FISCAL DECENTRALIZATION, LOCAL PUBLIC SECTOR FINANCE, AND INTERGOVERNMENTAL FISCAL RELATIONS: A PRIMER ON MULTILEVEL GOVERNMENT FINANCE

FISCAL DECENTRALIZATION, LOCAL PUBLIC SECTOR FINANCE, AND INTERGOVERNMENTAL FISCAL RELATIONS:

A PRIMER ON MULTILEVEL GOVERNMENT FINANCE

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Preface

The role that fiscal decentralization plays in public sector finance and public sector management around the world is evolving rapidly.

Fiscal decentralization, as part of broader decentralization reforms, has traditionally been pursued in the context of governance reforms to increase political competition and to bring the public sector closer to the people. In recent years, however, greater recognition has been given to the fact that key public services and investments, including in education, health, water and sanitation services, basic urban services, climate adaptation, and local economic development, all take place at the local level. As such, fiscal decentralization and intergovernmental finance—ensuring adequate level of financial resources for frontline services—are increasingly understood not just as part of public sector governance reforms, but rather, as a means to achieving inclusive and efficient service delivery at the local level as part of a multilevel public sector.

This paradigm shift has been accompanied by progress in the understanding of the global decentralization community of practice. While the study of fiscal decentralization has traditionally been the remit of public finance economists, the question of how best to fund the localized delivery of public services and sustainable development interventions is a matter of considerable interest to public financial management (PFM) experts and sector specialists, as well as to practioners from a large number of other disciplines represented among policy makers and development practitioners.

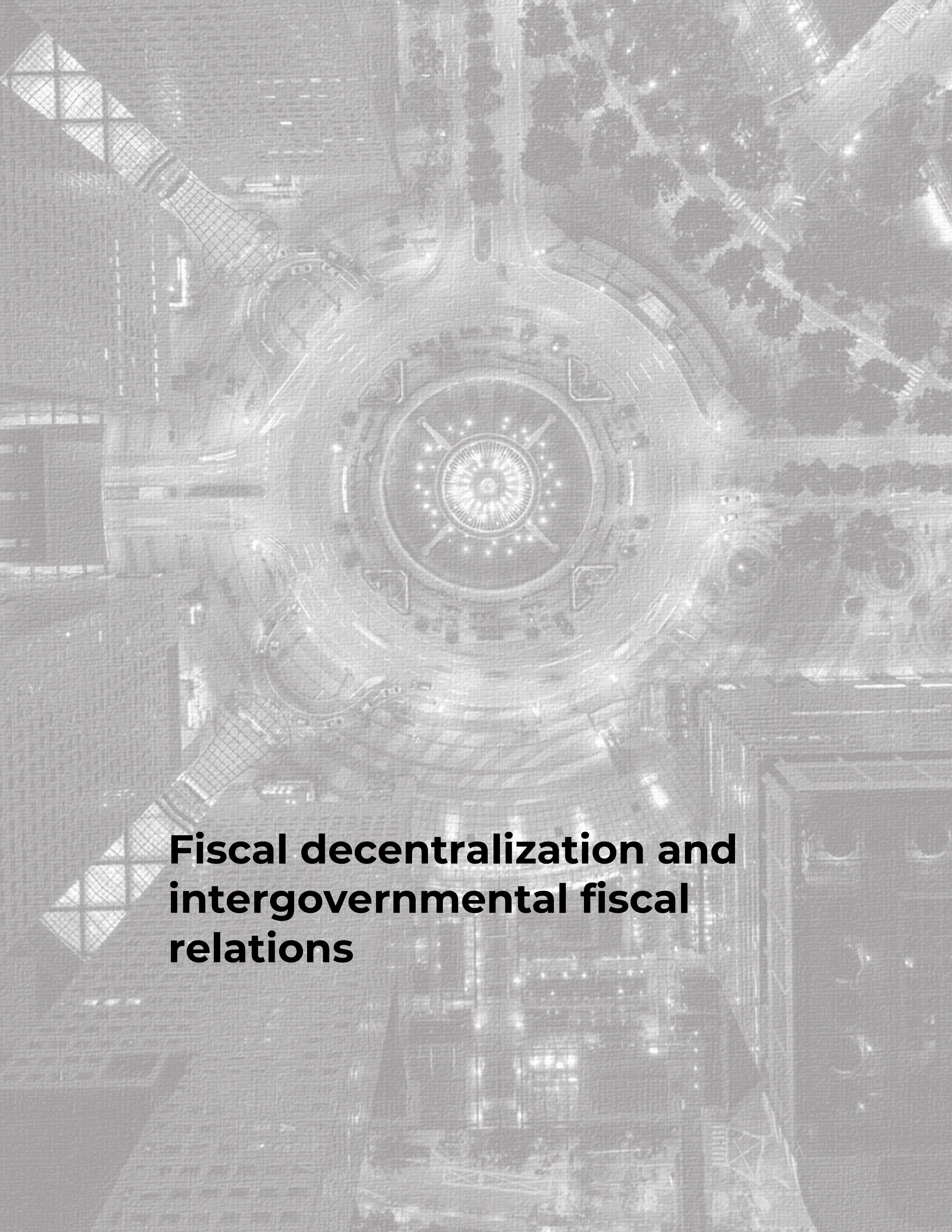
This note is one of a series to bring together the latest thinking on multilevel governance and intergovernmental finance. It is recommended to read this note together with *Decentralization, Multilevel Governance and Intergovernmental Relations: A Primer* (2022). These notes complement each other in providing a full picture of multilevel governance and intergovernmental fiscal architecture.

The objective of this primer on fiscal decentralization, local public sector finance, and intergovernmental fiscal relations is to:

- Present the conceptual foundations of fiscally decentralized systems and establish a common vocabulary by identifying the basic elements of fiscal decentralization and intergovernmental fiscal systems—the so-called "four pillars of fiscal decentralization."
- Provide foundational knowledge to policy makers, policy analysts, and other stakeholders to enable them to systematically identify the technical and political economy strengths and weaknesses of an intergovernmental fiscal situation.

- Provide guidance on how to assess the institutional, physical, and organizational capacities at different levels of government.
- Identify the options and instruments available to policy makers and development partners to engage in strengthening intergovernmental finance systems.
- Signal where to find additional knowledge and resources on for further learning.

Improving public service delivery in a multilevel public sector requires bringing together a diverse set of stakeholders from across different parts of a government. As such, a solid understanding of fiscal decentralization and multilevel government finance is not only required for specialists who work on (fiscal) decentralization reforms, but also a wide range of stakeholders who want to achieve localized development impact in their respective sector or thematic area. With this in mind, this primer is written to inform the perspectives of policy makers, policy analysts, government officials, sector experts, as well as civil society actors involved in multilevel public sector reforms worldwide.



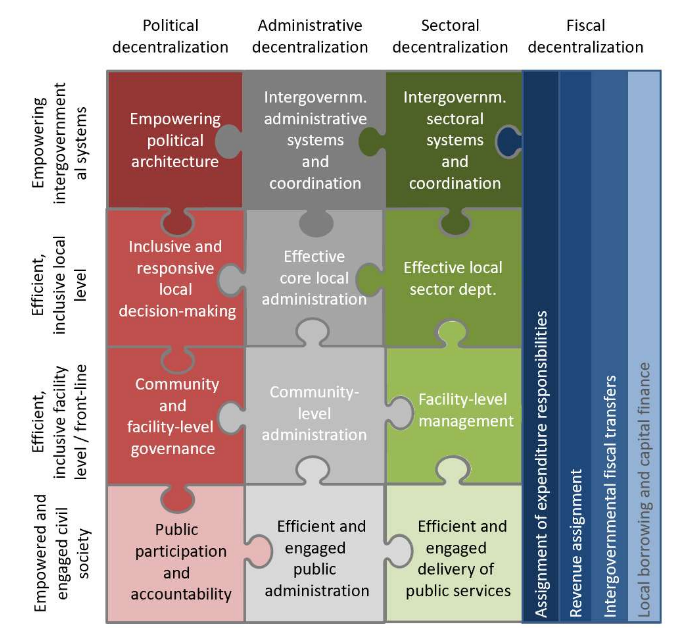
Fiscal decentralization and intergovernmental fiscal relations

1. Fiscal decentralization and intergovernmental (fiscal) relations

An effective multilevel public sector requires public stakeholders at different levels of government to work effectively—and work together effectively—in order to ensure that public spending is transformed into resilient, inclusive, sustainable, efficient and equitable public sector programs and results. A big picture look at decentralization requires consideration of the main dimensions of decentralization, including political, administrative and fiscal dimensions. When the focus is on a specific sector, it may further be appropriate to consider sector-specific issues as separate from other aspects of public administration.

Establishing effective multilevel governance systems requires action and coordination across different levels of government. It also requires an empowering intergovernmental architecture and systems at the central government level; efficient, inclusive and responsive local governments and/or other institutions at the local level; an efficient and well-managed system of frontline service delivery facilities or providers; and an engaged civil society, citizenry, and local private sector.

Figure 1.1 Fiscal decentralization and a multilevel public sector



Source: Prepared by authors.

The resulting assessment framework for decentralization, intergovernmental relations, and the local public sector (Figure 1.1) is formed by a 4 X 4 matrix representing the dimensions and levels of an effective multilevel public sector. Figure 1.1 locates fiscal decentralization within this framework. The following sections of this primer will unpack four pillars of fiscal decentralization (the last column in the figure) and discuss how they relate to the constituent elements of a multilevel public sector.

1.1 The four pillars of fiscal decentralization

The theoretical argument for fiscal decentralization is formulated as: "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision." In a fiscally decentralized system, the policies of subnational branches of governments are permitted to differ in order to reflect the preferences of their residents. As such, designing a fiscally decentralized intergovernmental system requires focusing on four areas, which are referred to as “pillars”:

1. Expenditure assignment: the assignment of expenditure powers, functions, and service delivery responsibilities at the various levels of government.
2. Revenue assignment: the assignment of revenue powers and division of responsibilities across revenue administrations.
3. Intergovernmental fiscal transfers.
4. Local government borrowing, debt and capital finance rules, responsibility, and accountability.

Although these four pillars are a useful construct that help to discuss and explore the various dimensions of fiscal decentralization, they are closely related to each other in line with the concept that “finance should follow function.” This means that through the first pillar, understanding the assignment of powers, functions, and expenditure responsibilities within the public sector – the “expenditure assignment” – indicates the level of expenditure requirements or the “expenditure needs” of different administrative levels and different local or regional government units. However, public sector resources are scarce and need to be prioritized. As a result, actual expenditures at all government levels often fall short of the “needs” or desired level of expenditures. To a large extent, the level and composition of local expenditures is driven by the availability of resources to be examined through the remaining three pillars: local own source revenues (OSR); intergovernmental fiscal transfers (IGFT); and borrowing or other debt financing mechanisms (FIN).[1] As such, the relationship between the four pillars in a balanced budget environment may be captured by the following notation EXP = OSR + IGFT + FIN. The composition of funding sources is different in different countries and in different sectors. In general, decentralization of public policy making power involves transfer of legal and political authority for planning projects, making decisions, and management of public functions from the central government and its agencies to subnational governments. The

[1] This nomenclature is especially relevant for devolved local government entities. The concept of the four pillars is the equally relevant for other (non-devolved) local-level entities, such as deconcentrated local administration units or local service delivery providers, authorities or facilities. For non-devolved countries, the context and terminology for the four pillars would have to be adjusted slightly to apply to the specific institutional setting.

transfer of authority and responsibility over public functions from the central government to subordinate or quasi-independent government organizations covers a broad range of topics. There is also no prescribed set of rules governing the decentralization process that apply to all countries. Decentralization takes different forms in different countries, depending on the objectives driving the change in the structure of government. While distinguishing among different types of decentralization is useful for pointing out its many forms, it is important to highlight the interlinkages between the pillars of an intergovernmental fiscal system.

