

## Chapter 2

# Public Budgets: Governance Structures, Norms, and Organizational Practices

**Abstract** This section focuses on public budgets and, subnational governments' expenditure and revenue choices. It begins with a general picture of public budgeting and of global trends in budgeting, such as performance budgets, the adoption of medium-term expenditure frameworks, and the creation of independent fiscal institutions. It then addresses the subnational governments' expenditure responsibilities. It explains the main drivers of subnational governments' expenditure needs and costs, approaches to estimating costs, the concepts of zero-based budgeting and participatory budgeting, and the increase of private participation in service delivery. Finally, issues regarding subnational governments' revenue options, such as taxes, user fees, and debt are discussed.

**Keywords** Budget • Fiscal autonomy • Expenditure responsibilities • Participatory budgeting • Performance budget

This section provides the basic tools for understanding public budgeting and subnational governments' expenditure and revenue choices.<sup>1</sup> It includes four subsections. The first lays out an overall framework for budgeting. It explains the notion of budget, its components and structure, and the budget cycle. Recent trends in budgeting, such as performance budgets, the adoption of medium-term expenditure frameworks, and the creation of independent fiscal institutions are also addressed. The second subsection analyzes patterns of expenditure responsibilities of subnational governments across countries. It discusses the main drivers of subnational governments' expenditure needs and costs and presents approaches to estimating costs. It explains the concepts of zero-based budgeting and participatory budgeting and examines the trend toward decentralization and increased private participation in public service delivery. The third subsection deals with subnational governments' fiscal autonomy. An overview of the main sources of subnational governments' revenues across countries is presented. The main questions involving the taxes levied and the user fees charged by subnational governments are debated. Finally, the last subsection is dedicated to debt. It discusses the common pool

---

<sup>1</sup> See Shah (2007a) for a comprehensive book on local budgeting.

problem and other political economy issues that contribute to subnational governments' fiscal indiscipline in several countries. It also examines whether the establishment of fiscal rules promotes sound fiscal policy.

## **1 Budget Basics**

Any organization, private or public, has to prepare a budget to manage its resources and activities properly, in order to accomplish its goals. While in the private sector most organizations have profit maximization as their key goal, the public sector's main objective is to improve the welfare of the population. Budgets are an important tool to discipline governments because the services they provide (public goods, correction of externalities, and other market failures) are not subject to market competition as are those supplied by private businesses. At the subnational level, budgetary institutions should serve to allocate the community's resources to their most preferred activities, e.g., those that best satisfy their needs.

### ***1.1 What Is a Budget?***

A budget is a document or a collection of documents comprising a detailed description of the expected revenues and expenditures of a given institution, associated with the activities that are planned for achieving specific purposes or goals, within a given period.

In the case of subnational governments, the local budget is intended to link the community needs with the amount of resources necessary to satisfy them, serving as a guide for local financial management and as a tool that can be used by citizens to evaluate subnational governments performance and fiscal discipline. Therefore, budgeting is fundamental for the planning, control, and evaluation process of governments.

In the public sector, budgets have three broad functions: economic, political, and legal. Economic, because they are an exercise of planning, controlling, and administering activities, intended to balance revenues and expenditures, and to allocate available resources efficiently in order to maximize social welfare. The budget establishes which activities will be undertaken (and therefore, the type, quantity, and quality of services provided to citizens) and how resources will be obtained and allocated. Budgets help officials to check if the flows of revenues and expenditures during the fiscal period materialize as planned, and if operational adjustments are necessary. At the end of the fiscal period, comparisons of budgets with accounting final reports allow an evaluation of whether the flows of revenues and expenditures were in accordance with expectations or not. If linked to the subnational government objectives, budgets allow for an assessment of its efficiency.

The political function of the budget results from the fact that budget proposals offered by the executive body of subnational governments have to be approved by committees that are usually elected. Furthermore, during the implementation of the budget and at the end of the fiscal period, officials have to present reports that require approval by legislative bodies. Finally, since budgets are regulated by laws, rules and regulations and, in some cases, they have a legal status, they carry out a legal function. They establish limits to managerial decisions and actions of subnational governments, and officials violating them may be subject to penalties.

There are several types of budgets. Operating (or current) budgets focus on ongoing operations while capital budgets are concerned with new long-term assets (such as land, infrastructures and equipment). In some countries, the law requires that subnational governments have balanced operating budgets. As for capital budgets, since they concern the acquisition and construction of assets that generate benefits over several years, inter-period equity suggests that they should not be financed by taxes in a single year, but rather by debt that is repaid over a period that extends farther into the future. Additionally, there are special fund budgets, which cover programs (e.g., highways) funded by specific revenue sources (e.g., sales taxes on gasoline).

The way the budget is prepared and presented, in terms of its components and structure, influences the allocation of resources and the government's capacity to monitor and control its activities. Therefore, considerable attention has been dedicated to establishing the desirable form and content of budgets.

To allow for comparisons over time and across governments, it is important to establish standard classifications for reporting revenues and expenditures, and rules for the structure and elements of budgets. There is usually more concern about reporting expenditures than revenues because governments, particularly at the subnational level, have power that is more discretionary over the former than the latter. Typically, at least three classifications of expenses are adopted: functional, organizational, and economic. For revenues, the economic classification is the most common. Classification systems vary from country to country. International organizations, such as the International Monetary Fund (IMF) or the Organization for Economic Cooperation and Development (OECD), also have standard classification systems that allow for cross-country comparisons.<sup>2</sup> The IMF economic classification of expenses includes eight categories (compensation of employees, use of goods and services, consumption of fixed capital, interest, subsidies, grants, social benefits, and other expenses) divided into subcategories. The functional classification has 10 components (general public services; defense; public order and safety; economic affairs; environmental protection; housing and community amenities; health; recreation, culture, and religion; education; and social protection) also divided in subcomponents. Revenues are divided into taxes, social contributions, grants, and other revenues.

---

<sup>2</sup> For a detailed description see the IMF's Government Finance Statistics Manual 2001.

Local governments can only budget effectively if they have the autonomy to determine expenditures and revenues and discretion for the use of funds, which depends on the degree of political, administrative and fiscal decentralization (Mullins 2007). Budgeting in developing and transition countries presents additional challenges. On the revenue side, many local governments face difficulties in increasing their funding resources. On the expenditure side, budgets mostly cover operating costs. To ensure the efficiency and sustainability of local services, namely the management of environmental resources, good governance practices and clear accountability are fundamental.

