

# Handbook of Fiscal Federalism

Presented by Ehtisham Ahmad, Fiscal Affairs Dept. (IMF)  
Washington, November 15 2006

The views expressed in this paper are those of the author(s) only, and the presence of them, or of links to them, on the IMF website does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the paper.

# Objectives

---

- Review developments in literature—which have been extensive in last 15 years
- Examine impact for policy making
- Prepare a reference volume for researchers and policy makers
- Some of the chapters more than reviews, but reflect contributions to the subject

# Objectives of volume

---

- How practice influences theory (asymmetric, contract federalism) ?
- How developments in theory reflect practice?
- How theoretical insights can be used to design policy?
  - Role of governance and institutions?
  - How can effective service delivery be assured?
  - Equity, efficiency and political constraints on revenue assignments?
  - Equity, equalization and institutional arrangements in the design of transfers?
  - Macro-economic stability—risks and opportunities

# Recent developments

---

- Traditional “normative theory” (Musgrave, Oates, etc) unable to explain institutional arrangements
  - Supranational issues (EU)
  - Difficulties seen in different parts of the world:
    - Regional developments
    - Asymmetric arrangements
- In recent literature:
  - Dropping assumption of benevolent governments (from Musgrave, Oates)
  - More effective and realistic modeling of **political economy** issues
    - Legal, political and administrative issues become critical
    - Information flows
    - Incentives and sanctions
  - Support for Bank-Fund emphasis on “good governance” and accountability

# Institutional arrangements and policy challenges

---

- Range of practices: Federalism and decentralization
  - Federalism effective in large, rich countries
  - Brazil, India (thriving)
  - Under stress in other countries (Pakistan, Nigeria—both late 60's conflicts)
  - Failure in others (West Indies, Rhodesia and Nyasaland)
- Unitary states with considerable autonomy
  - China, Indonesia
  - Increasingly in Latin America, but also in Africa
- Supranational arrangements in EU
- Major challenges in post-conflict situation: Balkans, Sudan, Iraq;
- Developing countries, as well as in the OECD (Bank-Fund-OECD network)

# Common considerations

---

- Political economy considerations
  - Vertical interactions/ supranational, national to sub-national layers
  - Horizontal interactions across units at a given level
- Critical role of the design of institutions
  - Importance of information
  - Laboratory or yardstick competition
- How to ensure accountability: no simple solutions
  - Center: scale of diversion
  - Local governments: “capture” and “lobbies”
    - Madison’s warning about “factions”

# Broad issues

---

- Intergovernmental interactions and competition
- Expenditure policies, institutions
- Tax assignments
- Financing issues (transfer design, borrowing; macroeconomic stability)
- Special issues:
  - Development context;
  - Natural resources
  - Environment
  - Corruption
  - Keeping countries together ?
  - Political institutions

# Intergovernmental interactions and competition

---

- Vertical competition
  - Constitutions and legal framework, important starting point (Breton)
  - Asymmetric responses (Congleton); efficiency with checks and balances
- Horizontal competition (Salmon)
- Spatial interactions
  - Causes and effects of tax competition (Revelli; Wilson)
  - Contractual dimensions (Eichenberger & Frey; Spahn)
    - Responsibilities result of bargaining rather than principles

# Issues for policy making: spending assignments and outcomes

---

- Who does what?
  - Normative and positive theories of government (Dafflon)
  - Size of government
  - Scope for contract federalism (Spahn)
  - Asymmetric decentralization and design (Congleton)
  - Difficulties in formerly planned economies (Rao)
- Service delivery focus: what works and who benefits?
  - Bardhan; J. Ahmad, S. Devarajan, S. Khemani, S. Shah.

# Issues for policy making: sequencing and information flows

---

- Sequencing of measures
  - Increased resources not sufficient to ensure improvement in quality and access
    - (J. Ahmad, Devarajan, Khemani, Shah)
  - Possibility of capture (Bardhan)
- PFM issues—good governance
  - Importance of intertemporal decision making
  - Should one move towards performance budgeting and contracts
    - Spahn vs. E. Ahmad, Albino-War and Singh
    - Preconditions important
  - Importance of consistent information—reporting and tracking—essential for effective competition

# Issues for policy making: revenue assignments

---

- Should mobile revenue bases be assigned to lower levels? (Ambrosiano & Bordignon)
- Revenue-sharing: pools or individual taxes:
  - Traditional vs political-economy approaches
- Importance of local own-source revenues at margin (Ambrosiano & Bordignon)
  - Credibility of intertemporal fiscal discipline
  - Hard budget constraints

# Policy issues: Financing Options and Constraints

---

- Equity, efficiency considerations and transfer design (Broadway)
- Efficiency in special and general purpose transfer design (Ahmad and Searle)
  - Management and monitoring of special purpose transfers
  - Disincentives of “gap-filling” transfers
  - Equalization models
  - Institutional arrangements

# Issues for policy making: Borrowing

---

- Macro-economic considerations—opportunities and risks
- Overall limits and apportionment between and across levels
- Options for control
  - E. Ahmad, Albino-War and Singh

# Emerging issues

---

- Decentralization and management of natural resources (Brosio; and Ahmad and Searle)
- Decentralization and corruption (Shah)
- Decentralization and poverty reduction (Bardhan; Rao; J. Ahmad et al.)
- Environmental challenges (Dalmazzone)
- Decentralization and maintaining national unity (Bird and Ebel)
- Role of political institutions (Galligan)

# Next steps

---

- Focus on effectiveness of process, service delivery; management of process
  - Research and policy advice in different parts of the world
  - Volume on management of fiscal decentralization (FAD)
  - Conference on effectiveness of service delivery (Moncalieri, summer 2007)
    - With ongoing research with UN (East Europe); FAD work
    - Bilateral donors
    - Multilateral agencies
  - Collaboration (with Bank and bilaterals) on countries on a case by case basis