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FISCAL DECENTRALISATION AND SECTOR FUNDING PRINCIPLES AND PRACTICES

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1. Introduction and Objectives of Fiscal Decentralisation

This Paper is intended to provide a general introduction to the subjects on Fiscal Decentralisation (FD) as well as lessons learned from a number of developing countries with recent experiences with FD. It introduces the main principles behind and components of FD and the links to the sector funding. It finally introduce some experiences from various modalities for support to FD, based on experiences from a large number of reforms in developing countries in Africa, Asia and Latin America. A number of technical annexes provide more detailed information on some of the core issues.

FD deals with shifting of responsibilities for expenditure and /or revenues to lower levels of government[1]. The nature of FD varies greatly across countries, as well as the definitions of the level of FD. The share of the LG expenditure and revenues of total public expenditures and revenues combined with the level of autonomy that LGs have to influence expenditure and revenue decisions, are often applied as the core indicators to define the level of FD in a country.[2] As for the overall design of decentralisation, where fiscal decentralisation is an important "pillar", the specific design and implementation of the system and processes of FD matters, and the sequencing of the reforms and links between the components of FD, are pertinent for the achievement of the FD objectives.

The ***objectives*** of FD are somehow similar to the overall decentralisation objectives, and can roughly be classified as follows:[3]

i) Improved *efficiency*: by strengthening the links between the mix of services with the citizens' demand and needs, being closer and more responsive to the *local preference* (matching of local preferences)*;*
ii) Improved financial *accountability* by bringing the government and decisions closer to the people in terms of options for voice, influence, information exchange, control and monitoring etc., and
iii) Improved *effectiveness*: by improving the likelihood of strengthening of competition in public service provision, mobilising citizens' contribution, innovation, etc.

In addition to these "rational" arguments for FD, there may be other reasons and objectives for decentralisation, see the *Paper on Decentralisation and Good Governance*, which equally apply to FD.

However, it is generally recognized that there are a number of important prerequisites for the success of FD. There are numerous pitfalls and risks such as e.g. macroeconomic instability, conflicts and inequality, problems in service delivery and

[1] Lower levels of government = Sub-national or local governments (LGs) (used in this paper). See www.wordbank.org/WBSITE/EXTERNAL/TOPICS/ for a general introduction of this subject. The Council of Europe uses the term "local authorities".
[2] See Ebel and Yilmaz, the World Bank (2002) for a discussion of the definitions of fiscal decentralisation and the implications for the measurement of impact. The term "intergovernmental fiscal relations" is often applied to refer to the division of fiscal powers and responsibilities among levels of government (see Bahl and Vazques, May 2006).
[3] See e.g. Ahmad, Brosio and Tanzi, IMF (2008) for a discussion of the intended objectives.

corruption, if the FD reforms are not properly designed, sequenced and implemented[4]. It is also acknowledged, that although there are general accepted principles for the design of FD reforms, the features of FD reforms should be largely country specific and should be adjusted to the historical, economic and political conditions prevailing in each country and closely linked with the other components of decentralisation.

2. Principles and Components of Fiscal Decentralisation

Although there are great differences in the nature of FD across countries, disagreements amongst various experts on impact of FD on areas such as poverty reduction, equity, growth and efficiency in service delivery, there is a remarkable agreement on some of the core design features of the system, well reflected in the *European Charter of Local Self-Government, 1995* (with comments) below[5]:

Text Box 1: The European Charter of Local Self-Government (with comments).

- Local Authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework or their power; *(the principle of having own source revenues, which can be adjusted at the "margin", e.g. through increase/decrease in the level of tax rates, eventually within a set ceiling, is important – many will say necessary - for local accountability, ownership and efficiency);*
- Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law *(this is important to ensure a balanced system without unfunded mandates and unrealistic expectations and demands);*
- Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of the statute, they have the power to determine the rate (*this is important to ensure local possibilities to adjust the revenues to the locally preferred level of local services and to ensure downward accountability);*
- The financial system on which resources available to local authorities are based shall be of a sufficient diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the costs of carrying out their tasks *(this is important to ensure a proper balance between LG functions and funding of these and requires a proper composition of revenue sources, e.g. mix of grants, fees and charges and local taxes)*;
- The protection of financially weaker local authorities calls for the institution of financial equalisation procedures or equivalent measures which are designed to correct the effects of the unequal distribution of the potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility *(design of these systems through the intergovernmental fiscal transfers poses a tremendous challenge in each country, but is important to avoid inequality, imbalanced service delivery and inefficient movement of people across LGs)*;
- Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them (*this is important to strengthen the dialogue, knowledge sharing, accountability, to avoid conflicts between the various tiers of government and to ensure longer term sustainability)*;

[4] See e.g. Tanzi (2001) for a comprehensive review of some of the pitfalls.
[5] A great part of the content of this article is also enshrined in the so-called: Victoria Falls Declaration, 2000, signed by a large number of African ministers of local government and in the "Commonwealth Principles on Good Practice for Local Democracy and Good Governance- the Aberdeen Agenda".

- As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction (*this is important to ensure that the LGs have possibilities to match local preferences and address local needs/peculiarities. However, the principle will often be balanced against the need to ensure adherence with some national service delivery targets (minimum standards) and most systems includes a combination of unconditional block grants and earmarked/targeted conditional grants*;
- For the purpose of borrowing for capital investments, local authorities shall have access to the national capital market within the limits of the law (*regulation of LG borrowing is important to avoid severe fiscal malpractices of LGs, to avoid demands for central government bail-outs in crises situation, problems with financially distressed LGs and macro-economic instability)*.

Source: Article 9 in the European Charter of Local Self-Government, 1995 (with comments from the author)

In addition to these overall principles, it is generally recognized that the FD reform should be balanced and properly sequenced[6], e.g. the revenue assignment reforms should follow the decentralisation of expenditure assignments with clarification of these, and the detailed regulations and guidelines should follow the overall framework legislation (such as organic laws).

As for the overall description of decentralisation, FD typically encompasses a number of key building blocks (pillars)[7], such as the following:

1. The assignment of *expenditure responsibilities* across tiers of government;
2. The assignment of *revenue* sources;
3. The structure and system of intergovernmental fiscal *transfers*;
4. The structure and system of local government *borrowing*;
5. Local government *financial management* issues, including systems of planning, budgeting, accounting, auditing, reporting and monitoring and fiscal accountability measures;
6. LG finance *institutional* structures and procedures, including coordination arrangements and support.

Each of these pillars is discussed in greater details below, keeping in mind that the interplay of the components is equally important for the likely success of FD. There are for instance limited benefits of having a high level of expenditure assignments without commensurate revenues and some influence on the priorities and revenue mobilisation. It should also be kept in mind that that features of the legal framework, human resources and capacity issues, and political will, described in the overall Paper on Decentralisation and Good Governance, are equally important for the positive impact of FD.

[6] Bahl and Vazquez (2006). The authors mention that this is often not the case, a fact that has caused many problems in the subsequent implementation.
[7] Most literature only deals with the first 4 pillars, e.g. UNCDF, (2005) and many textbooks on FD, but the other components are equally important and closely related to fiscal decentralisation.

3. Expenditure Assignments

The first pillar – both in terms of sequencing of the reforms and in importance - is the expenditure assignments[8]. It is generally recognized that there are no single best assignment of expenditure assignments across tiers of government, but that this will depend on the strategy and objectives of decentralisation in each country and a range of historical and political factors[9]. However, certain principles for assignments of expenditures are agreed upon by most agencies and experts within FD.

First and foremost, it is important that the expenditure assignments are defined in a *clear* and unambiguous manner with transparency and mutual understanding between the parties involved. This is to ensure that everyone knows who is responsibility and to ensure strong accountability in every chain of the service provision. Unclear assignments of expenditure assignments will often lead to diluted responsibilities and mutual complaints[10]. Functions may be shared in terms of funding arrangements, but it is important for everyone to know who is ultimately responsible for each sub-task within e.g. primary health care or supply of rural water. The LG Act in Zambia with 63 wide ranging functions of LGs, none of these mandatory, is a good example of the problems, as many of the functions in practices are handled by central government and/or various agencies, such as district health management teams, schools boards etc. outside of the devolved democratically elected and locally accountable LGs[11].

Second, functions should be allocated based on the principle of "*subsidiarity*"[12], which means that functions should be assigned to the lowest level of government that is capable of efficiently undertaking these functions. In principle, this means that the public services should be provided by the jurisdiction having control over the geographic area that would internalise the benefits and costs of such provision[13]. The key is here to maximize efficient and accountable decision-making for improved service delivery and to ensure that there is a closer match between services provided and service beneficiaries. Using the principle of subsidiarity implies that certain functions, such as macro-economic measures, defence, universities, etc., are best handled by the upper tier of government, with a national "catchment" area. Similarly functions, which have a strong element of income distribution[14], where citizens may have an incentives to move away from the LGs which attempt to introduce these, may best be handled at the central level, as well as functions with a strong element of "spill-over" to other jurisdictions/externalities. Functions, which are local in nature,

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[8] Some researchers make use the term "functional assignments", which is largely similar to "expenditure" assignments, although somehow broader, as expenditure assignments is focusing on the authority to spend, whereas some functions have no cost implications, see Gabriele Ferrazzi in GTZ: "*Functional Assignments in Multi-Level Government*", 2009 for a very detailed discussions of the concepts.

[9] UNDP (2005), World Bank, (2009), Bahl, (2000).

[10] Many countries have LG Acts which lack clear assignment of functions to LGs with an outline or list of shared and/or optional functions, e.g. Zambia and Cambodia.

[11] See Concept Paper (on Fiscal Decentralisation), May 2009, Ministry of Finance and National Planning.

[12] The principle of subsidiarity is also applied in EU in the division of tasks between the EU and its member states.

[13] Oates, (1972).

[14] This does not mean that LGs cannot have an important role to play within areas of social welfare, management of pensions etc., but that these areas should be strongly regulated.

such as solid waste management, local roads, water supply, sanitation, primary schools etc. are often handled by the LGs, which have the potential to reap the benefits of local knowledge, proximity, linking the benefits with the costs. However, there are differences, and some countries, e.g. Uganda, Tanzania, Indonesia and the Philippines have gone further in decentralisation of expenditure assignments than others such as Benin, Cambodia, Zambia and Bangladesh. Matching local preferences implies certain variations in level and quality of services, which may contradict another objective, which is to ensure certain *equity* in services across a country. However, this is a balance, which will depend on the type of services provided. In core areas, such as agency functions, see below, a set of clear minimum standards will typically be imposed on LGs and the funding system has often in-built potential instruments to ensure equity in allocations.

Third, in the decision of allocation of functions, using the above principle, a number of factors should be considered. Possibilities for economies of scale, level of externalities (actions of one authority affects another), equity, stability in the public sector and macro-economic concerns and objectives of having variations in the actual service delivery, reflecting local needs and demands, should be considered as well as other factors, see Annex 1 for further details on this.