## 1.2 Budget Cycle

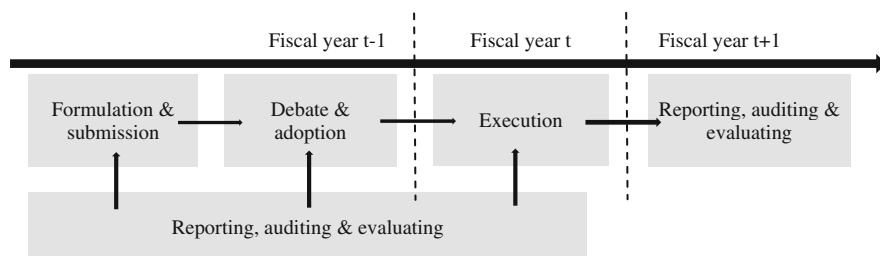
Public budgeting varies considerably across the world. It depends on the country's legal framework, as well as on the organizational structure of government.<sup>3</sup> The budgeting process involves interaction among numerous participants, from citizens to firms, and includes officials from various levels of government. Although budgets are usually set for a fiscal year, the budgeting process extends for a considerably longer period and is best understood as a cycle with overlapping phases, as shown in Fig. 1.

Four key general phases of the budgeting system can be identified.

- (a) *Formulation and submission*: in most cases, the executive body of government prepares and submits the budget for approval. The initial phase of the budget involves flows of information on spending requests and estimates of the resources available, as well as decisions on how scarce resources should be allocated among numerous public demands to attain the community's goals and objectives. The budget formulation is both a technical and a political process. Once finished, the budget proposal is submitted to the legislative body.
- (b) *Debate and adoption*: the legislative branch analyzes, debates, and proposes changes to the budget proposal. During this stage, the budget proposal is also frequently disclosed to the wider public. After being approved by the legislative body, the amended budget is officially adopted by the legislature and is put into effect.
- (c) *Execution*: the executive body implements the budget by operationalising plans, collecting revenues and spending money. Frequently, several control mechanisms are adopted during the budget's implementation, including cash management, audit-systems, appropriation and allotment rules, and transfers of authority. Accounting and reporting procedures are implemented to guarantee that revenues and expenditures are continuously monitored and stay on track with the amounts that have been estimated and authorized. The executive

---

<sup>3</sup> See Guess and Leloup (2010) for a comparison of public budget systems around the globe.



**Fig. 1** The budgeting cycle

branch has discretionary power to implement small budget adjustments, but substantial changes often require the approval by a higher level of government or by the legislative branch.

- (d) *Reporting, auditing and evaluating*: Public officials should be accountable to citizens for how they raise public monies and how they spend them. To guarantee accountability and keep stakeholders informed, frequent evaluation and reporting are critical. Although most citizens lack the time or knowledge to read governments' financial reports, they are often exposed to debates during electoral periods, which are used by opposition parties to attack the incumbent. Before, during and after the budget execution, several types of audits are implemented. Fiscal audits are intended to verify the accuracy of expenditure and revenue records, to determine if actual financial results are in accordance with the legally adopted budget, and to assess whether financial transactions comply with finance-related laws, rules and regulations. Operational and management audits review how specifically programs are carried out and evaluate the efficiency and effectiveness of management. Performance audits verify if the outputs and outcomes are in accordance with the benchmarks previously defined. Audits can be internal or independent. The increase of governments' deficits and debts during the recent global crisis, has led to the creation of independent fiscal institutions in a growing number of countries.<sup>4</sup> Common functions of these councils include the analysis of fiscal policy and budget proposals, the production or endorsement of macroeconomic forecasts, monitoring compliance with fiscal rules, and analysis of long-term fiscal sustainability. Essentially, these entities were created to increase fiscal policy transparency and soundness.

<sup>4</sup> In the European Union new regulations require member states to have independent fiscal institutions. For discussions on the role of independent fiscal agencies see Hagemann (2011), Kopits (2011), and Hemming and Joyce (2013).

### ***1.3 Performance Budgets and Medium-Term Expenditure Frameworks***

A global trend in budgeting is to supplement traditional budgets with performance budgets. These move the attention away from control of expenses and revenues toward responsibility for service outcomes or results. In performance budgets, expenditures are associated with outputs or outcomes. A program budget is an example of a performance budget, where resources and results are associated with specific programs. While subnational governments may lack technical skills in statistical monitoring and may be unable to produce a sophisticated evaluation of results, they can make up for that with their greater proximity to the citizenry being served. By paying attention to public response and integrating public input into the monitoring process, a results or outcome orientation emerges. Local services' results and outcomes are easier to monitor than those of central services are.

Budgets can be produced for a single fiscal year or for several years. Another important recent change in budgeting and public financial management is the widespread adoption of medium-term expenditure frameworks (MTEF). According to World Bank (2013), by the end of 2008, more than 75 % of all countries had adopted a MTEF. Most public programs require resources and generate benefits over several years. Under these circumstances, single-year budgets may not provide adequate information. MTEFs ensure a multiyear commitment of resources to policies and are, therefore, important for expenditure prioritization and for fostering government performance over the medium term. To implement them, governments have to consider possible trade-offs between short- and medium-term goals and equity issues over time. International organizations, such as the World Bank, included MTEF in their standard advice on budget reforms to low and middle-income countries, contributing to their spread around the world. World Bank (2013) provides strong empirical evidence, based on case studies and econometric analysis, that MTEFs enhance fiscal discipline and allocative efficiency.

## **2 Expenditure Responsibilities of Subnational Governments**

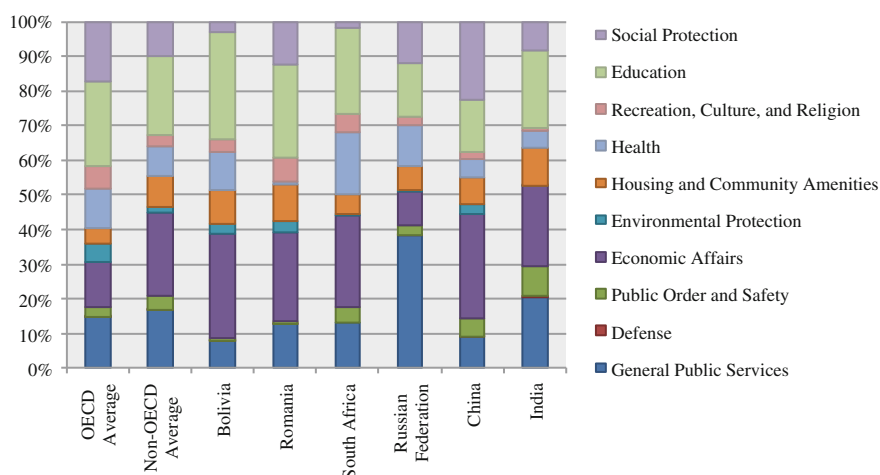
Subnational governments vary in their responsibilities across countries. As was studied in Sect. 1, they play an increasing role in public services delivery. Their expenditures represent an important share of total public expenditure in sectors such as environmental protection, housing, education, and health.