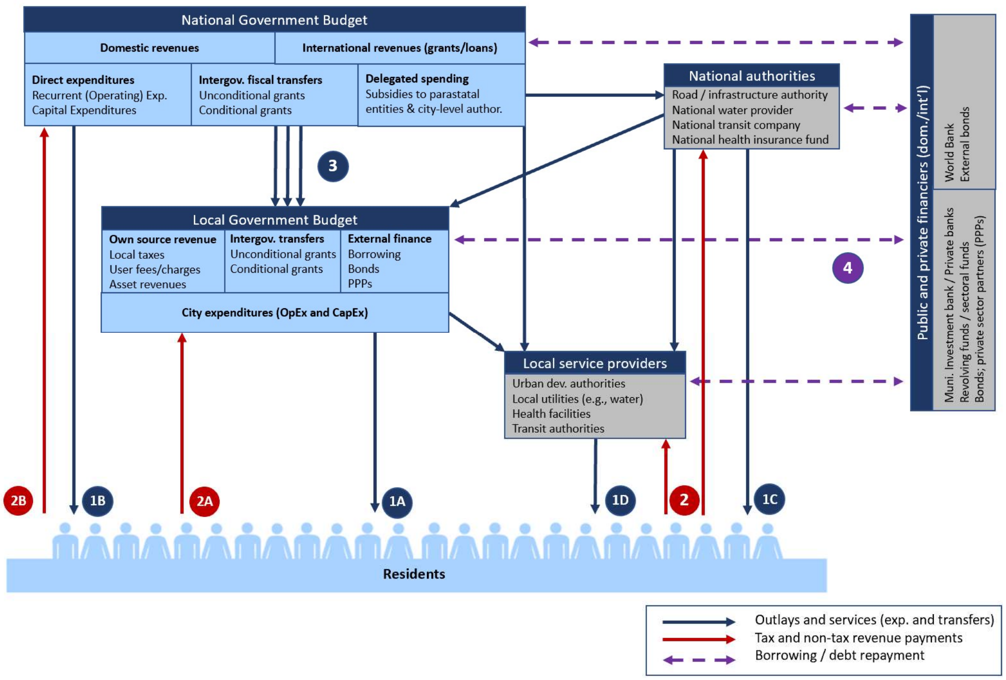
There is no easy answer to the question of how to design a decentralized system to promote transparency, accountability, and efficiency in public service delivery. This primer presents conceptual discussions on the design of an effective intergovernmental system, synthesizing academic and policy literatures as well as lessons learned from country applications. However, before the discussions on the pillars of fiscal decentralization, it is helpful to provide an overview of the complex service delivery and fund flow arrangements at the local level as they influence the design of intergovernmental system in every country.

1.2 An overview of intergovernmental finance and funding flows

The distinct challenge of intergovernmental finance is the large number of stakeholders and "nodes" in the system, which can make it much more complex to understand and track. A more detailed perspective on the interrelationship of the four pillars is provided in Figure 1.2, which presents a generic picture of the key institutional stakeholders in a multilevel public sector and highlights the typical funding flows among them.[2]

[2] This diagram shows a public sector with a national (central) government and one subnational (local) government level. By extension, one or more additional levels of subnational (regional and/or local) government may exist in a country.

Figure 1.2 An overview of intergovernmental finance and funding flows



Source: Prepared by authors.

First, the assignment of powers, functions, and expenditure responsibilities is an important factor in determining the relative size and composition of the expenditures of the national government, local governments, national parastatals, authorities, or agencies like a National Road Fund, and other local-level entities or authorities (such as local water utilities—indicated in the figure by Line # 1. Naturally, the ability of different stakeholders to fund their respective expenditure responsibilities is determined in the first instance by the assignment of revenue powers and the ability of government units at different government levels to effectively collect revenues from the sources assigned to them (Line # 2). In practice, however, and for good reasons, as further discussed below, the revenue-raising power assigned to local and/or regional governments often falls (far) short of the expenditure needs of subnational jurisdictions. As a result, intergovernmental fiscal transfers are provided to help fill the gap between local expenditure needs and local own source revenues (Line # 3). Additionally, subnational borrowing and capital finance can play a useful role, particularly in funding subnational infrastructure. In practice, however, borrowing and capital finance typically play a relatively small role in intergovernmental finance in most countries (Line # 4).

Traditionally, discussions of fiscal decentralization have tended to focus largely on devolved local government expenditures and revenues (Lines # 1A and 2A), along with intergovernmental fiscal transfers (Line # 3). Other mechanisms of decentralization and localization are increasingly understood to be important as frontline public services tend to be delivered through a combination of devolution, deconcentration, delegation and centralized provision – often concurrently in a complex and often messy mix of financing modalities. As such, Figure 1.2 explicitly takes these alternative mechanisms of decentralization and localization on board.

The first of these three alternative channels of decentralization and localization includes the direct and deconcentrated public expenditures by the central government in support of frontline services (Line # 1B). This category of localized expenditures includes a range of central government-led mechanisms to localize public interventions, such as vertical sector programs; deconcentrated service delivery; community-driven development programs; and direct cash transfer programs. These mechanisms all tend to involve direct delivery and funding of public services through on-budget central government expenditures, although these expenditures may have different implications for effective public sector management and effective public financial management (PFM) when compared to "regular" (headquarters-level) central government spending.[3]

A second mechanism for non-devolved decentralization and localization comprises spending on frontline services by parastatal entities, national authorities, national investment funds and similar entities (Line # 1C). The distinguishing feature of this category is that these entities tend to be off-budget at the central government level and outside the direct hierarchical control of the central government. Examples of such national entities, authorities, and funds include traditional parastatal entities such as a National Medical Supply Agency, a National Transit Corporation or National Water Authority, national hospitals, and national universities. There are others such as a National Roads Fund Authority, National Health Insurance Fund, Municipal Investment Fund, and other similar funds. These entities typically derive some or all of their funding from the central government ministries under whose authority they operate, in addition to any direct or indirect user fees and charges that the entity may be authorized to collect.[4,5] Depending on the exact combination or permutation of decentralization and

[3] The diagram does not show deconcentrated administration units as a separate box, as deconcentrated spending units are ultimately an integral part of the central government budget. In specific instances, it might be useful to visualize expenditures by deconcentrated spending units as a separate box in the diagram. The flow of funds between the central government and deconcentrated spending units would be considered subnational budget allocations, rather than intergovernmental fiscal transfers.

[4] In developing and transition countries, such national entities, authorities and funds often derive part of their funding from the World Bank, other international financial institutions, and development partners.

[5] Since these national parastatals or authorities are part of the central government, funds flowing from the central government budgets are technically not considered intergovernmental fiscal transfers.

localization modalities used, in different sectors these national entities can account for a large and often overlooked portion of sectoral funding.

A final non-devolved channel of spending on local public services is formed by semi-autonomous local service delivery providers whose finances are not included in the local government budget (Line # 1D). This grouping includes local providers that typically form the "last mile" of service provision, and include municipal utility companies, urban development authorities, and so on. Note that Figure 1.2 only highlights local service providers and facilities that have a degree of institutional and budgetary autonomy; to the extent that frontline facilities are operated "on budget" by the local government, the revenues and expenditures of these facilities are simply understood to be part of the local government budget.

In different countries and in different sectors, local service delivery providers may have a degree of institutional and financial autonomy. While local providers are sometimes corporate entities created, owned, or operated by local governments—for instance, under a board appointed by mayor or municipal council—in many other cases, such institutions are created or accountable to higher-level government authorities. As such, these local service delivery entities fund or deliver public services in coordination with – or sometimes, in a parallel and duplicative manner to – local governments. Given the off-budget nature of these entities, any funding received by these entities—whether from local government budget, national entities, or from tariffs, fees, or other payments—has traditionally been overlooked by the literature on fiscal decentralization.

The subsequent four sections of this note (Sections 2, 3, 4 and 5, respectively) provide a brief technical introduction to each of the four pillars of fiscal decentralization. Each of the sections will summarize the relevance of each pillar of fiscal decentralization, provide an overview of devolved intergovernmental finances in relationship to each pillar, and present an overview of non-devolved intergovernmental finances in the context of each pillar.

1.3 Real-world obstacles, the political economy of fiscal decentralization and entry points for development partners

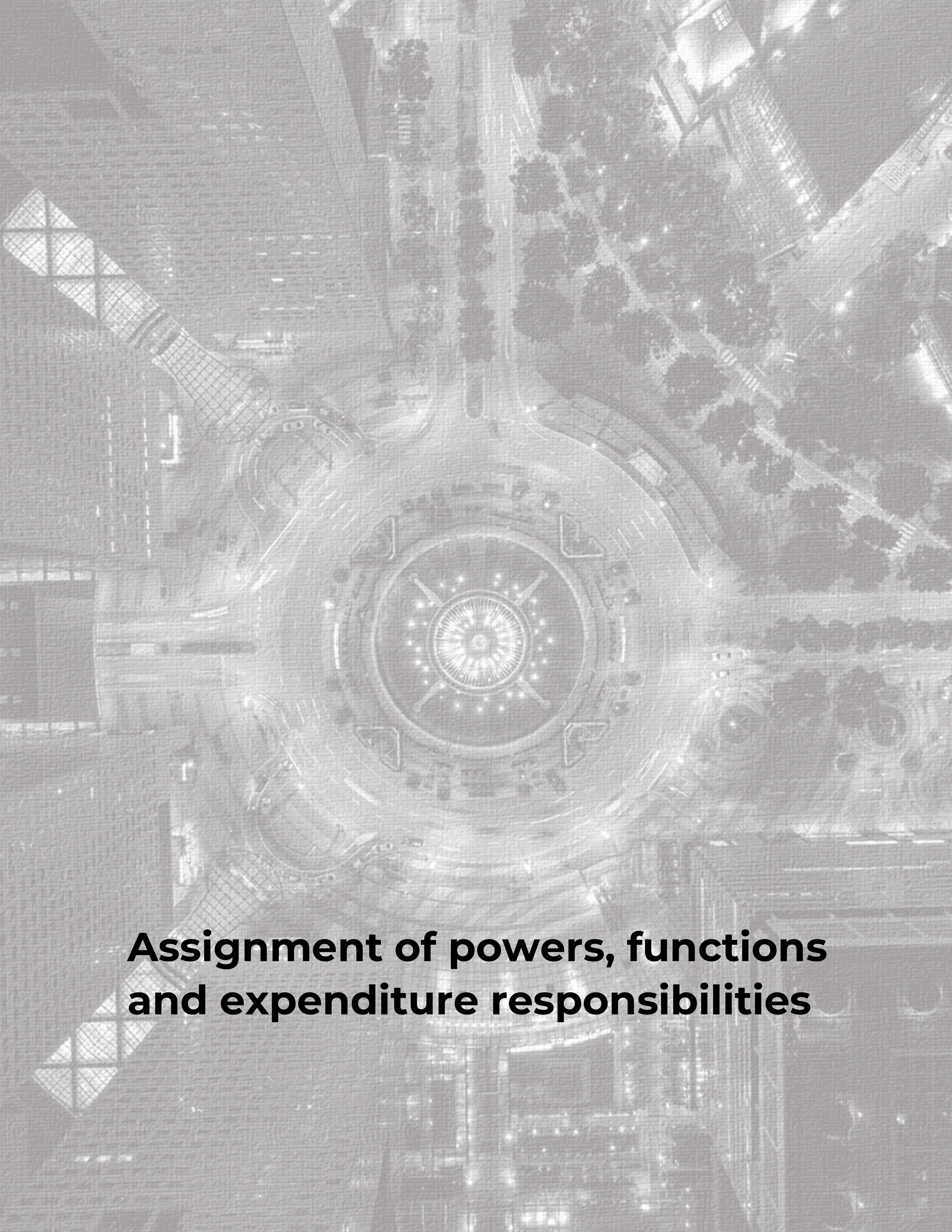
Decentralization reforms and other public sector processes are not just technical processes to be decided by technocrats; rather, they reflect a political or institutional contestation of power between different groups and individuals across and within different government levels.[6] As such, the design of fiscal decentralization, or a country's intergovernmental fiscal architecture, should not only be considered through a technical

[6] For an introductory discussion on the political economy of decentralization, see "Section 3: Understanding the political economy of decentralization and intergovernmental relations" in *Decentralization, Multilevel Governance and Intergovernmental Relations: A Primer* (LPSA/World Bank 2022).

lens, but should also be understood in the context of the political economy forces that help define it.

