN/Treaties/Html/122.htm.

Local governments may cooperate with their respective level counterparts in other countries; however, the manner of such cooperation must respect any laws and regulations as may exist in each country and take place within the framework of the powers of the authorities in question.[2]

Associations of local governments serve primarily three aims:

- Advocacy: promoting the interests of local authorities.
- Service provision: delivering services to local authorities; e.g., training, databases.
- Communication: serving as a platform where municipalities meet. The three directions of communication are: (a) communication between municipalities for the exchange of ideas and best practices; (b) bottom-up communication, ideas formulated at local level are communicated to central level; and (c) top-down communication, ideas about new legislation are communicated to local level.

It is important to emphasize that an association of local governments also has a political dimension. In defending the interests of municipalities, an association of local governments should not however be likened to an interest group, for an association does not represent specific groups pursuing particular economic or professional ends but represents all citizens served by the member local governments.

As a general rule, an association represents all local authorities of a particular kind on a regional or national basis. However, the official Explanatory Report of the Charter explicitly states that the right to belong to associations of this type does not imply central government recognition of any individual association as a valid interlocutor.

Inter-municipal Cooperation

Inter-municipal cooperation is a well-suited means for local governments to increase their capacity to carry out their growing tasks and responsibilities, without sacrificing autonomy and identity, as is necessary with far-reaching amalgamations (see briefing note "Joint Service Delivery").

As municipal responsibilities become increasingly complex and demanding, municipalities should continually seek out the best way to provide the services needed by their communities. One tool to assist in addressing this challenge is the establishment of different types of intergovernmental cooperation. Such cooperation is quite attractive, since its goal is more effective and efficient local government functioning. However, forms of cooperation of local government require careful design, in order that they strictly observe the main purpose of their existence: to serve the public interest, i.e., the interests of the citizens.

The functioning of an association is improved if higher levels of government do not interfere to a great extent in its decision-making processes and voting procedures. An association can strengthen its managerial capacity by recruiting an autonomous and professional managerial team, that is

2 It should also be mentioned that the provisions of the European Outline Convention on Transfrontier Cooperation between Territorial Communities or Authorities of 21 May 1980 applies to this type of cooperation, although some forms need not be restricted to frontier areas. The full text of the Convention is available at http://conventions.coe.int/treaty/en/Treaties/Html/106.htm.

bound by performance contracts including negotiated standards of service.

The role of national legislation should be limited to ensuring that noncompliance with financial payments is dealt with effectively, assuming that all partners contribute resources. It is also possible, even practical, to grant taxing and borrowing powers to associations; however, the granting of such powers is a sensitive issue, requiring careful consideration to ensure that the principles of accountability and representation are observed.

An important part of a local government association is its governing document. The governing document, in addition to defining the scope of the association, should also clearly identify the functions and responsibilities of partners; determine performance expectations; circulate trustworthy information among partners; and establish managerial structures and accountability lines—including mechanisms for joint evaluation of results. An association should also develop an adequate management reporting scheme to partners, donors and citizens.

Cross-Border and International Cooperation of Municipalities in Kosovo

Individual municipalities and associations of municipalities in Kosovo have the right to cooperate internationally but must do so in accordance with the law.[3] In this regard, municipalities are required to notify the central government of any international cooperation agreements, which are subject to supervision of legality.

Cooperation with municipalities from other countries may take different forms, such as cross-border cooperation (e.g., regional partnerships, "Euroregions"), international twinning programs, membership to international municipal associations, city to city partnerships.

Present Associations of Municipalities in Kosovo

Despite a sound legal basis for establishment of municipal associations, UNMIK and PISG have not always been ready to agree to the establishment of such independent entities. When the Association of Kosovo Municipalities (AMK) was formed, UNMIK hesitated for several months before registering it. It was formed at the beginning of UNMIK rule[4] in Kosovo, and it was quite difficult for UNMIK to accept the existence of any institutions in Kosovo that were not under its supervision. However, with the support of the Council of Europe and OSCE, UNMIK in the end conceded to registering the association, which operates today as a legal entity in Kosovo.