Fourth, the links between services and the possibility to bundle services, e.g. sanitation, water supply and school facilities should be considered. It is also important to recognize that within each function, such as e.g. primary health care, there are various sub-functions, see below[15], which may be allocated to various levels of government/and or contracted out to the private sector. An important distinction here is between "*provision*" (which is the overall responsibility for organisation, planning, budgeting, financing of the service, associated with governing) and the "*production*" which is the actual delivery of the service, such as solid waste transport, turning inputs into outputs). Whereas the LG will have a strong role in provision of services, much of the actual production can be contracted out and/or conducted by other agencies, particularly in areas where LGs lack economies of scale where the private sector can play a strong role[16]. Functions can often be divided in the following core sub-functions:

- Policy setting (often done by central government)
  - Regulations and standards
  - Monitoring
- Provision (organisation) (level of government depends on the type of service)
  - Planning and budgeting
  - Financing
- Production (may be done by another agent, e.g. private company)
  - Staff management
  - Construction
  - Maintenance
  - Operation

It is important to clarify each of these functions, and the interplay between these in the legal framework on FD.

[15] Based on ideas from the Diagnostic Tool Kit for Sectoral Decentralisation, Workbook, UNICEF; UNCDF and UNDP, (2007).
[16] A good example of this is fire brigades.

Fifth, many countries apply an *asymmetric* allocation of functions where the larger and/or stronger LGs are allocated more functions in terms of number and discretion (e.g. urban versus rural LGs). There are advantages of this in terms of ensuring that there are proper links between the capacity and the functional responsibilities, incentives to improve capacity etc., but this needs to be weighted against the extra complexity this creates in the design and implementation of reforms (legal framework, systems of funding etc.). Competent and well performing LGs may be entrusted additional responsibilities, funding and systems may be elaborated to incentivize this, see Annex 4 which deals with the issue of performance-based funding. As example of this is the system of LG in Nepal whereby there is a clear differentiation in the assignment of functions to village development committees, district development committees and municipalities based on a review of their size and capacity.

Sixth, LG expenditure assignments vary greatly in terms of the LG *autonomy* to influence decision on level and quality of the services, including the means of provision and production. Especially the type of *functions* assigned to the LG level is important.

As will appear below, the funding arrangement will depend on the type of expenditure assignments. Although there is often need for some guidance and incentives for LGs to adhere with national standards and targets, experiences from many studies have shown that excessive interventions, control and lack of local autonomy on the expenditure side, may deprive some of the decentralisation objectives in various countries and blur the accountability.[17] E.g. the strong input control within the system of grants in Uganda with 40 earmarked conditional grants has deprived the LGs the possibilities to address local needs and establish synergies between activities. Similarly, cumbersome budget approval procedures and interventions from the states and the central government have delayed activities and distorted the entire service delivery system in many districts and gram panchayats in India and in Zambia over the past 20 years.[18]

Seventh, although often not adhered with in practice, there are good arguments for a proper sequencing of the reform work on expenditure assignments, moving from the first steps of defining the responsibilities at each tier of government, to costing of these services to reviewing the affordability issues and the composition of the funding sources for each service.[19] Particularly the costing of LG expenditure needs is controversial, and there are various methods to determine the cost requirements and corresponding funding sources see Annex 2 for an overview of the methods. However, it is important not to mix the costing of the overall funding required for LGs to perform certain functions with the system design for specific allocation to each LG. Strict minimum service delivery standards and related funding system may reduce the LG autonomy to make local priorities and may reduce the possibilities to address local needs. However, the level of autonomy will largely depend on the type of function. Some functions such as those conducted on behalf of central government (agent functions), e.g. payment of pensions, will be strongly regulated. The sector papers include country specific examples within three core sectors – health, water &

[17] See e.g. Steffensen and Trollegaard, (2000) and Steffensen and Tidemand, (2004), Dege Consult, (2007).
[18] World Bank, (2009), Sassa, Steffensen et al 2000 and Dege Consult 2010 (Zambia).
[19] See Bahl and Vazquez, (2006, p. 19-21) for further details on each step.

sanitation and environment, and it appears that the organisation of tasks varies greatly across the countries.

The principles outlined above will be a useful guidance in the choice of expenditure assignments, but will in practice be mixed with policy, historical, institutional factors and power struggles, as functions often lead to decision-making power and decisions on the funding arrangements. However, in any case, some consensus on the assignment of expenditures is important for the next pillar of FD – "the revenue assignments". Too much confusion may lead to difficulties in determining roles and accountability[20]. It is also important to ensure that the main power and responsibilities of LGs are prescribed by law and changes of these should be based on sufficient consultations with LGs and citizens. This does not preclude that LGs are allowed a so-called "general competence" to take on board other functions than the mandated ones, and many countries have included this option in the legal framework sometimes within some limits (e.g. Cambodia, Denmark and many other OECD countries.

Common problems in many developing countries on the expenditure assignments have been lack of formal assignments, inefficient assignment, ambiguity and issues on joint expenditure assignments, where everyone pushes the blame for non-fulfillment of service delivery objectives. Development partners, including Danida, have supported the clarification and adjustments of legal framework on expenditure assignments in numerous countries (e.g. Ugandan and Tanzania), but the challenge has been that this support cut across several ministries, departments and agencies in each country, often with lack on a strong coordinative body.

What is equally important with the scope of the expenditure assignments is the consistency between the expenditure assignments and the financing arrangements (the revenue assignments), which is the subject for the next sections.

4. Revenue Assignments[21]

Ideally when the LG expenditure assignments are known, the next step – the second pillar of FD – should be definition of the revenue assignments. As mentioned under the general principles, finance should follow functions. The table below, in a simplified manner, illustrates the principles for the relationship between type of functions and the typical grant (transfer) schemes and the areas naturally funded by LG own source revenues:

[20] See Ferazzi, (2009) for further details on this.

[21] This section has benefited from professor Roy Kelly's presentation at Duke Summer Course on Fiscal Decentralisation and Financial Management, Kelly, Roy (2009).

Table 1: Relationship between the type of function and their finance

Type of Function/Financing	Local government financing	Financed by central government e.g. through grants
Pure Agency functions, i.e. central government request/demand that LG conduct functions on their behalf	(-) Limited own financing	+ Specific grants to encourage the LG to supply service, especially where certain minimum standards are necessary. Examples of this are the salary conditional grants in Uganda and Tanzania
Partly Agency functions (LG has certain influence on quantity/quality)	+/- Partly funded by own LG revenue sources, partly by grants from centre	+/- (Partly by grants, especially specific "earmarked" grants). An example of this is the primary health care grants (conditional grant) in Uganda and grants to sectors in the Chinese system of LG e.g. for health care services.
"**Own decentralised services**" The LGs have full discretion on the level and quality of the services	(+) Funded by LG own source revenues- e.g. through taxes, fees and user charges	Supplementary funding by general unconditional grants with the objective to correct horizontal imbalances and fill in the fiscal gap (unconditional or equalization grants). Examples of this are the block grants to union parishads in Bangladesh, the development grants to districts and villages in Nepal and the IRA grant in the Philippines, recurrent grants to LGs in Zambia as well as local development funds in many other countries such as India, Nepal, Solomon Islands, East Timor and Bhutan.

Funding of LG expenditure assignments are often divided in:

i) Revenue assignments (or own source revenues);
ii) Transfers - grants and various tax sharing arrangements[22] and

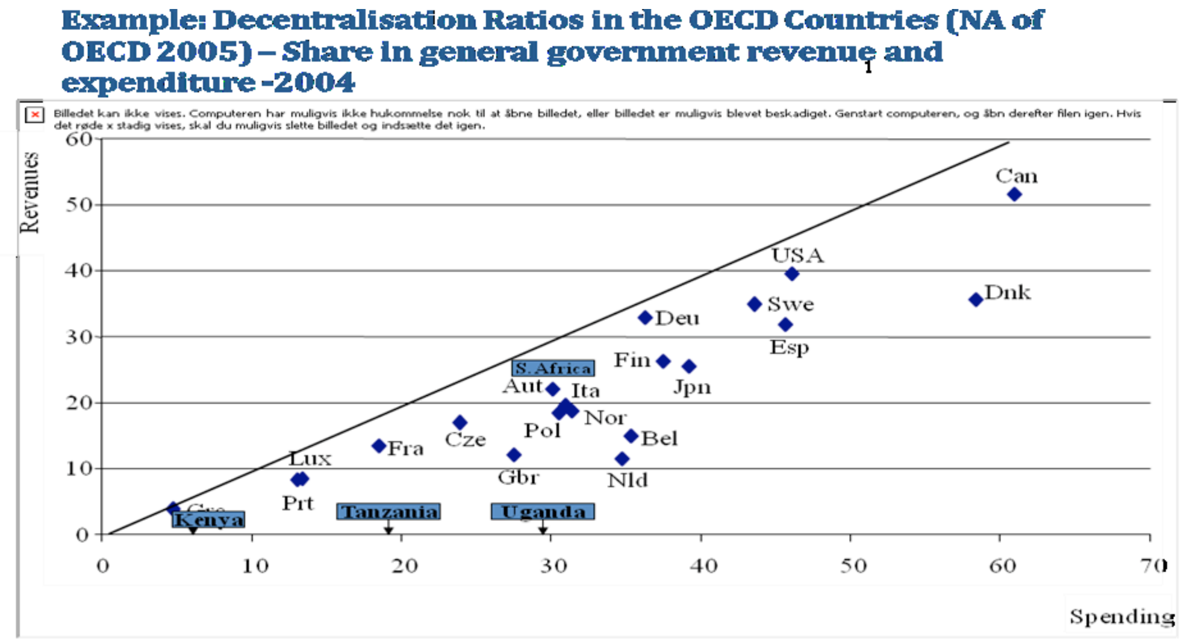
[22] See OECD, Blochliger and Petzold, 2009 for a discussion of the difference between grants and tax sharing. It shows that the definition of this various across OECD, IMF, council of Europe and others. LGs may have some influence on the tax sharing arrangement and bear more financial risks in terms of tax revenue losses or fluctuations than if revenues were based on grants. Within the OECD, tax sharing is distinguished from grants as cases where LGs have some risk sharing, funds can be used un-conditionally (not earmarked), there is stability in the revenue sharing formula and the share the LGs receive is strictly related to what it generates on its own territory. Most scholars (e.g. the Duke University's and Geogia State University's training courses of FD) treat tax sharing under the pillar "intergovernmental fiscal transfers", which will also be the case in this note. Shah (2009, p.

iii) Borrowing.

This section will deal with the first of these components.

Revenue assignments comprise various kinds of local taxes, user fees and charges. As there are typically relatively fewer "appropriate" LG taxes, the yield from the LG revenue assignments is often far less than the costs of the expenditure assignments. The reasons for this are that: i) taxes which are suitable for/ or influence economic stabilization should be central government taxes, as well as ii) taxes which are strongly movable, i.e. with a tax base, that can move easily between the jurisdictions and creates problems for LGs in taxation (some of the risks are distortion of allocations of labour, capital and business and unhealthy competition can be introduced between the LGs undermining the overall tax collection). Furthermore taxes that are complicated to administer, taxes that are very unequally divided between the LGs and progressive taxes that may create inequality in the country should also be reserved for central government.[23] In theory as well as in practice these taxes tend to be most appropriately assigned to the central government. Taxes such as VAT, corporate income tax, taxes on trade (important/export) are typically not appropriate LG taxes. Therefore with some exemptions, e.g. in some of the Latin American countries, most countries have moved faster on decentralisation of expenditure than with revenue assignments, leaving what is defined as "fiscal imbalance" in the FD arrangements, see below. The figure below also shows that developing countries are typically less decentralised on both functions and funding arrangements than e.g. the OECD countries.

Figure 1.