Beyond providing a technical overview of each of the four pillars of fiscal decentralization—in the context of complex intergovernmental fiscal systems that often rely on different approaches to decentralization at the same time—this note tries to identify some of the real-world obstacles encountered by policy makers and advocates for inclusive and effective decentralizatin and localization in supporting (fiscal) decentralization reforms and multilevel public sector strengthening. With this in mind, as part of the discussion of each of the four pillars of fiscal decentralization, each of the subsequent sections highlights common obstacles encountered in policy practice and a brief political economy perspective on each pillar.

In addition, Section 6 specifically raise implications for engagement by policy makers and development partners in fiscal decentralization and multilevel government finance, in terms of helping to identify possible areas of technical intervention in strengthening the intergovernmental fiscal systems.



Assignment of powers, functions and expenditure responsibilities

2. Assignment of powers, functions and expenditure responsibilities

2.1 Relevance of subnational expenditures

Many of the pro-poor public services that are required to achieve sustainable global development, including education, health services, access to clean water and sanitation, are delivered at the local level. In many countries, local public services and public sector investments in these areas are the responsibility of elected local and regional governments. In 2016, subnational government spending accounted for 24 percent of total public spending and close to nine percent of GDP on average (unweighted) for a global sample of 106 countries with available data (OECD/UCLG 2019: 50).

Unfortunately, comparative figures are not available for the relative importance of other types of local public spending, such as deconcentrated spending,[7] delegated spending,[8] or direct central government spending on local services—spending through vertical sector programs. An analysis of education and health finance in 29 developing and transition countries reveals that countries typically rely on multiple models of decentralization at the same time, and that non-devolved expenditures accounts for approximately two-thirds of all local public sector expenditures on health and education (Boex and Edwards 2014).

2.2 An overview of devolved (local government) expenditure responsibilities

The subsidiarity principle. In many countries, the main principle behind the assignment of expenditure responsibilities is the ***subsidiarity principle***. This principle suggests that—in order for the public sector to be as allocatively and technically efficient as possible—public sector ***functions should be performed by the lowest level of government that can perform the function efficiently***. Conversely, functions should not be performed by a higher-level government if these functions can be dealt with effectively by a lower-level government. While the subsidiarity principle is widely regarded as best practice to be followed around the world, some countries have formally adopted it as a formal legal principle, because it was in the 1992 Maastricht Treaty that established the European Union.

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[7] Deconcentrated spending refers to spending by deconcentrated offices of sector ministries in localities.

[8] Delegated spending includes spending mandate delegated by sector ministries to various governmental and quasi-governmental organizations including parastatal organizations, state owned enterprises, and utility companies.

The subsidiarity principle does not mean that *all* public functions should be performed at the local government level. In some cases, ***scale economies*** in the provision of public services may prevent a lower-level government from performing a function or task efficiently. In other cases, the territorial scale of provision would make it inefficient for a local government to perform certain functions. This occurs, for instance, when the ***benefits area of a service*** exceeds the territorial jurisdiction of the government responsible for provision. For instance, while a local park or playground that benefits a local community can be efficiently provided by a local government itself as the lowest government level capable of performing this function efficiently, it would be inefficient to assign the responsibility for national defense or the management of a specialized referral hospital to an individual local government unit.

<u>Unbundling functions</u>. An important concept related to the proper assignment of functions and expenditure responsibilities is the need to "unbundle" functions before applying the subsidiarity principle. ***Unbundling*** of broad sectoral functions or expenditure responsibilities (such as "health" or "education") requires subdividing the function into smaller pieces along several dimensions: not only can the responsibility for a service delivery function be divided into various sub-functions and tasks or along the lines of economic inputs required to deliver the service, but it is important to consider the responsibility for a function in a granular manner along four different dimensions, namely (a) the responsibility for policy-setting, regulation, and oversight; (b) the responsibility for financing; (c) the responsibility for management and ensuring provision; and (d) the responsibility for actual (frontline) service provision, sometimes referred to as "production."

An example of an "unbundled" assignment of responsibility for basic public health services is presented below in Figure 2.1. The example reflects a decentralized system in which the responsibility for ensuring provision of basic public health services is assigned to local government authorities (LGA). Through the LGA's District Health Office (DHO), basic health services are provided by local government-run public health facilities (PHFs), but – in this example – the Ministry of Health (MoH) plays an important role in setting sectoral policies and regulations. In addition, the ministry is extensively involved in the staffing of local DHOs and PHFs, with wage grant being provided by the central government, further provides conditional grants for operation and maintenance (O&M), and directly implements sectoral capital projects such as local health facility construction. Other central-level stakeholders assigned partial responsibilities over basic health services in this example include the Medical Stores Department (a parastatal entity), the Ministry of Finance (MoF), and the Public Service Management Department (PSM).

Figure 2.1. Unbundling the responsibility for a function: the elements of the provision of a function (example)

FUNCTION

	HR	O&M	Supplies	Capital	Coord.
Policy & regulation	PSM / MoH	MoH	MoH/MSD	MoH	MoH
Financing	PSM /MoF	MoH	MoH/MSD	MoH	LGA/DHO
Provision	LGA/DHO	LGA/DHO	MSD	MoH	LGA/DHO
Production	LGA/PHFs	LGA/PHFs	LGA/PHFs	Contractor	LGA/PHFs

Source: Based on Boex (2015:15). *Note: see main text for acronyms.*

When the subsidiarity principle is applied to functions that are properly unbundled, three types of public services emerge: exclusively national (central or federal) government services, exclusively local government services and functions of concurrent (joint central-local) responsibility.

- ***Exclusively central government services***—mainly national defense, international relations, certain macro-economic stabilization functions, and possibly specific social protection programs—are public services where the national government is the lowest-level government that can efficiently perform all aspects of functional responsibility: policy-setting and regulation; financing; provision; and production.
- ***Exclusively local government services*** such as local parks, streets and street lighting, and solid waste management, are public services where local governments are the lowest-level government that can efficiently perform all aspects of functional responsibility—policy-setting and regulation, financing, provision, and production. This is generally the case for basic local services which lack a strong redistributive dimension or (vertical or horizontal) externalities beyond the local jurisdiction.[9] To the extent that local governments are assigned the authority and responsibility to deliver exclusively local services, local governments are able to "manage local affairs" and function as an efficient platform for local decision-making and service delivery without much support from higher-level governments.
- In practice, however, many public services are ***concurrent (joint central-local) functions***. This includes key social sector services such as education and health, as

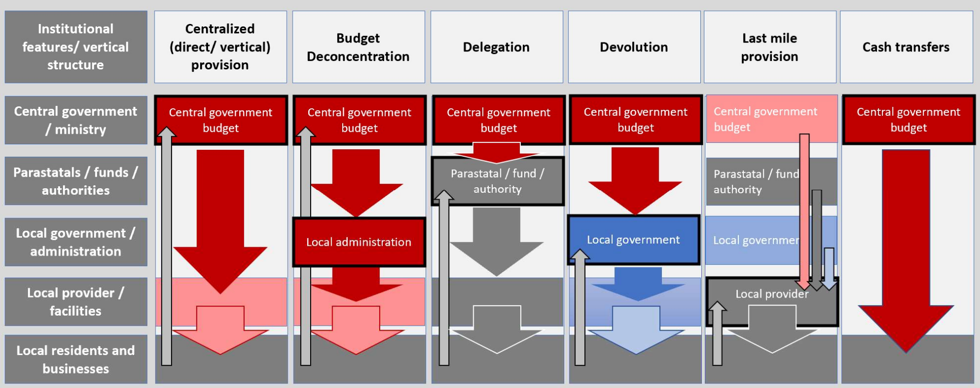
[9] When a local public service has a strong redistributive dimension or produces (vertical or horizontal) externalities, it is likely that higher-level government ought to be involved in policy and standard-setting and/or financing in order to ensure an optimal level of public provision.

well as sectors such as agriculture and water and sanitation. Concurrent functions are functions for which local governments *are* the lowest government level that is able to take care of some aspects of the function—typically provision and production. In such cases, it would be inefficient to assign other aspects of the service – typically policy setting, regulation, and financing – to the local government level, and those would therefore have to be assigned to at a higher-level government. The effective delivery of concurrent functions or services requires careful coordination between different government levels, not only within the sectoral or administrative sphere, but across political and fiscal decision making as well.

2.3 An overview of non-devolved expenditure assignments

An incomplete picture of expenditure assignments may arise if one were to merely analyze central government expenditures and local government expenditure; in many countries and sectors, alternative (non-devolved) approaches to decentralization and localization are used (Figure 2.3).

Figure 2.3: Overview of decentralized/localized service delivery and funding arrangements



Note: Red boxes and arrows indicate central government budgets and funding flows; blue boxes and arrows indicate local government budgets and funding flows; grey boxes and arrows reflect off-budget entity budgets and funding flows (or entities with indeterminate ownership).

Source: Prepared by authors based on Boex (2015).

In order to establish the extent to which stakeholders at each government level share the responsibility for service delivery in practice, mapping out the institutional trajectory and volume of the various funding flows—including different mechanisms used for different economic inputs or sub-systems within each sector—forms an important starting point for further policy analysis.[10] It is not unusual for local government finance specialists to be largely unaware of non-devolved sectoral funding flows, and sectoral experts are quite often more familiar with centralized funding flows within the sector than with any devolved funding mechanisms.

2.4 Common obstacles in expenditure assignments: technical challenges

Clarity in the assignment of service delivery responsibilities across levels of government facilitates better delivery of services and establishes clear accountability linkages. However, it is not unusual for countries or sectors (or development partners) to face an analytical challenge in answering the basic question: what the actual or de facto assignment of functions within a country or sector is as revealed by public sector expenditure patterns. This question requires assessing the volume and management of local government expenditures in a country by sector or function. Additionally, it requires considering service delivery expenditures made by central government through vertical programs or deconcentrated spending; national and regional parastatal entities, authorities and fund; and by local service delivery providers—for instance, from user fees or funding flows not already identified. The assessment of expenditure assignment also needs to take into account any limitations on the institutional powers or authority of local governments vis-à-vis the role of stakeholders at higher government levels. For example, while local governments are often assigned *de jure* responsibilities for basic urban services such as solid waste management, local water supply, or sanitation, even in urban areas, the role of local governments in improving public service delivery performance may be limited (Boex, Malik, Brookins and Edwards 2016).

As the first pillar of fiscal decentralization, problems with the assignment of functions and expenditure responsibilities tend to reverberate through the intergovernmental fiscal system. As discussed below, the biggest challenges with the assignment of expenditure responsibilities are not caused by technical or conceptual issues during policy design; instead, the main challenges are typically encountered during the policy implementation stage. Implementation obstacles include: (a) a gap between the *de jure* and *the de facto* assignment of functional responsibilities, as central ministries are often unwilling to let go of service delivery responsibilities; (b) weak vertical and horizontal intergovernmental sectoral coordination, including coordination challenges with parastatal entities and local-level (frontline) service delivery authorities; (c) the lack of "local political will," or misaligned political incentives for local governments to effectively deliver services,

[10] As noted in Figure 2.3, it is not unusual for intergovernmental institutional and fiscal arrangements to differ for human resource expenditures (salaries and wages), operation and maintenance spending, sectoral supplies, and capital infrastructure spending. The governance or management—coordination; oversight; community engagement—associated with a public service could be considered a fifth input or sub-system.

especially concurrent services; (d) inadequate local government administrative capacity; and (e) underfunding of local expenditure responsibilities.