## 2.1 Defining Expenditure Needs and Costs

Expenditure needs of subnational governments are higher in more decentralized countries and where they are assigned a broader range of public services. In some countries, the assignment of responsibilities across levels of government is defined by the constitution (e.g., Switzerland and South Africa), in others by statute at the national or provincial level. Frequently, the set of functions assigned to subnational governments depends on the size (population) of the jurisdiction with capitals of metropolitan areas being responsible for more functions. Services such as sanitation, garbage removal, street repair and cleaning, fire protection and recreation facilities are the responsibility of subnational governments in almost all countries. The assignment of other functions, namely education and health care, which are more costly, varies across countries. According to Shah and Shah (2006), subnational governments in developing countries have limited autonomy in expenditure decisions and they are typically allowed to discharge a number of functions, which are mandated from above.

As can be seen in Fig. 2, most subnational governments devote the largest part of their budget to education, followed by economic affairs, general public services and social protection. Non-OECD countries included in the graph spend less in environmental protection and recreation, culture and religion than OECD countries do, but they spend more on economic affairs and housing and community amenities.

Expenditures are determined by not only the degree of decentralization, but also by the functions assigned to subnational governments and the needs of the population. They are also determined by supply side factors influencing the costs of



**Fig. 2** Expenditure composition for subnational governments. *Source* Own calculations based on the IMF's Government Financial Statistics. *Note* For each country, the latest data available was used. The non-OECD average refers to the countries considered in the figure

public service provision, such as the level and quality of services provided and inefficiencies in provision resulting from mismanagement.

The costs incurred in delivering a given level of a public service vary across subnational governments. The main factors influencing costs are the quantity and composition of inputs needed given the available technology, the prices of inputs, physical features of the region (altitude, temperature, and other environmental factors), and the social and demographic characteristics of the population.

Labor costs are frequently an important part of total costs incurred by subnational governments. They depend on the wage paid and the number of workers hired. Frequently, public employees receive the same wages regardless of the subnational government hiring them. However, in some countries subnational governments can use higher compensation to attract workers with better qualifications or stimulate them to move to remote or high criminality areas. Non-labor costs are associated with inputs such as raw materials, energy, land, and equipment. Capital expenditures are a special type of non-labor local expenditure. They relate to the expenditure to acquire capital assets. The physical characteristics of the place where public goods and services are delivered also influence costs. For example, roads, sewage, water and energy are easier to provide in flat areas than in areas with high altimetric amplitude. Weather conditions, such as temperature and precipitation are also relevant issues. Additionally, economies of scale, density and scope may also influence costs. Several empirical studies suggest that many public services have U-shaped average costs. For public services with high-fixed costs and relatively low operating costs, costs per unit of output decline as the scale of production increases (economies of scale). However, after a certain level of production, economies of scale are exhausted and average costs increase with scale. Nauges and van den Berg (2008) analyzed water and sewerage utilities in Brazil, Moldava, Romania and Vietnam. They found evidence of economies of scale in the last three countries; however, returns to scale decreased with utility size. Finally, their results reveal that there are increasing returns to production and customer density in all countries, and that economies of scope exist in the three countries where utilities provide both water supply and sewerage services.<sup>5</sup>

The socio-demographic profile of the population also affects costs. People from different age groups demand specific services, such as elementary education for the youngest and facilities for the elderly. Needs for basic health care and social protection are larger in low-income communities with a high incidence of poverty.

## 2.2 *Approaches to Estimating Costs*

A budget is a financial plan that is oriented toward the future. Accurately forecasting future expenditures and resource needs is critical to good local financial

---

<sup>5</sup> For another study on returns to scale, see Reingewertz (2012).



management and to the achievement of established goals. According to Schroeder (2007), four general forecasting techniques can be used for expenditures and revenues. The first is judgemental forecasting, that is, to rely on local experts to generate forecasts. This approach may be necessary when data on the public sector is limited, but dangers are inherent when the quality of the forecast depends entirely on the knowledge of the experts. The second technique is to apply time series analysis to project the next year's flows based on what has happened in the recent past. This method implicitly assumes that the variables that influenced expenditures and revenues in the past will continue to influence them in the future in a similar manner. The third method consists of deterministic techniques. For example, to predict the labor expenditure of a local government, a forecaster calculates the product of the number of employees and the average annual wages and salaries, making assumptions about the value each of these variables will take. This technique does not require the assumption that revenues or expenditures will rise or fall as they did in the past, but explicit assumptions about the factors determining the variables being forecasted must be made,<sup>6</sup> and these assumptions may turn out to be wrong. Finally, there are statistical (or econometric) forecasting models that while the most sophisticated might require more data.

Let's now focus on estimating costs. Some costs are relatively easy to estimate, either because they are fixed by legislation (such as salaries) or ruled by contracts (e.g., equipment or debt payment). However, others are more discretionary or unexpected and, therefore, much less predictable (e.g., equipment repair or recovery from natural disasters). Reschovsky (2007) proposes three approaches to estimating the costs of local public services. When good data on public outcomes is available, it may be possible to estimate a cost function. Cost functions are statistical relationships between expenditures on a specific public service, outcomes of the public service, prices of the inputs necessary to produce the public service, environmental factors that may influence the relationship between inputs and output, and characteristics of local governments that may influence spending. Estimation of cost functions can be very demanding in terms of data. For services such as water and energy distribution or garbage collection, output is relatively easy to measure. Regarding water, the number of households having access to potable water or the number of liters consumed can be used. However, for other services such as police protection, education, or health care, measuring outputs is more difficult. An alternative method is to estimate an expenditure equation that relates per capita expenditure on a specific output with input prices, environmental factors that might influence the relationship between inputs and outputs, and variables that determine preferences for the public good. Finally, when gathering data is problematic, it is possible to rely on a panel of experts to identify the minimum cost of providing a specific public service.

