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FISCAL DECENTRALISATION AND SECTOR FUNDING PRINCIPLES AND PRACTICES

ANNEX 1

Principles of Expenditure Assignments

The views expressed in this paper are those of the author(s) and do not necessarily reflect the view or policies of the Ministry of Foreign Affairs of Denmark

Jesper Steffensen

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Principles of Expenditure Assignments[1]

Expenditure assignments is the first pillar in the framework of Fiscal Decentralisation (FD) and the basic place to start focusing on any reform in the entire system of local government.

Assignment and Clarity in Expenditure Assignments

There is no universal single best assignment of expenditure responsibilities amongst different government levels, but choices will have to be made in each country based on a number of factors such as economic, historical, political and structural features.

However, a clear **delineation of service delivery responsibilities** for each tier of government is of critical importance for efficiency and accountability (and identification of the duty bearer) of the future decentralized system in any country. Problems in the assignments of expenditures may lead to:

- Lack of accountability as it is hard to judge the responsible agent and place a clear responsibility;[2]
- Sub-optimal provision, duplication of efforts and poor quality of services;
- Conflicts between the tiers of governments;
- Dissatisfied citizens, lack of trust and conflicts;
- Difficulties in defining the funding required for each tier of government, as the expenditure needs are becoming blurred;
- And ultimately hesitation and resistance to continue and deepen the decentralisation process.

Discussions on the assignment of expenditures should be closely linked to the discussions on the future funding system and the revenue assignments, which will depend on the type of local government expenditures (among other determinants).

In brief the reasons to give high priorities to the clarification and delineation of expenditure assignments are to ensure that:

- There is a clear line of accountability (everybody knows who is responsible and it is possible to follow-up and monitor the service delivery), and less overlaps and duplication of authority;
- There is a clear link between tasks and financing hereof; decentralisation of tasks is followed by commensurate revenue assignments. Costing of functions is only possible when there is certain clarity on the scope;[3]
- The tasks are carried out at an appropriate level and by units with the sufficient capacity (see below) and as close to the citizens (the beneficiaries) as possible, applying the so-called "*subsidiarity principle*", which entails that government functions

[1] Functional assignment and expenditure assignments are used interchangeably in this document, although it is recognized that functional assignments may include activities, which do not have any cost implications, such as regulatory framework, guidance etc. See G. Ferazzi, GTZ, 2009 for a detailed discussion of the various concepts.

[2] Based on numerous country studies, UNCDF has concluded that lack of clear expenditure assignments is one of the major constraints in the development of efficient decentralized systems, leading to conflicts, overlapping functions, duplication of efforts and systems that undermine accountability, cf.: UNCDF: "Taking Risks" – P. 178 by Roger Shotton, 1999.

[3] It is often rightly said, that government must settle on the assignment of the expenditure responsibilities to local governments at least an assignment that will hold for the near future, before it can choose and efficient mix of taxing and decided on the assignment of other revenue sources, cf. e.g. Roy Bahl, "*Implementation Rules for Decentralization*", 1999.

should be assigned to the lowest possible level of government that is capable of efficiently undertaking this function[4].

Without a clear delineation of tasks and responsibilities it is impossible to estimate the required funding needs and to ensure a balanced system of LG finance, including identification of the appropriate funding sources – e.g. taxes, user fees and grants. Hence a certain clarification of the tasks is an important prerequisite for a detailed grant design – both in terms of the vertical and horizontal distribution of funds.

Finally, a clear statement of expenditure assignments (responsibilities) is important to reduce unproductive overlap, duplications and contradictions in the legal and regulatory framework.

A clarification of the expenditure assignments does not mean that various tiers of governments cannot work together on provision of various services, e.g. contribute in common to various investments, and e.g. share the costs of a larger road construction. However, the responsible agent should be clearly defined and made clear for every key player and for the constituencies from the onset of the reform process. The same goes for the operational and maintenance costs implications of any investments. The clarification of expenditure responsibilities does not mean that all tasks in the legal framework needs to be mandatory – the legal framework in many countries, e.g. Cambodia, Denmark, Argentina, Brazil[5] allow LGs to have general competence, often mixed by some described mandatory functions. However, it is often useful to distinguish between mandatory and voluntary/optional LG tasks.

Factors to be considered in the actual choice of expenditure assignments

The figure below outlines some of the key factors, which should be considered in the actual delineation of expenditure assignments.

