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Fiscal Decentralisation

In order for local governments to be able to embrace the potential of decentralisation in terms of poverty reduction, enhanced participation and improved local service delivery, they have to be adequately resourced. Fiscal decentralisation therefore involves important decisions about the assignment of central and local responsibilities as well as how these expenditure responsibilities should be financed. It is not solely about the transference of financial resources from one layer of government to another, it is also about the extent to which local authorities are able to make decisions themselves over the management and use of devolved resources and local revenues, and about how they account for those resources.

Guidance on fiscal decentralisation

The following documents are good introductions to the issues of fiscal decentralisation in developing countries:

UNDP, 2005, 'Fiscal Decentralisation and Poverty Reduction', UNDP Primer, UNDP, New York
How can fiscal decentralisation contribute towards reducing poverty and achieving the Millennium Development Goals (MDGs)? This primer from the United Nations Development Programme (UNDP) outlines the main principles of fiscal decentralisation and examines the links between fiscal decentralisation and poverty reduction. It argues that a well crafted set of intergovernmental fiscal relations are vital for ensuring that decentralisation can contribute to poverty reduction.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=3359

Tanzi, V. 2001, 'Pitfalls on the Road to Fiscal Decentralization', Economic Reform Project Working Paper no. 19, Carnegie Endowment for International Peace
In recent years pressures for greater fiscal decentralisation have increased in many countries. Is decentralisation really the right route to take? Are there alternatives which can better address the same objectives? This paper from the Carnegie Endowment for International Peace considers issues around fiscal decentralisation, including potential drawbacks and possible alternatives.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=425

This Commonwealth Secretariat book contains chapters on many elements of fiscal decentralisation and good public financial management at the local level:

Devas, N., Alam, M. et al., 2008, *Financing Local Government*, Commonwealth Secretariat Local Government Reform Series, Commonwealth Secretariat, London. http://publications.thecommonwealth.org/financing-local-government-472-p.aspx

Expenditure and revenue assignment

The first consideration in fiscal decentralisation is the clear assignment of functions and responsibilities among different levels of government. There is no 'best' method for assigning expenditure responsibilities as design will be influenced by historical and political contextual factors. However, a commonly used principle is the 'subsidiarity principle' (see chapter on Designing and Strengthening Local Government) which states that government functions should be assigned to the lowest level of government that is capable of efficiently undertaking this function.

It is generally thought that functions best retained by central government are the provision of nation-wide services, for example defence, and initiatives aimed at income redistribution. Functions best allocated to local government include those with regional or local benefits e.g. hospitals, primary education, local roads, markets, water supply and sanitation.

In several developing countries contradicting or missing legislation has led to overlapping of responsibilities, which reduces service efficiency. Having clear, unambiguous expenditure assignment between central and local levels sets a vital foundation for other important aspects of fiscal decentralisation, such as revenue assignments and intergovernmental transfers.

McLure, C. and Martinez-Vazquez, J., n.d. 'The Assignment of Revenues and Expenditures in Intergovernmental Fiscal Relations', World Bank Institute, Washington DC

How should responsibility for expenditure be assigned among different levels of government? Which revenue sources should be assigned to subnational government? This paper from the World Bank Institute examines the principles and difficulties of expenditure and tax assignment. It argues that fiscal decentralisation requires a clear assignment of functional responsibilities among different levels of government, together with sufficient budgetary autonomy for subnational governments.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=3382

Local revenue administration

Local governments in developing countries often lack the capacity to efficiently collect and manage revenues. In addition, incomplete information on the tax base, poor compliance and weak enforcement mean that the level of local taxes collected is generally low. Local revenue administration in developing countries therefore needs support, including in the areas of information collection for assessment purposes, data inputting infrastructure and integrated financial management systems. Attention must also be paid to strengthening compliance via public information and public relations campaigns aimed at consensus building and creating incentives for paying taxes, not just punishments for non-compliance.