Source: National Accounts, OECD (2005), and Steffensen and Tidemand (2004)

293) defines revenue sharing as part of the transfers to LGs as a transfer with special features in terms of how the size of the transfers is calculated.

[23] See e.g. Broadway and Shah (2009, p. 164) for a more detailed discussion of these issues.

The gap between the expenditure and the revenue assignments is what is often filled in with the intergovernmental fiscal transfers (grants from central government). This does not mean that local revenues or "own source revenues" are not anticipated as important. They are pertinent to ensure local accountability - citizens who pay taxes/user fees and charges are more likely to demand accountability and LGs are more likely to pay attention to preferences of the citizens if they rely on their funding support[24]. It is also important to ensure a strong ownership and proper links between benefits and costs at least at the margin in the system of LGs as this promotes fiscal responsibility and longer-term sustainability.

LGs in countries, which have a very low level and share of own source revenues such as Uganda, Tanzania, Ghana, Cambodia, Nepal and Bangladesh, also tend to be strongly controlled by central government through the fiscal transfer systems with their in-built conditions. The notion: "*The one who pays for the music decides the songs*" is often proved. It is therefore commonly said that LGs own source revenues is a necessary but not sufficient condition for effective FD. Although LG own source revenues only constitute less than 40 % in the developing countries[25], and less than 15 % in countries like Uganda, Tanzania, Nepal, Bangladesh, Bhutan and Cambodia, they are important elements in the overall funding arrangements, and promote downwards accountability[26]. Without LG own source revenues, LG will tend not to be guided by what is called "*hard budget constraint*", where they are supposed to be responsible for balancing the expenditure with revenues and ensuring efficiency in resource allocation. Local revenue sources are furthermore important to safeguard that LGs can make their own spending priorities at the margin and not be fully controlled by central government. Local revenues are finally important for the LGs borrowing capacity and creditworthiness.[27]

But what are then good local revenue sources? In principle these should be buoyant and high yielding (meaning that they should be responsive to increase in income, costs of services, inflation and size of the population); relatively stable; not distorting; relatively equally distributed across LGs (to avoid inequality and complicated equalisation systems); easy to administer and visible (i.e. it should be possible for citizens to know and appreciate the contribution to the LG and its use of funds).

In practice, the commonly applied local taxes in the developing countries are property taxes and business licenses and various types of user fees and charges, e.g. market fees. A surcharge on personal income taxes is a potential future income, but is often hampered by the weak level of development of such systems and is mostly applied in a few OECD countries[28]. Common problems in many countries have been the unwillingness by central government to allow LGs sufficient revenue *autonomy* to influence the local revenues and address local needs, and there is a non-conducive environment for LG taxation in most developing countries. In many countries, e.g. Uganda[29] and Tanzania, several local taxes have been abolished recently without

[24] See Gibson and Hoffman (2007) for a review of this issue.
[25] Shah (2006 and 2007).
[26] Studies have shown that when payments from citizens are scrapped, the dialogue between the LGs and the citizens diminish and the participation level tends to be negatively affected, Dece Consult and NCG, Tidemand, Ssewankambo and Steffensen (2008).
[27] See e.g. Bahl and Vazquez (2006).
[28] However, some countries like Zambia, have various types of LG income taxes (personal levies in the case of Zambia).
[29] In these countries, abolition of taxes was on top of the political campaign in various elections to gain popularity. Some of the taxes were criticised for being cumbersome and against poverty alleviation objectives, but these issues could have been addressed through marginal technical improvements, see Steffensen and Tidemand 2004, and Dege Consult and NCG (2008).

sufficient considerations on alternative sources. In other countries, e.g. Zambia, the central governments strongly control the LG tax rates and the tax base and there are numerous examples of political interferences in LG revenue mobilisation. Reforms and improvements of own source revenues or local revenues have been a great challenge also due to the lack of political support to ensure unpopular, but important, decisions. There also seems to be a "crowding out" impact when own source revenues come below a certain percentage of the total revenues due to increases in grants. LGs in a number of developing countries where grants constitute more than 80 % often tend to focus on how to increase this larger share, instead of focusing on the minor component – local revenues. There are even examples of grant systems which reward reductions in LG's own revenue collection, e.g. in systems where the size of collected local revenues is amongst the allocation criteria (Rwanda and Cambodia re. provinces[30]).

Concerns have sometimes been raised about the poverty impact of local taxes and studies of problems in local taxation have often been (mis)used to abolish a range of taxes, e.g. the development levy in Tanzania and Graduated Tax in Uganda instead of trying to reform the existing system of tax base setting, the rates and improve the administrative efficiency and fairness in collection methods.

OECD and World Bank studies also confirm that reforms and improvements of the local revenues in developing countries have been far less successful than other reforms and argue that there is need for a more systematic approach to this issue.[31] The focus on intergovernmental fiscal transfers has been a more popular although not without great challenges as well, see below.

5. Intergovernmental Fiscal Transfers[32]

Introduction and objectives of intergovernmental fiscal transfers

Intergovernmental fiscal "transfers" is the most significant revenue source for most developing countries – and a key pillar of FD. It constitute on average more than 60 % of the total LG revenues in developing countries, and 30-35 % in OECD countries with great variation between e.g. Denmark with a low level (less than 20 %) and UK with a relative high level of transfers from central government. In many countries such as Uganda, Tanzania, Indonesia, Philippines, Bhutan, Nepal, Cambodia, East Timor and many others, the transfers to LGs constitute more than 80 % of the total LG revenues, and the features of the systems are regularly discussed and reformed. The term "transfers" cover a wide range of financing instruments ranging from intergovernmental grants, subsidies/subventions (often in French speaking countries) to sharing of revenues (including tax-sharing). However, if LGs have influence on the tax rate and/or tax rates, the tax sharing arrangements should be considered part of

[30] See Boex, Jamie: Moving Forward with development of a National Fiscal Decentralisation Policy Framework in Cambodia. Instead the revenue potential could have been introduced without any negative impact on incentives.
[31] OECD, Lessons Learned on Donor Support to Decentralisation and Local Governance, p.34-35, (2004) and World Bank: "*Decentralisation in Client Countries- An Evaluation of World Bank Support"*1990-2007 (2009).
[32] This section has benefited from a range of papers and articles, among these UNDP primer (2005), Roy Kelly, presentations at Duke University (2009), Jesper Steffensen, presentation at Duke University (2007), GSU (2001), Shah (2006) and (2007) and World Bank, web-page on external topics (2009)

the own source revenues. The design and implementation of the intergovernmental fiscal transfer systems (IGFTS) has important implications for the efficiency and equity of public services, incentives and accountability systems.

It is generally acknowledged that one of the most important principles in the design of the IGFTS is to ensure clearly defined objectives of the transfers and to design the systems accordingly. In practice there are several *objectives* in play of which the major ones are:

- *Correcting or adjusting vertical imbalances* – closing the fiscal gap between expenditure assignment and revenue assignments (see previous section). The transfers may be used to ensure that LGs have adequate revenues to discharge designated functions (expenditure needs), especially as other types of revenues (taxes, user fees, charges etc.) cannot generate adequate revenue for LGs due to various reasons[33];
- *Compensating* LGs for complying with central government requirements or implementing central government programs that are delegated to the LGs; This may be done through yearly calculations of the impact of new legislation/decisions on transfers of tasks and/or through current adjustments of the size of the grants;
- Correcting or adjusting *horizontal imbalances*[34] – i.e. equalisation. Transfers can be used to "equalise" the LGs' conditions for service provision and to bring the LGs closer to a situation where all of them, potentially, have about the same ability to provide basic services to the citizens. Extra resources are typically transferred to LGs with lower fiscal (tax) capacity and/or higher expenditure needs than the average national level;
- Correcting or adjusting negative or positive *externalities* with public goods provision. Grants may be used to compensate LGs for services they provide, which impact areas beyond their jurisdictions i.e. where there are positive or negative "spill over" effects. For instance grants can be provided to ensure that sufficient educational services are provided, and that the environmental issues are sufficiently addressed. LGs tend to look mainly on their own local needs, ignoring the impact this may have on other LGs. This may often lead to a sub-optimal provision of certain services in a country. However, the provision of education services in a LG may benefit other parts of the country (positive impact) and environmental pollution may affect areas beyond the LG borders (negative impact). Another example is immunisations/vaccinations which may be provided at a level less than warranted from the perspective of the entire society, if left entirely to the decision of each LG;
- Closely related to the third objective, - coordinating, harmonising and *influencing* LG spending with central government goals may also be an objective. Various forms of grants may be used to stimulate LG spending within national priority areas/ standards[35]. It is important to stress that a transfer system should as much as possible ensure budget autonomy and flexibility at

[33] Particularly due to the fact that many taxes are most suitable for management at the central government level.
[34] Reference is made to: The Reform of Intergovernmental Fiscal Relations in Developing and emerging Market Economies, Anwar Shah, The World Bank, (1994) for a review of the importance of LG equalisation systems, especially in developing countries. Equalisation systems equalise net fiscal benefits across LG (promote equity) and discourage fiscally induced migration, reduce barriers to factor mobility and thereby, if properly designed, facilitate economic efficiency.
[35] See Broadway and Shah (2009, p. 237) for a discussion of this objective.

the LG level and should not lead to a micro control of the LG expenditure priorities as this will reduce the achievement of the efficiency objective of FD;

- *Ensuring efficiency in LG* revenue mobilisation, financial management and utilisation of funds. It is important that transfers do not create negative incentives for LG revenue mobilisation and expenditure management. Grants may, however, be used more actively to stimulate LG performance, e.g. within the area of tax effort, financial management, good governance and/or other areas[36];
- Providing central government with adequate *flexibility* to pursue macroeconomic stabilization policy and influence the overall activity level within the LG sector. The central government may wish to ensure that the overall activity level in the national economy can be adjusted, and the size and distribution of the fiscal transfers may be an important element hereof. This objective should be balanced against another objective, which is to ensure that the transfers are predictable, stable and transparent seen from a LG perspective to ensure appropriate local planning and budgeting processes.

In addition to these genuine objectives of transfers, there may be more informal objectives such as central government attempt to control LGs, and/or wish to offload underfunded functions – and the push of so-called unfunded mandates down to LGs with insufficient compensation as part of a strategy to reduce CG budget deficit. The design of the transfer system and the allocation criteria will depend greatly on the main focus and specific priorities of these objectives.[37]

Types of transfers

The overall architecture of the fiscal transfer systems impacts on the options and autonomy for LGs to delivery services. The first important distinction is whether the grants are **specific purposes** (categorical) i.e. the grants can only be spent on (specific functions/are conditional in terms of utilisation), or **general purpose** (non-categorical) i.e. unconditional in terms of utilisation[38], where the grants may be used to finance a broad range of services. Within each of these broad categories[39] an additional sub-division can be made in grants targeting <u>development</u> (sector-specific and non-sectoral grants) and grants for <u>recurrent</u> purposes (sector specific or non-sector specific)[40]. The systems vary greatly from the Ugandan "model" with more than 35 different unconditional and conditional grants to the systems in Bangladesh and East Timor, with only one genuine non-sectoral grant. There are various pros and cons on sector conditional grants versus non-sectoral unconditional grants, simplified in the figure below:

[36] Please refer to the Paper: *Conceptual Basis for Performance Based Grant Systems and Selected International Experiences*, by Jesper Steffensen and Henrik Fredborg Larsen, 2005 for an overview of the performance based grants and a forthcoming publication on the same subject by UNCDF, Jesper Steffensen (Draft 2009).
[37] However, there are many international examples of transfer systems, which have created problems in achieving some of the stated objectives and which provide conflicting signals and impact.
[38] Sometimes this distinction is made between sector grants and non-sector grants, but this is more focusing on the sector issues.
[39] If grants are defined for use on either specific recurrent costs or capital investments, they may be viewed as specific, but not sector specific. The figure deals with the sector specific – non-sector specific distinction. This means that each of the two strings may actually be divided in recurrent and development grants.
[40] This is an important distinction in many countries, e.g. Yemen, Ghana, Uganda, Tanzania and Cambodia.