2.5 Political economy considerations: common obstacles in expenditure assignments

The assignment of functions and expenditure responsibilities is not only an important technical aspect of decentralization, but the expenditure assignment decision—both in terms of legal assignment as well as the decision on "who does what" in practice—is often shaped by political economy forces.

<u>Empowering intergovernmental (fiscal) systems: expenditure assignments</u>. In fact, there is a considerable gap in some countries—especially among developing and transition countries that are at the front end of their transition to a more decentralized system—between the assignment of functions and expenditure responsibilities that would be prescribed based on good technical guidance, versus the reality dictated by political economy forces. Rather than applying the subsidiarity principle and adhering to the mantra that "finance should follow function," in accordance with good technical guidance, the political economy reality in many countries is that "functional assignments and finances follow political and institutional power".

The vertical assignment of powers, functions, and expenditure responsibilities is often a contentious area of (fiscal) decentralization reform, with central (sector) ministries usually arguing that local governments are inadequately capacitated to perform sectoral key functions. Although local capacity issues are often a concern, it is not unusual for capacity constraints to be used by central-level officials as a (sometimes thinly veiled) excuse to prevent the sector ministry from yielding its power and resources to the local government level. Likewise, it is not uncommon for planning ministries or public service management agencies to be motivated by narrow institutional self-interest in their opposition to the decentralization of their powers, functions and resources to lower-level government entities.

In fact, in countries that have initiated decentralization reforms, a gap between the legal (*de jure*) functional powers and their *de facto* expenditure responsibilities—caused by the slow transfer of powers, functions and resources, is perhaps the most typically and biggest challenge to the successful decentralization reforms. Other political economy related problems arise in the assignment of expenditure responsibilities as well. For example, it is not unusual for a central government to (knowingly or accidentally) assign function responsibilities to a government level that, according to the subsidiarity principle, is too small or too weakly capacitated to efficiently deliver public services. In some cases, such expenditure assignment decisions are made in order to bypass regional elites or administrative opposition at higher levels, while in other cases higher level governments are avoided to minimize centrifugal forces or to limit local governments from being used as a platform for political competition.

Efficient, inclusive and responsive local governance: expenditure assignments. It is not just in the intergovernmental context that expenditure assignments and expenditure choices can be distorted by political economy forces; even when functions are assigned perfectly in accordance with the subsidiarity principle, it is quite likely that political considerations will come into play when local expenditure decisions are made. In fact, given that local governments are expected to set local spending priorities within a hard budget constraint, local government officials should be expected to make their expenditure choices not only on the basis of national policy commitment and technical considerations, but rather, on the basis of their constituents' preferences and in line with spending priorities that are electorally or otherwise politically rewarding to them.[11]

In assessing local spending decisions, it is useful to keep in mind the duality of local governments. Local governments serve as platforms for local decisions-making and service delivery in areas of exclusively local interest, such as streetlights, local parks. They also serve as a platform that can be leveraged by higher government levels for national development objectives or for concurrent functions, for which the social benefit of service provision is often not fully captured or appreciated by either local residents or local politicians. But, under a devolved system, unless specific arrangements are in place to ensure otherwise, local leaders should be expected to over-spend on local projects with immediate benefits to the community, such as livelihoods projects or community-based infrastructure, while underspending (relative to national priorities) on social sector development and other concurrent functions.

Engaged civil society, citizens, and business community: expenditure assignments. Inclusion, participation, transparency, and accountability in guiding and monitoring public expenditures are widely understood to be important features of effective decentralization and good governance. These principles represent important underlying values for stakeholders at all levels, but political economy pressures, such as pressure from political party officials or electoral pressures, may cause elected officials to set aside these principles when they are under pressure to "get things done." A similar type of political economy incentive—the desire to avoid negative scrutiny that comes with being the bearer of bad news—may act on local administrators, facility heads, and frontline workers when it comes to reporting on the performance of local expenditures. Mansuri and Rao (2013) argue that decentralized, participatory development is most effective

[11] It is not unusual for central government hesitance to decentralize sectoral powers, functions and resources (and the resulting underfunding and weak local administrative capacity in areas of concurrent responsibility) to serve as a justification for local politicians not to take ownership over challenging sectoral functions while focusing on spending programs that are electoral "low-hanging fruit."

when local institutions work within an “accountability sandwich” formed by support from an effective central state and bottom-up civic action.

Box 2.1 Background and resources on the assignment of powers, functions and expenditure responsibilities

- **Municipal Finances: A Handbook for Local Governments** (Catherine Farvacque-Vitkovic and Mihaly Kopanyi); World Bank, 2014.
- **Measuring the Local Public Sector: A Conceptual and Methodological Framework** (Local Public Sector Country Profile Handbook); Local Public Sector Initiative, 2012.
- **Measuring Fiscal Decentralization, Concepts and Policies** (Junghun Kim, Jorgen Lotz and Hansjörg Blöchliger); OECD Fiscal Federalism Studies, 2013.
- **Self-rule Index for Local Authorities**; European Commission 2015.
- **The vertical assignment of functions and expenditure responsibilities** (Jamie Boex); Local Public Sector Initiative, 2015.
- **Assigning responsibilities across levels of government: Trends, challenges and guidelines for policy-makers** (Dorothée Allain-Dupré); OECD, 2018.
- **Revised Guidance for Subnational Government PEFA Assessments**; PEFA, October 2020.

Revenue assignments and local revenue administration

3. Revenue assignments and local revenue administration

3.1 Relevance of revenue assignments and own revenue sources

Although revenue sources are often less decentralized than expenditure responsibilities, tax revenues are an important source of income for subnational governments, accounting for one-third of total subnational government revenue or roughly 3.3 percent of GDP on average (OECD/UCLG 2019: 71, 77).[12] Other (non-tax) own revenue sources such as user charges, fees, and property income, account for another 11 percent of subnational revenue or approximately an additional one percent of GDP. Naturally, the importance of subnational own source revenues, and the breakdown between the different types of own source revenues, vary considerably from one country to another.

3.2 An overview of devolved (local government) revenue assignments and administration

The economics of local taxation under fiscal federalism. Unlike central government taxes (which are generally defined as compulsory payments to the central government for which there is no *quid pro quo*), local government taxes in a well-designed intergovernmental fiscal system are more appropriately seen as quasi-user fees for locally-provided services. Indeed, in order to maximize social welfare and improve the allocative efficiency of resources in a decentralized public sector, the goal of local taxation is not to maximize the volume of local revenue collections, but rather, to ensure that local taxpayers in different local jurisdictions only pay local taxes commensurate to the level of locally-provided services that they demand from and get supplied by their local government.[13]

In line with the concept that "finance should follow function," local taxes and user fees should be considered appropriate funding sources to pay for exclusive local government functions—where the benefits of local government services largely or wholly are received by residents of the local government jurisdiction itself. As noted in Section 3.3 below, to

[12] According to the OECD definition used, tax revenue is not made up only of own-source taxes, but includes shared taxes as well. Even with this more expansive definition of subnational government tax revenues, subnational taxes account for only 14.9% of public tax revenues. As discussed further below, the main funding source for subnational governments (on average) is formed by intergovernmental fiscal transfers.

[13] In this sense, decentralized provision of locally-provided goods mimics market-provision of private goods, where consumers opt to consume a private good up to the point where the marginal benefit from the good equals the marginal cost. Basic economic analysis (for instance, in the context of a representative agent or median voter model) suggests that in addition to the local governments' responsiveness to constituent preferences, other key determinants of the optimal level of local taxation include the relative price (i.e., efficiency or inefficiency) of local service provision and the presence or absence of general-purpose grants.

the extent that concurrent functions partially or largely benefit residents outside the local government jurisdiction, it would be conceptually more appropriate to fund such concurrent government functions in part or in whole through intergovernmental fiscal transfers.

Assignment of own revenue sources. Public finance theory prescribes a number of rather stringent conditions to determine which taxes and revenue sources should be considered good candidates for assignment to the local or regional level (Bird 2000). In fact, in line with the subsidiarity principle, the only taxes and revenue sources that could be suitably collected by subnational governments are revenue sources that (a) can be administered efficiently at the local or regional level; (b) are imposed solely or mainly on local residents;[14] and (c) do not raise problems of harmonization or competition between subnational governments or between subnational and national governments.[15]

The only major revenue source usually seen as passing these stringent tests for assignment to the local level is the property tax; the second-largest category of local revenues in many countries tends to be user fees and charges. In fact, for all other high-yielding tax sources—including personal income taxes, corporate income taxes, value-added taxes or sales taxes, and trade taxes—it could reasonably be argued that the central government is the lowest level of government able to collect those revenue sources without causing inefficiency. As a result, it is no surprise that the vast majority of revenues in most countries is collected by the central government.

Tax autonomy and the assignment of shared revenue sources. Because the practical scope for autonomous subnational taxation—in a way that ensures efficiency—is limited, some countries assign local governments the right to collect different revenue sources, while limiting the control of subnational governments over one or more aspects of these taxes. This results in a spectrum ranging from own source revenues fully under the control of local decision-makers to tax sharing arrangements over which local governments have no control (Table 3.1).

[14] An efficient assignment of revenue sources should prevent the possibility of "tax exporting", by which a local or regional government is able to impose a tax burden on residents outside its jurisdiction. For this purpose, it is important to recognize that the burden of a tax may be borne by someone other than the person who pays the tax. For instance, while import duties are paid by the importer, the actual burden of the tax is typically borne by the final consumer (because the cost of the import duty raises the final sales price). As such, assigning the power to levy import duties to local governments (or the practice of charging an *octroi* on the trans-shipment of goods through a local jurisdiction) would effectively allow local government to tax the residents of other local governments without providing commensurate services to them.

[15] Tax competition between different subnational jurisdictions as well as duplicative taxation by different levels (resulting in cumulative high marginal tax rates) would have the potential for economic distortion and inefficiency.

Table 3.1 A taxonomy of tax autonomy (OECD)	
Class	**Nature and extent of tax autonomy – relative to higher-level government (HLG)**
a.1	The recipient subcentral government (SCG) sets the tax rate and any tax reliefs without needing to consult a HLG.
a.2	The recipient SCG sets the rate and any reliefs after consulting a HLG.
b.1	The recipient SCG sets the tax rate, and a HLG does not set upper or lower limits on the rate chosen.
b.2	The recipient SCG sets the tax rate, and a HLG does sets upper and/or lower limits on the rate chosen.
c.1	The recipient SCG sets tax reliefs – but it sets tax allowances only.
c.2	The recipient SCG sets tax reliefs – but it sets tax credits only.
c.3	The recipient SCG sets tax reliefs – and it sets both tax allowances and tax credits.
d.1	Tax sharing arrangement in which the SCGs determine the revenue split.
d.2	Tax sharing arrangement in which the revenue split can be changed only with the consent of SCGs.
d.3	Tax sharing arrangement in which the revenue split is determined in HLG legislation (less frequently than once a year).
d.4	Tax -sharing arrangement in which the revenue split is determined annually by a HLG.
e.	Other cases in which the central government sets the rate and base of the SCG tax.
f.	None of the above categories of a, b, c, d, or e applies.

Source: Kim, Lotz, and Blöchliger (2013).