---

<sup>6</sup> For example, regarding future salaries or wages, one possible assumption is that they will increase at the same rate as inflation. Expected values for the amount of labor to be employed should depend on the amount of output to be produced.

### ***2.3 Zero-Based Budgeting and Participatory Budgeting***

Mapping expenditures to the perceived preferences of citizens is a complex process that is time consuming and involves high costs. Given the limited period of time within which the budget is prepared, and in order to avoid conflicts over budgetary options, in traditional budgeting only marginal changes to previous base budgets are introduced. Most programs are rolled over from one year to the other, thus avoiding the difficult process of negotiating their discontinuance with stakeholders. Since the 1970s, it has become clear that incremental budgeting leads to an upward bias in spending that can contribute to the growth of government and to higher deficits. In developing countries, where resources are very scarce relative to the development needs, the negative effects of incremental budgeting practices are even higher. Therefore, efforts have been made to overcome these shortcomings.

In the late 1970s, zero-based budgeting was introduced in the US. As the name suggests, at the beginning of each budget cycle the starting point is zero so that the continuation of programs is not guaranteed. Each spending agency has to justify every item in its request for funding. This approach allows the discontinuation of programs that are no longer necessary so that resources are used based on needs and not on decisions taken in the past. In practice, zero-based budgeting is difficult to implement due to the high costs involved. First, it is time consuming to justify each item included in the budget and human resources to perform the needed evaluations are often lacking. Second, some public programs are not easily negotiable because they are regulated by legislation and involve multi-year contracts. Third, zero-based budgeting does not guarantee that low priority programs will be rejected because it does not take into account the political pressures and institutional features that drive budgetary decisions.

Another effort to make budgeting more rational is participatory budgeting.<sup>7</sup> It relates to the direct participation of citizens in deliberations and negotiations over public spending and resource allocation. Traditionally, citizens' participation in subnational governments has been political. Through campaigns, voting and lobbying, citizens try to influence public representatives and officials. Some argue that citizens' views should be incorporated earlier, starting when budget proposals are being defined. In a very simplified way, participatory budgeting can be described by the following sequence of steps: residents propose and discuss spending ideas, budget delegates prepare proposals based on these ideas, residents vote on the proposals and the government implements the proposal selected. This enables taxpayers to work with the government to make the budget decisions on how to spend part of a public budget. It engages people in government by ensuring that communities are well-represented in the different phases of the budget process

---

<sup>7</sup> For an overview of the principles underlying participatory budgeting, regional surveys and country case studies, see Shah (2007b). For web information consult the site of the Participatory Budgeting Project (<http://www.participatorybudgeting.org/>), a non-profit organization that helps communities decide how to spend public money, primarily in the US and Canada.

(planning, development, approval). It gives an opportunity to marginalized and excluded groups of the population to influence subnational governments' policies in accordance with their interests.

Participatory budgeting was first introduced in 1989, in the city of Porto Alegre in Brazil and it significantly improved facilities in the town, particularly those that benefited the poor.<sup>8</sup> For example, sewer and water connections increased from 75 % of total households in 1988 to 98 % in 1997. Given the noticeable positive impact of PB in citizens' lives, it has spread across the world. According to Mikesell (2007), participatory budgeting has been successfully implemented by local governments in several countries, such as Brazil, Canada, China, the Dominican Republic, Ecuador, India, Indonesia, the Philippines, Serbia, South Africa, Sri Lanka, Tanzania, the United Kingdom, and Uruguay. There is broad variation in the design of PB programs, as they are conditioned by the local social, political and economic environment.

The more open and inclusive policymaking processes provided by participatory budgeting help to ensure that policies are better informed and will better match citizens' needs. Well-implemented participatory budgeting improves subnational governments' performance and enhances the quality of democracy. However, as mentioned by Shah (2007b), participatory budgeting also has significant dangers that need to be avoided. When participatory budgeting functions poorly, it can be captured by interest groups, lead to cynicism about democracy, and diminish long-term planning, as many participants are only interested in securing short or medium-term public works projects.

## ***2.4 Private Participation in Service Delivery***

To increase the match between citizens' needs and service delivery, several countries have decided to end public monopolies in areas including sewage disposal, and water and electricity distribution. Private sector participation (World Bank 2004) in these areas has been permitted. When possible, the emergence of private competition where citizens can choose the provider based on price and output quality gives citizens a voice and may ensure a better match between demand and supply. However, for infrastructure services requiring high fixed costs and involving strong economies of scale (i.e., water and electricity distribution) or involving network externalities, a single distributor provider may be technically more efficient. Additionally, government intervention may be justified for equity reasons, to guarantee minimum equitable access to the services. In this case, two arrangements are possible. The first is to have a public sector provider. Most of

---

<sup>8</sup> For an analysis of the Brazilian case, see the World Bank report available at [http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2009/11/03/000333037\\_20091103015746/Rendered/PDF/514180WP0BR0Bu10Box342027B01PUBLIC1.pdf](http://www-wds.worldbank.org/external/default/WDSPContentServer/WDSP/IB/2009/11/03/000333037_20091103015746/Rendered/PDF/514180WP0BR0Bu10Box342027B01PUBLIC1.pdf).

these providers belong to subnational governments but in some cases to central governments. When the central government is responsible for regulating and delivering the service it has little incentive to hold itself accountable. Devolution of responsibilities to subnational governments creates opportunities to benchmark performance and provide fiscal incentives to stimulate efficient service delivery. However, according to Foster (2005),<sup>9</sup> devolution may also lead to losses of scale economies, difficulties of attracting private investment into a highly fragmented sector, and conflicts that arise when a central government imposes regulation in a sector that is legally under municipal control. The second arrangement is for the government to create incentives for private provision, regulate the service and monitor its behavior. Private participation may increase management expertise and private investment, and lead to the introduction of incentives for high quality service delivery. Like decentralization, private provision may enhance accountability by separating providers from policymakers.<sup>10</sup> The success of reforms depends crucially on how the legal and policy frameworks are designed and on the accountability of subnational authorities (Kurian 2010). In recent years, output-based approaches that tie public disbursement of funds to specific service or output deliveries are being increasingly used as a tool to increase access to services.