Table 2: Pros and Cons from conditional versus unconditional grants

Types of grants	Advantages	Disadvantages
Unconditional	• Support local autonomy and efficiency, local planning and budgeting • Easy to administer and reduce transaction costs • Strengthen downward accountability • Useful for devolved services	• May lead to inefficient spending if lack of local capacity to plan and prioritise • May lead to crowding out of local contribution to funding of services
Conditional	• Support national minimum standards of services • Stimulate services in core areas • Useful for agency functions and functions with externalities	• May lead to too much control and lack of clear accountability • Hard to measure and control – many transaction costs • May distort local priorities • Reduce local efficiency in resource allocation in accordance with local needs and priorities

Second, the grants may either be lump-sum, i.e. a fixed amount, or based on a matching principle, implying that the LGs have to cover a given percentage of the expenses, e.g. 5-10 %. In addition, both the lump-sum and matching grants may depend on the LG effort, e.g. the tax effort or financial management efforts (reporting standards, etc.) and/or service output measures. The matching grants can be closed ended with a fixed maximum amount, or open ended, i.e. depending on the actual costs and activity efforts by LGs.

In addition to these distinctions, grants can be classified by: 1) the way the overall *size of the pool* of resources is determined and 2) the way the *grants are distributed horizontally* across the local governments, see the table below, which is a further adaptation and adjustment of Roy Bahl's and Johannes Linn's (1992) typology[41], particularly with inclusion of performance-based grants. Zambia is a good example of both where there are ongoing reforms to move away from system of ad-hoc vertical and horizontal allocations to grant schemes based on careful considerations on the costs of services and formula-based criteria. Table 3, below, provides a grant typology, based on an internationally recognized categorization, adjusted to take into account the new features associated with the PBGS approach[42].

[41] And inspired by the Fiscal Primer: *Fiscal Decentralisation and Poverty Reduction*, UNDP, (2005).
[42] The table is an adaptation of the typology used in Bahl & Linn (1992) and Bahl (1999), adding the PBGS features.

Table 3: A Taxonomy of Intergovernmental Transfer Programmes and Examples				
	Method of determining the total divisible pool			
Method of allocating the divisible pool among eligible units	Share of national tax revenues	Ad hoc decision or programme specific	Reimbursement of expenditures	Allocation based on estimates/measures of the relative total LG expenditure needs and revenue mobilisation capacity
1) Origin of collection of the tax	A Philippines	--	--	…
2) Formula	B1 Philippines** Indonesia Ghana (DACF) Rwanda (LASBF)	B2 India-BRGF	--	B3 Some of the Nordic Countries Philippines**
3) Total / partial cost reimbursement	C1	C2	C3 Many countries in OECD, e.g. Denmark	---
4) Ad hoc decision	D1	D2 SOI-recurrent grants Zambia: Capital grants	--	D3
5) Performance based (may be combined with 1-4.)	E1 (Ghana-DDF) Tanzania (2009)*** Bhutan (2009 – annual block grants although not as a %)	**E2** E.g. Uganda (LGD) Tanzania-(LGSP)*** Nepal - (LGCDP)	E3 (E.g. Denmark, Japan and Canada)*	E4

		Bangladesh Indonesia Pakistan and others		

Source: Adapted from Bahl (1999) and Bahl & Linn (1992), combined with the features of the PBGS.

* Kind of performance-based funding through the many conditions attached to some of the grants.
** A rough estimation of the expenditure needs of each tier was conducted at the start-up of devolution, but this is currently being up-dated. The adjustment has been in group B1 as it is now a fixed % of the national revenues. The coming PBGS (planned) will be based on a rough estimate of the required size, i.e. (E2)
*** Government of Tanzania has moved from a project specific allocation to an allocation based on a specific % of the public revenues.

Transfers can be distributed to LGs as (conditional or unconditional) formula-based transfers (Type B1, B2 or B3 transfers). Alternatively, transfers can be designed as "ad-hoc" grants where central government has discretionary power (Type D1, D2 or D3), or as full or partial reimbursement of actual local expenditure (Type C1, C2, or C3 transfers). The formula based transfers are sometimes based on detailed calculations of the overall expenditure needs of the local governments (Type B3)[43] Even the size of the overall ad-hoc distributed transfer pool (no clear formula applied) may be based on some overall measures of the total need of all LGs (Type D3), but this model is rare.

Transfers can also be provided in the form of revenue sharing, whereby local governments receive a share of certain revenues collected within their boundaries (Type A). Revenue sharing is considered as a form of transfer when the LG has no control over the tax base, the tax rate, tax collections or the sharing rate (e.g. the Local Development Fee in Nepal or the sharing of wealth taxes in the Philippines).

Finally, and more recently, a number of countries[44] have introduced more performance-based grant (PGBS) allocation systems, where the size of the grants is adjusted against the local governments' performance (type E1, E2, E3 and E4), typically based on calculations of the appropriate expenditure needs to be covered by the system, rough estimates or availability of funding, reviews of absorptive capacity, minimum level required for meaningful investments, etc.

As most PBGSs have been launched by specific projects or national programmes, they are classified as <u>category E2</u>, as the size of the funds is allocated based on the overall *programme specific* considerations. A formula-based basic allocation formula is used and allocations are then adjusted against the LGs' performance. Some of the countries could potentially move towards types E1 or E4 when further studies of the overall fiscal system are conducted[45] and when the overall LGs' fiscal need versus their

[43] Attempts to make these overall calculations of expenditure needs have been undertaken in a number of countries, e.g. the Philippines, Indonesia, Uganda, Latvia and Estonia (planned in Zambia). Although it is hard to define detailed needs, these surveys have provided some indication of outcomes of existing revenue sharing arrangements and future directions in the allocations.
[44] E.g. Kenya, Uganda, Tanzania, Ghana, Nepal and Bangladesh. Other countries, like the Philippines and Indonesia, are preparing similar schemes.
[45] Indonesia and Uganda (2004-05) have invested considerable effort into analytical work aimed at defining the expenditure needs of various LG functions.

revenue potential is further defined. In Ghana the system approximates to type E1 features, as the PBGS is funded partly from the revenue sharing grant (the District Assemblies' Common Fund). Tanzania has also recently moved towards this type of system with Government's contribution to the overall PBGS funding pool set as a specific percentage (2 %) of the Government's total budget[46] (model E1), although the size has not been based on detailed calculations.

In addition to the distinction above, grants are often divided into *development grants* (which may be discretionary grants allowing LGs to prioritise the sectors or sector specific) and *recurrent* grants "earmarked" for recurrent costs. Many development partner support programmes focus on the first type of grants, and have increasingly included various types of performance incentives. Please refer to Annex 3 for more detailed typology of the intergovernmental fiscal transfers.

Principles for design of IGFTS

As it appears, there are numerous ways and means to design the transfer system, and no single best choice. However, there is generally agreement amongst experts[47] that that the following principles should be adhered with:

Box 2: Principles for design of IGFTS

1. Keep the *objectives* clear and transparent and design the system accordingly, and keep the number of objectives behind each grant to the bare minimum;
2. Contribute *adequately* to the funding of the vertical fiscal imbalance between assigned tasks and own revenue sources,
3. Address the differences in *fiscal capacity* and the *expenditure needs* of the LGs and equity concerns;
4. Preserve *budget autonomy*: A transfer system should preserve budget autonomy at the local level within the constraints provided by national priorities
3. Support, not undermine, decentralisation and local revenue raising;
4. Ensure a reasonable number of different systems of transfers and transfer modalities;
5. Transparent, *formula* and needs-based allocation across local governments enhancing horizontal equity (pro-poor);
6. Ensure stable, *predictable* and timely transfers. As part of this, grants should be announced in due time to fit into the budget cycle;
7. Enable LG *flexibility* & initiative within national policy;
8. Involve and strengthen the *whole LG structure* and consider various types of units;
9. Ensure upward, downward & horizontal *accountability*. This will include simple, targeted, and consolidated reporting systems;
10. Achieve public *participation* and transparency;
11. Base the system on the availability of *data* and keep it as simple as possible;
12. Ensure proper *incentives* to improve on administrative performance and service provision, e.g. through rewarding proper initiatives and penalising inefficiency;
13. Link the transfer reforms to *other LG reforms* and initiatives, especially the LG finance system (taxes, user charges) and the capacity building activities;
14. Keep track on the actual *implementation* of the system, i.e. the transfer flow;
15. *Adjust* the system to new LG structures, tasks and responsibilities and ensure proper transitional schemes;
16. Keep the overall system and the criteria for allocation as *simple* as possible to ensure

[46] Excluding budget expenditures for debt-servicing and the like.
[47] Some of these are drawn from MoFPED, Uganda (2001); Broadway & Shah (2009); GSU (2001); UNDP (2005); World Bank (2009); Kelly (2009); Steffensen and Tidemand (2004) and Dege Consult & NCG (2008) and program experiences.

understanding, support and administrative feasibility.

On the other hand, the transfer system should **not**:

1. Base the size of the transfers on the existing infrastructure and services (service outlets), i.e. should not be a gap filling grant, as this provides disincentives to improve;
2. Bring about sudden and large changes (the system should consider whether the LGs should be held harmless during the transition);
3. Be subjected to political interference in the allocation of funds during the FY;
4. Cover deficit and financial mal-practise as this will create disincentives to improve on financial management;
5. Be solely based on an equal share approach as this does not consider the different needs in the various LGs;
6. Be based on criteria, which can be influenced and manipulated by the LGs
7. Establish multiple conditional grants, which undermines local autonomy and flexibility
8. Be part of a strategy to transfer the fiscal deficit down from central to LGs.

As mentioned, some of these principles may require significant time to implement in practise, e.g. the wish to improve LG incentives and reward good performance. However it is important in the short term that the formulas for allocation are not penalizing LGs, which have managed to improve own revenue generation and have made an effort to improve on the service provision and coverage of infrastructure. It is also important to note that it may not be possible to achieve all the principles simultaneously, that conflicts may emerge and that certain trade-offs are needed, e.g. a flexible system adjustable to new LG functions may not be fully stable and predictable. Similarly a strong incentive system may, if not properly designed, contradict the equity objective.

The horizontal allocation of funds across LGs is often subject to special attention, particularly as part of the objective to level out fiscal disparities between LGs and target resources towards the most needed/poor areas. Development of suitable allocation criteria is a special "science", and there are several pitfalls to be avoided. Annex 3 deals specifically with this issue and provides the theoretical background as well as country examples. Very few countries comply with all the principles outlined above, and the IGFTSs are subject for current reforms in most development countries. Zambia is a good example of this, where the Government on-the-one hand provides deficit grants to LGs with large debt and with the other hand does not pay the full obligations to LGs on property rates and plan to introduce performance-based allocations with the aim to promoted improvements in LGs' Public Financial Management (PFM) practices.