For instance, central legislation might provide local governments with the power to collect a certain tax – a corporate income tax, for example – while defining the base of this tax uniformly across the entire national territory in order to limit the administrative burden of local taxation on taxpayers. Similarly, central legislation may limit the tax rates that local governments may impose on local taxpayers for different taxes – for example, by setting lower and upper bounds – in order to prevent territorial or vertical tax competition. Alternatively, central authorities may simply decide to share the revenue collected from certain revenue sources with subnational governments. For example, this may be done on a derivation basis (based on where the revenue is collected) without giving subnational governments any control over the tax base, the tax rate, or the sharing rate.[16]

In addition to property taxation, another area of focus for subnational revenue mobilization efforts could be on user charges and fees. The ability of local governments to collect these types of revenues depends considerably on the assignment of functional powers; local institutions' ability to deliver local services in way that provides value-for-money; and on the capacity and willingness of users to pay for these services.

[16] As noted in Section 3.3 below, economists consider that such shared revenues are in fact intergovernmental fiscal transfers. Nonetheless, it is not unusual for the domestic Chart of Accounts to register such shared revenues as own source revenues rather than as intergovernmental revenues in order to give the appearance of tax autonomy.

3.3 An overview of non-devolved revenue assignments

Traditionally, the discussion of revenue decentralization and the assignment of revenue powers has focused almost exclusively on the local property tax and any other local tax and non-tax revenue funds that are part of the local government budget. Virtually no systematic attention has been paid to the assignment of revenue powers to non-devolved actors in the intergovernmental system. This includes any discussion or analysis of revenues collected by national parastatal entities, authorities and funds—revenues collected by entities that are funders or providers of delegated services. Also overlooked are revenues collected by local government-owned public companies, delegated service providers, and other "last mile" providers such as local water utilities, transit companies, or fee-collecting local health facilities. All these revenues are typically excluded from measures of revenue decentralization, as traditional measures of revenue decentralization focus exclusively on national government revenue collections and local government revenue collections. Any revenues collected by off-budget entities at both the central government and local government levels are often simply overlooked.[17]

While the reliance on non-devolved revenue sources is likely to vary significantly from country to country and from sector to sector, these revenues are likely to play a much more significant role than commonly recognized. For instance, in the provision of public health services, how much do local health facilities collect in terms of user fees or private or social health insurance payments in a way that is not captured by local government accounts? In turn, how much revenue do national or local health insurance schemes collect from the public? Similarly, to the extent that schools collect school fees from parents and/or to the extent that school committees or parent-teacher committees, as quasi-public entities, contribute to the provision of primary education, how significant is this funding?[18]

In the provision of water and sanitation services, what is the total revenue collected each year and subsequently spent for recurrent operation and capital purposes by off-budget urban water utilities? Similarly, in rural areas, what revenues are collected by water user committees which, in many countries, serve as the *de facto* provider of rural water

[17] Compared to other sectors, the health sector offers a positive example, as the World Health Organization's accounting of Total Health Expenditures seeks to incorporate different funding flows, including public sources (government spending); private (out of pocket) spending; social health insurance; and donor organization spending. Despite the extensive guidance in the sector, however, it is often still difficult to entangle how much is being collected and spent of health services, and, by whom, at the subnational level.

[18] Boex and Vaillancourt (2014) point to the case of education spending in Madagascar. Primary education is formally a central government responsibility provided in a deconcentrated fashion following a classic French model. In 2010-2011, centrally hired primary school teachers (either as permanent civil servants or contractual employees) accounted for only 32% of all public school teachers; of the remaining 68% (called FRAM teachers), 48% were hired and paid in part by parental committees and in part by a subsidy paid directly to teachers by the central government and 20% were hired/paid by parent's committees, often with in kind payment (rice).

services? Both of these questions should be answered fully to get a comprehensive picture of water and sanitation revenues. It is not unusual, however, for the accounting of water and sanitation revenue and spending to focus exclusively on capital investment spending, and to ignore the revenues and expenditures needed to operate and maintain water and sanitation infrastructure.

Likewise, to the extent that roads and other transportation infrastructure may be operated in an off-budget manner by a national road fund (often funded by a fuel levy) or by dedicated transportation authorities or public-private partnerships (PPPs), what are the fuel levies or road tolls that are collected by these authorities or entities that operate and/or maintain public sector roads or bridges?

3.4 Common obstacles in domestic revenue mobilization and subnational revenue administration: technical challenges

Local own source revenues are seen by many as a preferred source of funding for local government services. This is not only because there is a stronger conceptual link between the benefits and costs of locally-provided services,[19] but also because local taxpayers are expected to exert stronger oversight over the efficient spending of their own local tax contributions. Furthermore, revenue decentralization gives subnational governments a fiscal stake in the economic success of their jurisdictions. As a result of these factors, the failure to decentralize revenue powers while decentralizing expenditure responsibilities is generally assumed to result in greater local fiscal indiscipline and risk taking.

But, the evidence on this point is mixed. Given the fact that the collection of most major revenue sources—with the exception of property taxes—is generally assigned to the central government in line with the subsidiarity principle in revenue administration, virtually every country in the world faces a significant primary vertical fiscal imbalance. In many countries, the assignment of shared revenue sources on a derivation basis, or the introduction of local surtaxes or piggy-back taxes is often able to reduce the vertical fiscal gap in a way that provides resources to subnational governments without the potential inefficiencies associated with full revenue decentralization (Hunter 1977).

Nonetheless, lackluster collection of local taxes and other own source revenues in many local jurisdictions is common, particularly in developing and transition countries. Analyses of local revenue performance frequently attribute the lack of local revenue effort to an amorphous "weak local revenue administration" which, in turn, is often attributed to a "lack of local political will." Instead, weak local revenue performance is often caused by a combination of factors, including the fact that local governments are assigned unpopular

[19] The link between local taxes and local expenditures and accountability at the local level is called Wicksellian connection. See Bird and Slack (2013).

taxes that are relatively costly to collect, and have weak enforcement powers and weak political incentives and/or the absence of hard budget constraints.[20]

As a result, most real-world interventions related to revenue assignment and local revenues are intended to ensure that subnational governments administer the limited revenue instruments assigned to them as efficiently as possible. Efforts to improve local property tax administration (particularly in urban areas), often play on outsized role in development partner interventions related to local government revenues (Kelly, White, and Anand 2020).

3.5 Political economy considerations: common obstacles in revenue assignments

Empowering intergovernmental (fiscal) systems: revenue assignments. Public sector revenues tend to be much less decentralized when compared to public sector expenditures. As noted in Section 2, when we apply the subsidiarity principle to the function of public taxation and revenue administration, most revenues are efficiently collected at the national level. An additional reason for this pattern is that political economy forces cause revenues to be highly centralized. Most Finance Ministers will be hesitant to give away high-yielding revenue instruments to subnational governments, and thereby reduce the ability of the national fiscus to ensure macro-fiscal stability.

Furthermore, it is common for central government politicians—ahead of their next election—to abolish local taxes that are unpopular with the electorate, allowing central politicians to cut taxes for voters without a negative impact on their own (central) budget. More often than not, these local revenue sources are reinstated after the election, when locally elected leaders appeal to the national party that local revenues are an important foundation for the financial survival of local governments.

Efficient, inclusive and responsive revenue assignment. In response to news that local governments are collecting only *x* percent of the revenue that they *could* be collecting (where *x* is a small number, sometimes even as small as 10 percent), it is not unusual for national-level politicians or policy researchers studying local revenue administration to condemn local government officials for lacking the political will to collect own source revenues.

Such criticism may or may not be warranted, and if nothing else, it does not necessarily point to a problem with local tax administration. It is useful to start by acknowledging the political economy argument that local revenue collections are not *intended* to be maximized, but rather, that local revenue collections are optimal where the marginal cost

[20] National revenue authorities don't necessarily do any better job when asked to collect local revenues (Fjeldstad, Ali, and Katera 2019).

to local taxpayers of additional taxation equals the marginal benefits from additional public services. In an effectively decentralized system, if the chain of accountability is working, locally elected officials are the arbiters of the level of local taxation at which this optimum is achieved. The “lack of political will” may simply reflect a rational political response to a situation where it might be politically easier for a mayor to get additional resources as a special grant from central government compared to collecting from local constituents. Local leaders may also exhibit a lack of political will to collect own source revenues results if the efficiency or responsiveness of local government spending is relatively low. A low level of lack of political will is only a real concern if local politicians are setting effective tax rates – through a combination of formal tax rates and weak revenue administration and enforcement – that result in a level of local taxation that falls below what is considered optimal by local constituents.

A bigger concern may actually be when predatory local taxation, the opposite of inadequate revenue mobilization, occurs.[21] Another serious problem occurs when the local government administers local taxes and revenues in a patently inequitable mannerfor example, enforcing taxes on political opponents, but not on political supporters, or when pervasive inefficiency or corruption exists in local tax administration. It is not just local politicians who are to blame at the local level for weak local revenue administration. As long as local politicians and taxpayers are satisfied to remain at an equilibrium of low taxation and low service delivery performance, the tax administration apparatus does not face strong incentives to improve its collection performance. Perhaps unsurprisingly, then, most local revenue mobilization efforts focus on other local administration improvement efforts such as improving land administration and property valuation, while basic revenue collection activities, such as billing systems and enforcement and collection of arrears, are frequently overlooked.

<u>Engaged civil society, citizens, and business community: revenue assignments</u>. While the long term success of any public sector depends on its ability to generate revenues from which to fund public sector expenditure, it is equally important to consider the perspective of the (local) taxpayer in determining the assignment of revenue sources and the optimal level of taxation at different levels. In most countries, even under the best of circumstances, taxpayers are unlikely to pay their (local) taxes if payment can be avoided without negative consequences. Tax collection and enforcement issues aside, local taxpayers’ willingness to pay taxes in return for local public services is likely to be limited if the local government’s decision making is unresponsive, or if the local government’s capacity to efficiently deliver services is weak.

[21] The definition of predatory taxation is often in the eye of the beholder. However, most people would be concerned about the efficiency and equity of local revenue assignments if a major share of local revenues would benefit tax collectors, or if these local revenues are mainly used to pay for the sitting allowance of local officials.

A final political economy consideration regarding local revenue collection is how the money gets spent. Wealthier taxpayers might be willing to pay local taxes if they perceive benefits from higher local taxes. However, the willingness of wealthy taxpayers to support pro-poor local services is often limited by the strength of local social contract. Thus, local revenue compliance may decline over time when local governments pursue redistributive policies beyond the level supported by those contributing most to the local treasury.

Box 3.1 Background and resources on revenue assignments and local revenue administration

- **Subnational Taxation in Developing Countries: A Review of the Literature.** Richard Bird: World Bank, 2010.
- **Sub-central Tax Autonomy.** Hansjörg Blöchliger and Maurice Nettley: OECD Fiscal Federalism Studies, 2015.
- **Municipal Finances: A Handbook for Local Governments.** Catherine Farvacque-Vitkovic and Mihaly Kopanyi: World Bank, 2014.
- **Property Tax Diagnostic.** Roy Kelly, Roland White, and Aanchal Anand: World Bank, 2020.

Intergovernmental fiscal transfers

4. Intergovernmental fiscal transfers

4.1 Relevance of intergovernmental fiscal transfers

Intergovernmental fiscal transfers are the primary source of revenue in a majority of countries around the world, on average accounting for over slightly over half (51 percent) of total subnational government revenues, or 4.2 percent of GDP (OECD/UCLG 2019: 70). However, there are considerable variations in the magnitude of intergovernmental fiscal transfers across countries, both in terms of absolute size as well as in terms of their share in total subnational revenues. While intergovernmental fiscal transfers play an important role in both urban and rural local governments, the role of transfers is often more dominant in rural local governments that may have a limited taxable economic base of their own.