In industrialized countries, the trend toward public ownership and private provision occurred in the Reagan-Thatcher era. In France and the USA, water assets have been assigned to local governments. To take advantage of economies of scale, clusters of political jurisdictions were created to delegate water services to private or semi-public companies. In Bolivia, Colombia, and Brazil, inter-jurisdictional agreements also exist in the water services. In England, the local water system was consolidated into regional bodies after World War II and they were privatized in the 1980s. A centralized agency relying on incentive-based instruments regulates the market. Since the 1990s, private participation in water, sanitation and electricity has grown significantly (World Bank 2004).

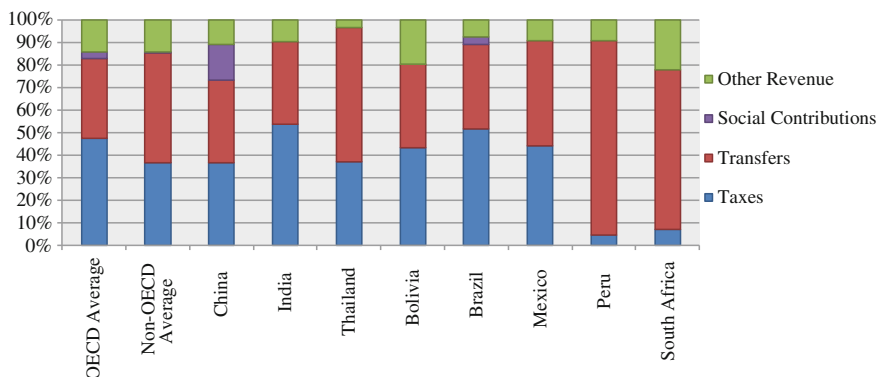
### 3 Local Governments' Fiscal Autonomy

A wide portfolio of revenue sources improves government's risk sharing, helps to handle economic fluctuations and reduces the impact of unexpected events in revenues. Therefore, it is important for subnational governments to diversify their sources of revenue. State and local governments receive revenue from fiscal transfers, a variety of taxes, charges and fees, and borrowing. Fiscal transfers

---

<sup>9</sup> Foster (2005) analyzed water service reform in Latin America, during the 1990s, where most countries moved from unregulated centralised public provision of water to regulated decentralised public provision.

<sup>10</sup> This topic will be developed further in the next section.



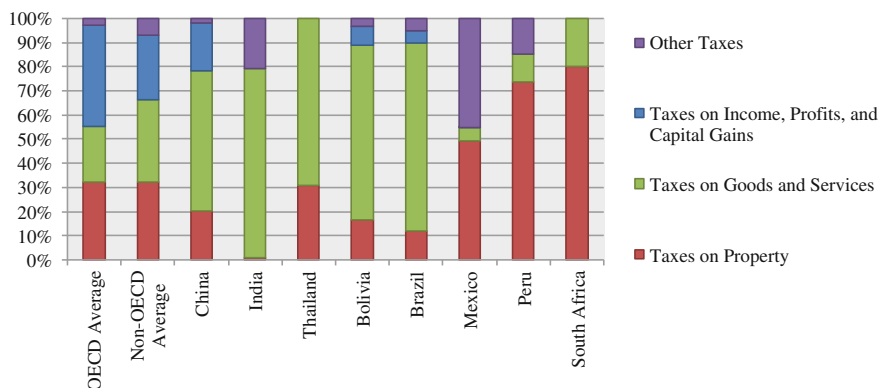
**Fig. 3** Composition of revenues for subnational governments. *Source* Own calculations based on the IMF's Government Financial Statistics. *Note* For each country, the latest data available was used. The non-OECD average refers to the countries considered in the figure

include intergovernmental transfers within the country, as well as transfers from foreign governments and international organizations.

In terms of budgeting, revenues are relatively hard to predict accurately because they depend on exogenous factors such as economic performance at the local and national levels (tax revenues) and citizen's preferences (fines and fees). Revenues that are contractually established, promised in advance by other governments or institutions, or set by law like property tax, are easier to estimate. Revenue estimation errors may lead to resource misallocation and to the accumulation of debt.

As can be seen in Fig. 3, the large majority of subnational governments' revenue comes from taxes and intergovernmental fiscal transfers. In OECD countries, almost 50 % of revenue is collected through taxes, while in developing countries the largest part comes from intergovernmental fiscal transfers. For example, in Peru and South Africa, subnational governments are extremely dependent on transfers. In these countries, tax decentralization has not kept pace with political and expenditure decentralization (recall that subnational governments' expenditures represent 20 % of total public expenditure in Peru and 50 % in South Africa—Table 1). This separation of taxing and spending decisions undermines accountability to local citizens, since it reduces subnational politicians' need to explain their decisions to their electorates. However, in other countries such as Brazil and India, subnational governments rely more on self-financing, which is important for strengthening governance, efficiency and accountability. In China, around 16 % of subnational revenues are obtained from social security contributions, which is the largest share in the sample. This is because Chinese local governments have responsibilities in the social security area, namely in terms of pensions and unemployment subsidies.<sup>11</sup> Items included in Other Revenue represent more than

<sup>11</sup> For a review of subnational taxation in Brazil, Russia, India, China and Nigeria see Bird (2012).



**Fig. 4** Composition of subnational governments' tax revenues. *Source* Own calculations based on the IMF's Government Financial Statistics. *Note* For each country, the latest data available was used. The non-OECD average refers to the countries considered in the figure

10 % of subnational governments' revenues. They include, among others, property income, sales of goods and services, and fines, penalties and forfeits.

Figure 4 shows that the composition of subnational governments' tax revenues varies substantially across countries. For OECD countries, revenues from taxes on income, profits and capital gains are the largest, followed by taxes on property. For non-OECD countries, taxes on goods and services and property taxes have the biggest share. Mexico, Peru and South Africa rely mostly on property taxes, while China, India, Thailand, Bolivia, and Brazil rely on taxes on goods and services.

### 3.1 The Property Tax

Taxes on property account for more than 30 % of tax revenues of subnational governments.<sup>12</sup> They are generally taxes on land and capital (buildings and equipment). An important advantage of the property tax is that it generates a certain, and therefore predictable income. However, taxes on property also have disadvantages. First, they are frequently regressive.<sup>13</sup> Although only landlords pay it, when property taxes increase rents also tend to go up because landowners transfer the burden of the tax to the tenants. Additionally, increases in property taxes are particularly painful for those with fixed incomes, such as retired people

<sup>12</sup> For an analysis of the property tax reform in Vietnam see McCluskey and Trinh (2013), for Kenya see Kelly (2002), and for Latin America see Sepulveda and Martinez-Vazquez (2011). McCluskey et al. (2012) provide a broader discussion on property tax.