Recently the basic allocation criteria for horizontal allocation such as needs based criteria (population size, size of the land area, cost indexes etc.) have been supplemented by more performance-based criteria, often within the field of public financial management, good governance and transparency in many countries, to promote improvements in LGs' performance. The access to and size of the grants are then adjusted against the LG performance in clearly defined functional areas. The initial experiences from these systems have been very encouraging, and the systems are now being rolled out in an increasing number of countries, see Annex 4[48].

The design of IGFTs will depend on the *objectives* of the grant system see the table below:

Table 4: Links between objectives and design

Grant objective	Grant design	Examples of better practices	Examples of practices to avoid
Bridge the vertical imbalances (fiscal gap) and contribute to the funding	Various types of revenue sharing Unconditional grants	The Danish block grant system with annual adjustments for new tasks	Deficit grants Complicated tax sharing (China and Zambia)
Reduce regional fiscal disparities	General unconditional (non-matching) equalisation transfers with clear criteria for needs and/or fiscal capacity	Fiscal equalisation in Canada, Denmark, Germany. Attempts to address fiscal disparities in Nepal and Bhutan	Equalisation through multiple tax sharing arrangements (China); Conflicting criteria in the formula (Rwanda) Uganda where the equalisation grant is insufficient and used to finance other functions such as new districts
Compensate for positive spill-over/externalities	Open ended matching conditional transfers	Grant for teaching hospitals in South Africa Support to activation of unemployed people in Denmark	Close ended matching grants and grants which manipulate decisions Grants with conflicting percentages of cost recovery
Guarantee for National minimum service delivery standards (NMS)	Conditional non-matching grants (may be output based where conditions are related to minimum outputs)	Health transfers Brazil and Canada Social pension grants in Scandinavia	Grants which strictly control the service norms without any LG autonomy (previous Russian system). Unrealistic NMS which are not sufficiently funded (many countries)

[48] This Annex is an abstract of a forthcoming publication on performance-based grants by UNCDF, author Jesper Steffensen: Performance-Based Grant Systems - Concepts and International Experiences (October 2009).

Grant objective	Grant design	Examples of better practices	Examples of practices to avoid
			Unrealistic calculations of NMS (Tanzania 2000-01)
Influence local priorities in areas of high national but lower local priority	Open ended matching grants and/or grants which are targeted specific areas	Many grants focusing on development oriented investments; Matching transfers for social assistance (Canada before 2004)	Misuse of influence to conduct micro-control of LGs (a tendency in many countries, e.g. Uganda with more than 35 very detailed /earmarked grants) and complex transfer system in China
Provide stabilisation and overcome infrastructure deficiencies	Capital grants provided maintenance is possible	Capital grants which consider the fiscal capacity of the LGs (with some matching rates), e.g. Nepal, Uganda (LGDP), Bhutan (annual block grants), Solomon Islands (provincial capacity development grants), Ghana (District Development Facility) and Tanzania (LGSP)	Ad hoc allocations Typical the case in many Central and Eastern European countries in the 1990s. Is still the case in some countries, particularly from so-called pork barrel funds in the Philippines, Nepal, Kenya, Zambia and other places where funds are allocated ad hoc from the constituency development funds/and or ad hoc allocations to councils
Promote LG performance in core functional areas	Performance-based grant allocations, combined with some of the other grant features	Uganda (LGDP), particularly from 2000-2007, Tanzania (LGSP from 2004), Nepal (LGCDP grants) from 2008 - all for development oriented expenditures with incentives to improve performance in-build in the formula	Arbitrary reward schemes based on political patronage Grants which cover LGs' deficit, bail out non-performing LGs, or is based on existing level of infrastructure (i.e. provides no incentives to improve), e.g. some of the sector grants in Uganda.

DDF: District Development Facility, LGCDP: Local Governance Community Development Programme, LGDP: Local Government Development Programme, LGSP: Local Government Support Programme.
Source: Adapted from Broadway & Shah (2009) with several adjustments and new country examples.

When the design of IGFTSs has been completed, preferably in a close dialogue between central and LGs as well as other stakeholders, it is important to develop, issue and disseminate clear grant guidelines to LGs which determine the size, the criteria for allocation, the allowed spending from the grants (investment menu), the reporting and accountability system and procedures. It is also important publicity to announce the size of the grants and the point of time for disbursement to strengthen information flow and accountability.

Danida has been involved in the support of the grant systems in several countries, including Uganda (support to the Local Government Finance Commission and support to the Local Government Development Grant system); Ghana (support to design and funding of the new District Support Facility); Nepal (support to the Fiscal Commission and to the new system of topping-up of Governments development grants); Bhutan (support to the Gross National Happiness Commission and the new annual block grant system); Bangladesh (support to the new block grant system to Union Parishads) and many other places. Most recently, Danida has supported the design and development of the new innovative performance-based grant systems in Ghana and Nepal. The support to the performance-based grant systems has often been a way to ensure greater harmonisation and alignment between DPs and the Governments and the on-budget support to the intergovernmental fiscal transfers has been combined with more direct CB support and support to system development. Based on the experiences it is important to ensure:

- Close dialogue amongst all core stakeholders in the design work;
- Proper buy-in to the introduction of the reforms from core stakeholders, champions of the reform and clear institutional framework for the IGFTS, see Section 10;
- Current follow-up and support to the administration of the IGFTS, particularly regarding performance-based systems which are more demanding;
- Transparency and accountability in all phase of the work on IGFTSs – transfers is about funds and funding is important for power, hence it is important, but challenging, to avoid political capture of the IGFTS.

The list of literature offers a broad overview of further experiences on IGFTSs

6. Local Government Borrowing and Debt

The last funding source – LG borrowing - is the least advanced in the developing countries, and only few countries have well-functioning systems for this, and most experiences are still from problems with various forms of informal borrowing and LGs with high level of unpaid obligations/liabilities/arrears – local governments under fiscal stress. However LG borrowing is a potential source, which may gain importance over the next decades along with improved creditworthiness of LGs, particularly in the larger and urban authorities. Much of the capacity building, revenue mobilisation and performance incentives also promote a future system of LG borrowing.

There are several good reasons for LG borrowing for longer-term capital development projects. Many projects are necessary here and now, but will benefit the future generations, hence it is not possible and fair to demand a funding of all costs in year one. Strategic borrowing in growth or income generating activities may also provide LGs with future high yielding revenues. Furthermore, strong systems of LG borrowing may instil fiscal discipline and good incentives for LGs to improve performance in financial management. Various creditworthiness agencies have started operating in some of the (often urban) LGs in some of the most advanced developing countries. This is sometimes supported by various development partners in the initial phases and reviews of how LGs can improve creditworthiness in the medium to longer term have often been supported as part of analysis in new grant programmes.[49]

However, there are many pitfalls and bad examples of LG borrowing, such as debt crises in Latin America and problems with intermediate borrowing institutions in some African countries (e.g. the Tanzanian Local Government Loans Board – lots of loans have not been repaid) and the Chinese experiences from bail out of LGs which have problems in balancing expenditure and revenues and numerous informal borrowing arrangements[50] and LGs' involvement in micro-credit (e.g. Nepal). Even in cases where there are strong restrictions on LG borrowing, LGs are often entering in more informal banking overdrafts, arrears in payments of service providers/various creditors, informal borrowing etc. There are numerous examples from this in e.g. Kenya, Zambia, China and India. In India the Centre has not been able to exercise full control over state borrowing and the states have been able to avert debt controls through off-budget borrowings and guarantees[51]. Similar problems are observed in many other places at the LG level. The reasons for these problems may vary from non-conducive environment for fiscal decentralisation, e.g. transfer of un-funded mandates to LGs, initiatives to undermine LG revenue assignments (e.g. abolition of taxes), to lack of LG incentives to improve PFM and hopes to be bailed out by central government in cases of failure to honour commitments. Many LGs have poor records and commitment control systems to ensure that funds are available when entering new fiscal obligations. The box below provides some experiences from how problematic the situation can be:

Box 3: LGs with Debt

The amount of LG arrears/unpaid obligations in **Uganda** is significant, particularly within the areas of payment of pensions to LG officials. The central government has stepped in and is trying to address the problems. Some salary and pensions arrears have been settled centrally, but new analyses are being conducted of the entire LG pension and salary liabilities. In **Zambia** various studies have been conducted of the LGs debt and arrears and the central government has established as special retrenchment grant (which is working as a debt recovery/deficit grant) and started transferring funds to LGs for debt recovery. Most of the debt is within areas of salaries, pensions, statutory obligations and utilities. However, the debt has increased since the launch of this grant in 2006, and there is need for a new review of the total scale of the problem. LGs have no incentives to address the problem, which has been created by a combination of central government transfer of unfunded expenditure mandates to LGs, abolition of core LG revenue sources, and poor PFM performance at the local level. There is a lack of a strategic approach to resolve the issue in a systematic and sustainable manner. In **Kenya** the LG has been running into very large debt and unpaid obligations, particularly in the 1990s. The Government through the Local Authority Transfer Fund (LATF) pursued to create stronger incentives for LGs to develop debt recovery strategies/to enter agreements with creditors etc., and to start addressing the problem. The initiative has had some impact, but not yet fully resolved the problem. Very strict LG borrowing regulations combined with lack of strong inspection, audit, follow-up on audit, and non-predictable grant

[49] E.g. various DPs have supported credit-rating of some of the provinces in the Philippines and various benchmarking exercises of LGs strengths and weaknesses in PFM are ongoing in Indonesia with support from a joint DP basket fund.
[50] World Bank (China, 2007).
[51] GSU. "*India Fiscal Condition of States, International Experiences and Options for Reform*", 2005.

system, etc. has led to a large amount of informal borrowing amongst LGs in **China**, which may poses future fiduciary and financial risks. In the **Philippines**, there has been a mix of grants and borrowing, whereby some grants could only be received if the LGs took a loan from the municipal development fund under the Ministry of Finance, -a system, which may lead to exaggerated borrowing and diluted incentives. In **Denmark** (a country with some strong control on LG borrowing), a few LGs have historical not been able to adhere with the central government's minimum requirements on cash liquidity and are in such situations put under stronger control and supervision for a certain time period (under some kind of administration) by central government to rectify the situation in a strategic manner.

The lessons learned from LG borrowing have been that:

- LG borrowing should be backed by a robust and transparent legal framework and systems and procedures for where to borrow, for which purposes, and possible ceilings and monitoring and supervision frameworks;
- It is important to ensure that LGs are faced with "hard budget constraints", i.e. the central government should not "bail out" defaulters/LGs which has taken on board unrealistic debt burdens, but the LGs should learn that fiscal discipline is an advantage[52]. In cases where LGs are heavily financially stressed, central government should help LGs in the design of strategies to recover the debt;
- Intermediate borrowing institutions may be a step on the road towards private credit to LGs, but can also be a stumbling block if the agencies are displacing private capital and/or are not properly designed. There are generally many pitfalls in this process, particularly if central government representatives put themselves in the managing position/boards of these institutions and/or if they are not driven by competitive methods;
- LGs are <u>not</u> in a good position to function as borrowing institutions for others, such as e.g. bodies for delivery of micro-credit to community groups – this is risky business and often linked to patronage and lack of transparency[53];
- Strong incentives for LGs to ensure creditworthiness should be supported from any initiatives on LG borrowing[54];
- Debt thresholds may be established in a manner to ensure that LGs borrowing is not getting out of hand.[55] There are good reasons e.g. to restrict LG borrowing to development oriented areas, such as capital investments in infrastructure (e.g. roads and utilities) and services (e.g. schools and health centres) and to establish some ceilings, particularly in the first phases[56].
- Performance-based grant systems with a system of assessment of PFM indicators and links to allocations, may be an important intermediate tool to promote higher level of LG creditworthiness and fiscal discipline.

