Fiscal Decentralization: Implications for Tourism

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1: Introduction

Tourism is the world’s fastest growing industry, generating, on an annual basis, more than 230 million jobs and contributing hundreds of billions of dollars, collectively, to the economies of nations in all regions.\(^1\) In many developing countries, tourism is the number one job and revenue generator. Within the tourism industry, ecotourism activities are also becoming more important and further growth is expected in the future. Recognizing the global importance of ecotourism, the United Nations designated the year 2002 as the International Year of Ecotourism.\(^2\) This declaration is a manifestation of the UN’s ongoing recognition of the importance of tourism resulting from its “…direct effects on the social, cultural, educational and economic sectors of national societies and their international relations” (WTO 1998). The year 2000 UN designation also demonstrates recognition that ecotourism is a critical element in ensuring the sustainable development of tourism.

The continued growth of tourism and ecotourism requires investment by both the public sector and the private sector. This paper focuses on the government financing of tourism-related expenditures in the context of what is known as fiscal decentralization—the process by which countries are moving away from highly centralized service delivery and financing to new arrangements whereby subnational governments are assuming increasing fiscal responsibilities.\(^3\) The form and extent of fiscal decentralization has implications for the development and implementation of policies related to tourism and other domestic activities as well as for policies dealing with global issues such as foreign investment, trade and international taxation.

The second section of this paper discusses why and how fiscal decentralization is occurring; the third section sets the conceptual framework for the assignment of expenditures and revenues among different levels of government; the fourth section applies this framework to the tourism industry and discusses tourism in a decentralized setting. Section 5 provides a summary of the paper and suggests further areas for research on tourism in the context of fiscal decentralization.

2: What is Decentralization and Why Is It Occurring

Decentralization refers to the distribution of a nation’s functional responsibilities between its central government and subnational governments along various dimensions, e.g., fiscal, administrative and political. Fiscal decentralization specifically refers to a nation’s alignment of expenditures and revenues between its central government and its subnational governments. The extent of decentralization ranges from deconcentration where responsibilities are distributed among different levels of the central government to devolution where independent subnational governments are given substantial responsibility for decisions regarding the level of services to be provided, how they are to be provided and how they are to be funded.

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\(^1\) Tourism-related job and revenue estimates were made by the South Pacific Project Facility (SPPF) funded by the International Finance Corporation (IFC). The estimates include jobs and revenues directly generated by tourism as well as jobs and revenues indirectly generated through the multiplier effects from tourism.

\(^2\) Ecotourism is a segment of the tourism industry in which “…the main motivation of the tourists is the observation and appreciation of nature as well as the traditional cultures prevailing in natural areas.” (WTO 1998).

\(^3\) Decentralization sometimes results in an increasing the role of the private sector in service delivery and financing. This topic is beyond the scope of this paper, but is suggested for further research.
Proponents of decentralization argue that stronger subnational governments will increase efficiency in service delivery resulting in a better match of services to citizen priorities. They also posit that decentralization will bring government closer to the people thereby improving the quality of democracy and increasing the role of previously disenfranchised groups—including the indigenous population and women—in the decision-making process. Those who are more skeptical about the efficacy of decentralization question the service-delivery capacity of local governments, especially in developing countries.

Despite the skeptics, decentralization is occurring in countries throughout the world, usually reflecting the broader process of political and economic reform underway in a country. For example, in many Latin American nations, decentralization is taking place as part of the overall democratization process. In a number of African nations, the growth of multi-party political systems and other governance reforms has resulted in the demand for more local participation in decision-making. In transition economies, subnational governments are assuming increasing importance as new decentralized systems are evolving to replace the crumbling centralized structure.