<sup>13</sup> A regressive tax imposes a burden that is a greater fraction of income for lower-income individuals than higher-income persons. Taxes can also be progressive or proportional.

who may be forced to sell their homes. Second, property taxes are hard to administer and somewhat arbitrary. Unlike other taxes, subnational governments determine both the tax rate and the tax base of property taxes. The tax liability is the product of the tax rate and the property assessed value by the jurisdiction, most commonly the market value. However, when property is not sold frequently its value has to be estimated; otherwise, it may become increasingly under-assessed. Regardless of the practices and procedures used to perform the estimations, they are always subject to error.

When subnational governments rely extensively on property taxes, differences in the value of property across jurisdictions generate differences in their capacities to provide public goods and services. In wealthy communities, or in places with capital-intensive industries, or with a high construction rate it is easier for subnational governments to provide high levels of public services with low tax rates than in areas where the value of property is low.

### ***3.2 Other Tax Revenue***

In several countries, subnational governments are authorized to levy taxes on goods and services. In countries like India, Thailand and Brazil, they constitute a very important source of revenue for subnational governments. When applied to all merchandise, these taxes are clearly regressive. They place a proportionately higher burden on low-income people because they spend a higher proportion of their incomes than rich people do. To reduce its regressivity, most countries exempt certain goods and services (e.g., food for home consumption, drugs, electric and gas utilities) from taxation. Taxes on goods and services are usually easier to administer and govern than property taxes, but they may lead to strategic competition among subnational governments and it is difficult to collect taxes on purchases made by residents in other jurisdictions. Subnational governments may also benefit from miscellaneous other taxes on goods and services, such as taxes on tobacco products, alcoholic beverages, motor fuels, and on the extraction of natural resources. Severance taxes on natural resources help to pay for environmental damages resulting from extraction, and keep other taxes low. However, when the jurisdiction becomes highly dependent on them, a fall in the price of the natural resource can exert severe damage to the local economy.

Taxes on income, profits and capital gains are also important sources of revenue for subnational governments, particularly in OECD countries. They can be used strategically by subnational governments to attract population and businesses.

### 3.3 *User Fees*

User fees are classified as Other Revenue in the IMF's Government Financial Statistics classification of revenue (see Fig. 3). User fees include prices charged by subnational governments on goods and services they provide, license taxes and fees required to undertake some activity. Common examples are water and sewer charges, tolls on roads and bridges, bus charges, and parking fees.

Several advantages are associated with user fees. First, only those who use the good or service are asked to pay (benefit principle). Second, they allow for a more direct relationship between the services and their costs than with tax financing. Third, user fees can also be used to moderate consumption. They can be increased to reduce access to overcrowded facilities, or assume different values during the day of the week or month in order to smooth consumption and promote an efficient utilization of the good or service. Finally, persons who do not live in the jurisdiction but benefit from public services must also pay the price. However, user fees also have disadvantages. First, they fail the ability to pay principle, since poorer persons are those more in need for public services but they may not have enough income to support them. A second potential problem is that they may generate high administrative costs to the subnational government (e.g., measuring use and collecting the fee) and compliance costs to the users (e.g., time costs).

User fees are frequently used to finance water, sewer and garbage collection services. In the case of water, the fee usually comprehends a connection charge, a capital and distribution charge, and a water-supply charge (Fisher 2007). For sewer services, the rationale is similar. Because metering sewer discharges is not common, except for industry, the fee frequently varies according to the amount of water consumed. Fees for garbage collection should depend on the amount and type of garbage made by the household, in order to connect costs with financing and generate incentives to avoid refuse through recycling. However, it is not easy to measure the amount of refuse, so in practice garbage collection services are frequently financed through general taxes or a fixed fee per month.

In several developing countries, governments do not charge consumers for water and sanitation services because they are considered unable to pay for the services. However, some studies claim that several consumers are willing to pay higher prices to firms offering services that are more reliable (World Bank 2004). According to Kurian and Ardakanian (2015), this contradiction can be explained by the fact that: (a) subnational governments are highly dependent on intergovernmental fiscal transfers that finance the construction of technical options that are highly costly and involve operating costs that cannot be supported from local revenues; and (b) it is difficult to identify the individuals who in fact cannot afford the services to give them infrastructure connection subsidies, so nobody ends up paying. Furthermore, it is frequently difficult to identify households that are benefitting from the service but not paying, the staff managing the service frequently lacks incentives to increase the number of clients, which is decisive for per capita charges reductions, and politicians use grandiose infrastructure projects to woo the electorate.



## 4 Debt

Although constrained by law in most countries, subnational governments can issue debt to finance their activities. Borrowing is particularly relevant to finance long-life capital infrastructure when it is recognized that transfers from upper levels of government are insufficient to satisfy the needs of the population. Because such investments generate benefits over the long run, intergenerational equity recommends that the associated costs be spread over the asset's useful life period. The main approaches adopted by subnational governments to fund infrastructure are: direct access to financial markets; the creation of financial institutions to serve as intermediaries between local governments and lenders (by pooling risk and having a better knowledge of how financial markets operate, they facilitate access to loans by local governments); borrowing from development banks and other financial institutions; and engaging in public-private partnerships.<sup>14</sup>

The capacity and prudence of debt financing by subnational governments depends on the financial market situation, the creditworthiness of the government, and the type of expenditure to be financed. When subnational governments borrow, they must predict the future expenditures needed (debt service) to pay back the loan and the interest on it. Therefore, debt is a commitment of the government's future revenues. Thus, it must be issued and managed carefully, in order to avoid future problems of fiscal unsustainability and difficulties in accessing the debt market.

The interest rate paid on loans is a key variable that is determined by the availability of funds in the financial market and by the financial situation of the local government. Borrowing is self-limiting because when lenders have doubts about the financial situation of a government, they will demand higher interest rates on the loan, which in the extreme case may exclude the government from the debt market. An indicator that is frequently used to assess the creditworthiness of local governments is the ratio of net operating surplus to anticipated new debt service payments. To ensure financial sustainability, subnational governments should establish a debt policy that limits the total amount of debt and debt service, establishes parameters for the issuance of new debt, and informs citizens and the financial community of the local government's goal of developing sound fiscal policy.<sup>15</sup> Mikesell establishes the following principles for responsible local debt-management.