In cases where there is no *formal* regime in place for LG borrowing, there a examples of severe informal borrowing, often leading to problematic LG fiscal positions and

[52] E.g. the current arrangement in Zambia is very risky, as the Central Government is transferring debt recovery grants, without a clear strategy on how to avoid similar future problems with the debt creation.
[53] Examples of this have been seen in e.g. Bangladesh and Nepal.
[54] Performance-based grants can be one tool to promote this transformation.
[55] These are introduced in different countries like Uganda (ceiling on the share of the budget) and in Denmark (strongly regulated for which purposes borrowing can be done, e.g. for utilities, and investments in houses for elderly people, etc.)
[56] Even in Denmark, with a strongly decentralised system of LG finance, the LG borrowing is strongly regulated and targeted.

large amount of outstanding arrears (unpaid bills and credits). This is observed in various countries like China, Uganda[57], Zambia[58] and the Solomon Islands.[59]

7. LG PFM and Fiscal Accountability

Many of the issues on Public Financial Management reviewed at the central government level are equally important at the LG level, although there are certain key differences. The stages in PFM and many of the challenges from planning to follow-up on the audit reports[60] and issues on fiscal accountability are also present at the LG level, but LG PFM is furthermore characterised by:

- Having a stronger influence from the *external environment*, whereby LG cannot issue the basic rules and regulation on PFM themselves, but have to rely on central government initiatives. There are obvious differences in this especially between the Anglophone and francophone countries (the latter have often less autonomy and stronger central controls), although there are also great differences across each of these groups of countries. The central government's control of LGs within areas such as expenditure priorities, autonomy on the LG revenues and flexibility allowed in the grant system, as well as transparency, predictability, timeliness in the intergovernmental fiscal relations impact greatly on the LGs possibilities to improve PFM and the question about attribution becomes central;
- The links between administration and politicians are often closer at the LG level, with regular council meetings and shorter distance to the councillors – this is particularly the case within public procurement, where involvements of politicians in technical activities is not uncommon in many systems at the LG level;
- The capacity of the LGs [61] in some countries in terms of man-power, qualifications, etc. may be less than at the central level, especially in the remote areas, but some of the functions, such as number of transactions equally simplified;
- Some of the accountability measures, such as social audit, public hearings, participatory planning and budgeting process have greater potential for impact at the LG level, but are often not fully realised;
- The potential through innovative performance-based grant schemes to influence the LG PFM performance is immense, and increasingly applied and encouraged in many countries.[62]
- The dialogue with the central government and the support from the centre to address PFM weaknesses and challenges are pertinent for the progress in LG PFM reforms.

[57] E.g. Kragh, Williamson and Steffensen (2004).
[58] See forthcoming PER of Fiscal Decentralisation in Zambia, Dege Consult, 2010.
[59] In Solomon Islands, the central government has supported to coverage of the informal debt of the provinces, but not yet fully solved the problem. In China there is numerous examples of heavily indebted LGs e.g. Bird and Wong, (2005) and World Bank (2007, China).
[60] See World Bank, (2004, Public Financial Management) for a review of the stages.
[61] However, the low level of capacity at the local level is often used as an argument to avoid transfer of power, functions and finding to LGs, without any proper comparison with the central government's capacity.
[62] See Annex 5.

PFM reforms have been pursued at the LG level as part of the overall FD reform process and/or as stand-alone initiatives in nearly all developing countries over the past decade. Tools for establishing the baseline on PFM and for identification of the strengths and weaknesses have been developed, of which the Public Expenditure and Financial Accountability (PEFA) tool is amongst the most commonly applied[63]. Until recently the PEFA tool was mostly targeting the central government level, with one indicator- the features of the intergovernmental transfer system (indicator 8) - as the only specific indicator for the LG system. PFM at the LG level was sometimes covered using the same indicators or a subset of these[64]. However, recently a new draft tool for customizing the central level PEFA indicators to the LG level has been elaborated with adjusted performance indicators. These are to be applied depending on the level of LG autonomy and the specific system in case. Other more country specific tools, although still of general interest, are the Local Government Financial Management Measurement Framework developed in Indonesia[65] and numerous performance-assessment manuals in the countries using performance-based grant systems (PBGS), see Annex 4. These assessment tools are useful to establish baselines, to review the areas in need of reforms, to design strategy and initiatives, and in the case of the PBGS assessment tools, to establish stronger incentives for LGs actually to improve performance.

PFM reforms and reforms to strengthen *fiscal accountability* should go hand in hand, and are both important for strengthening of LG service delivery[66]. Although FD has great promises for improved fiscal accountability[67], results have been mixed due to various reasons.

Some of the challenges have been to establish proper mechanism for public awareness and participation in the PFM cycle from planning to auditing and lack of information/transparency in processes. Many reforms have been initiated without sufficient attention on the accountability. However, a number of initiatives are increasingly put in place to address this gap in addition to the more traditional PFM initiatives (such as improvements of planning and budgeting documentation, record keeping, internal and external audit). Some of these are the following[68]: Procedures for public access to planning and budgeting processes and promotion of LG participatory planning (Uganda and piloting in Zambia), citizens oversight bodies (e.g. vigilance committees in Bolivia and Gram Sabhas in India) robust disclosure and reporting on budgets, accounts, audit reports, and transfers, openness in procurement processes (e.g. NGO seats in the technical and award committee for LG contracts in the Philippines); LG public accounts committees with citizens' representatives (Uganda), citizens report card system (Bangalore in India and piloting in the Phillipines), social audits and hearings with supervision of LG by citizens in a village (e.g. India and Nepal – under development), benchmarking of LG performance (e.g. Indonesia and Uganda/education), citizens' charters (Nepal), and establishment of LG

63 www.pefa.org
64 An example of this was the PEFA 2005 in Uganda.
65 World Bank (2005, Indonesia). Studies in Uganda have shown that if LG PFM and institutional frameworks are improved, the likelihood of improved service delivery is much higher. Ministry of Local Government, Uganda (2007):
66 See e.g. the World Development Report, 2004: Making Service Work for Poor People World Bank 2004.
67 Fiscal accountability deals with transparency in management of public funds, managing of funds in a prudent and responsible, cost efficient manner with integrity and openness in all process of the PFM cycle, including reporting, control and auditing.
68 See the World Bank home page: www.worldbank.org/socialaccountability_sourcebook/ for an excellent overview of many of these measures as well as Yilmaz et al (2008).

accountability facilities to monitor performance (Mozambique). Please also refer to the Social Accountability Sourcebook (www.worldbank.org/socialaccountability_sourcebook) for further information on some of these initiatives. Often these innovative measures are supplemented by systems for supervision from central government and combinations of LG and community development programme support with proper linkages between the supply and demand sides.

However, without some discretion and clarity over LG expenditure and revenues[69] and predictable rule-based intergovernmental fiscal transfers, LGs will have good argument for passing the blame on to other actors in cases of non-performance. As argued by Yilmaz et al (2008) LG discretion on expenditures/revenues and accountability measures should go hand in hand, and one cannot be greatly ahead of the other. For example - who are to be blamed for LG budget deficits, if the LGs' budgets are to be approved by central government, if they have no autonomy on the revenue side and if the transfers are unpredictable and delayed?[70]

Second, increasing amount of evidence suggest that LG accountability is strongly related to the manner in which the LG revenues are composed (so-called fiscal link between citizens contributions and benefits). The importance of having own source revenues and revenue autonomy to ensure accountability and efficient service delivery should not be underestimated. Recent studies have shown that abolishment of taxes/user payments can have detrimental impact on accountability[71].

In most countries support to the PFM reforms is therefore combined with support to the wider decentralisation reform process (e.g. support for drafting improved budget and procurement guidelines, support to reform of the overall intergovernmental fiscal framework, refining PFM procedures, annual reviews of decentralisation, support to policy development and coordination, etc.). The Solomon Islands is a good country example of this. Here the newly introduced performance-based grant scheme - the Provincial Capacity Development Fund (PCDF) - is part of a larger capacity development effort, impacting upon the entire PFM cycle (see the figure below). The system has had a significant impact on the PFM performance of the provinces, just two years after its introduction[72] and is an example of a holistic approach to PFM reforms. It has also lead to better harmonisation of the DP support with assistance from UNDP/ UNCDF, AUSAID and EU. This does not mean that <u>all</u> PFM issues should be tackled at the same time. The so-called platform approach to PFM reforms, whereby the most fundamental issues are tackled prior to more sophisticated measures ("you need to walk before you can run approach") is also increasingly applied at the LG level, although there are cases where advanced tools such as performance contracts have been initiated prior to a tackling of the basic issues of

[69] There is a general agreement that systems where LG have no own source revenues, the LGs are likely to be less accountable to the citizens despite alternative measures (see e.g. Yilmaz et al (2008), Bahl and Shroeder (1983), Kelly (2009, Duke University), Dege Consult (2008) and others.

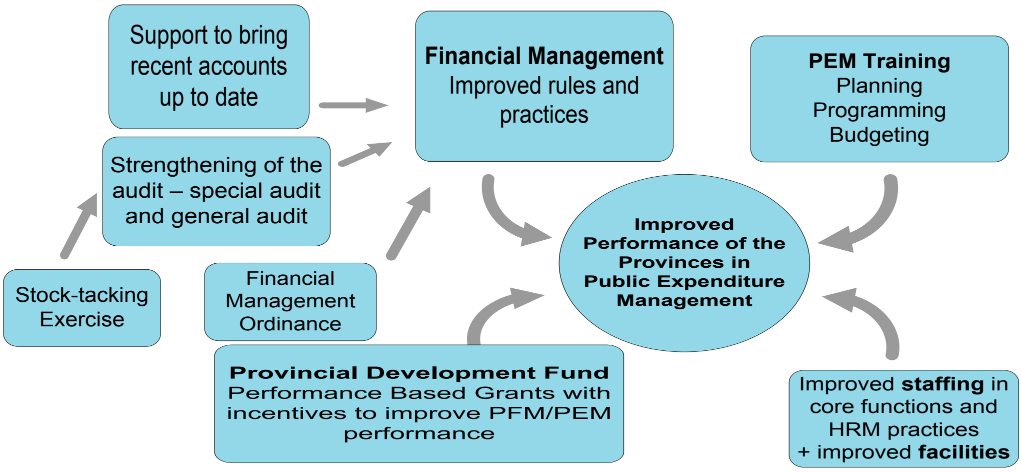
[70] This discussion is on top of the agenda e.g. in Zambia, where LGs are in a debt trap due to past central government interventions.

[71] See e.g. Hoffman and Gibson (2007), which compare Tanzania and Zambia and conclude that in cases with increases in local generated revenues, the accountability is stronger and services are more efficiently delivered responding to local needs. Ebel and Yilmaz (2002) also emphasize the importance of autonomy on the revenue side for efficiency and accountability. Dege Consult & NCG (2008) also found reduced level of participation and accountability in cases of abolition of citizens' contribution to taxes and user fees in Uganda.