The degree of decentralization varies widely across countries, reflecting differences in their history and culture and in their legal, political and administrative structures. Bahl and Linn (Bahl and Linn 1992) estimated that in twenty-one (21) developing countries, subnational governments accounted for between 6% and 50% of total government spending. In Byrd’s (Byrd and Vaillancourt 1998) comparison of decentralization in eighteen (18) developed, developing and transitional countries, he estimated that between 8% and 60% of total government expenditures were attributable to subnational governments. In general, the extent of decentralization appears to be greater in industrialized countries than in developing countries and in those in transition. However, there is variation within each of these three groups of countries, and developing and transitional countries are closing the decentralization gap with industrialized nations.

Not only do countries differ with respect to their degree of decentralization, but so, too, do they differ in the extent to which they distribute responsibilities among levels of government for specific functional areas, e.g., transportation, health and education. Variation among countries in their institutions and laws governing intergovernmental interaction as well as differences in their history and culture will have a strong impact on which functions are decentralized and to what extent.

Making international comparisons of the functional distribution of expenditures and revenues among levels of government is quite difficult due to differences in fiscal classification among countries and to variations in how countries collect and report data. Compounding the comparison problem is that the International Monetary Fund (IMF)—the traditional source of data for international comparisons—no longer publishes sufficient information on intergovernmental transfers to permit meaningful comparisons, by country, of functional distribution at all levels of government. The IMF does, however, publish data on functional area expenditures by local governments—the level of government commonly below the intermediate state/province level—that permit international comparisons. Using these data for ten (10) countries, Rafuse (Rafuse 1999) found significant diversity in local governments’ spending among most functions. For example, he found that the Transportation and Communication function accounted for a

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4 The IMF has not published data on intergovernmental transfers by function since 1994.
significant proportion of spending in four of the ten countries, but not in the other six. On the other hand, Rafuse found commonality in spending by local governments on some functions, e.g., no local government showed any significant expenditure on the Public Order and Safety function.

No published estimates are available as to the extent of the decentralization of “tourism” since it is not a traditional government function such as the Transportation and Communications function. Tourism is, instead, a “service industry” with segments in many broad functional areas of government such the Transportation and Communications function and the Public Order and Safety function. What activities are included in the tourist industry and which level of government should be responsible for providing and funding them, are discussed in Section 4 of this paper in the context of the conceptual decentralization framework presented in Section 3 presented below.

3: Expenditure and Revenue Assignment

Effective decentralization requires that all levels of government have the authority to make decisions about expenditures and an adequate level of revenues–either raised locally or transferred from the central government–to pay for these expenditures. Following the theme of the fiscal decentralization literature that “finance follows function,” Section 3 begins with an analysis of the decisions regarding which level of government should be responsible for which public functions.

Expenditures

The basic issue in fiscal decentralization is what public functions are most appropriately “assigned” to each level of government. These levels of government include a nation’s central government, its intermediate level governments (e.g., states and provinces), and its local governments (e.g., municipalities). To establish the conceptual framework for the distribution of expenditure responsibilities, economists focus on issues of efficiency and equity, where efficiency means satisfying needs/preferences for goods and services at the lowest possible cost. Public administrators, too, are concerned with efficiency, but they also stress other factors such as accountability, transparency and capacity.

The Economists’ Framework

Following Musgrave (Musgrave 1959), economists define three general functions of government in a market-based economy: allocation, distribution and stabilization (sometimes referred to as macroeconomic policy). Musgrave’s functional distribution may be used to establish the framework for the intergovernmental assignment of expenditures. In reference to tourism, the allocation function applies most directly and is therefore described in most detail in this paper. The distribution and stabilization functions are briefly described to provide a fuller understanding of overall government obligations within a decentralized system.
The *allocation function* pertains to the role of government in providing or arranging for the provision of what are called public goods and quasi-public goods\(^5\) and otherwise influencing the allocation of resources by the market through, for example, regulatory policy and use of selective taxes and subsidies. Public goods and quasi-public goods are distinguished from goods generally supplied by the private sector by: (1) their nonappropriability\(^6\) or (2) their generation of what are known as externalities. In the case of nonappropriability, the exclusion of non-payers is practically impossible and any number of users can consume the same good/service at the same time. The private sector will not supply the good since a market price cannot be determined because people will receive it even if they are unwilling to pay for it and the purchaser will not use it up. An example of a pure public good is national defense: once it is supplied, non-payers cannot practically be excluded from protection and the protection of one person does not diminish the protection of others. In this example, the non-exclusion and non-exhaustion characteristics of national defense explain why government is involved in providing or arranging for the provision of national defense.