- “Long-term debt should be used only to acquire capital infrastructure that has a useful life longer than the maturity of the debt.
- Debt should not be refinanced to extend its maturity (although it may be refinanced to take advantage of lower interest rates).

---

<sup>14</sup> For details see Alam (2010). See OECD (2012) for principles for public governance of public-private partnerships.

<sup>15</sup> For an example of a simple local government debt policy that can be adapted as needed, see Kaganova (2011).

- Short-lived capital assets should be financed with current revenue rather than by borrowing.
- Local governments should integrate capital asset planning and financial planning to ensure the affordability of long-term infrastructure programs.
- Debt should be issued on a competitive basis.
- Localities should practice complete, comprehensive, and clear debt reporting” (Mikesell 2007, p. 34).

However, lack of fiscal discipline by subnational governments is a problem in several countries, particularly in developing ones. Below we present some explanations for the problem and discuss whether the establishment of fiscal rules promotes sound fiscal policy.

### ***4.1 The Common Pool Problem and Other Political Economy Issues***

One of the first explanations for fiscal indiscipline by subnational governments is the common pool problem. When subnational governments are highly dependent on transfers from higher levels of government, they tend to overspend and to accumulate budget deficits. Because of lack of coordination, local decision makers take full credit for additional spending in their jurisdiction and the benefits it brings to the residents, but fail to internalize fully the costs that all taxpayers must bear. The problem is aggravated if subnational governments expect to be bailed out by the central government in case of financial distress. This moral hazard problem is known as the soft-budget constraint problem (Kornai et al. 2003). It has been studied, among others, by Velasco (2000), Rodden et al. (2003), and Krogstrup and Wyplosz (2010).

During election campaigns, local politicians may adopt opportunistic fiscal policies to signal competence and woo the electorate (Rogoff and Sibert 1988). Evidence on political business cycles at the subnational level is extensive. For developing countries, see Sakurai and Menezes-Filho (2011) for Brazil, Drazen and Eslava (2010) for Columbian municipalities, and Khemani (2004) for Indian states. For analyses of the rents appropriated while being in office see Battaglini and Coate (2008), and Yared (2010).

Government fragmentation and political instability may also be associated with larger deficits (Roubini and Sachs 1989) and debt can be used strategically (Persson and Svensson 1989; Alesina and Tabellini 1990) by a government that expects to lose the next election to a party with different ideology, in order to condition the latter’s policy options. For evidence at the local level, see Pettersson-Lidbom (2001) for Sweden, and Solé-Ollé (2006) for Spain.

Conflicting interests among different generations regarding fiscal policy management were analyzed by Song et al. (2012). They developed a dynamic politico-economic model of government debt where debt is used by governments to shift the fiscal burden to future generations.

## 4.2 *Balanced Budget Rules*

Recognizing the importance of promoting sound fiscal policy at the subnational level, several countries have imposed numerical targets for subnational governments' budgets, namely balanced-budget rules. Pioneering studies to evaluate their efficacy in securing fiscal discipline where performed in the US (Holtz-Eakin 1988; Poterba 1994; Bohn and Inman 1996). Results indicate that balanced-budget rules improve fiscal outcomes, particularly on the part of the budget subject to constraints. However, fiscal rules are frequently hard to enforce, and they can generate incentives for governments to circumvent them through creative accounting practices (Milesi-Ferretti 2003; Beetsma et al. 2009), such as the substitution of spending on items subject to numerical rules with those that are not. Focusing on the European Union, Von Hagen (2006) finds that the fiscal rule of the Maastricht Treaty significantly diminished political budget cycles, but had small effects in restricting fiscal policy in larger countries. He also concludes that rules have been more effective in countries with good budgeting institutions. For Japan, Von Hagen (2006) concludes that rules had little effectiveness.

## Keywords and Definitions

Ability to pay principle	A principle of taxation stating that taxes should be levied according to the taxpayers' ability to pay, those who have more wealth or earn more money should pay more taxes
Benefit principle	A principle of taxation stating that those who benefit the most from public goods/services should pay more to support those goods/services
Budget	Document or a collection of documents comprising a detailed description of the expected revenues and expenditures of a given institution, associated with the activities that are planned for achieving certain purposes or goals, within a given period
Participatory budgeting	A process of direct participation of citizens in deliberations and negotiations over public spending and resource allocation of a defined public budget
Performance budget	Budget that associates the input of resources with the service outcomes or results
Tax	A compulsory contribution to public revenue levied by the government on income, or property, or added to the cost of some goods, services and transactions
User charge	Sum of money demanded by a government for the use of a publicly provided good or service