[72] Annual Assessments of the provincial governments' performance. E.g. before the reforms in 2007 none of the provinces produced any reports on use of grants, financial statements, etc. Today, these procedures are in place in all provinces.

salary payments, pension schemes, payroll registration, etc. (Uganda is an example of the latter).

Figure 2: The Solomon Islands- the PBGS as Part of a Larger PEM/PFM Reform



Source: Programme Document of the Provincial Government Strengthening Programme (PGSP) in the Solomon Islands, 2007. The programme combines support to a new development grant system with strong systemic and organisational capacity development of staff and organisations, as well as strengthening of the incentives to improve performance.

Danida support to LG PFM has most often been in form of a hybrid between financial support and TA to improved intergovernmental fiscal relations, capacity development and system development, e.g. in Uganda, Ghana Nepal and Bangladesh.

The lessons learned have been that LG PFM reforms should:

- Be part of the overall support to FD and other components of decentralisation in a mutually strengthening manner;
- Focus on incentives in addition to more traditional focus on technical improvements;
- Apply a step-wise approach where there is focus on the basic issues, while preparing for more advanced reforms;
- Support the intergovernmental fiscal transfer system, as these are often a useful entrance point to other reforms, including PFM improvements, see below;
- Use a learning-by-doing approach whenever it is appropriate. Lack of capacity, including PFM capacity should not be used as an argument of not pursuing fiscal decentralisation, and much of the improvements only take place through the actual learning process, provided that sufficient incentives for improvements are in place and operating. It should be noted that capacity at the central government level often leave great room for improvement, but that this is typically less easy to document.

8. Sector Funding

Sector funding cuts across many of the issues raised in the previous sections. Although it is not possible to establish sector-specific funding rules and observe clear sector-specific practices, there are some variations across the types of services to be delivered in terms of the typical funding arrangements. As mentioned in Section 4, the theory argues that pure agent functions should typically be funded largely by (conditional) grants from central government, although this may be augmented by own source revenue such as user fees and charges, whereas more discretionary functions, where LGs have a greater degree of autonomy, to a larger extent are funded by own source revenues and/or unconditional grants.

Generally, LGs' functions can be divided into three types:

1. *Agency functions: The LGs perform tasks and services without own influence (or little influence) on the level and quality of the services – the LGs perform the functions on behalf of the central government as agents (e.g. some types of pensions, payment of social benefits or payment of teacher salaries)*

2. *Partly agency functions: LGs have only partial influence on the level and quality of services they provide e.g. primary schools in many developing countries today, where the LGs perform the tasks but with a number of detailed norms and standards. Examples of this is where the health workers' salaries and many other cost items, e.g. drugs, are financed and controlled by central government;*

3. *Discretionary functions: The LGs have a strong control and responsibility over the services and the level and quality of these services themselves (e.g. LG general administration, certain primary health care functions, local roads, distribution of water etc.).*

Second, there are some signs of differences in the funding arrangements across sectors such as Environment, Health and Water/Sanitation, which will be explored further in the sector papers and findings from this review will lead to up-date of this Paper. As mentioned in Section 4 unclear assignments and blurred responsibilities often lead to conflicts between central and LGs about the funding arrangements for core sectors as well as problems with accountability towards the citizens. This problem is common for all sectors.

An important challenge in the overall FD system is the link between the overall decentralisation process/ the fiscal decentralisation strategy and the strategies for funding of LG service delivery functions within the various sectors. Whereas the overall strategy(ies) may promote LG autonomy, simple and unconditional grant systems and deepening of the integrated decentralisation process with cross-sectoral priorities, sector strategies may pursue much more earmarked and controlled systems to preserve sector interests and pursue national (sector) targets. This is often worsened by the silo-based planning budgeting process promoted as part of the SWAps in some countries with weak mechanisms for cross-sectoral priorities and linkages. Some initiatives have been launched recently to build bridges between these two approaches, e.g. the Danida's support to the Local Service Delivery Programme in Ghana, whereby the sector grants are expected to be subsumed into the general district development facility (DDF) –a non-sectoral discretionary development grants- to promote local planning and budgeting after a 3-years period with specific sector grants. Piloting of sector grants as an element of various integrated reform processes in countries such as the Philippines, Nepal and East Timor is another example. The challenge is to balance central policy and targets with local flexibility and priorities, while ensuring some horizontal equity, minimum level of services and fairness in the delivery of local services. Please refer to the sector-specific papers for further details.

The overall steps involved in establishing sector funding arrangements are typically: i) definition of LG tasks and links to the provision of services by other tiers of government, ii) determination of level of autonomy within various tasks and sub-tasks, iii) review of budgets (previous budgets) and cost implications, iv) review of optional funding sources and development of feasible funding strategies and implementation plans, including adjustment of national budget v) issuing of guidelines to LGs on planning, budgeting, use of funds, reporting and accountability etc.

Danida with its sector expertise has been involved in support of sector funding arrangements, encompassing support to decentralisation, with fiscal implications for LGs in numerous countries, e.g. Uganda, Ghana, Tanzania, Bangladesh, Nepal, Bhutan, Benin and Bolivia. An overview of the decentralisation components[73], supported in the programme countries, shows great variations in the funding modalities, see below under Section 10.

9. Coordination of Fiscal Decentralisation and Institutional Issues

Coordination of fiscal decentralisation (FD) and the reform process is often one of the major bottlenecks in efficient implementation of any decentralisation processes. FD cannot work probably without a strong coordination of the fiscal decentralisation policy, coordination and dialogue on legal framework and guidelines to LGs, strong and robust monitoring of LGs, coordinated management of grant and revenue systems, coordination of grant allocation criteria and modalities etc.

However, there are often inherent conflicts between various parties in the intergovernmental institutional set-up, particularly between: i) The ministry responsible for local governments (Ministry of Local Government/Ministry of Local Development, etc.), ii) Ministry of Finance, and iii) various strong sector ministries (health, education, etc.). Examples of weaknesses are: i) the fragmented and insufficient data collection – data on LG finance is often not sufficiently and timely collected or lack coordination and consolidation. An example of this is the insufficient coordination and implementation in the relationship between the Ministry of Local Development in Nepal and the National Planning Commission leading to weak monitoring of the LG's use of funds, and lack of consolidated data on grants and LG expenditure and revenues in Zambia ii) reporting and monitoring of LG finances with conflicts between various agencies on the supervisory roles (an example of this is multiple and overlapping fiscal inspections in Uganda and overlaps in auditing of LGs

[73] Danida: Overview of Decentralisation Components (DC) in programme countries.

in Zambia (Office of the Auditor General and Ministry of Local Government and Housing) leading to inefficiency and high transaction costs), iii) conflicts in the establishment of grant allocation schemes where various schemes may potentially undermine each others (e.g. Ghana with multiple funding sources for the same expenditures in the sector of Education[74]), iv) conflicts or weaknesses in the strategic development and policy setting, leading to conflicting policies, legal framework and guidelines on FD (an example of this is in Uganda where the Ministry of Local Government has requested the LGs to produce a development plan framework with a 3 years perspective, but whereas the National Planning Authority has suddenly announced to LGs that they should use a five year perspective without changing the existing legal articles and the conflicts in Cambodia on who should lead the Decentralisation and Deconcentration policy (from 2005-06) leading to delays in adoption). In Tanzania as well as in many other countries, there have been conflicts between the coordinating ministries (here Ministry of Finance/President Office-Regional Administration and Local Government and the sector ministries e.g. Education) on the implementation of the new recurrent grant formulas.

A wish to ensure adherence with national targets or general distrust in LGs has often lead to heavy central government control of the LG planning and budgeting process with ex ante approval of the LGs' budgets and micro-control (an example of this is in India where budget for the Gram Panchayats (LGs) Backward Regions Grant Funds have to be approved/endorsed by both the states and the central government), where softer means could have been utilised, see annexes 3 and 4. Another example of this is the system in Zambia with numerous control and approval procedures of the LG budget, tax rates, approval of user fees and charges etc are impacting negatively on the LG fiscal positions.

The ministries of local governments are often tasked to coordinate the overall fiscal decentralisation process, but have difficulties in performing this role due various reasons such as their weaker status compared to more powerful ministries, their inherent interest in controlling LGs, their weak capacity and as these ministries are often seem as just another "sector" ministry by other sector ministries. This often leads rivalries and fights about resources and staff. A number of countries, such as Uganda, Zambia, Malawi, South Africa, Nigeria, Indonesia, India, Solomon Islands and Nepal have tried to establish various kinds of – more or less independent- local government finance commissions and/or institutional coordination mechanisms to support a stronger guidance and coordination of the fiscal decentralisation processes, but the impact of these varies greatly in practice, also as their tasks have sometimes been either too comprehensive and/or overlapping with other agencies, and/or they have not had the institutional clout in the competition with other actors.[75]

The involvement of *associations of local authorities* in the coordination of the FD reform process varies greatly, but there is certainly scoop for benefitting from their representative roles, their knowledge, expertise, legitimacy and close links to the LGs. As the associations have traditional been relative weak in many developing countries, support to these have been part and parcel of many FD programmes.[76]

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[74] Steffensen (Ghana, 2007 Review of grants in Education).
[75] See e.g. Boex and Vazquez (2004, Working Paper 04-20) for a detailed review of 9 country examples.
[76] Examples of this is the long-term Danida support to the associations of LGs in Uganda and Nepal.

Danida has a vast experience from supporting the coordination arrangements on Fiscal Decentralisation, including various fiscal commissions and associations (e.g. from Malawi, Uganda and Nepal).

The lessons learned have been that:

- One model of institutional coordination, e.g. establishment of strong LG fiscal commissions, does not fit all countries. The set-up should be adjusted to the countries' political, historical as well as particularly the stage and mode of decentralisation – a stronger policy on devolution of major funds are funding sources calls for a more robust coordination arrangements;
- Coordination should be horizontal (between various ministries) as well as vertical, between central and local governments – in the latter, the local government associations can play a major role, not only in advocating for local interests (e.g. higher shares of the public budgets), but also through the knowledge, expertise and legitimacy they can bring to the table;
- It is important to resolve the issue of coordination of data collection, reporting, monitoring and inspection to strengthen efficient and reduce transaction costs for everyone;
- Support should be rendered to ensure clearly defined roles of the Ministry of Local Governments, Fiscal Commissions, Ministry of Finance, and sector ministries in terms of tasks as well as relative authority. In certain cases, it may be necessary and prudent to establish a special coordination arrangement above the sector ministries, e.g. under the Presidents office (see the Governance Paper) to ensure that cross –cutting fiscal issues and concerns are properly addressed.
- Flow of funds to LGs should be as direct as possible avoiding routing through various agencies, which will tend to reduce transparency and timeliness.

10. Support Modalities

The findings from a survey in 2004 which revealed that support to fiscal decentralisation reforms have often been fragmented, scattered and without and overall strategy and action plan (OECD, 2004, p 37) are still valid. Another study in 2006/07 concluded that[77]:

"From the information availed it is not always clear how many of these projects are supporting comprehensive national decentralisation reform efforts where major decentralisation reform aspects (legal, policy, political, fiscal, and human resources) are addressed in a substantive manner. Only approximately 10 % of the projects surveyed can be categorised in this manner."