In the case of externalities, market transactions between a buyer and a seller affect third parties not involved in the transaction. These third party effects, i.e., externalities, may be either positive or negative and their value is unlikely to be fully recognized in a market situation, leading to underproduction or overproduction of the good/service. For example, in health services a person vaccinated against polio receives direct benefits for which she can be required to pay. However, the vaccination also protects those who do not pay—this is the externality or third party benefit that may not be considered and therefore the service may be under-produced from the perspective of society as a whole. In this example, the existence of the externality associated with vaccinations explains why government is involved in providing or arranging for their provision.

Under the allocation function, the role of government is to intervene when the market fails to allocate resources efficiently. The objective of government in fulfilling its allocation function should be to do the best it can to respond to “consumer preferences.” Allocation decisions involve not only public vs. private service delivery, but also the spatial domain of benefits and costs, i.e., which level of government should be assigned the delivery of public services to insure that consumer preferences and needs are met.

There is general agreement among public finance experts that the most efficient intergovernmental allocation of responsibilities for providing public and quasi-public goods occurs when the lowest level of government that is capable of adequately providing them is assigned the responsibility of doing so. This is known as the *principle of subsidiarity*. However, there are a number of factors that may bear upon the capacity of subnational governments to provide goods and services adequately and efficiently. These factors include: economies of scale, the existence of spillovers and fiscal disparities among subnational levels of government.

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\(^5\) The terms public goods and quasi-public goods encompass services as well as goods.

\(^6\) Nonappropriability refers to a category of good/services that are characterized by two properties: (1) they are nonexhaustive which means that one person’s use of the service does not preclude full concurrent use of that service by others; and (2) they provide services that make it practically impossible to exclude nonpayers from participating in the benefits.
Economies of Scale. Economics of scale occur when output responds more than in proportion to an increase in inputs. In the public sector, it means that the cost-per-person served decreases as the size of the service unit increases. For example, if economies of scale were in effect, the per capita costs of supplying water would decrease as the size of the service unit increases. There is some evidence that economies of scale exist for capital-intensive services such as water supply and electricity distribution, but little evidence that economies of scale exist for labor-intensive services such as police and fire protection.

Spillovers. Full reliance on the principle of subsidiarity may also be difficult due to what are called spillovers, i.e., externalities that “spill over” jurisdictional boundaries. If benefits/costs accrue to nonresidents, local governments will probably not consider them, resulting in inefficient production and provision decisions. For example, assume that City A constructs a sewer-treatment plant that dumps partially treated sewage into a river that flows downstream past City B that takes water out of the river for its municipal water utility. The more City A cleans up the sewerage, the better off City B will be. However, City A will not take the benefits to City B into consideration when deciding on the most efficient size of its sewer-treatment plant. Given these spillovers, City B could offer to compensate City A for costs incurred in building a larger plant. Or, in the absence of such compensation, a higher level of government that encompasses the entire area that benefits from the service could provide the service. This solution would satisfy what is known as the principle of correspondence that calls for the spillover area and service delivery level of government to coincide (Oates, 1972). In the example of sewage, operationalization of the correspondence principle would result in a regional government (encompassing both City A and City B) assuming responsibility for the sewage-treatment plant. In the absence of regional government, a state/provincial government could build the plant. An alternative solution to the existence of spillovers is that a higher level of government could finance the service (in this example, the sewage treatment plant). The grants (or taxes) could internalize the externalities and hence result in a socially efficient allocation of resources.

