Decentralization and Governance for Sustainable Growth

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Bangkok, December 2019
THE MULTILEVEL IMPERATIVE FOR THE SDGs
Objectives for sustainable and inclusive development: what changes?

• **Objectives for sustainable growth and multi-level finance**
  - Shift in focus from output and income to well-being, quality of growth, and fiscal and environmental sustainability—most of the SDGs involve local provision
  - Need for **clean, compact and connected cities** (**On-going LSE/CUT Program with a focus on China and Mexico**) for sustainable job creation and a prosperous society, as well as improved environment
  - Linked to **rural revitalization, as well as development of secondary cities for sustainable spatial dynamics**
    - Affect incentives to move to where the jobs are and better quality of life—cannot restructure metropolitan areas otherwise (Jakarta and the new Capital of Indonesia)

• **Major constraints**: weakness in own-source revenues at the sub-national level, as well as information and governance limitations
  - Decentralization of functions without proper financing can lead to unfunded mandates, and worse outcomes (Pakistan, 18th Amendment)
  - **Shared revenues is not “own-source”**, and cannot anchor access to credit or buildup of liabilities, e.g., PPPs
  - Sustainability requires that additional liabilities must be commensurate with ability of jurisdiction to raise additional revenues
A comprehensive approach is needed

• As agreed in COP24 in Katowice in December 2018, following the advice of Stiglitz and Stern, environmental (and distributional) concerns need to be incorporated into investment decisions at all levels of government

• **Economy-wide systems of shadow prices** are a starting point for infrastructure investment choices at different levels of government, and also help to guide the overall tax design issues
  • Ongoing work in Mexico and China

• **Focus on incentives facing firms and workers, and at lower levels of government** (Ahmad and Stern, 1991, G24 papers 2019; LSE/CUT Paper 2019)

• Need to **restructure very large metropolitan areas** (Mexico City, Guangzhou and Beijing and Jakarta), and create **new employment generating “hubs”**
  • Often linked to responses to trade perturbations—risks and opportunities
  • **National connectivity is necessary, but not sufficient** (N-S rail links in Italy, Chile)

• **Critical to avoid complexity, breeding incentives to cheat and “game the system”** leading to inequality (Tanzi 2018—KISS principle!!)

• **Importance of risk management**, essential in China (Government Economic Plan 2018-21) see also Liu Shangxi and Li Chengwei (2018), as well as India, Indonesia and Pakistan
COORDINATION OF MULTILEVEL INVESTMENT STRATEGY, SUSTAINABLE GROWTH AND FINANCING OPTIONS

Main parameters, approach to
- Environmental damage
- Income Distribution, employment and living standards
- Appropriate cost of public funds (discount rate)
- Apportionment of local debt limits

- Inclusive growth strategy
- Tax reforms (at national and local levels)
- Minimum public services for social sustainability
- Full information on national, state and city level investments and operations
- Additional financing instruments
- Management of risks

Improvement of local public service delivery
- Clarity in responsibilities
- Own-source revenues for accountability, and equalization transfers
- Complete balance sheets for transparency

Sustainable urban hubs
- National investment in connectivity
- Design and Financing for city level infrastructure
- Innovation and Employment generation

Governance and decentralization
Some assignment issues of importance for SDG delivery at the subnational/local level

• Tension between decentralization as “political ideology” (removing concurrent lists in South Asia, e.g., Pakistan 18th Amendment) and national (growth/income distribution) or supranational goals (SDGs, climate change)
  • Decentralization of administration and policy meaningless without adequate finance, leading to unfunded mandates
    • What if local governments fail to pay school teachers, despite assignments (Nigeria, late 1990s)?
    • Sets up a political economy game with higher levels, especially with incomplete information

• Assignments involve (1) policy; (2) administration; and (3) financing
Differing tendencies to centralize some functions and administration, Decentralization of others

**Centralization needs**
- Risk management
- Cooperation
- Coordination
- Harmonization

**Factors**
- Economies of scale
- Spillovers
- Congestion and Environment
- Information generation

**Political economy**
- Institutional
- Equalization
- Interpersonal equity

**Supranational (EU)**
- Rules; regulations
- Common policies

**National/federal**
- Policy
- Financing
- Equalization

**Provincial/State**
- Financing at margin
- Accountability

**Local/Cities**
- Own source revenues
- unlocking private funds
- Sustainable cities and “hubs” for growth and employment

**Decentralization**
- Devolution
- Participatory democracy
- Control
- Accountability and effective provision

**Sustainable growth**
- Clean and compact cities to avoid congestion and pollution

**Political economy**
- Yardstick competition
- Gainers and losers
But overlapping responsibilities and earmarks for SDGs—often hard to manage at s/n level

• Requires identifying separately what is spent (by function and economic categories) by a jurisdiction:
  • On behalf of the central/provincial administrations
  • As part of the jurisdiction's budget in order to meet local preferences