A clarification of expenditure assignments may seem to be a simple task, but it requires in fact a thorough, and often demanding, review of the following issues:

- The responsibilities for organisation (provision) of the services - who is in overall charge of the particular service?
- The administrative and planning responsibilities, e.g. who is in charge of planning, budgeting and accounting?
- The responsibilities for the actual production of services; (e.g. private sector, NGOs, public production etc. dealing with a move from input to output in an chain of production) – who is in charge of the actual production of e.g. a school building?
- The responsibilities for the monitoring and supervision of the service provision;
- Consideration and clarification of the responsibilities for capital and recurrent expenditure assignments as well as salary and non-salary components and the inter-linkages between these components;
- The extent to which the LGs have autonomy in the priority setting – concerning the determination of the quantity and quality of the services. A pertinent issue here is how to pursue an appropriate balance between adherence to national service delivery targets, e.g. pupil/teacher ratios in the field of education, and local autonomy to adjust the services to local preferences to reap the benefits of decentralisation, including allocation efficiency?

[4] This principle is also been applied in the EU, in the relationship between member states and the Commission.
[5] See Shah, Anwer (ed) 2006.

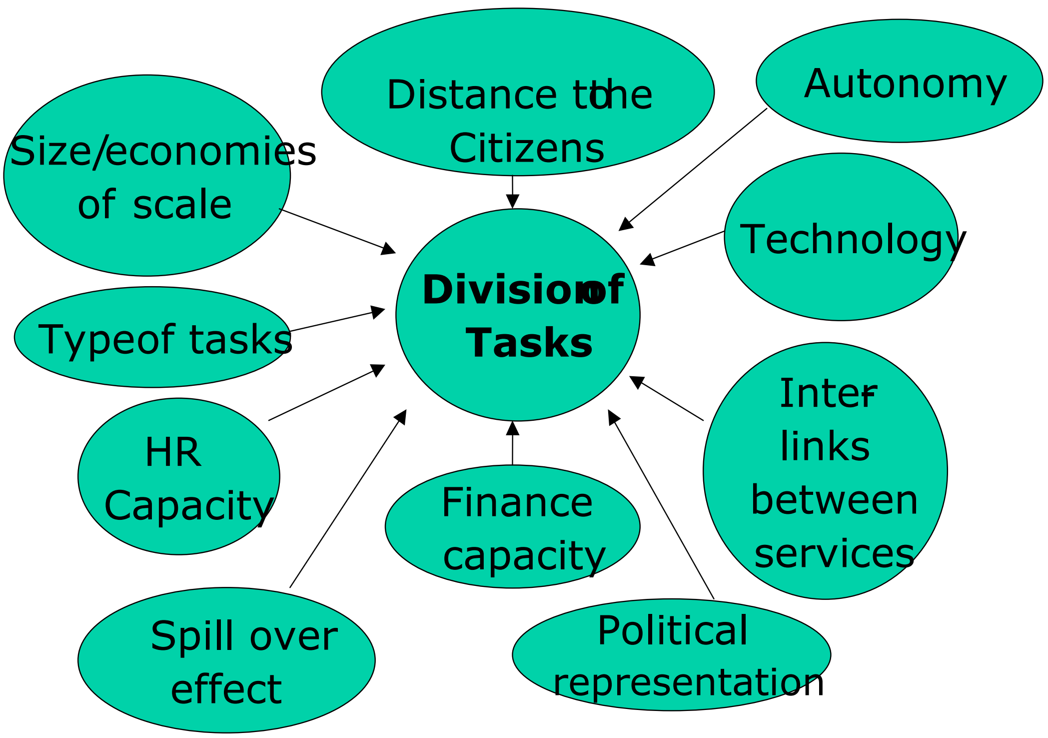
- Standard setting and policy making versus – service provision (in terms of the responsibilities for the services and organisation of the tasks);
- Financing of the services – who is responsible and for which components?

In the discussions of the division of tasks and responsibilities across tiers of governance it is generally accepted that the assignment should be based on the principle of **subsidiarity**, i.e. the tasks should be transferred to the lowest possible level, closest to the people, consistent with allocative efficiency, and provided that this level has the sufficient capacity to perform the task in a professional manner[6].

In the decision about assignment of tasks and responsibilities each of the following factors outlined below should be considered [7]. It is important to mention that in practice these are not used in a mechanized manner and with various weights from country to country. Often trade offs and compromises are necessary with close involvement and dialogue amongst the involved stakeholders.