It is important to acknowledge that the importance of intergovernmental fiscal transfers is not a coincidence or a temporary situation. Instead, in almost all countries, we should expect a permanent "primary" vertical fiscal imbalance, a situation where subnational expenditure needs exceeding subnational own source revenues, before intergovernmental fiscal transfers are taken into account (Hunter 1977). This structural imbalance is due to the fact that the extent of optimal expenditure decentralization is consistently greater than the optimal level of revenue decentralization, when the subsidiarity principle is applied to both. As such, an important raison d'etre for intergovernmental fiscal transfers is to help to reduce this vertical fiscal imbalance or gap. Another reason for intergovernmental fiscal transfers is to ensure an equitable horizontal distribution of resources, typically by making sure that localities with greater expenditure needs or lower own revenue potential receive greater transfer allocations.

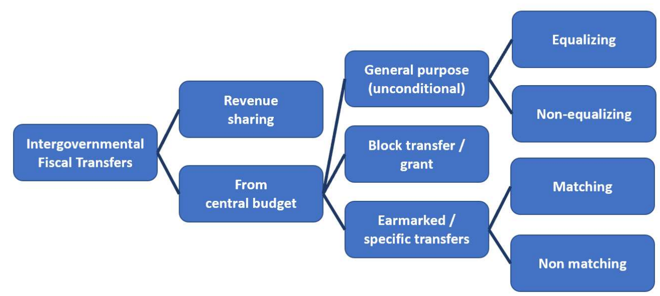
4.2 An overview of intergovernmental fiscal transfers

What are intergovernmental fiscal transfers? Intergovernmental fiscal transfers (IGFT) include a wide range of fiscal instruments by which funds are transferred from one government unit – often at a higher government level – to another government unit often at a lower government level. Sometimes IGFT are referred to as grants or intergovernmental expenditures by the "giving" government, and as intergovernmental revenues by the recipient government. Many other (often country-specific) terms are used to describe different types of intergovernmental fiscal transfers, including general allocations, equitable shares, subventions, and subsidies.

Intergovernmental fiscal transfers or intergovernmental expenditures are different from other "direct" government expenditures or outlays based on the fact that there is no immediate *quid pro quo*. While the recipient government may (or may not) have to fulfill certain conditions to receive fiscal transfers, the provision of transfers is generally not a final payment for specific goods or services rendered—as is the case, for example, with wage expenditures or the purchase of goods and services or capital infrastructure.[22] On the revenue side, intergovernmental fiscal transfers differ from other own revenue sources in that the recipient government does not have any control over the rate, base or collection of intergovernmental fiscal transfers.

Types of transfer schemes. The actual nature of IGFT schemes varies greatly, both across and within countries. Some, such as revenue sharing schemes are accounted for on the revenue side of the budget. But most transfer schemes are recorded on the expenditure side of the central government budget, which may include general-purpose (unearmarked or unconditional) transfers or grants, as well as categorically earmarked transfers or "block grants" and specific/earmarked grants (Figure 4.1).[23,24]

Figure 4.1 A typology of intergovernmental fiscal transfers



Source: Boadway and Eyraud (2018).

In addition to the variations in transfer-related terminology, which often differs from country to country, there is no single consistent approach or typology to classify IGFT schemes (Hunter 1977; Bahl and Linn 1992; OECD 2013; Boadway and Eyraud 2018).

[22] In fact, in the case that one government unit directly purchases a good or service from another government unit, the nature of the transaction changes, so that such a transaction would no longer be classified as an intergovernmental fiscal transfer (U.S. Census Bureau 2006).

[23] Despite shared revenues sometime being classified as own revenue sources in the Chart of Accounts of different countries, as noted above, public finance economists tend to consider shared revenues as IGFT when the recipient government does not have any control over the rate, base, collection or sharing rate of the shared revenue source.

[24] Categorical or block grants are conditional grants that are required to be spent on a specific spending category, but otherwise allow the recipient a degree of discretion on how to spend the grant resources. For instance, a cross-sectoral capital development grant or a local education sector grant can be provided as a categorical grant, allowing the recipient government a degree of autonomy, as long as the resources are spent within the relevant sector or spending category. A specific or earmarked conditional grant allows the recipient government little or no spending discretion. For instance, specific earmarked grants may be used to pay for specific infrastructure projects approved by the central government, or pay for the wages of filled staff positions, as approved by the central government.

Most of the typologies used to classify different types of transfer schemes consider some combination of five elements of transfer design. These are:

1. The nature and manner of determining the size of the transfer pool or vertical allocation—for example, rule-based vertical allocation versus discretionary vertical allocations, on-budget or off-budget, and revenue-sharing versus budgetary transfers.
2. The manner or nature of determining the horizontal allocation of the transfer resources—for example, formula-based horizontal allocations versus discretionary horizontal allocations; equalizing versus non-equalizing.
3. The extent and nature of or earmarking imposed on the transfer—for example, unconditional or general-purpose grants versus more conditional or earmarked grants such as categorical grants or specific grants.
4. The economic (incentive) nature of the transfer—for example, matching grant or partial reimbursement versus non-matching grant/full reimbursement.
5. The existence of "performance-based" access conditions (or incentives) and other conditions relating to the management of grants—for example, requirements related to the planning, budgeting, and use—as well as the reporting on the use—of transfers).

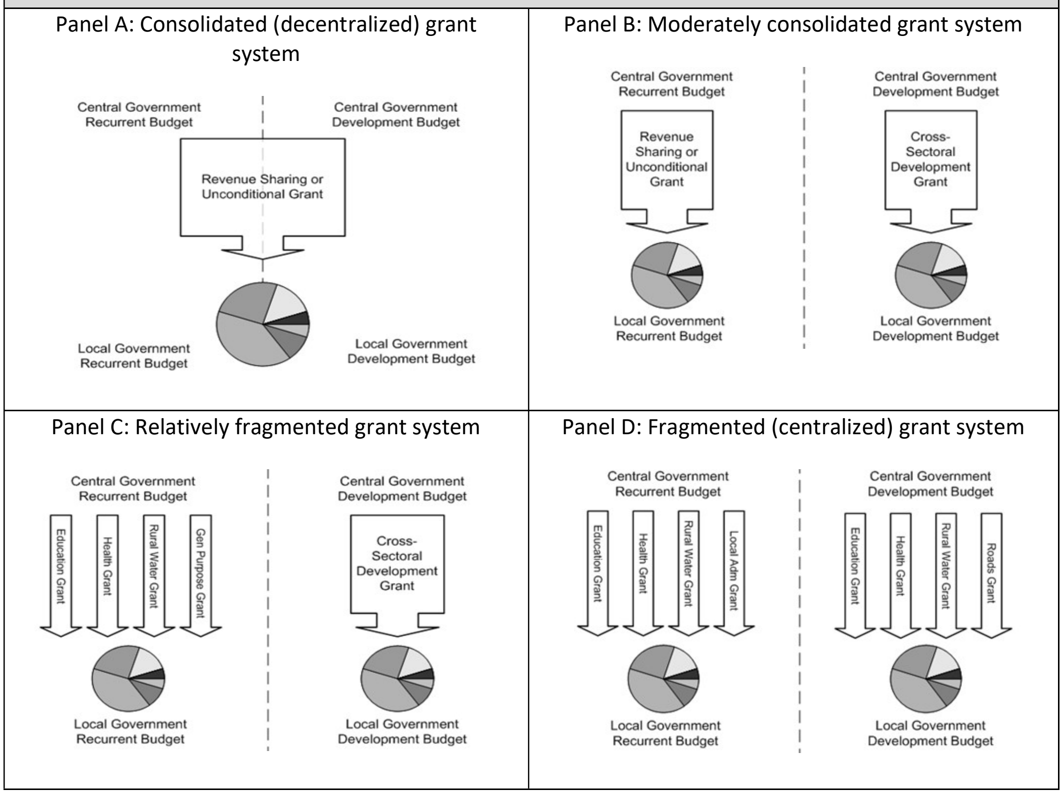
While elements the last three listed types define the level of conditionality associated with transfer schemes, all categorical and specific grants impose some degree of conditionality and are generally referred to as conditional grants.

<u>Types of transfer systems</u>. In addition to acknowledging the wide range of IGFT schemes that can be designed and implemented, it is useful to recognize that the composition of IGFT systems ranges widely around the globe. As shown in Figure 4.2 (next page), these systems can be modulated by policy makers from a highly consolidated transfer system – comprising one large unconditional funding flow with extensive subnational or decentralized decision-making power and control – to a highly fragmented transfer system, with a large number of often highly conditional intergovernmental funding flows allowing for extensive centralized control.

There is no single, universal "better" international practice when it comes to IGFT systems. In some cases, especially to the extent that subnational governments perform effectively as inclusive, responsive, and accountable mechanisms for subnational decision making and services delivery, a highly unconditional grant system might result in effective public sector performance, as in Germany. The same transfer system under greater institutional constraints with respect to political and administrative systems is likely to perform more poorly as experienced in Nigeria. Many countries, such as Indonesia, Kenya, and South Africa try to avoid an excessive conditional grant system and opt for a mix of general-purpose and conditional grants. At the same time, some federal countries like the

United States that are generally considered highly devolved rely on highly fragmented and earmarked transfer systems.

Figure 4.2 A typology of intergovernmental fiscal transfer systems



Source: Authors.

Fragmentation of the transfer system often results in a multiplicity of schemes—each often with their own minimum access conditions, spending requirements, disbursement triggers, and reporting requirements. This often strains the ability of local government officials and local financial management systems to manage different funding flows. More often than not, development partner projects contribute to this fragmentation and complexity rather than help resolve it. In addition, as further discussed below, formal IGFT schemes often operate alongside non-devolved vertical funding mechanisms, thus resulting in a reality far beyond the neat linear funding arrangements implied by the diagrams in Figure 4.2 above.

<ins>The key to unlocking the power of subnational governments</ins>. In public policy discussion of transfer schemes the horizontal allocation formula almost always gets most of the attention. But in reality, it is actually the increase in fiscal space associated with the

vertical allocation (the size) of transfers that unlocks the power of local governments, simply by providing local governments with greater financial resources to do more things that they could not afford based on their own revenue sources alone. By providing a binding ("hard") budget constraint, a well-designed transfer system has the potential to greatly improve the allocative efficiency of the public sector. This is effected by strengthening public sector planning and transforming the planning process from the preparation of unaffordable or poorly prioritized wish lists, to a system within which local officials are required to meaningfully prioritize and plan their expenditures in a results-based manner.

In addition, transfers can further be used in more strategic ways. For instance, different types of conditional grants – categorical or specific grants and matching grants – can be used to encourage local governments to increase their spending on specific functions, such as concurrent functions, or tasks that might otherwise be underfunded. Also, well-designed transfer schemes—in particular, performance-based grants—can be used to provide specific carrots and sticks for local governments, for instance, to improve local governance arrangements, or to improve local service delivery outcomes.

Universal principles. Over the years, experienced policy practitioners and analysts of fiscal decentralization have arrived at a list of a dozen or so universally accepted principles of sound transfer design (Bahl and Linn, 1992; Shah, 1995; Martinez-Vazquez and Boex, 2001). Although the exact number of points and the phrasing of the individual points vary slightly among different sources, these universal principles are commonly accepted as important guidance in designing an effective grant system (Table 4.1).[25]

[25] Although subnational budget allocations in Egypt are technically not intergovernmental fiscal transfers, as governorates are deconcentrated entities rather than autonomous local governments, much of the literature on intergovernmental fiscal transfer design applies.

Table 4.1. Universal principles of sound intergovernmental fiscal transfer design	
Principle	**Clarification**
1. Clear objective	The allocation should be guided by a clearly stated policy objective.
2. Revenue adequacy	Transfers should provide adequate resources for purpose at hand (and avoid unfunded mandates)
3. Preserving budget autonomy	Conditions placed on transfers should balance national priorities and local autonomy.
4. Enhancing equity and fairness	The transfer mechanism should support a fair allocation of resources.
5. Stability	The allocation should be stable and predictable over time.
6. Simplicity and transparency	The transfer mechanism should be simple and transparent.
7. Incentive compatibility	The allocation approach should not provide negative incentives.
8. Focus on service delivery	Transfer formulas should focus on the demand (clients or outputs) rather than the supply (inputs and infrastructure) of local government services.
9. Avoid excessive equal shares	Excessive reliance on the “equal shares” principle as a major allocation factor should be avoided.
10. Avoid sudden large changes	Avoid sudden large changes in funding for local governments during the introduction of the new transfer mechanism.