The AMK was established (i) to provide a forum for cooperation and joint action between municipalities and with the central ministries, and (ii) to promote the principles of the European Charter of Local Self-Government. The AMK has observer status in the Congress of Local and Regional Authorities in Europe and is a member of the Network of Associations of Local Authorities in

3 International cooperation between municipalities must accord with all of the following: Kosovar legislation, relevant municipal statutes and/or statutes of associations, as well as the statutes of the relevant international partner municipality(ies) or association(s).
4 The Association of Kosovo Municipalities was established on 30 June 2001.

South-East Europe. Policy papers developed by the AMK are already contributing to donor strategies and improved local-central dialogue. These include statements (particularly on youth, gender and social housing issues) to promote European standards of performance for local government in relation to gender balance and minority inclusion.

In January 2003, the representatives of the municipalities of Zvecan, Zubin Potok, Leposavic and Kosovska Mitrovica formed the Union of Serb Municipalities in Kosovo. UNMIK criticized its establishment, and considered it an attempt to divide Kosovo into Serb and Albanian populated areas. However, the Union is clearly consistent with the spirit of the European Charter.

Up to now, no information has been made public about whether the Union has applied for registration at the Ministry for Public Services. Nonetheless, the Union is quite active, and is presently calling for a boycott of Kosovar institutions by all Serbs in Kosovo. The situation is aggravating, and the Union has even taken upon itself to impose a "state of emergency" in the municipalities populated by Serbs.

Even though it is quite difficult to cooperate with Serbian dominated municipalities, more effort should be made to encourage the Union of Serb Municipalities in Kosovo to register. There is also a need to educate the municipalities populated by Serbs about the enabling legal framework that exists in Kosovo. In addition, the international community, and especially EU countries, should continue to pressure the government of Serbia to allow Serbs in Kosovo the autonomy to decide for themselves how they would like to cooperate, and the types of municipal cooperation they would like to establish.

Issues at the Kosovo Final Status Negotiations[5]

In May 2005, Mr. Kofi A. Annan, UN secretary general, appointed the Norwegian Ambassador Kai Eide as his special envoy to undertake a comprehensive review of the situation in Kosovo. The purpose of the review was to assess whether the conditions were in place to enter into a political process designed to determine the future status of Kosovo, in accordance with Security Council resolution 1244 (1999). In the beginning of October 2005, Ambassador Eide submitted a detailed report on Kosovo's progress in implementing a set of internationally endorsed standards, covering eight areas—including democratic institutions, the rule of law, human and minority rights, refugee returns, economic development and Pristina-Belgrade dialogue. Despite the fact that Ambassador Eide concluded in his report that "standards implementation in Kosovo has been uneven," he recommended to proceed with the discussions on status.[6]

In his report, Ambassador Eide considers decentralization a necessary tool for achieving a sustainable return of minorities. According to him, a broad decentralization process, similar to those in Macedonia and the Presheve (Presevo) Valley (southern Serbia), will be necessary in order to create

5 For more discussion, see *Belgrade/Pristina Proposals for Minority Protection, Local Self-Government Reforms—Any Progress?* available on the Geneva Centre for Security Policy's website at http://www.gcsp.ch/E/meetings/Issues_Institutions/Europe/Meeting_Conf/2006/Minorities-Kosovo/Deda.pdf.

6 For a comprehensive review of the situation in Kosovo, see Annan's letter to the president of the Security Council at http://www.securitycouncilreport.org/atf/cf/{65BFCF9B-6D27-4E9C-8CD3-CF6E4FF96FF9}/Kos%20S2005%20635.pdf

a "breathing space" for minorities. According to the report, part of the decentralization process would be creation of "a number of new municipalities where primarily Kosovar Serbs would have a considerable majority." In those municipalities, Serbs could have more competencies in police, justice, education, culture, media and economy, while "horizontal connections between municipalities with Serb majorities" and "modalities for special connections with Belgrade" could be allowed. He stressed though that the establishment of "horizontal links" between Serbian municipalities must be done without endangering Kosovo's central institutions.