• Requires the full GFSM2014 classification in the Chart of Accounts (COA), but also whether spending is on s/n budget, or part of earmarks, special purpose transfers
  • Many emerging market countries, especially in LAC and Asia do not even include the GFSM2014 economic and functional categories as part of the Chart Of Accounts, but derive by mappings (e.g., Pakistan, Bolivia, Peru, Ecuador)
  • Impossible to provide the needed information on a timely basis, despite very expensive sub-national IFMISs

• Full balance sheet information needed to address the buildup of liabilities
  • Including with project-related bond issues, and
  • PPPs

• Without information, and aligned incentives, earmarks are generally ineffective

• Also requires own-source revenues at the margin for accountability (weak link in many emerging market countries) for efficiency in subnational spending for the SDGs
**Issues with overlapping reassignments of functions**

<table>
<thead>
<tr>
<th>Economic classification/ GFSM Functions/COFOG</th>
<th>Compensation</th>
<th>Use of goods and services</th>
<th>Fixed capital</th>
<th>...</th>
<th>Acquisition of non-financial assets</th>
<th>Admin/ Units Codes</th>
<th>Projects Codes</th>
<th>Programs/ Sub-programs Codes</th>
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<td>M</td>
<td>C/R</td>
<td>C</td>
<td>M/C/R</td>
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<tr>
<td>b. Hospital</td>
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<td>C/R</td>
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<tr>
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<td>R/C/M</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>A</td>
<td>A</td>
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</tbody>
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**Notes:**
- ‘C’ represents a central assignment, ‘R’ is regional and ‘M’ is municipal.
- X would be relevant codes reflecting the institutional arrangements and A are actuals for outputs and outcomes respectively, that depend on sectoral analyses.

Buildup of “hidden” liabilities reduces accountability and effectiveness of spending...

- Liabilities, including PPPs, should be on local government balance sheets, (IPSAS 32, and GFSM2014) and linked to own-source revenues

- **Incentive incompatibility at sub-national level**—game play with liabilities and Implicit support for dubious private investments
  - Seen in 2008 Eurocrisis, see Ahmad, Bordignon and Brosio, 2016) and in many G24 countries
    - Private liabilities become public liability—through the Banking System (e.g., Spain 2008)
    - Lack of progress on adopting IPSAS/GFSM standards on PPPs in EC; France only required sub-national balance sheets from 2016
  - China: incomplete balance sheets at the local level (Ahmad and Zhang, 2018 for Jiangsu county), although the GFSM2014 standards have been adopted

- **If liabilities can be hidden, cross jurisdictional coordination infeasible, and subnational fiscal rules become ineffective**
  - Both aggregate limits and apportionment across subnational levels, should be linked to “sustainable growth hubs”
Financing instruments and governance

• Debt limits should include all forms of general government liabilities

• Full information on assets and liabilities must be in sub-national balance sheets
  • This includes provisioning for PPPs
  • Sustainability needs to be based on tighter than GFSM2014 standard—own-source revenue at margin, and not just revenue sharing even of untied (typically part of a compact to close vertical gaps and fund basic expenditures, as in China)

• Managing subnational financing and risks and apportioning debt across levels of government, requires
  • Early warning mechanisms as well as debt resolution mechanisms
Own-source taxes for stable provision of services, equalization and access to private finance

Based on ongoing LSE/CUT work in China and Mexico
Drivers of change: financing sustainable urban design—multilevel own-source taxes

**National/provincial tax agenda**
- VAT permits creation of economic space, (integration of SEZs—abolition of borders around Shenzhen for GBA linkages)
- Expansion of PIT base (function of non wage income and assets) for redistribution,
  - subnational piggyback does not imply increasing overall tax rates or levels, and
  - does not require local tax administration
- Carbon Tax with Local piggyback, important for more congested areas
  - But requires a careful assessment of gainers and losers

**Local/city third-tier taxation**
- Vehicle and congestion taxes
- Property tax on occupancy and cost of service delivery
  - with local rate setting within national bands
  - Link with national masterfiles (expansion of the PIT base)
  - Can be offset against PIT liabilities
Role of simple and integrated VAT

• More than just a revenue-spinner for general government
• Helps **to reduce cheating in all taxes** by generating information on all stages of the value-chain
  • Only works if there are no exemptions or breaks in the btb value chain
  • Does not work with split bases
• Mexico integrated VAT in 2013, led to a 4.5% increase in the tax/GDP ratio—largely because of stopping cheating in the income taxes and excises
• China, 2015, **integrated the subnational business taxes on services with the national VAT**, with the same revenue results as Mexico,
  • to reduce the cost of doing business as the exchange rate was appreciating, and wages were rising
  • Creation of an economic space (see above on SEZs and Shenzhen)
• India trying to do the same with Constitutional Amendment, but multiple administrations is a big problem
• **Do not even think of subnational surcharges on the VAT**—**would be a huge mistake!!**
Revenue-sharing and transfer design options?