There is still a clear tendency in most development countries to support single projects, specific LGs (area-based programmes) and lack of link in the support to the national framework with government systems and procedures. However, more recently, there are a number of good examples and practices on how support, specifically to the intergovernmental fiscal transfer systems, can spearhead more

[77] See Dege Consult & NCG, (December 2006).

comprehensive harmonisation and alignments of support to fiscal decentralisation. The table below shows examples of these initiatives[78].

Table 5: Examples of joint support to Fiscal Transfers to LGs

Country	Name and feature	Comments
Uganda (Funding of a sector investment plan)	The Support to the Local Government Development Programme, II from 2003-2007 was joint support from 5 development partners to the Government's discretionary development grant system (performance-based grants), encompassing both development grants, capacity building grants to LGs as well as systemic support to joint reviews, guidelines, technical tools etc. From 2007 the support was continued, but with new modalities, i.e. support to the entire LG sector investments plan (LGSIP) – an action plan for implementation of the overall decentralisation strategic framework, see JFA and MoU. 5 DPs have supported the LGSIP from 2007-2010 through a basket funding arrangement, which since 2008 has included a topping-up of the Government funded local development grant.	Among the supporting partners to the existing LGSIP are: the World Bank, Netherlands, Austria, Ireland Aid, Belgium and Danida. The support to the LGDP II from 2003-2007 has been evaluated successfully and has lead to better harmonisation and alignment of the support to decentralisation in Uganda. 2007-2009: The overall policy and division of labour has lead to decisions of a number of DPs to move out of support to decentralisation. There have also been some frustrations from some DPs about the delays and quality in accountability from the Ministry of Local Government and issues in respect of the Governments decentralisation policy such as proliferation of districts, but it is assessed that the support to the sector investment plan through a basket has somehow counterbalanced this. Due to the division of labour between DPs, the existing basket funding arrangement will end in 2010, but Danida will continue to support decentralisation and the LGSIP: The LGSIP support has improved

[78] Often called Joint Financing Agreements (JFAs), Memorandum of Understanding or Letter of Intent. These documents are not legally binding, but establish strong moral obligations and deviations from the text are not usual.

Country	Name and feature	Comments
		coordination amongst the DP and Government, but the plans has met constraints in the overall decentralisation environment as well as in the technical design (originally too much focus on support to central institutions and smaller activities instead of major issues in funding of service delivery).
Ghana Joint funding of a new grant system	The District Development Facility (DDF) f is a newly introduced grant in Ghana with support from a number of DPs. It supports discretionary development funding for local investments and capacity building grants. Allocation is based on clear formulas, and performance of LGs in Ghana. A new Danida programme – the Local Service Delivery Programme (LGSDP) supports the DDF, and it is expected to use a phased approach whereby in parallel to increased DDF-funding for the first three years, there will be decreasing earmarked and area-based sector support within feeder roads, water and sanitation in up to 36 districts. After the 3 years, based on an assessment, it is expected that there will be a merging of the sector funding into the DDF. Should the evaluation be positive, the DDF will in 2012-13 be used as the sole funding mechanism for investment funding covering the funds from the sectors. The earmarked sector funding will cease and the support will from then on be nation-wide.	Among the support partners are: AFD (France) KFW (Germany), GTZ (not part of the DDF support), CIDA and Danida. The DDF support has led to better harmonisation of the support from DPs to decentralisation, but the future impact is still to be assessed. It has not yet been possible to establish a joint support to the entire decentralisation process (like the support to the LGSIP in Uganda), but the support to the DDF is a first important step towards harmonisation and alignment of the DP support to FD in Ghana.
Nepal Joint funding of a comprehensive	Support to the Local Governance and Community Development Programme (LGCDP) of which the support to the topping up of the Government's performance-based development	The support has been put in place after a longer period of joint programming and design. The support is rendered to a joint programme, but various DPs use

Country	Name and feature	Comments
programme with different modalities	grants to all tiers of LGs is a core component. Nearly all the DPs in Nepal are supporting the LGCDP, and a JFA has been signed to regulate the support from the DPs, which have decided to provide direct Budget Support. The support is complemented by a basket fund arrangement for effective capacity development support and other systemic reforms.	different modalities. A group of 5-6 DPs will use budget support modalities (sector earmarked) as the preferred support modality. Some 2-3 partners will finance a basket of capacity building support and finally some few DPs will continue with specific project but within the coordination arrangements and work-plans of the larger program (activity plan).
Bhutan – Joint Funding of the LGSP	Support to topping up of the governments annual capital block grant system, with related CB support in areas such as planning, budgeting, procurement and other PFM areas as well as good governance.	The support is based on joint funding modalities, joint reviews and regular meetings between DPs and the Government under a joint steering committee for the programming support.
Bangladesh Joint funding of a core programme with main components of grants to LGs	Support to the Local Government Support programme (LGSP) with performance-based grants to union parishads. A number of DPs (World Bank, SDC, UNCDF, UNDP, EU and Danida) are supporting the various components of the programme, which encompasses funds for investments, capacity building and system support. The grant system will gradually be rolled out to the entire country.	The support to fiscal decentralisation (mostly focusing on grants to LGs) is using a two tracks-model, with deepened and testing of sophisticated grant modalities in some parts of the country (six districts) in parallel with the general roll-out of a new simple, but performance-based grant system to all union parishads countrywide.

Although stronger alignment and harmonisation of support to fiscal decentralisation and a move towards sector budget support (and for some DPs general budget support) is the declared strategy for many DPs, there are numerous bottlenecks for this to happen. A set of "*General Guiding Principles for Enhancing Alignment and Harmonisation of Local Governance and Decentralisation*" was adopted by 28 development partners, including Danida, on November 2008. The declaration contains a number of measures such as joint reviews, division of tasks, coordination, and other working procedures to boost the future alignment and harmonisation. With the areas of FD, support to PFM, and support to establishment robust IGFTS with strong incentives for LGs to improve performance and capacity are important measures to overcome some of the distrust in common support to existing systems and procedures. Particularly the performance-based grant systems described in Annex 4 have shown a great potential to pave the way for budget support and alignments, as it reduces the risks and strengthen the capacity of LGs to respond to the accountability requests.

The support from DPs has generally been less successful in areas such as improvements in LG own source revenues due to lack of top level political commitments and linkages to the grant systems. Joint support to strategies which properly links the components outlined above- expenditure and revenue assignments, fiscal transfers, PFM and capacity development are rather unique, but the few examples provide important lessons for the future initiatives and for other countries. Please refer to the overall Good Governance Paper for further discussions of the issues on coordination.

Joint Financing Agreements

The Joint Financing Agreements (JFA) have been an increasingly important instrument to ensure better harmonisation and alignment of the support to fiscal decentralisation with government systems and to establish common framework for support, flow of funds, accountability and monitoring (reporting, auditing, follow-up, reviews etc.). The JFAs are often quite different in content and scope ranging from the **Ghanaian** Letter of Intent, which mostly focuses on the support to a new performance-based development grant system – the District Development Facility -, and where it is clearly envisaged that other types of support modalities (e.g. capacity building support to core ministries) will be organised outside of this agreement, to the support from the JFA DP partners in **Uganda**, that covers in principle all activities under the local government sector investment plan (LGSIP which goes from 2006-16). However, in Uganda there are a number of development partners outside of the JFA basket, which support the same investment plan using other modalities (often the project mode). In **Nepal** there will be three main types of support – the support from the development partners, supporting sector budget support, e.g. ADB, Danida, Norad (recently SDC has joined) and in the future also DFID and CIDA, supporting specific budget lines in the Government's budget framework, and with complimentary support from some of the same DPs outside of the JFA (this covers support to a basket funding of technical assistance to the host Ministry – Ministry of Local Development (support organised by UNCDF) and to non-grant activities, such as e.g. revenue enhancement activities (funded by GTZ). As in the case of Uganda there is an overall plan to be supported (although in the case of Nepal not a formal *strategy*, but a comprehensive local government/community development *programme*). As in Ghana and Uganda, a number of other DPs (e.g. GTZ and JICA) support specific components of this programme using other more project-mode modalities.

The lessons learned from these JFAs, where Danida is involved, have been that various support modalities may be complimentary, and that it is easier to mainstream support to intergovernmental fiscal transfers, than technical assistance. The latter is often constrained by lack of strong government procurement systems[79], issues on priorities, and other bottlenecks in the Government systems. The design of JFA will

[79] Parts of the programme in Bangladesh has nearly broken down due to problems and delays with government procurement.

typically reflect the maturity of the entire system of decentralisation in a country, the capacity of the host institutions (e.g. in areas such as financial management/procurement) but may also be somehow influenced by the aid modalities of the leading DPs within decentralisation in each country.

11. Lessons Learned and Concluding Comments

The lessons learned from the reforms of systems and procedures in fiscal decentralisation have proved the importance of:

- Developing a robust (fiscal) decentralisation strategy to support the course of the work and a proper sequencing of the work, i.e. work on the expenditure assignments prior to the revenues, work on simple accounts prior to work on performance-based output budgeting, getting input under control prior to outputs, etc.
- Having a clearly defined assignment of expenditure assignments applying recognized criteria based on the principles of subsidiarity, going through the criteria outlined in Annex 1;
- Ensuring that the intergovernmental fiscal funding system is well adjusted to the type of functions that the LGs are supposed to perform;
- Ensuring some level of LG autonomy on the revenue side (possibilities for LGs to influence the level of own source revenue yield) to ensure accountability, ownership, efficiency and longer –term sustainability;
- Addressing LG borrowing in a cautious and step-wise manner, with a strong legal framework, and risk mitigating measures, keeping up good incentives for LGs for fiscal discipline;
- Ensuring that LGs are faced with what is defined as "hard budget constraints", i.e. they do not expect "bail out" from central government, extra grants, deficit funding every time they have mismanaged the local finances, and they feel that they are accountable for the efficient use of funds, and revenue raising;
- Avoiding unnecessary central government interference in local priorities and decision-making, however, with overall oversight and supervision of adherence with legal framework;
- Clear, transparent, equitable, timely, and predictable fiscal transfer system. Supporting design and implementation of new innovative intergovernmental fiscal transfer systems linking the investment funding with capacity development support and strong incentives for LGs to improve performance and capacity – the new performance-based grant systems -have shown encouraging results;
- Focusing on continuously to improve on the LG PFM, which should be linked to the level of autonomy – i.e. more autonomous systems of LG finance, requires other systems of PFM than highly centralised systems;
- Acknowledging that support to accountability should focus on both the supply side (e.g.) request to publish funding of transfers, improving the predictability of transfers, etc. and demand side, support to citizens awareness, possibilities to be involved in planning, budgeting, project implementation etc. A number of tools have been developed, and good initiatives are available in many countries, but there is a great scope for strengthening of this in most countries. The focus

on accountability should be both upwards (from LG to central government, downward from LGs to their constituencies /citizens and horizontal (internally in LG organisation/authority);

- Moving away from a piecemeal DP support approach to FD reforms, with lack of logical sequencing, and links between support components to a more comprehensive support to the entire FD strategy, and as a minimum with clear linkage between the initiatives from various development partners;
- Keeping the incentives of various stakeholders in mind in reforms, particularly in areas such as taxation and grant design;
- Having monitoring and supervision systems focused on moving away from ex ante control and prior interventions, to ex post reviews and accountability, managing for results;
- A strong system for coordination of the FD (as the case for the overall decentralisation reform process) with clear institutional defined responsibilities.