UN Secretary-General Kofi Annan accepted the report prepared by Ambassador Eide, and recommended its approval to the Security Council. On 24 October 2005, the UN Security Council endorsed his recommendation to launch a political process to determine Kosovo's status. On 1 November, Mr. Annan announced his intention to name former Finnish President Martii Ahtisaari to be his UN special envoy to lead the international process. Ahtisaari began his mission in late November 2005.[7]

The first round of talks between the two negotiating teams from Belgrade and Pristina in February 2006 focused on decentralization, as one of the core issues to be addressed in the context of the status resolution.

According to the UNOSEK team, the Kosovo Negotiating Team was very constructive with respect to the right of municipalities to freedom of association and mutual cooperation. Kosovar representatives assured UNOSEK that the future Law on Local Self-Government—in accordance with the European Charter of Local Self-Government and the best international practices—will explicitly provide for the right to freedom of association for municipal governments, and allow municipalities to form consortia or partnerships to jointly carry out municipal tasks.

In this regard, the Kosovo Negotiation Team even elaborated forms of partnership, or consortia, in an attempt to encompass all generally acceptable forms of inter-municipal cooperation.

1. *Shared public services*. Two or more municipalities agree to use the public service structures of one or all participating municipalities to carry out specific municipal tasks in the participating municipalities.
2. *Joint in-house company*. One or more municipalities form a legal entity (company) vested with the authority to perform certain municipal functions, and which may also principally engage in commercial activity.
3. *Out-sourcing*. One or more municipalities outsource certain municipal tasks to a private operator(s), who are to ensure quality standards. An example would be the contracting of a commercial company to carry out waste collection and recycling in one or more municipalities.

As far as the right to form associations for advocacy purposes at the central level of government, this right is already guaranteed by UNMIK/REG/2000/45 on Self-Government of Municipalities

7 Documents on the work of the United Nations Office of the Special Envoy of the Secretary-General for the future status process for Kosovo (UNOSEK) can be found on its website at http://www.unosek.org.

in Kosovo[8] and UNMIK/REG/1999/22 on the Registration and Operation of Non-Governmental Organizations in Kosovo.

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Bringing It All Together

24.
Benefits, Costs and Rules of Fiscal Decentralization

Roy Bahl

Contents

Benefits, Costs and Rules of Fiscal Decentralization

To bring all these briefing notes together—a final note that provides a set of operational guidelines for the decentralization dialogue and the practicalities of policy implementation.

The growing interest in fiscal decentralization in Kosovo is part of a worldwide pattern. In fact, it is the rare place that does not put strengthening of subnational government on its development policy agenda. The purpose of this briefing note is to address two of the overarching aspects of decentralization: the cost and benefits and the set of problems surrounding its implementation.

Some Benefits and Costs[1]

What are the major advantages to be gained from investing more fiscal powers in local governments? The first, and most important, are the welfare gains that come from moving government closer to the people. This is the economic efficiency argument that drives the thinking of most economists who work on this subject (Oates 1972; Musgrave 1983). The argument is straightforward. Let us assume that people's preferences for government services vary, e.g., because of religion, language, ethnic mix, climate or economic base. Let us assume further that people have sorted themselves so that those with like preferences live in the same region. If subnational governments respond to these preferences in structuring their budgets, decentralization will result in variations in the package of services delivered in different regions. People will get what they want and so the welfare of the population will be enhanced. Under the same circumstances, but with a centralized system, service provision would be more uniform and people in different regions would get less of the service mix that they want.

The potential benefits from decentralization, then, include: (a) more accountability on the part of government officials because they are on the hook for service delivery to the local population that elected them, and (b) more willingness on the part of the local population to pay for services, because they get what they want. If one advocates fiscal decentralization, one must believe this story, as it is the primary argument. Some further argue that successful fiscal decentralization addresses several of the problems common to developing countries: revenue mobilization, innovation in economic decision-making, accountability of elected officials, capacity development, and grassroots participation in governance.