Fiscal Disparities. Another problem in fully applying the subsidiarity principle to determine expenditure assignment has to do with economic and fiscal disparities among subnational levels of government in a given country. While application of the subsidiarity principle would lead to the assignment of service provision to the lowest level of government possible, it may not have the fiscal capacity to do so. Because there is often a mismatch between the need for government services and the capacity to finance these services, higher levels of government may intervene by providing various types of fiscal assistance or by actually providing the service.

The distribution function of government relates to the role of government in changing the distribution of income, wealth or other indicators of economic well being to make it more equitable than would be under strict market allocation. Most public finance experts argue for assigning this function to the central government based on two assumptions: (1) that the ability of taxpayers to move from place to place within a given country weakens subnational governments’ ability (and perhaps, desire) to provide differential benefit and tax packages; and
(2) distribution decisions usually reflect an entire nation’s values regarding the “proper”
distribution of resources. Subnational governments have limited ability to affect distribution
goals in an open economy where people and economic activities can move from place to place.
However, subnational governments do participate in the distribution function through provision
of services, e.g., health and education, to those who, in the absence of government provision,
would not purchase such services.

The *stabilization function* pertains to government’s efforts to stabilize the economy, preventing
high unemployment, controlling inflation and improving prospects for economic growth.
Governments do this through monetary policy (manipulation of the money supply) and fiscal
policy (changes in taxation and expenditures). There is general agreement among public finance
experts that the national government should have the primarily stabilization responsibilities, but,
here again, subnational governments may have a role, albeit a relatively smaller one than the
central government.

The Public Administration Framework

In addition to efficiency and equity, public administrators consider other factors in recommend-
ing which levels of government should be responsible for which functions. Among the most
important factors are local government capacity—to plan, finance and manage service delivery–and
accountability.

*Local Capacity.* The *subsidiarity principle* suggests that local governments’ proximity to
their constituents places them in a better position than the central government to manage
resources and to meet constituent preferences. However, subnational governments—especially local governments—may not have the capacity to manage service delivery. Central governments could use (and have used) insufficient local government capacity as a reason to maintain their service delivery dominance. Building local government capacity for service delivery is an important objective of many international organizations, such as the United Nations and the World Bank, and of bilateral donor agencies such as the U.S. Agency for International Development (AID), the U.K. Department for International Development (DFID) and Sweden’s Agency for Development Cooperation (SIDA).

*Accountability.* For decentralization to be effective, all levels of government in a country have to have systems of accountability that provide transparent information to permit residents to monitor government performance and to take actions to improve accomplishments. Related to accountability is the issue of transparency and corruption. It is generally assumed that the desire for more accountable delivery of services will increase the pressure for more transparent local governments in which corruption will be easier to identify and thus to reduce. Although a greater degree of decentralization does not necessarily correlate with less corruption, it is generally easier to identify corruption at lower levels of government (i.e., to “name names” that people know) and to take actions to reduce it.
Revenue Assignment

Following the dictum that “finance follows function,” this section of the paper focuses on what revenues are available to finance expenditures at different levels of government. Governments at all levels rely on a wide variety of revenue sources to finance service delivery. These revenue sources include: taxes, charges for goods and services provided, intergovernmental transfers from higher levels of government and borrowing in capital markets. Each of these sources is briefly described below. A more specific discussion of revenue assignment as applied to tourism is presented in Section 4.

Taxes

The intergovernmental assignment of taxes will depend, to a large extent, on the particular mix of taxes used in a country. In practice, in some countries, tax assignment is based on constitutional provisions, in other countries on statutes and in others, on regulations. In most countries where the constitution provides for an allocation of taxes, the allocation is between the central government and intermediate governments including states and provinces. Local governments are seldom referred to in constitutions, and it is generally the intermediate levels of government, such as the states in the U.S. and provinces in China, that determine local taxing power. However, in some countries, such as Brazil and Mexico, the constitution recognizes the municipal level of government. For example, in Mexico, the constitution gives municipios—the level of government below the states—exclusive authority for imposing property taxes and in Brazil the constitution prescribes specific taxes that are to be levied by each level of government.