4.3 An overview of non-devolved subnational funding flows

By definition, IGFTs include only the funding flows such as general revenue sharing or grants-in-aid between two government units which, in many cases, means the central government as the funder and a local government as the recipient. Indeed, virtually all discussions and analyses of IGFTs limit themselves to these transfers. In reality, however, as illustrated earlier in Figure 2.3, numerous different types of non-devolved vertical or intergovernmental funding flows operate alongside IGFTs.

Although there is little available on systematic quantitative analysis of non-devolved funding flows, the most common non-devolved subnational funding flows (or quasi-transfers) are likely to include:

1. ***Centralized spending on local public services***. In some countries, different aspects of local frontline services are provided and/or funded directly by central government ministries, often through national vertical or sectoral programs. For instance, in Bangladesh, the majority of frontline health services—including the salaries of health workers—are managed and funded under the central government’s budget vote by

the Directorate General of Health Services, Health Services Division. Even in countries such as Sierra Leone, where local health services are *de jure* a local government function, it is not unusual for frontline health workers to be employed by the central government. In other countries like Tanzania, where recurrent health services are provided in a devolved manner, the construction of new health facilities may be funded from the central ministry budget, alongside the provision of sectoral block grants and other sectoral transfers to the local level.[26] This category of fund-flows also includes grants to service providers that are not formally part of the public sector, such as grants from the Ministry of Forestry to Forest User Groups in Nepal, or funding support by the central Ministry of Water to local water user associations or committees. It is often difficult to disentangle how much national program spending actually reaches the front line.

2. ***Deconcentrated spending on local public services***. A second non-devolved funding flow includes deconcentrated spending on local services. As opposed to the previous example, under budgetary deconcentration, the subnational departments or offices are separate budget organizations, units or cost centers in the budget, and are therefore easier to identify. For example, in Egypt's national deconcentrated budget structure, the funding provided for the basic services delivered by governorate-level sectoral directorates are not contained in the central ministry budget, but rather, in separate, dedicated budget votes for these directorates.[27] In other countries, deconcentrated funding streams operate alongside centralized and/or devolved funding flows. For example, in Bangladesh where, as noted, health programs are largely delivered in a centralized manner, Upazila subdistrict Health Offices and Upazila Health Complexes are operated and funded by the Health Services Division in a deconcentrated manner, rather than as part of the Directorate General of Health Services.
3. ***Funding support from national parastatal entities, funds, and authorities***. Sometimes, local governments, or alternatively local-level facilities or service delivery providers receive funding support from national parastatal entities, funds and authorities. This may include resource allocations to local governments for road maintenance from the Roads Funds, as in Tanzania; payments to local health facilities for maternal health services from the National Health Insurance Fund ("Linda Mama")

[26] In many countries, development partner-funded investments in sectoral infrastructure are made through centrally managed programs, even when the provision of sectoral services is legally devolved to the local government level.

[27] As such, deconcentrated budget systems have subnational budget allocations rather than proper "intergovernmental fiscal transfers". Based on historical practices in deconcentrated systems (when deconcentrated units had their own bank accounts or their own accounts within the central treasury system), the term "transfer" is sometimes still used in deconcentrated system as the (real or indicative) cash-flow transfer received within the national treasury system (or into the external bank account) from which deconcentrated units were able to incur spending commitments or make outlays. In many modern central treasury management systems, such "cash transfers" to departmental accounts are no longer needed, as payments are settled electronically within the treasury system.

in Kenya; or allocations from sectoral trust funds or investment authorities, as with grants from the Water Sector Trust Fund to county governments in Kenya. In these cases, the funding entity is typically an extrabudgetary entity at the central government level, while the receiving entity may be either be a local government or a non-devolved local entity. Due to the partial or full off-budget nature of these transactions, depending on which data sources are being used (central or local), it may be easy to overlook these transfers or grants.

4. ***Provision of frontline services by national parastatals, funds, and authorities***. In other cases, national parastatals, funds, and authorities or even donor partners may provide in-kind inputs in support of local public services, rather than a flow of funds. For example, rather than receiving funding from the Medical Stores Department (MSD), local governments may receive a notional budget or account from MSD against which they can "purchase" medicines, which are then delivered in-kind. Similarly, local agriculture departments may get seeds and fertilizer through in-kind distributions, rather than fiscal transfers.

Box 4.1 Grants funded by international financial institutions and development partners

Intergovernmental fiscal transfers can be a good entry-point for international financial institutions and development partners to support improved subnational governance or improved subnational service delivery. When they use this entry-point for policy reform, development partners should avoid standalone projects. Instead, they should design funding modalities to align with the country's transfer system whenever possible and ensure that the funding mechanism being introduced is a sustainable part of the country's long-term intergovernmental fiscal architecture.

When possible, development partners should provide funding support in an on-budget manner as a top-up to existing grant schemes, rather than introducing parallel funding streams that contribute unnecessarily to the fragmentation of the grant system and increase the administrative burden on local officials. When this is not possible, the second-best option is to provide create a new on-budget grant modality—for example, a sector grant supported by a multi-donor trust fund under a sector-wide approach. Only as a last resort should development partner grants bypass the national government and be deposited straight from donor-controlled project accounts into local government accounts or, even worse, pay local contractors directly for services rendered to the local government, thus bypassing central and local public sector systems altogether.

Because most "devolved" countries actually rely on a combination of devolved and non-devolved service delivery institutions and funding approaches, it is critical to consider and analyze the reliance on non-devolved grants and (quasi-)intergovernmental fiscal transfers in order to achieve a solid understanding of the intergovernmental fiscal context.

4.4 Common obstacles in intergovernmental fiscal transfers: technical challenges

Intergovernmental fiscal transfers are a relatively blunt instrument of intergovernmental finance. The importance of IGFT to intergovernmental finances notwithstanding, it should be recognized that, in practice, transfers are actually a relatively blunt policy tool, as local governments and local government officials—as rational economic agents—tend to respond to receiving different types of grants, sometimes in helpful ways, and sometimes in ways that undermine the performance and accountability of the public sector.

For example, when local governments are provided with additional unconditional grant resources to a local government, it is common for local leaders to react by reducing local tax collections in response to the increase in grant resources, doing so in response to the preferences of their local constituents.[28] This means that for every hundred dollars in unconditional grants provided, spending will increase by less than a hundred dollars. Furthermore, it is unlikely that the local government will direct these resources towards central government priorities. In fact, it should be expected that local officials will spend any additional general-purpose resources on local priorities. While such political responsiveness may not be appreciated by the national fiscus, this is simply a rational economic choice for elected local government officials in response to an expanding budget constraint.[29]

Similarly, whereas sectoral (block) grants or specific grants may be provided by the central government in order to achieve a specific national policy objective, it is important to be aware that local governments may decide to reduce their own spending from general-purpose funds in support of this function when a conditional grant is introduced—for example, in favor of spending programs deemed to be in higher need of the marginal dollar. Likewise, unless spending from conditional grants is carefully monitored, it would not be unusual for local governments to "accidentally" spend resources outside the menu of permitted expenditures. Again, given that the public sector is often underfunded, and given that performance metrics are often difficult to validate, which is true in every country, but especially in countries with weaker public administration, it should not be surprising if local public officials over-report certain data, such as enrolment, a number related to health attendance. if doing so would help them attract greater funding for the

[28] In some cases, the local council may actually reduce the local tax rate in response to receiving additional general-purpose grants. In other cases, the reduction in local tax collections may happen more gradually.
[29] In fact, it is quite possible that a lot of "lack of political will" to collect own source revenues is actually caused by a combination of (a) low demand for local public services by local constituents and (b) the availability of transfer resources. The impact of the transfer system on own revenue collections should be expected to be especially negative or perverse if local governments are provide with a soft budget constraint and/or deficit grants.

purpose of improving local service delivery. For performance-based grants: results results may be overstated for the same reason..[30]

Another concern in the design of IGFT is a misalignment of expectations associated with the grant system. Expectations can misalign in a number of different ways. A first common misalignment in expectations is known as the "tragedy of the commons," which occurs when a local government is allocated an unconditional grant and, in response, every central sector ministry expects that the local government will allocate these resources to fund *its* (ministries') sectoral services and programs. When this happens, a strain will be put on the intergovernmental (fiscal) system as a whole: sector ministries will under-provide conditional sector grants, local government services will be underfunded across the board, and local governments will systematically fail to achieve the results that are set by central government ministries.

A second misalignment in expectations takes place when the central government allocates unconditional grants in a pro-poor manner to local governments by using the number of poor residents in each locality as an allocation factor, and expects local governments to spend these resources on pro-poor programs. In reality, however, the inclusion of a poverty variable in the allocation formula has no bearing on whether local governments will spend these resources in a pro-poor manner.

A third misalignment in expectations takes place when central government designs a conditional grant scheme – for example, a performance-based grant program that requires the recipient to abide by numerous central government conditions – but then provides inadequate funding to give a meaningful fiscal incentive to local administrators and decision-makers to adequately implement the conditional grant program. The local government may accept the grant while resenting the conditions being imposed, and the central government will end up complaining that local governments are incompetent or dragging their feet.

Beyond the concerns noted above, there are a number of common challenges, including:

- ***The structure of the transfer system is unclear or is excessively fragmented and conditional***. It is not unusual for the grant system to lack a clear link between the functional responsibilities to be funded and the composition and size of the various transfer mechanisms. A failure to achieve an appropriate balance between unconditional and conditional grant instruments places unnecessary

[30] Naturally, there is an additional incentive for over-reporting of performance achievements if frontline staff themselves benefit from better performance in the form of performance bonuses. For instance, this performance-bonus structure was the basis for (alleged) extensive cheating by teachers and educators under the No Child Left Behind Act in the United States in the 2010s (Strauss 2015).

restrictions on local budget autonomy, often resulting in reduced allocative efficiency.

- ***The process or timing of intergovernmental budget formulation process.*** One of the most important benefits of fiscal decentralization is that it requires local governments to plan and prioritize in the context of a hard budget constraint. But, if the central government fails to set grant ceilings in a timely manner as part of the central government's budget formulation process – or if the central government changes grant ceiling after issuing the local budget circular – local governments are unable to prepare their plans and budgets in an in effective, inclusive, and accountable manner.
- ***Problems with vertical and horizontal allocation.*** The vertical allocation of resources may be inadequate to achieve the required service delivery objectives. The horizontal allocation of resources may also be fair or inefficient. For example, some local governments may receive relatively more resources than needed for their expenditure needs compared to other localities.
- ***Disbursement problems.*** Transfers should be disbursed in a complete, consistent and timely manner. It is not unusual, however, for central governments to fall short in this regard, due to poor planning or weak cash management. In other cases, the complexity of disbursement procedures causes delays. In fact, it is not unheard of for grant releases to be made on the last day of the financial year. The failure of the central government to disburse committed resources in a timely manner can cause considerable downstream problems such as low budget performance, unpaid local government staff, and delays in contracting.

4.5 Political economy considerations: common obstacles in intergovernmental fiscal transfers

<u>Empowering intergovernmental (fiscal) systems: intergovernmental fiscal transfers</u>. While the design of IGFT systems and schemes is a highly technical exercise, the issue is highly political at the same time. After all, there is nothing more political than the allocation of public resources to competing demands. In fact, political economy forces permeate not only specific decisions regarding the vertical and horizontal allocation of resources, but also the design of the grant system as a whole. This includes decisions regarding the mix of conditional versus unconditional grants and the choice of formula-based versus discretionary grant schemes).