A second important benefit is the promise of increased revenue mobilization. This happens because decentralization can broaden the aggregate tax base by reaching the traditional income, consumption and wealth tax bases in ways that a central government cannot.[2] The instruments

1 This note draws on Bahl 1999. For more lengthy discussions of the pros and cons of fiscal decentralization, see Bahl and Linn 1992; Litvak, Ahmad and Bird 1998; Bird and Vaillancourt 1998; Tanzi 1996; Martinez 1997; and Dillinger 1994.

2 In this essay as well as throughout this volume, no final political status for Kosovo is presumed. Thus in many cases "central" government can be thought of as referring to a relationship between a highly autonomous provincial government and "sub-provincial" local governments. However, if Kosovo were to gain independence, it should then be noted that one of the key tools of macroeconomic stabilization—*viz*, monetary policy—would likely rest with the supranational European Central Bank.

available at the subnational level for this purpose include payroll taxes, levies on the sales or assets of firms, licenses to operate, betterment charges and property taxes. If this hypothesis is correct, subnational government taxes are not raised at the expense of reductions in central level taxes. Furthermore, the claim of subnational governments on central revenues *via* intergovernmental transfers are reduced by increased local revenue mobilization.

There can also be costs associated with fiscal decentralization and perhaps this is why not all places choose this policy route. Heading the list is macroeconomic control.[3] Central governments would like the flexibility to respond quickly to changes in the economy, for example, to raise taxes or cut expenditures to deal with a deficit. If the government is locked into a fixed share of revenue allocated to local governments, the ability to cut the deficit by reducing expenditures is significantly reduced. The pressures from the International Monetary Fund (IMF) and the World Bank for more austere economic policy to bring about internal or external balance usually requires maintaining an acceptable level of the fiscal deficit and limiting the level of domestic credit. In a truly decentralized economy, both targets are more difficult to achieve than in a centralized economy.

A second cost of decentralization is that the center will lose some control over infrastructure development because local governments will have some discretionary spending power. The net result of fiscal decentralization could be a shift of resources from central governments that have higher rates of savings and investment to provincial and local governments that spend at a greater rate on consumption of goods and services. Fiscal decentralization could therefore lead to a lower rate of spending on infrastructure, perhaps jeopardizing national growth.

Another line of thinking is that national priorities for capital investment do not conform to local government choices. The national government is interested in investments in infrastructure that have regional and national benefits; for example, irrigation, national roads, and power. Subnational governments will be focused on capital investments with regional and local benefits.

A fourth point is that revenue centralization gives a greater *potential* for equalization. In countries where the claim of local governments on the overall tax base is small, the central government can create a larger pool of funds for allocation among local governments on an equalizing basis. Moreover, if the local governments are not given independent taxing powers, the fiscal disparities to be equalized will be smaller. However, just because the central government has more funds to allocate, it does not necessarily follow that they will allocate these funds on an equalizing basis. In fact, most countries do very little equalization through their grant systems.

3 More detailed discussions of this topic may be found in Bahl and Linn 1992; Prud'homme 1995; Ter-Minassian 1997; Tanzi 1996; and Spahn 1997. A reading of these papers shows that there is anything but uniform agreement on this point.

Implementation Rules for Fiscal Decentralization

There is no one right way to do fiscal decentralization. Much depends on the policy objectives that the government most wants to achieve. It follows that the success of any fiscal decentralization policy will be hostage to the implementation plan. The following are twelve rules, more or less generic, that might be used to guide fiscal decentralization.[4]

Rule #1: Fiscal Decentralization Should Be Viewed as a System

Intergovernmental fiscal relations must be thought of as a system, and all the pieces in this system must fit together.[5] Thus, implementation should begin with a design of the comprehensive system, and should lay out the plan for each element of the system. A little reflection will lead one quickly to the conclusion that fiscal decentralization involves a lot more than fiscal matters. In fact, the electoral system and civil service arrangements are arguably as important as the taxing and spending components. The other key pieces are subnational government revenue-raising power, borrowing powers, expenditure assignment, and budgetary discretion. A "one-off" piecemeal reform, encompassing only one element of the system (e.g., the sharing of nationally levied and collected revenues) or a transfer system is not likely to lead to success (see "Sequencing Fiscal Decentralization Reform" in this volume).