## References

- Alam M (ed) (2010) Municipal infrastructure financing. Innovative practices from developing countries. Commonwealth Secretariat Local Government Reform Series No. 2. London
- Alesina A, Tabellini G (1990) A positive theory of fiscal deficits and government debt. *Rev Econ Stud* 57(3):403–414
- Battaglini M, Coate S (2008) A dynamic theory of public spending, taxation and debt. *Am Econ Rev* 98(1):201–236
- Beetsma R, Giuliodori M, Wiers P (2009) Planning to cheat: EU fiscal policy in real time. *Econ Policy* 24(60):755–804
- Bird RM (2012) Subnational taxation in large emerging countries: BRIC plus one. Institute on Municipal Finance and Governance Paper on Municipal Finance and Governance, 6. Munk School of Global Affairs. IMFG, Toronto
- Bohn H, Inman RP (1996) Balanced-budget rules and public deficits: evidence from the U.S. states. *Carnegie-Rochester Conference Ser Public Policy* 45:13–76
- Drazen A, Eslava M (2010) Electoral manipulation via voter-friendly spending: theory and evidence. *J Dev Econ* 92:39–52
- Fisher R (2007) State and local public finance, 3rd edn. Thomson South-Western, Mason
- Foster V (2005) Ten years of water service reform in Latin America: towards an Anglo-French model. Water Supply and Sanitation Sector Board Discussion Paper Series, 3. World Bank, Washington, DC
- Guess GM, Leloup LT (2010) Comparative public budgeting. University of New York Press, Albany, NY
- Hagemann R (2011) How can fiscal councils strengthen fiscal performance? *OECD J: Econ Stud*, 2011/1. [http://dx.doi.org/10.1787/eco\\_studies-2011-5kg2d3gx4d5c](http://dx.doi.org/10.1787/eco_studies-2011-5kg2d3gx4d5c). Accessed 13 Apr 2014
- Hemming R, Joyce P (2013) The role of fiscal councils in promoting fiscal responsibility. In: Cangiano M, Curristine T, Lazare M (eds) *Public financial management and its emerging architecture*. IMF, Washington, DC, pp 205–224
- Holtz-Eakin D (1988) The line item veto and public sector budgets: evidence from the states. *J Public Econ* 36:269–292
- International Monetary Fund (2001) *Government finance statistics manual*. IMF, Washington, DC
- Kaganova O (2011) Guidebook on capital investment planning for local government. World Bank Urban Development Series Knowledge Papers, 13. The World Bank, Washington, DC
- Kelly R (2002) Designing a property tax reform strategy for sub-Saharan Africa: an analytical framework applied to Kenya. *Public Budg Finance* 20(4):36–51
- Khemani S (2004) Political cycles in a developing economy. *J Dev Econ* 73:125–154
- Kopits G (2011) Independent fiscal institutions: developing good practices. *OECD J Budg* 11(3):35–52
- Kornai J, Maskin E, Roland G (2003) Understanding soft budget constraint. *J Econ Lit* 41:1095–1136
- Krogstrup S, Wyplosz C (2010) A common pool theory of supranational deficit ceilings. *Eur Econ Rev* 54(2):273–281
- Kurian M (2010) Financing the millennium development goals for water and sanitation: issues and options. In: Kurian M, McCarney P (eds) *Peri-urban water and sanitation services: policy, planning and method*. Springer, Dordrecht
- Kurian M, Ardakanian R (eds) (2015) Institutional arrangements and governance structure that advance the nexus approach to management of environmental resources. In: *Governing the nexus: water, soil and waste resources under conditions of global change*. Springer, New York
- McCluskey WJ, Cornia GC, Walters LC (eds) (2012) *A primer on property tax: administration and policy*. Blackwell Publishing Ltd., Oxford

- McCluskey WJ, Trinh H (2013) Property tax reform in Vietnam: options, direction and evaluation. *Land Use Policy* 30:276–285
- Mikesell JL (2007) Fiscal administration in local government: an overview. In: Shah A (ed) *Local budgeting, public sector governance and accountability series*. The World Bank, Washington, DC, pp 15–51
- Milesi-Ferretti G (2003) Good, bad or ugly? On the effects of fiscal rules with creative accounting. *J Public Econ* 88:377–394
- Mullins D (2007) Local budget process. In: Shah A (ed) *Local budgeting, public sector governance and accountability series*. The World Bank, Washington, DC, pp 213–264
- Nauges C, van den Berg C (2008) Economies of density, scale and scope in the water supply and sewerage sector: a study of four developing and transition economies. *J Regul Econ* 34 (2):144–163
- Organisation for Economic Co-operation and Development (2012) *Principles for public governance of public private partnerships*. OECD, Paris
- Persson T, Svensson L (1989) Why a stubborn conservative would run a deficit: policy with time-inconsistent preferences. *Quart J Econ* 104(2):325–345
- Petterson-Lidbom P (2001) An empirical investigation of the strategic use of debt. *J Polit Econ* 109(3):570–583
- Poterba J (1994) State responses to fiscal crises: the effects of budgetary institutions and politics. *J Polit Econ* 102(4):799–821
- Reingewertz Y (2012) Do municipal amalgamations work? evidence from municipalities in Israel. *J Urban Econ* 72:240–251
- Reschovsky A (2007) Compensating local governments for differences in expenditure needs in a horizontal fiscal equalization program. In: Boadway R, Shah A (eds) *Intergovernmental fiscal transfers. Principles and practice*. The World Bank, Washington, DC, pp. 397–424
- Rodden E, Eskeland GS, Litvack J (eds) (2003) *Fiscal decentralization and the challenge of hard budget constraint*. The MIT Press, Cambridge
- Rogoff K, Sibert A (1988) Elections and macroeconomic policy cycles. *Rev Econ Stud* 55:1–16
- Roubini N, Sachs J (1989) Political and economic determinants of budget deficits in the industrial democracies. *Eur Econ Rev* 33:903–938
- Sakurai SN, Menezes-Filho N (2011) Opportunistic and partisan election cycles in Brazil: new evidence at the municipal level. *Public Choice* 148(1–2):233–247
- Schroeder L (2007) Forecasting local revenues and expenditures. In: Shah A (ed) *Local budgeting, public sector governance and accountability series*. The World Bank, Washington, DC, pp. 53–77
- Sepulveda C, Martinez-Vazquez J (2011) Explaining property tax collection in developing countries: the case of Latin America. *International Studies Program Working Paper No. 11-09*. Andrew Young School of Policy Studies, Georgia State University, Atlanta
- Shah A, Shah S (2006) The new vision of local governance and the evolving roles of local governments. In: Shah A (ed) *Local governance in developing countries. Public sector governance and accountability series*. The World Bank, Washington, DC, pp. 1–44
- Shah A (2007a) *Local budgeting. Public sector governance and accountability series*. The World Bank, Washington, DC
- Shah A (2007b) *Participatory budgeting. Public sector governance and accountability series*. The World Bank, Washington, DC
- Solé-Ollé A (2006) The effects of party competition on budget outcomes: empirical evidence from local governments in Spain. *Public Choice* 126:145–176
- Song Z, Stosletten K, Zilibotti F (2012) Rotten parents and disciplined children: a politico-economic theory of public expenditure and debt. *Econometrica* 80(6):2785–2803
- Velasco A (2000) Debt and deficits with fragmented fiscal policy-making. *J Public Econ* 76:105–125
- Von Hagen J (2006) Fiscal rules and fiscal performance in the European Union and Japan. *Monetary and Economic Studies, Institute for Monetary and Economic Studies, Bank of Japan* 24(1):25–60

World Bank (2004) World development report: making services work for the poor. World Bank, Washington, DC

World Bank (2013) Beyond the annual budget: global experience with medium-term expenditure frameworks. World Bank, Washington, DC

Yared P (2010) Politicians, taxes and debt. *Rev Econ Stud* 77:806–840

Intergovernmental Fiscal Relations

Questions of Accountability and Autonomy

Veiga, L.; Kurian, M.; Ardakanian, R.

2015, XI, 69 p. 14 illus., 13 illus. in color., Softcover

ISBN: 978-3-319-06295-2