- Often revenue-sharing (and transfers—both untied and special purpose) needed to close vertical gaps with subnational governments
  - Political economy concerns in China in 1993/4
  - But problematic basis for overall local budgets (could vary a lot with natural resources, and cyclicality of VAT, and seen now with national tax reductions)
  - *May negate the positive incentives with appropriately designed taxes if transfers fill “gaps”*

- But does not constitute “own-source revenues”, which permit:
  - Distinguishing feature is some control over base/rates at margin; and
  - Critical for accountability, and
  - Sustainable access to credit and private financing
Multilevel policy and administration of own-source revenues

- **Incentives and institutions are critical**
  - Arm’s length administration needed – modern functional model, possibly for all taxes
  - Popular models that reward officials for increasing revenues create rent-seeking opportunities
  - Critical role of own-source revenues for accountability and opening access to credit

- **Does not imply that a local/subnational tax administration is needed** for each own-source tax
  - Piggy-backed arrangements for broad based taxes for intermediate levels (including large metropolitan areas)
  - Would generate incentives for sub-national governments to share information with national tax administration

- **Unitary states: central legislation of band is possible**
  - Local administration not needed, but local information is an important consideration

Note: enforcement would include both (1) the maintenance of a common data base on transactions and assets, using tax and third party information, and (2) audit.
“Piggy-back” on Personal Income Taxes for revenues and enhancing equity

• **National PIT may be inequality enhancing**, if non-wage income poorly covered
  • with split bases, PIT largely applied to formal sector wages—becomes an additional burden and double taxation of labour with the payroll tax (e.g., Mexico)
  • Could generate further informality and base erosion

• **Subnational piggy-back on PIT (specified number of percentage points)**
  • Could generate local information on assets (e.g., property registers, cars) to verify non wage income flows, making overall PIT more progressive, together with information from VAT (wages and profits)
  • **Does not require sub-national administration**
  • **Would protect local jurisdictions from adjustments in national tax rates for macroeconomic purposes**

• Higher revenues accrue to richer regions, **so an equalization transfer system would be needed**
“Piggy-back” or surcharge on a carbon tax

- In unitary states, like China and Indonesia, the center could legislate a band for a “piggy-back”, and the local government could choose where within a band it should set its rate
  - Easiest to see in the case of say a carbon tax, where pollution levels vary
  - A local “piggy-back” on a central base and administration maintains the center’s tax rate setting capabilities, with some local flexibility
  - Higher rate possible in large metropolitan areas (Mexico City, Jakarta, Guangzhou)
    - Already the case with taxes on property transactions in China
US-style property taxation, does not work well in developing countries (abandoned in UK)

• **Ownership and valuation basis**
  - Works efficiently in the US, requires accurate information on ownership/legal title (cadaster) and recording of transactions and current market prices, closely linked to quality of public education, and ease of transportation (e.g., proximity to metro stops)
  - Annual adjustments pick up effects of changes to infrastructure—hence enhancing the ability of the city to finance infrastructure, although
    • there may be an additional levy “betterment tax” for infrastructure financing
  - This tax and betterment levies are the tax-based elements of popular “land value capture”

• **Interface with Federal income tax system** (restricted by the current administration), and municipal bonds
  - Critical element in local/municipal bond system, as an indicator of “ability to pay” and accountability

• **Copied widely, but with limited success** (China, Senegal, Mexico/rest of LAC ave 0.3% of GDP, SSA and South Asia even lower)
  - Major expense on building costly cadasters although new technology and big data make this easier,
  - Political economy problem: taxing potentially asset rich but income poor households major stumbling block in many countries
  - Leads to further exclusion and alienation of informal households
Alternative model of property taxes

• The most visible of taxes, so generates the most opposition, unless closely linked with benefits: the Marshallian “beneficial tax”

• Simple tax based on occupancy and using simple band depending on location and linked to cost of service delivery
  • Avoids complexity of full cadaster and complex valuation changes by linking registration and occupancy to costs of service delivery
    • Useful in countries with complex ownership/leasehold/communal structures (China, Senegal), and can generate 1.5-2.0% of GDP in a relatively short period
  • Can help informal households access public services
  • Can assist in removing “nuisance fees and charges” that add to the complexity of doing business (e.g., the gross surcharge on VAT for education in some cases)

• Property tax on businesses and sales would still follow the valuation model, supported now by “blockchain technology (some interesting experiments in China)
China: property taxes to replace land sales and better manage local debt