Getting all the pieces on the table is the first part of the rule; making the pieces fit together is the second. For example, Indonesia's recent "big-bang" decentralization in 2000 considered both expenditure assignment and revenue assignment, but the planning was done by two different ministries, with little coordination. There did not seem to be a concern about making the two sides of the budget fit together.

Rule #2: Finance Follows Function

The second rule is to get the correct order of reform. First should come the assignment of expenditure responsibility (function) to local governments, and *then* the assignment of revenue responsibility (finance) should be determined. The key for this sequencing is that one cannot establish the level of subnational government revenues required independent of an estimate of expenditure needs. If one begins this process by fixing revenues, the correspondence between expenditure assignment and revenue allocations is lost. Moreover, it becomes difficult to sell a hard budget constraint if the process begins with an insufficient revenue assignment.

Rule #3: There Must Be a Strong Central Ability to Monitor, Evaluate and Lead Decentralization

Places such as Kosovo that are in transition out of the legacy of Socialism are for the most part characterized by highly centralized systems of government and tend to remain centralized for

4 These rules were first developed in Bahl 1999.

5 In this briefing note, *intergovernmental fiscal relations* refer generally to the division of fiscal powers and responsibilities among levels of government. *Fiscal decentralization* refers to an intergovernmental system where the balance of power moves more toward the subnational government sector than has been the case.

quite some time. If control by the center reflects political resistance to relinquish powers to a new group of bureaucrats, it will likely thwart fiscal autonomy such that the promised benefits of a decentralized society will be lost. But, if the control exercised is in the form of oversight and consists of monitoring, evaluating and leading, then the payoffs may be high. The following are some examples of the appropriate types of such oversight:

- Establishing and maintaining a uniform structure of subnational government accounts that are regularly and properly audited.
- Setting disclosure requirements with respect to debt financing of capital improvements and enforcing rules-based borrowing limits (Joumard and Kongsrud 2003).
- Monitoring the fiscal performance of local governments, and identifying those in financial difficulties as well as those exerting weak revenue mobilization efforts.
- Annually reviewing the performance success of government finance instruments (transfers, subsidies, local taxes) combined with a willingness to make needed policy adjustments.
- Confirming compliance with the terms of conditional grants, expenditure mandates and taxing limits.
- Providing technical assistance to local governments; the smaller local governments, in particular, are likely to require assistance in areas such as accounting, treasury, tax administration, data processing and project evaluation.

Typically, central and provincial governments in transition countries are not up to these tasks because they do not have sufficient administrative capacity to lead the development of local government finances. Two ingredients necessary to this job are (i) a fiscal analysis unit, probably best located in the finance ministry with adequate staff to continuously monitor local government finances; and (ii) an extensive data system that will allow quantitative monitoring and evaluation. Placement within the finance ministry affords the opportunity to coordinate activities with those responsible for other fiscal control measures, e.g., tax policy and borrowing.

Another option is to create an independent unit whose primary duty is policy research and advice. South Africa's permanent Fiscal and Finance Commission is such a unit. Uganda's Local Government Finance Commission is also permanent, but India's central and state finance commissions are only constituted every fifth year. Most countries, however, do not have such units.

There are also problems with the availability of a comprehensive data system to support the work of the fiscal analysis unit. A census of government finances that systematically reports actual financial outcomes for every subnational government is essential information if the performance of the intergovernmental system is to be monitored, analyzed for its strengths and weaknesses, and forecasted. Yet, it is not common in transition countries to have an up-to-date information system that describes the finances of subnational governments in detail. Rarer yet is a fiscal analysis model that is used to track the performance of local government finances.