[6] E.g. UNCDF: "*Primer on Fiscal Decentralization*", p.3, November 2005.
[7] Based on previous work in several countries, e.g. Nepal, Cambodia, East Timor and Ghana.

The Assignment of Functions



For instance a transfer of all tasks to the lowest tier of government will contradict the wish to deliver efficient services with sufficient **economies of scale**. On the other hand centralising services may lead to lack of interaction between the citizens and the government authorities, lack of **accountability** and long distances to the service outlets, and lack of adjustment to local priorities. It should be noted that good technology, e.g. computerised systems or equipment, makes it easier to decentralise more tasks to the local levels.

Furthermore, it is generally proved that task should be transferred to a geographical area, which *internalises* the costs and benefits, e.g. if some tasks require a larger number of inhabitants and have impact on a larger territory like hospitals and major roads, these tasks should not be assigned to the lowest level of government. Hence, the size of the benefit area (sometimes called "catchment area") matters.

In the decision about the division of tasks, it should also be kept in mind that some tasks are highly interrelated (should be grouped/bundled), e.g. water supply and sanitation, urban roads and refuse disposal, and sometimes need to be carried out by the same tier of government. Allocation of some tasks is also necessary for local cross-sectoral and sub-sectoral priorities.

It is also generally accepted that certain public services related to overall **macro-economy stability** and national scope, such as security, should be kept at the central level. Although LG can have an important role in social affairs and poverty alleviation, it is also generally recognized that there are limits to which LGs can and should be involved in certain types of **re-distribution functions**, due to possible spill-over and risks of increased inequality. However, this does not preclude that LGs can be involved in various functions such as social safety-net programmes etc. like in the Scandinavian countries, but it requires substantive regulations and standards issued from the centre. Public service delivery of local nature is the prime function of LGs in most countries.

It is important to seek clarity in the policy on the following main issues:

- What are the present key service responsibilities for each tier of governance: central government, divided in the above-mentioned types of responsibilities?
- Are any major changes in this division of tasks anticipated over the coming 5-10 years? Why? And what are the prerequisites for such changes?
- Should the division of tasks and responsibilities be the same in the urban and rural areas and/or smaller and larger LGs – is it possible to imagine an asymmetric process of decentralisation where some move faster than others[8]? What should be the differences? What kind of incentives will this impose on the main agents?

[8] Although this approach has its advantages, OECD has recently argued that it causes a number of problems in areas such as designing appropriate grant equalization systems and that it undermine inter-regional solidarity, OECD: "*Fiscal Equalisation*" in OECD Countries, Working Paper No. 4, COM/CTPA/ECO/GOV/WP (2007/4), 2007.

- Should the division of tasks be aligned with the capacity and performance of the authorities – e.g. a flexible system with decentralisation of more tasks to the larger and more capable units and less to the smaller ones?
- How to ensure sufficient cross-sectoral cooperation in the service provision?
- Level of autonomy in service provision – how to pursue an appropriate balance between adherence to national targets, e.g. pupil/teacher ratios in education, and local autonomy to adjust the services to local preferences?
- How to ensure proper links between the service "provision" (authorities in charge of the provision and responsible e.g. for supervision, control and monitoring) and service "production" (authorities in charge of the actual implementation) – e.g. a local governance tier may be responsible for the organisation of primary schools, but the actual service production may be carried out by user committees, parents organisations, private schools etc. How should this be organised for the key sectors?
- The relationship between the *mandated* obligatory functions versus *permissive* (voluntary) functions – determination of this is also important for the overall funding system;
- Agency functions (where the local authority perform the services on behalf of the central authority, as agents) versus devolved functions, which are under the responsibility of the local authority and where this authority has a certain level of autonomy on the planning and priorities – again decision on this has direct implication on the optimal composition of revenue sources;
- In cases where certain functions are shared (and even co-funded), e.g. with the health sector, a clear arrangement for information sharing and coordination should be put in place;
- Laws and regulations, followed-up by guidance, training and information sharing, should be clear and sufficient to avoid confusion;
- Finally a clear system for communication to the citizens about responsible agents, service targets and actual service delivery performance against these targets needs to be established.

Further reading

Broadway, Robin and Shah, Anwar: "*Fiscal Federalism: Principles and practices of multiorder governance",* Cambridge University Press, 2009 (Broadway and Shah, 2009)

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