- Major urbanization along the coast driven largely by land sales since the early 1990s
    - Cause urban sprawl and loss of prime agricultural land in the fertile deltas
    - Accrue to off-budget Urban Development Investment Corporations which engage in PPPs—helps to generate unknown liabilities
    - potential for rent-seeking behaviour
- Experimentation with variants of ownership-valuation property tax models tried in Shanghai and Chongqing but without much success
- Local bond issuance since 2015 designed to minimize local risks, but require property taxes or other own-source revenues, to work effectively
  - Shared revenues and transfers cannot be increased by local governments to cover additional liabilities, hence not very helpful in meeting sustainability criteria
- Critical element in financing social services and infrastructure in new interior “hubs”
- Neither land sales or property transactions provide assured annual revenues to underpin bond markets or PPPs
China: “beneficial property tax” (2% of GDP) simulation for six cities
(Case a: education/housing support only to migrant households)

<table>
<thead>
<tr>
<th>City</th>
<th>Atkinson index (A2)</th>
<th>Gini Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Y1</td>
<td>Y2</td>
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<tr>
<td>Guangzhou</td>
<td>0.60</td>
<td>0.58</td>
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<tr>
<td>Shanghai</td>
<td>0.72</td>
<td>0.73</td>
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<tr>
<td>Shenyang</td>
<td>0.63</td>
<td>0.50</td>
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<tr>
<td>Wuhan</td>
<td>0.52</td>
<td>0.57</td>
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<tr>
<td>Xian</td>
<td>0.47</td>
<td>0.47</td>
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<tr>
<td>Fuzhou</td>
<td>0.51</td>
<td>0.56</td>
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</tbody>
</table>

Note: Fuzhou: migrants do not appear to be the poorest in the city—probably well-educated professionals
China: Beneficial property tax (2 % of local GDP) with education subsidy to all households

<table>
<thead>
<tr>
<th>City</th>
<th>Atkinson Index (2)</th>
<th>Gini Coefficient</th>
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<td>Y1</td>
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<td>0.51</td>
<td>0.56</td>
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</tbody>
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Note: The simulation is under the assumption of providing education subsidy to all households, regardless of migration status
What the “beneficial property tax” does for local finances....

<table>
<thead>
<tr>
<th>Selected Finances of The Six Cities (2016)</th>
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<tbody>
<tr>
<td>RMB billion</td>
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<tr>
<td></td>
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<tr>
<td>Guangzhou</td>
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<tr>
<td>GDP</td>
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<td>2%GDP</td>
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<tr>
<td>Education Spending</td>
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</tbody>
</table>

Source: Statistical Yearbook 2017 of the six cities.

- 2% GDP property tax is sufficient to cover education subsidies in some but not all cities.
- Specifically, in Guangzhou, the high deficit and debt overhang exacerbates risks that fluctuations in revenue shares will both add to debt and jeopardize basic education spending, and housing support.
- Opens up a meaningful discussion of spending reassignments without unfunded mandates.
What does the beneficial property tax do for Guangzhou and Guangdong/GBA?

• A “beneficial tax” 2 % of local GDP essential to “de-risk” existing liabilities,
  • Also basis for accessing new credits for GBA infrastructure, and to “ring fence” city level liabilities in a new cooperative institutional framework
  • Anchor provision of basic education, and housing support—critical in the political acceptability.
  • Can facilitate the elimination of nuisance taxes that are hard to administer, such as the local Education surcharge on Gross VAT
  • *Eliminate the need for reliance on land sales* to finance local spending and borrowing
• Provide migrant and “informal” workers with a basis for qualifying for basic services and housing
• Can provide the basis for a within Guangdong equalization system
  • to permit each locality with the “ability to provide assigned services at similar levels of tax effort”
Equalization framework and financing education through the 2% property tax in Guangzhou Districts, 2016

<table>
<thead>
<tr>
<th>District</th>
<th>GDP</th>
<th>Current tax revenue</th>
<th>2%GDP</th>
<th>Education spending</th>
<th>Financing education by the property tax in Guangzhou Districts (surplus/deficit)</th>
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<td>0.75</td>
<td>1.73</td>
<td>-0.98</td>
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Conclusions
Conclusions

• Careful assessment of decentralized functions with SDGs and climate change requirements—
  • who does what?
  • How are the functions administered and at which level, including mandates?
  • And which level finances and ensures compliance?

• Financing decisions have to be related to the relevant institutional arrangements and spending assignments including accountability circuits

• Sub-national tax agenda is key:
  • Provincial/local taxes do not require subnational tax administrations; and overall limits consistent with macroeconomic stance can be assured with “piggy backed options”
  • Property tax can be adapted to local circumstances
  • Core element in any operational fiscal rule

• Unlock sustainable access to private finance (municipal bonds, PPPs) without adding to risk at each “responsible” subnational level

• Enhanced governance essential: sub-national balance sheets consistent with GFM2014/IPSAS
  • Major emphasis needed by both MOF and Planning agencies in deciding on investment priorities