Rule #4: One Intergovernmental System May Not Fit All Subnational Governments

Many believe that there must be a uniform intergovernmental fiscal system under which all subnational governments must operate. Certainly there are good arguments for this. If all subnational governments have the same expenditure responsibilities and revenue-raising powers, management of the system is much easier. Moreover, there is no hint of political favoritism as ad hoc differentiation among local units is not permitted.

However, there is another view, that uniformity may not be a necessary—or desirable—condition for effective decentralization. For example, a better route may be to begin fiscal decentralization with the larger local government units and to let the smaller ones "grow into it." Subnational governments have very different capabilities to deliver and finance services, and certainly different capabilities to borrow. It may be necessary to set up a system where these differences are explicitly recognized, i.e., where different local governments are given different financing powers and expenditure responsibilities (Bird and Ebel 2006). Places that are in the lower tier of capability could rely more heavily on grants; while more developed places could rely more heavily on local taxation and could borrow to finance capital outlays.

Rule #5: Fiscal Decentralization Requires Significant Local Government Taxing Powers

Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes and charges, as opposed to the case where financing is primarily by central government transfers. The local tax must be visible to local voters and large enough to impose a noticeable burden. Minor taxes and nuisance taxes will not do the trick.

Rule #6: Governments Must Keep the Fiscal Decentralization Rules That They Make

The fiscal decentralization plan is usually made by ministry officials, where lawyers draw up the decentralization laws, and training is then provided to local officials. In short, it is the higher level of government that makes the rules by which the new system will operate. Very often, these rules take the form of implementing regulations, rather than laws or constitutional imperatives. But, the higher level does not always keep the rules that it makes. For example:

- The promise of budgetary discretion is often followed by the imposition of unfunded expenditure mandates on local governments and/or an under funding of agreed upon transfers.

- The reassignment of expenditure responsibilities to subnational governments is made, but without the reassignment of commensurate revenue support.

- The abolition or capping of subnational government revenue-raising powers without an offsetting reduction in expenditure responsibility is a common problem. A good example occurs when a higher level of government puts a cap on a local tax. This compromises local revenue efforts and undercuts local self-government autonomy.

Rule #7: Keep It Simple

Subnational government administrative systems often cannot handle complicated intergovernmental fiscal arrangements. The same may be said of the central government systems necessary to monitor and evaluate intergovernmental fiscal arrangements. Simple fiscal decentralization structures will require the local governments to allocate fewer resources to administration, and will lower the monitoring and evaluation costs facing the central government. Complication is often introduced into the intergovernmental fiscal system by well-meaning policy analysts, because they do not properly take into account the capability of the administrative system to handle these refinements.

This is not to say that simplicity alone should drive intergovernmental reform. Indeed, there are complications that cannot and should not be avoided, e.g., disclosure requirements for local government borrowing, uniform accounting systems that follow accepted principles, and prescriptions for audit procedures. But the basic rule is to protect simplicity by limiting the number of objectives to be accomplished by each policy instrument and to be mindful of the administrative capacity of the local and central governments to administer (enforce) the system being designed.

Rule #8: The Design of the Intergovernmental Transfer System Should Match the Objectives of the Decentralization Reform

There are many different kinds of intergovernmental transfer systems, with many different types of impact on local government finances. Some stimulate local spending; some are substituted for local revenue effort; some are equalizing; and some lead to more local government fiscal autonomy than others. Countries often enter into grant design without fully exploring the alternatives and their differential impacts. Intergovernmental transfers have two dimensions: the size of the distributable (or "divisible") pool, and the distribution of this pool among eligible local government units. Some have referred to the divisible pool dimension as having to do with the *vertical fiscal balance* between the central and subnational governments, and the allocation dimension as having to do with *horizontal fiscal balance*. Both dimensions must be part of the policy design.[6]

6 Bahl and Linn 1992, Chapter 13.

Rule #9: Fiscal Decentralization Should Consider All Levels of Government

There is an inter- as well as intra-governmental dimension to intergovernmental fiscal relations. In some countries, provincial governments are too large to allow a level of citizen participation that insures voter preferences will matter, or that accountability of government officials will result. In such cases, fiscal decentralization must be carried through to the lower level of government. One must take care, however, to not overly fragment (make too many small) general purpose governments (Bird, Ebel, and Wallich 1995).