In theory, there is no agreed upon construct as to what level of government should impose any particular tax. However, public finance experts do generally agree on what might be called “principles” of intergovernmental tax assignment that are concerned with efficiency of markets, efficiency of administration and revenue adequacy.

Efficiency of Markets. A market economy can be expected to maximize income and wealth if all resources (e.g., labor and capital) are free to move among jurisdictions without distortions created by the tax structure. If subnational governments tax mobile production factors (such as capital), these factors could relocate to lower taxing jurisdictions producing inefficiencies in market decisions. To minimize inefficient behavior, subnational governments should tax, to the extent possible, immobile factors of production such as property.

Efficiency in Administration. A general rule in evaluating tax policy at any level of government is that a “good tax” should be relatively easy to administer and collect. Efficiency in tax administration is generally increased when the level of government levying the tax has extensive knowledge of the tax base. For example, local governments have the greatest knowledge of the value of the local property tax base and can most readily manage the local property tax base. In contrast, the corporate tax base may be distributed across multiple jurisdictions and thus efficiency is improved when it is taxed at a higher level of government.

Revenue Adequacy. At all levels of government, the tax yield should be adequate to meet government needs. Accordingly, tax instruments used to implement specific policy objectives (e.g. redistribution or stabilization) should be assigned to the level of government having the responsibility for the policy. For example, progressive taxes
should be levied by the central government to fulfill its role in income redistribution. The assignment of taxes to subnational governments should “ideally” produce sufficient revenues so that “…at least the richest subnational governments …finance from their own-source revenues all locally produced services primarily benefiting local residents” (Byrd, 1993). Intergovernmental fiscal transfers from the central government can be used to compensate for variation in fiscal capacity among subnational governments.

User Charges

User charges (sometimes referred to as user fees) are payments for voluntarily purchased goods/services sold or rented by the government. A user charge is the public sector version of a market price—nobody has to pay it, but you are excluded from the service or receiving the license if you are not willing to pay for it. This differs from a tax that is a compulsory payment based on holdings of the tax base, e.g., if you have taxable income (the tax base), you pay an income tax; if you have no taxable income (no tax base) you pay no tax. User charges include, for example, charges for use of government land, admission to government parks/recreation sites and licenses (e.g., a dog license) not associated with regulation. Some public finance experts have expressed the opinion that for local governments, “…the first rule… should be wherever possible charge” (Byrd 1993). This dictum is based on the potential of charges to promote efficiency in service delivery.

Intergovernmental transfers

Nearly all countries provide some form of intergovernmental transfers from the central government to subnational governments. In fact, in most developing countries, transfers are the primary revenue source for subnational governments. In general, intergovernmental transfers are undertaken for reasons of efficiency or to equalize the fiscal capacities of subnational governments. For example, in the case of efficiency, transfers can compensate subnational governments for benefit/cost spillovers to non-residents. In the absence of these transfers or other interventions (e.g., a higher level of government actually providing the service) subnational governments may not provide efficient services levels. Intergovernmental transfers can be subdivided into two categories: conditional and unconditional.

*Conditional.* Conditional grants require that the recipient government use the grant for specified purposes. The grant can be either matching or non-matching. A matching grant requires that the recipient government share in the cost of the supported programs; a non-matching grant does not impose this requirement. Both matching and non-matching grants can take two forms: formula and project. Under formula grants, distribution of funds to eligible governments is generally made according to legislatively or administratively determined formula. Formula elements may include measures of need, e.g., per capita income and size of applicant (population). Project grants are distributed at the discretion of the grantor for particular projects. They may or may not be awarded on a competitive basis. Negotiated transfers, even with conditions and matching requirements, are less transparent than are formula-driven transfers.

