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How Lebanese decentralization can work

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For decentralization in Lebanon to succeed, elected local officials endowed with wide prerogatives must have adequate fiscal resources to provide services and development. Having said that, what matters is not only how much revenues are allocated to sub-national governments, but also where that money comes from.

Generally, sub-national governments rely on two major sources of finance: the first is taxes and fees that they directly administer; the second is intergovernmental transfers from central to sub-national governments. The first ensures that elected local governments have fiscal autonomy from the central government and compels local officials to be accountable to their constituents. Nevertheless, revenues generated from local taxes are rarely sufficient to undertake development.

Consequently, intergovernmental transfers are needed to cover the development needs of sub-national governments. Relying too much on such transfers, however, makes sub-national governments fiscally dependent on the central government and hence undermines decentralization. Therefore, the trick is not only to provide adequate resources to elected local bodies, but also to make sure that a balance is struck between the two major types of revenues. On top of that, once transfers are brought into the picture, they open up another set of challenges, namely on what basis should they be distributed to the sub-national governments?

The decentralization draft law that was released on April 2, 2014, addresses these issues head on. First, it ensures that locally elected qada councils will have sufficient fiscal resources to provide services and development commensurate with the international experience. Second, it promotes fiscal autonomy by basing a significant portion of these revenues on direct local taxes and fees. Third, it aims to reduce socioeconomic imbalances as well as reward tax collection efforts by distributing transfers from the central government according to clear, transparent and equitable criteria.

A proxy measure of fiscal decentralization is how much local and regional governments spend as a percentage of overall central government spending. Municipalities in Lebanon spend, on average, 5-7 percent of central government spending. Comparing this to an average of 27 percent in other countries such as the Czech Republic, France, Hungary, Ireland, Georgia and Slovenia, it is evident that local governments in Lebanon are chronically underfunded. For Lebanon to catch up with these countries, the elected qada councils must deliver public goods and services that amount to $1.5 billion per year. This is a significant figure that will require multiple sources of revenue, many of them outlined in the new decentralization draft law.

Although the draft law identifies six types of revenues, the three major sources that will finance spending are the direct taxes and direct fees administered by the qada as well as the intergovernmental transfers. Since many central government responsibilities have been reassigned to regional governments under the new draft law, it is only logical that fiscal resources follow suit. For this reason, qada councils will now directly administer taxes on built real estate, a portion of the income tax, and a portion of real estate registration fees. It is estimated that these two principal sources – direct taxes and fees, will fund around 60 percent of regional administration spending, which is roughly in line with international experiences. Furthermore, the draft law does not impose any new taxes or fees on citizens, with the exception of a new tax on real estate profit.

The remaining 40 percent will be funded by intergovernmental transfers. The existing intergovernmental grant system in Lebanon, better known as the Independent Municipal Fund, is mired with flaws, such as the lack of transparency in the sources and disbursement mechanism of revenues, the illegal use of the fund for non-local benefits, and inequitable distributional criteria, among others.

Accordingly, the new decentralization draft law creates a new grant system, referred to as the Decentralization Fund, which will have more fiscal resources, improved distributional criteria, and a better governance structure. In order to augment the resources of the fund itself, the draft law requires that it be financed by taxes and fees that provide reliable and significant revenues. These include 25 percent of the total VAT revenues collected by the central government, 10 percent of the total mobile phone bills, 25 percent of the total custom revenues and 25 percent of the inheritance fees, among others. The total estimated revenues from these taxes and fees amount to around $900 million a year. This figure is not only three times higher than the revenues from the current IMF, but it is also equivalent to around 2 percent of GDP, which is closer to the 3 percent average share of these transfers in other developing countries.

The distribution criteria of the new Decentralization Fund will focus on directing resources to where they are most needed, with the objective of equalizing the level of development across the country. To this end, the draft law sets four criteria for distributing funds to the qadas.

The first is the level of development of the qada, where poorer regions will get more revenues than their wealthier counterparts. The second and third criteria are the number of registered citizens and the surface area of the qada since the more populated qadas and those with a large surface area need more resources than the less populated and the smaller qadas.

Finally, in order to encourage qadas to exert more effort in collecting their assigned taxes and fees, the fourth criteria is their tax effort measured by the collection rate, that is, the amount of taxes actually collected compared to the total taxes that should be collected. Essentially, these criteria ensure that a qada that is poor and has a large registered population and surface area and a high tax collection rate gets more transfers than a richer, smaller and less populated qada that exerts little tax effort.

In order to ensure that it remains independent, the Decentralization Fund is governed by representatives from the qadas and municipalities. More precisely, the board of directors is made up of 18 members – nine of them are elected by the qada presidents from the pool of qada members who serve on the executive authority, with the remaining nine members elected from and by municipal council presidents, ensuring that different sizes of municipalities are represented. The board hires and oversees the director of the Decentralization Fund whose job is to distribute the resources based on the established criteria. In addition to being subject to post-monitoring by the Court of Accounts, the fund is also subject to an external audit and is required to publicly publish its reports on a quarterly basis.

The new decentralization draft law has not only recognized the importance of sufficient fiscal resources needed to finance service delivery and development, it also strikes a balance between the two major sources of revenues. The draft law ensures greater fiscal autonomy for regional governments, achieves more equity across regions and encourages regional governments to exert more effort in their tax collection.

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