Rule #10: Impose a Hard Budget Constraint

A hard budget constraint implies that those governments that are given autonomy will be asked to balance their budgets without recourse to any end-of-year assistance from the central government. This is another of those rules that higher levels of government must keep; and local governments must believe that they are "on their own." Enemies of the hard budget constraint include fiscal measures such as the following:

- deficit grants, i.e., year-end grants to cover revenue shortfalls;
- bailouts on delinquent debt; and
- direct coverage of year-end shortfalls on certain items of expenditure.

Many "post-socialist" transition governments prefer to hold to a paternalistic approach to intergovernmental fiscal relations. The fiscal year begins with a vertical imbalance between local government expenditure needs and revenue authority, and perhaps even an uncertain level of grant distribution from the center. A year-end budget deficit is, in effect, planned, and deficit grants are a guarantee that local governments come to depend on. This was the case of Budapest for the first four to five years of its "self-governance" until, recognizing the dependency trap, the city undertook a policy to aggressively utilize their legal spending, tax and regulatory powers (Pallai 2003).

Rule #11: Recognize That Intergovernmental Systems Are Always in Transition and Plan for This

Some elements of a fiscal decentralization program will be short-lived, e.g., their relevance may diminish with economic development. There are many examples of this: disparities among regions within a country change; the quality of the basic infrastructure changes; priority areas for investment change; and the technical capacities of local governments change. Central governments must incorporate some degree of flexibility into their fiscal decentralization plans in order to adjust to such changes. How does a government do this while keeping a transparent structure to the intergovernmental fiscal system? The following are some possible answers to this question.

- Establish, as Kosovo has, an intergovernmental grants commission that reviews the allocation of intergovernmental transfers every few years, and recommends changes in the system. This approach, which must be expert and transparent, gives local governments enough certainty to plan their finances over a multi-year period and at the same time provides flexibility to accommodate change.

- Allow for changes in the local tax structure to capture changes in economic structure. As some local areas develop and urbanize, it may be possible to piggyback onto central and provincial taxes, broaden the tax base so as to pick up non-traditional sectors (e.g., the self-employed, small shops), or to use special benefit taxes such as tolls or special land assessments. These advances in tax structure should be encouraged.

- Provide for explicit "graduation" provisions for local governments. There should be a specified period for review to determine whether any given local government could graduate to the next highest class of local fiscal autonomy.

Rule #12: There Must Be a Champion for Fiscal Decentralization

It seems a paradox that fiscal decentralization can be such a popular policy in transition countries, but then have few enthusiastic champions. For decentralization to succeed there must be a strong *internal* champion that understands the costs and benefits of establishing such a program.

One can use ad hoc reasoning to try and identify the centers of strong support for decentralization policy. Such a categorization is presented in a "stylized" manner in Table 1. The strongest supporters are listed in the top cells of the table and the weakest in the bottom cells. Decentralization is a grass roots movement, which means that voters and elected politicians, including the president/prime minister, should be natural champions. But, if decentralization conflicts with macroeconomic stabilization policy, that support will be less firm. Hyperinflation or recession offers far more of a threat to re-election chances than does the absence of a good decentralization program.

Parliament will embrace programs that voters embrace, and therefore is a potential champion of decentralization. However, members of Parliament may also be particularly interested in how programs benefit their own constituency (and their popularity); hence they may be less enthusiastic than policy analysts about the need for transparency.

Though local governments can be expected to favor decentralization, the rich and poor among them may take very different views on the preferred version of decentralization. The more well-off local areas will favor increased fiscal discretion and a *laissez-faire* approach to fiscal decentralization while the poor will opt for a redistributive system based on a guaranteed revenue flow.