*Unconditional.* In some countries, central governments transfer funds to subnational governments through systems that can be described as "tax sharing" or "revenue sharing." Both provide “no-strings” general fiscal assistance. Revenue sharing is a share of central government revenues distributed by a statutory formula or by negotiation to subnational
governments. Tax sharing is a distribution of revenues from a specific central
government tax to subnational governments based on origin of collections of the national
tax. The distribution can be based on a statutory formula or on negotiations with
subnational governments. Negotiation raises issues of accountability and transparency.

**Borrowing**

Theoretically, all levels of government could borrow money to finance selected government
activities, especially infrastructure expenditures. But, not all central governments permit
subnational governments to borrow. However, subnational governments need to borrow for
several reasons, primarily to give themselves the ability to tax future beneficiaries for large-scale
infrastructure projects rather than imposing the full costs on current taxpayers (who do not
receive all the benefits of the expenditure). The primary concern with borrowing by subnational
governments is what is known as the “moral hazard problem” which is that access to financial
markets by subnational governments may create unplanned fiscal liabilities for central
governments. However, according to the World Bank: “…the academic literature and country
experiences…do not suggest an a priori adverse link between decentralizing borrowing powers
and the central government's ability to maintain fiscal discipline and macroeconomic stability.
Rather, the key seems to be the design of fiscal decentralization, particularly the design of the
regulatory framework under which borrowing powers are decentralized” (World Bank 1999).

**4: Fiscal Decentralization and Tourism**

Tourism activities generate billions of dollars in tax revenues, collectively, to nations throughout
the world. On the expenditure side of the budget, tourism activities require governments to: (1)
expand services they that already supply to the local economy, e.g., infrastructure and public
safety; and (2) in some cases make expenditures specifically for tourists, e.g., a sports stadium.

Tourism happens at “destination areas” that attract non-local visitors. These visitors include
business travelers coming to, for example, conventions and trade fairs, as well as leisure travelers
coming to see the sights or simply relax on the beach or hike the mountains. Each type of visitor
will have different demands but all are similar in that they are “non-local,” are coming to a
destination area and generate demands for government expenditures (and for private sector
expenditures, as well). In the context of fiscal federalism, the questions that arise are: which level
of government should be responsible for expenditures that affect tourists and how should these
expenditures be financed?

It is beyond the scope of this paper to examine decentralization issues related to the many types
of tourist-related governmental expenditures. The remainder of this paper will thus focus on
three specific expenditures that are representative of major functional areas of government and
are critical for sustainable development of tourism. They are: (1) transportation, specifically
roads; (2) natural resource management; and (3) water supply and sanitation.

**Roads.** Roads are a critical component of a nation’s infrastructure as it relates to tourism. They
provide access for tourists to natural, cultural and recreational attractions, they link tourists to

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7 The words tourist and visitor are used interchangeably in this paper and in the tourism industry, in general.
8 Other major components of a nation’s infrastructure include water and sewerage systems, electricity and telecommunications
networks.
and from airports, trains and other mass transit facilities; and they bring residents of surrounding areas into tourism areas to provide services to visitors. The existence of externalities explains the role of government in the transportation sector.\(^9\) Decentralization theory provides a strong justification for decentralization of the responsibility for roads while still maintaining a role for the central government.

**Expenditure responsibilities.** When roads primarily benefit local users, decentralization theory – specifically the principle of subsidiarity – suggests that local governments should have the responsibility for them. Citizen preferences can be best incorporated into the decision-making process if planning, implementation, construction and maintenance are localized. Decentralizing to the local level should also increase accountability and transparency, especially when local contractors and workers are considered. If local governments do not have the capacity to provide for local roads, an “intermediate” level of government or the central government can work to enhance this capacity. Intermediate levels of government and the central government can also help to build technical skills for road development for local projects that are technically demanding. International and bilateral donor agencies can (and do) also play a role in working to improve the capacity and technical skills of local governments.