Odd-Helge Fjeldstad, 2004, 'To Pay or Not to Pay? Citizens' Views on Taxation in Local Authorities in Tanzania', Working paper no. 8, Chr. Michelsen Institute, Norway
Can tax compliance be established in poor countries without an extensive and costly enforcement apparatus? This research in Tanzania by the Chr. Michelsen Institute suggests that this question is important because governments, seeking power on the basis of popular consent, face restrictions in their use of coercion in tax collection. The study concludes that the challenge for local government taxation in Tanzania is to raise domestic revenues from consenting citizens.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=1026

Kelly, R. et al, 2001, 'Improving Revenue Mobilisation in Malawi: Study on Business Licensing and Property Rates,' Final report to the Government of Malawi, UNDP and UNCDF, Lilongwe, Malawi
How can the Malawian Government develop a strategy to improve the ability of local assemblies to mobilise locally generated revenues such as property rates and business licences? This research from Duke University covers issues related to the tax base, valuation, classification, tax rates, assessment and billing, collection, enforcement and taxpayer service. It concludes that the revenue base information is incomplete, collections are low and enforcement is virtually non-existent. Policy needs to be fine-tuned. However, the primary obstacle to successful local revenue mobilisation is weak administration.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=3322

Local revenue sources

Local governments often struggle to collect adequate levels of revenue from local taxation. The most common forms of local taxation in developing countries are property tax and business or service taxes, which come in many different forms. Charges on services such as water provision, markets and waste management are also important sources of local revenue.

The following resources offer practical advice on how to maximise local revenue collection and how to design appropriate and efficient taxation systems.

Blore, I., Devas, N. and Slater, R., 2004, 'Enhancing Tax Revenues', Chapter 4 in *Municipalities and Finance: A Sourcebook for Capacity Building*, Earthscan, UK
How can municipalities enhance tax revenues? What scope is there for propoor reform of local taxation? This chapter from *Municipalities and Finance: A Sourcebook for Capacity Building* uses case studies to address these questions by focusing on property tax and business or service taxes. It is advisable to concentrate on a few innovations at a time within a strategic plan. This requires: continuity in staff capacity; an appreciation of the best political sequencing of reforms; and an economic model that is acceptable to the taxpaying public. The best way of making municipal public finance pro-poor may be to ensure that local taxes do not impinge unnecessarily on the poor, while using tax revenues to extend access to essential services.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=3378

Blore, I., Devas, N. and Slater, R., 2004, 'Exploiting Charges', Chapter 5 in *Municipalities and Finance: A Sourcebook for Capacity Building*, Earthscan, UK
How can local governments implement user charges for services that do not exclude or overburden the poor? This chapter from *Municipalities and Finance: A Sourcebook for Capacity Building* suggests that charging need not impact disproportionately on the poor. Charges can accommodate fluctuating incomes through billing criteria such as prepayment meters and phased payments. It may be helpful to view the poor as good repeat customers who have periodic problems of service purchase. Corruption should be addressed through processes such as organisational culture change which supports selfpolicing and peer pressure. Local government associations could request more liberal charge regulations and policies from central governments.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=3379

Bahl, R., Smoke, P. and Solomon, D., 2003, 'Overview of the Local Government Revenue System' in eds. Bahl, R. and Smoke, P., *Restructuring Local Government Finance in Developing Countries: Lessons from South Africa*, Edward Elgar Publishing, UK
How effective is the local government revenue system in South Africa? Research from Georgia State University finds that local governments have access to tax bases that are productive, and urban councils finance a significant share of their budgets from their own resources. However, rural councils lack resources and are more dependent on intergovernmental transfers. Reforms to existing sources of revenue and the

adoption of new ones should be based on decisions made about the assignment of powers and functions and about the government's goals for fiscal decentralisation.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=3339

Intergovernmental fiscal transfers

There is no simple, universal pattern for successful intergovernmental fiscal transfers (IFTs). Transfers are needed where it has been decided that a local government should be responsible for the provision of a service for which it does not have adequate fiscal capacity. 'Vertical fiscal imbalance' is the shortfall between the expenditure functions assigned to a local government and the revenue-raising authority given to them. This problem is amplified where there is a multi-tier structure of subnational government. 'Horizontal fiscal imbalance' arises from differences between the financial capacity of a local government and the demand for public services within their jurisdiction, for example a subnational government in a poor area will be able to raise less revenue from taxes and user charges but faces a similar, or possibly greater, requirement for service provision than a richer municipality. These financial gaps are filled by IFTs. Transfers can be used as a method of 'equalising', or making up for the disparity between the revenue raising abilities of wealthier regions in comparison to poorer ones. A good transfer system must be designed so that it is transparent, not prone to political manipulation, easily understandable, equitable, predictable and delivers resources in a timely manner.

Many local governments in developing countries are highly dependent on IFTs – although statistics vary, many receive more than 80 per cent of their finance in this way. Some researchers have criticised IFTs for undermining accountability relations between local government and their citizens and for causing service inefficiencies due to soft budget constraints. However, a lack of suitable local revenue sources, particularly in poorer, and rural areas, means dependence on transfers is essential. The design and implementation of transfers so that they provide the right incentives to local governments is therefore critical. A number of countries have adopted semi-independent local government finance commissions to advise on the design of IFTs.