Table 1. Strong, Weak and Ambivalent Supporters of Fiscal Decentralization

Potentially Strong Supporters	Comments
The People and Their Elected Representatives	Demand for more participation in governance at the local level.
The President and/or Prime Minister	Decentralization is a popular policy with the electorate. However, the president/PM must also be very mindful of stabilization concerns with decentralization, since inflation and unemployment are usually the greatest danger to his/her political standing.
The Parliament or Congress	Decentralization is a popular policy with the electorate. Parliament would like to identify with specific local projects that they could "bring home," therefore, they may favor a less transparent and less structured system.
Urban Local Governments	"Give us the autonomy to tax and spend." Urban local governments are often most concerned with how their autonomy is circumscribed, and how their access to their tax base is limited.
External Donors	Donors provide encouragement and some technical assistance to get the process underway, but external assistance is no substitute for in-country champions and capacity development.
Potentially Weak Supporters	
Ministry of Finance	Would propose strict limits to decentralization in order to continue to wield the main fiscal tools for stabilization policy purposes.
Ministry of Economy	Would like to control the type of investment made, as well as the regional distribution of investment. Typically interested in programs with big externalities vs local benefit programs.
Line Ministries	Would like to control the standards of public service delivery, and often would like to hold an approval or sign off power.
Ambivalent Supporter	
Ministry of Local Government	Would favor a greater guaranteed share for local governments, but would like to control the distribution of those resources.
Weaker local governments	Would like a guaranteed transfer of resources from the urban and wealthier local governments to the rest. More interested in a transfer system than in a local taxing system.

Finally, some of the external donors and advisors will champion fiscal decentralization. The World Bank and the Inter-American Development Bank tend to see decentralization as part of a development strategy that will lead to a more satisfactory and balanced growth, and promote decentralization as a country strategy. The IMF takes a more cautious and qualified view because of its concern with any policy that might promote fiscal instability. These external advisors can play an important catalytic role. When they bring funding as the carrot, they oftentimes catch the attention of government officials and stimulate the government to begin looking harder at the decentralization issue. But unless the government itself is enthusiastic, the harder look will not lead to meaningful policy reform and in fact will be quickly forgotten when the money is gone. The implementation stage is never reached.

There are three major detractors of fiscal decentralization policy. The finance ministry as the keeper of the tools to address macroeconomic instability will not want to give up its control over these tools. Typically, the ministry of finance will favor an ad hoc over a transparent regime. If this ministry is on record as favoring decentralization, it will tend to be a very controlled form of decentralization. One might look for the following features in such a program:

- limited freedom for local governments to set tax rates for any major taxes;
- strictly controlled borrowing powers;
- budget approval by higher level government, or stringent expenditure mandates;
- an ad hoc system of intergovernmental transfers, that would give the central governments some flexibility to withhold full distributions in hard times; and
- centrally controlled wage and salary rates for local government employees.

The ministry of economy could be a significant opponent. This ministry will be interested in a system that allows central rather than local direction of investment. If investment decisions are decentralized to any significant extent, it will compromise national planning on the distribution of capital expenditures by function and by location.

And, the line ministries often oppose decentralization on grounds that seem more paternalistic. Their view is that the local governments do not have the technical capacity to deliver services or to plan resource allocation; hence there must be strong central direction. Line ministries, if they are persuaded on fiscal decentralization, will be more comfortable with conditional grants and mandated expenditure requirements.

Concluding Comment

Despite the rhetoric, fiscal decentralization is often held back. Until recently the advantages of centralization and the political power of the centralists have been too strong. But the world has changed, and the case for decentralization is becoming more irresistible. It may be slowed by an unstable world economy, as most new policies will be, but its time may have come. Governments around the world are increasingly elected on a platform of citizen participation in governance; economic development has eroded some of the arguments in favor of fiscal centralization; and the service delivery capabilities of local governments have improved dramatically. Moreover, some view granting local autonomy as better than separatism as a policy direction. The enemy now is poorly conceived decentralization policies. Design must match objectives, and implementation must face up to the many dimensions of decentralization.

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