Where there are significant inter-jurisdictional spillovers or significant benefits that accrue to non-residents (such as benefits that accrue to tourists who demand wider and better roads), an intermediate level of government should have responsibility for roads. The central government can also have an important role in prescribing national standards for construction such as those that pertain to road width and alignment depending on traffic volume and use by heavy vehicles.

**Revenues.** Local governments can finance roads using own-source revenues such as user fees (e.g., tolls), earmarked taxes (e.g., gasoline tax) or general taxes. They can also borrow in capital markets to finance the roads. Another revenue source is intergovernmental transfers from a higher level of government to the local government. An alternative way of financing roads is what can be called “informal financing” in which local residents/businesses contribute time, money and technical expertise to build them.

**Natural Resources Management.** In many countries, the key features that attract tourists are part of the natural environment, e.g. national parks, animal reserves, rain forests, coastal zones and beaches. In this International Year of Ecotourism, increasing attention is being focused on these resources and their management. The existence of externalities explains the intervention of government in the management of natural resources. Decentralization theory provides a justification for the decentralization of some, but not all, expenditures associated with natural resources management.

**Expenditures Responsibilities.** Determining which level of government should be responsible for natural resources management depends on the nature of the resource. If, for example, it is a local park that benefits local resident then the responsibility should be local. However, most tourism attractions are not small local parks but regional or national treasures. While a local jurisdiction may be the actual site of the resource (e.g., a national

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\(^9\) See page 5 this paper for discussion of externalities.
park), the *principle of subsidiarity* would not apply due to benefit spillovers beyond local boundaries. If local government were fully responsible for managing natural resources, they probably would not consider benefit spillovers in budgetary decisions, thereby resulting in under-funding from the perspective of the nation as a whole. Further, local governments may not have the capacity for natural resource management. However, local government (or the community) can become involved in the protection of natural resources. To encourage local government and community involvement, the central government, as well as international and bilateral donor agencies, can facilitate and build local organizational capacity and effective community participation in decisions regarding the use of resources. Alternatively, there are significant possibilities for the local private sector and local NGOs to contribute to the protection and enhancement of natural resources.

**Financing.** User charges can be used to pay for the protection and enhancement of natural resources since use of these resources is voluntary and non-users can be excluded. Taxes that are “earmarked” for natural resource management can also be levied. For example, a tax on hotel accommodations in a national park area could be earmarked for natural resource protection and enhancement (almost as a “user charge”). Alternatively, if the benefits of the resource are national, annual budget appropriations from the central government can be directed at natural resource management and enhancement.

**Water Supply and Sanitation.** Regardless of its natural resources, a country will have difficulties attracting tourists unless it has a clean and adequate water supply and acceptable sanitation services. The existence of positive health and environmental externalities explains the role of government in supplying both water and sanitation services. Decentralization theory provides a strong justification for decentralizing water supply and sanitation responsibilities to lower levels of government, while still maintaining a role for the central government.

**Expenditure Responsibilities.** Application of the *principle of subsidiarity* would suggest that the lowest level of government capable of adequately providing water and sanitation services, supply them. This level of government is best able to identify citizens’ preferences and needs and to assess local water and sanitation conditions. The lowest level of government capable of providing water/sanitation may not be local government, however, due to the existence of economies of scale\(^\text{10}\) and, in some cases to inadequate local fiscal capacity, as well. Whether or not local government has the functional responsibility for water supply and sanitation services depends on the size of the local government. For example, some large urban municipalities may be in the position to efficiently supply water and to provide sanitation services. However, if local government’s capacity is not adequate to supply water or sanitation services in the most efficient manner, an intermediate level of government should assume the responsibility.