Bird, R. and Smart, M., 2001, 'Intergovernmental Fiscal Transfers: Some Lessons from International Experience: Lessons learned on Intergovernmental Fiscal Transfers', paper prepared for Symposium on Intergovernmental Transfers in Asian Countries: Issues and Practices, February, Tokyo
What can be learned from international experience of intergovernmental fiscal transfers? Research from the University of Toronto suggests that the most critical aspect of intergovernmental transfers is their effect on policy objectives. The incentives that transfer systems create for central and local governments determine whether the results of transfers will be good or bad.

Those receiving transfers need a clear mandate, adequate resources and sufficient flexibility to make decisions. They must be held accountable for results. Transfers have to be properly designed to satisfy these conditions.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=3309

Sen, T.K. and Trebesch, C., 2004, 'The Use of Socio-Economic Criteria for Intergovernmental Transfers: The Case of India', Working Paper no. 10, National Institute of Public Finance and Policy (NIPFP), New Delhi
How does the intergovernmental transfer system operate in India? How appropriate are the various socio-economic criteria? What features are desirable for the Indian transfer system? This paper by the National Institute of Public Finance and Policy, New Delhi, examines the transfer system in India from the perspective of the Finance Commission. It finds that an overarching consideration is that of incentives built into the system: the safest being one that bases transfers on variables completely outside the control of recipient governments.
Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=1147

The following two donor reports are very in-depth studies of the theory and operational practice of IFTs, including case study material.

- Eds. Boadway, R. and Shah, A., 2007, 'Intergovernmental Fiscal Transfers: Principles and Practice', Public Sector Governance and Accountability Series, World Bank, Washington D.C
  http://siteresources.worldbank.org/PSGLP/Resources/IntergovernmentalFiscalTransfers.pdf

- Eds. Smoke, P. and Kim, Y., n.d., 'Intergovernmental Fiscal Transfers in Asia: Current Practice and Challenges for the Future', Asian Development Bank
  http://www.adb.org/Documents/Books/Intergovernmental_Fiscal_Transfers/default.asp

Subnational borrowing

As decentralisation is advancing in many developing countries, the issue of local government borrowing is gaining importance. In a number of countries, subnational governments have growing opportunities to borrow from financial institutions or international donors. However, this is constrained by the limited sources of local revenue available to local governments to facilitate loan repayment. Inadequate regulation and control of subnational borrowing is also an issue of concern, and in some countries, most notably in Latin America, excessive borrowing by local government has been damaging to macroeconomic stability.

Plekhanov, A. and Singh, R., 2007, 'How Should Subnational Government Borrowing Be Regulated? Some Cross-Country Empirical Evidence', IMF Staff Papers, vol. 53, no. 3, International Monetary Fund

How effective are borrowing constraints on fiscal balances? This paper, published by the International Monetary Fund, analyses panel data in order to assess the most effective borrowing constraints for containing local fiscal deficits. It concludes that no single institutional arrangement is superior under all circumstances. Institutional characteristics, particularly the degree of vertical fiscal imbalance, the existence of any bailout precedent, and the quality of fiscal reporting will affect the suitability of certain arrangements.

Full summary available in alphabetical appendix or online at:
http://www.gsdrc.org/go/display&type=Document&id=3336

Case studies

- Iversen, V. et al, 2006, 'Private Tax Collection – Remnant of the Past or a Way Forward? Evidence from Rural Uganda', *Public Administration and Development*, vol. 26 no. 4 September pp. 317–328:
  http://www.gsdrc.org/go/display&type=Document&id=2546
- Yemek, E., 2005, 'Understanding Fiscal Decentralisation in South Africa', Institute for Democracy in South Africa (IDASA), Pretoria
  http://www.gsdrc.org/go/display&type=Document&id=1496
- Majumdar, M. and Banerjee, I., 2004, 'Delegation to Devolution: West Bengal', MIDS Working Paper no. 185, Madras Insititute of Development Studies, Chennai
  http://www.gsdrc.org/go/display&type=Document&id=1239

Other resources

- World Bank course on Fiscal Decentralization and Local Governments, held in New Delhi, December 2002:
  http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/EXTSAREGTOPPRISECDEV/EXTSAREGTOPDECENTRALIZATION/0,,contentMDK:20259862~pagePK:34004173~piPK:34003707~theSitePK:496900,00.html