There are also significant possibilities for the participation of the local private sector and local NGOs in some aspects of water supply (e.g. small-scale irrigation projects) and in sanitation services (e.g. organizing local volunteers to clean up trash). And there is also a role for the central government in, for example, regulating water rights and setting national environment standards.

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\(^{10}\) See page 5 this paper for discussion of economies of scale.
Revenues. User charges are the most efficient way to finance water supply and sanitation services since consumers can pay for the levels and types of service they prefer. The structure of the user charges used to support operations and maintenance are important for determining equity and efficiency. For example, in many developed countries—especially in areas with water shortages—an "increasing block tariff" (IBT) is often used to improve the efficiency of water delivery by discouraging wasteful water use. The IBT prices water at a low initial rate up to a specified volume of use, then at a higher rate for additional consumption. In many developing countries, however, many households do not have individual water meters and so the imposition of an IBT would not promote efficient use of water.

Due to the extensive health and environmental externalities associated with water supply and sanitation, if user charges were imposed, subsidies would have to be provided to those who could not afford to pay for an adequate level of water or sanitation services.

An alternative to user charges to finance water supply and sanitation would be general tax revenues of the subnational government, with formula-based conditional transfers from the central government to address differences in fiscal capacity.

5: Summary and Suggestions for Additional Research

This paper has addressed a generally overlooked issue associated with tourism—the implications of fiscal decentralization on tourism-related expenditures and revenues of government. The approach taken was: (1) to define fiscal decentralization and to describe why it is occurring; (2) to suggest a conceptual framework for expenditure and revenue assignment to different levels of government; and (3) to apply this decentralization framework to selected tourist-related expenditures.

The decentralization framework set forth in Section 3 provided some general guidelines regarding fiscal decentralization. The efficient intergovernmental allocation of expenditure responsibilities occurs when the lowest level of government that is capable of adequately providing them is assigned the responsibility of doing so. This is known as the principle of subsidiarity. However, there are a number of factors that may bear upon the capacity of subnational governments to provide goods and services adequately and efficiently. These factors include: economies of scale, the existence of spillovers, and fiscal disparities among subnational levels of government. When any or all of these factors are present, higher levels of government may have to subsidize service delivery through intergovernmental transfers or by actually assuming the responsibility for service delivery. Further, subnational governments—especially local governments—may not have the capacity to manage service delivery. Central governments could use (and have used) insufficient local government capacity as a reason to maintain their service delivery dominance. Building local government capacity for service delivery is an important objective of many bilateral donor agencies such as the U.S. Agency for International Development (AID), the U.K. Department for International Development (DFID) and Sweden’s Agency for Development Cooperation (SIDA).
In Section 4, the decentralization framework was applied to decentralization issues as they relate to three tourist-related expenditures: (1) transportation, specifically roads; (2) natural resource management; and (3) water supply and sanitation. It was shown that the intergovernmental assignment of service delivery can take many forms depending on the nature of the service. It was also shown that there are a variety of revenue instruments that can be used to finance tourism-related expenditures, again depending on the nature of the expenditure.

Suggestions for Additional Research

This paper suggests a way to begin looking at tourism in the context of fiscal decentralization. Other research that would advance knowledge of this subject includes, but is certainly not limited to, the following topics:

- Application of the decentralization framework set forth in Section 3 to other tourism-related expenditures, including those that are perhaps not as obviously related to tourism (e.g. education of the indigenous workforce) but are nevertheless critical to tourism’s long-term sustainability.

- Collection and analysis of information on how countries are decentralizing tourism-related expenditures and any constraints to decentralization.

- Collection and analysis of revenue sources being used by different levels of government to finance tourism-related expenditures. Alternative revenue sources should also be analyzed.

- Analysis of the impact of decentralization of tourist-related expenditures on indigenous people and on women.

- Analysis of the role of the private sector in service delivery in a decentralized economy.
References