While a neutral observer would balance the pros and cons of conditional versus unconditional grants or judge the technical merits of formula-based versus discretionary grant schemes, central government officials are likely to have an institutional or even personal stake in deciding on the nature of the grant system. While formula-based grants may be preferred on technical grounds – due to their objectivity, predictability, transparency – the choice of grant instruments itself may be determined by a contestation of power, both within and between political parties as well as within and between different ministries. Powerful members of parliament or powerful mayors may prefer that the bulk of resources is provided through more discretionary allocation mechanisms rather than rules-based and formula-based transfers, which would allow them greater control over the allocation of resources by lobbying the Minister of Finance or other relevant ministries, such as the ministries responsible for local government or urban development. Representatives of politically weaker jurisdictions may prefer a formula-based approach, which—while limiting their own discretionary power—could ensure a more favorable distribution of resources for their constituencies. The Minister of Finance may prefer to have discretionary control in setting the total pool of funds transferred to subnational governments from year to year, rather than using a predictable vertical sharing rule, which would provide more stability for local governments, but would give the Minister fewer tools to ensure macro-fiscal stability. Similarly, central sector ministries may prefer conditional sectoral grants over unconditional grant schemes, especially if the grant is located within the ministerial budget votes, and gives ministry officials the power to approve or decline disbursements based on whether conditions have been met. Therefore, as a result of the political economy forces, there is a tendency for transfer systems to become increasingly fragmented over time, as national actors and many development partners have a desire to exercise control and oversight over funding flows to the local level through conditional grants.

Once the structure and nature of the grant system has been decided, the actual vertical allocation of resources, typically determined as a part of the central government's annual budget formulation process, is again subject to political economy forces. Determining the size of the various transfer pools should be informed by the desire to provide adequate funding based on the policy objectives of the grants in a way that balances the financial needs of local governments with those of central ministries. But, in most countries, the vertical allocation decision is ultimately a policy decision made by Cabinet—by political representatives leading central government ministries. In order to (partially) counteract potential bias in the vertical allocation of resources, some countries have constitutionally or legally put in place different intergovernmental institutions, such as India's Finance Commission, Kenya's Commission on Revenue Allocation (CRA), or Nepal's National Natural Resource and Finance Commission (NNRFC), to be a more neutral arbiter of vertical fiscal balance.

Even when a formula-based approach is selected, rather than a more discretionary horizontal allocation approach, it is important to recognize that the presence of a formula-based allocation mechanism does not assure that the horizontal allocation of resources is necessarily objective or fair. After all, it is typically central government bureaucrats who prepare the proposals for grant allocation formulas, while central government politicians hold the power to enact or reject the formula-based allocations of transfer resources. For instance, if powerful politicians from wealthier jurisdictions have a stronger voice in parliament, equalizing grants may face a higher political hurdle, while matching grants, which may cause wealthier local jurisdictions to receive greater transfers. would be more favorably received.

A number of studies have been done on the political economy of transfer allocations over the years, looking specifically at the horizontal incidence of IGFT across different local governments. The collective findings of the literature suggest that while normative considerations and voter choice considerations are often significant forces in the distribution of transfers, political factors are consistently a major driving force in determining the horizontal incidence of IGFT in fiscally decentralized systems around the world (Boex and Martinez-Vazquez 2004). Recognizing the fact that the development of grant allocation formulas is not merely a technical exercise—but that politicians have to approve the resulting grant formulas, and that they will view the formula through a political economy lens—requires policy analysts and technical experts to "think political." This means that though the mandate of policy analysts and development practitioners is purely technical, it would be counterproductive to ignore who the main "winners" and "losers" would be from the introduction of a new grant program or from the change in an existing allocation formula.

Efficient, inclusive and responsive local governance: intergovernmental fiscal transfers. In almost all cases, IGFT are provided to encourage changes in the choices made by local government officials. In some cases, transfers have the intended effect; for example, a sectoral block grant may result in improved service delivery outcomes. In other cases, grants may have unintended consequences; for example, an unconditional grant may lower own source revenue collections.

The exact impact of IGFT on the political and budgetary decisions at the local level is highly context-specific, and depends on the exact nature of the transfer or transfers provided to the local government level—unconditional, conditional, or performance-based. How local governments respond to fiscal incentives provided by higher-level governments depends on how elected local officials, local administrators, and frontline service providers balance the various demands placed on them from different directions, and in some cases, on the nature of the intergovernmental fiscal transfers. For instance, if wage grants are provided as part of a sector block grant, this may provide local governments an incentive to hire workers that provide high value-for-money, and to replace non-performing workers. The decision to terminate weak performing staff may be different if wage grants are explicitly tied to the salaries of workers being sent from the sector ministries. Thus, terminating an underperforming worker would result in a decrease in the wage resources made available.[31]

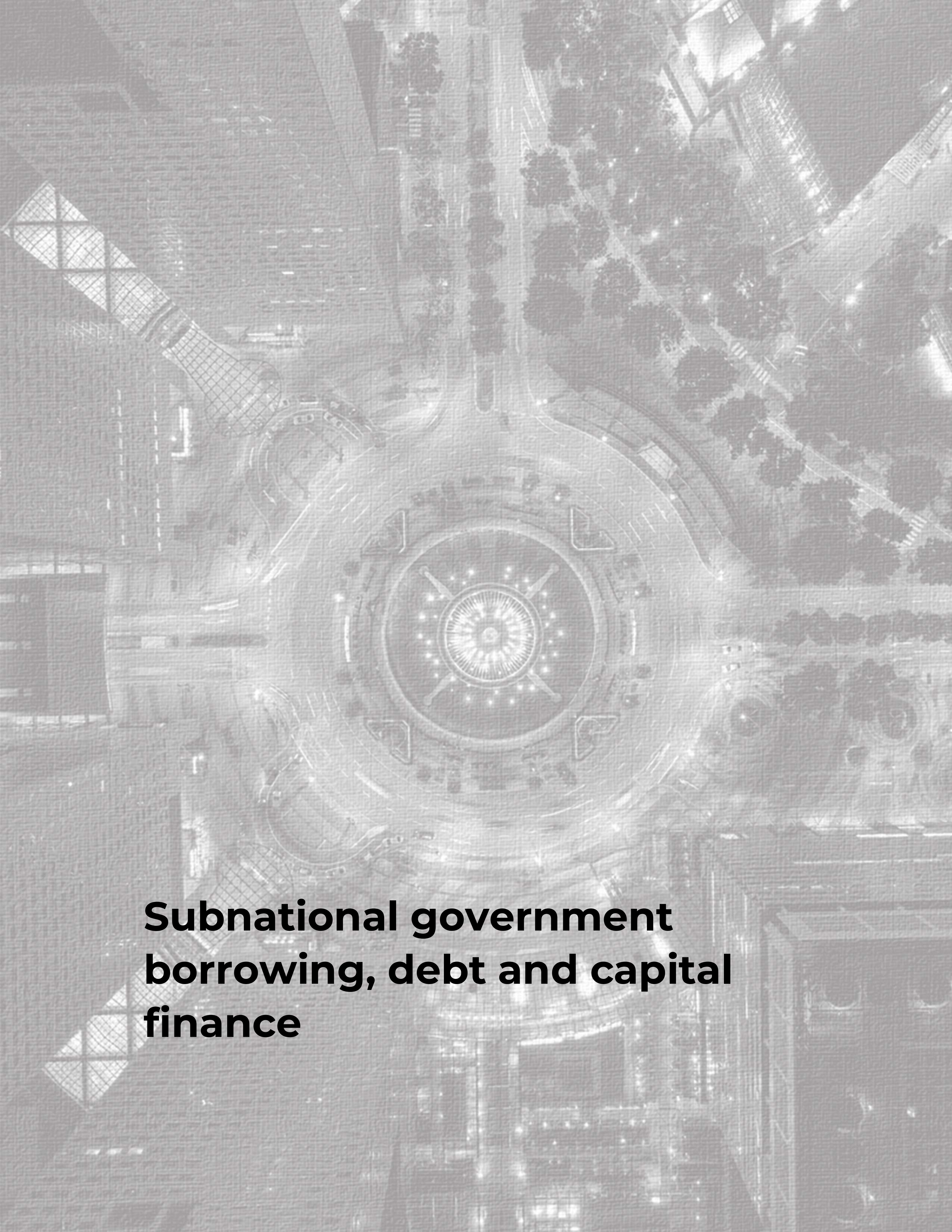
[31] Under either scenario, however, the choice faced by the local health administrator (or the health facility head) to terminate an under-performing health worker is not just a technical decision, but needs to balance

A final observation regarding the political economy of IGFT deals with an argument made by some observers that local governments are more likely to spend transfer resources in a more frivolous manner when compared to funding that was collected from local taxpayers. While this may be true in certain cases, local government leaders may also waste own source revenues unless political accountability mechanisms are strong and effective. In the end, the effective use or misuse of intergovernmental fiscal transfers will depend on the vertical as well as the horizontal context within which these resources are placed.

Box 4.2. Further background and resources on intergovernmental fiscal transfers

- **Intergovernmental Fiscal Transfers: Principles and Practice.** Robin Boadway and Anwar Shah: World Bank 2007.
- **Fiscal Equalization in OECD Countries.** Hansjörg Blöchliger, Olaf Merk, Claire Charbit, and Lee Mizell: OECD Fiscal Federalism Studies 2007.
- **Fiscal Equalization: Challenges in the Design of Intergovernmental Transfers.** Jorge Martinez-Vazquez and Bob Searle, eds.: Springer 2007.
- **Designing Sound Fiscal Relations Across Government Levels in Decentralized Countries.** Robin Boadway and Luc Eyraud: IMF 2018.
- **Conditional Grants in Principle, in Practice and in Operations: A Toolkit.** World Bank 2022.

the demands of the community or facility's governing committee; whether or not the decision will be seen favorably by the local elected leadership; and/or whether doing so would have ramifications for his or her own promotion within the sector's service cadre.



Subnational government borrowing, debt and capital finance

5. Subnational government borrowing, debt and capital finance

5.1 Relevance of borrowing and capital finance.

The fourth and final pillar of fiscal decentralization is comprised of subnational government borrowing, debt, and capital finance. The volume of this pillar of fiscal decentralization is often the smaller compared to the others; on average, borrowing and other sources of finance account for approximately 5 percent of total subnational revenues (OECD/UCLG 2019: 71).

Despite its relatively small overall volume, the topic of subnational borrowing and capital finance attracts considerable interest due to its potential to "punch above its weight," to the extent that it enables subnational governments to mobilize relatively sizable resources for the purpose of financing specific capital investment projects. Unlike the earlier pillars of fiscal decentralization (revenues and transfers), however, borrowing or other forms of capital finance, does not actually increase the amount of money that is available to subnational governments over time (Figure 2.3). Instead, financing mechanisms such as loans or bonds merely shift access to funds over time, as loans contracted today have to be repaid over time and thus reduce the resources available for public expenditures in the future.[32]

5.2 An overview of subnational government borrowing, debt and capital finance

Local and regional governments in many countries face a balanced-budget requirement. This means that, in principle, subnational governments should balance their budgets each year and ensure that they are able to cover their planned expenditures with available own and shared revenues and transfers. Problems arise when local income (revenues and transfers) and expenditures are not balanced at the end of the year.[33] If allowed at all, subnational governments often face limitations on their power to borrow. In many countries, borrowing is only permitted for the purpose of financing capital investments, rather than borrowing for financing unsustainable recurrent spending or deficits.

[32] Sometimes this is referred to as the difference between "funding" and "financing": funding is the money available to a subnational government (often derived from a variety of sources, including taxes, fees and transfers), whereas financing is the process of raising loans or capital (in the form of loans or bonds), typically for capital investment purpose.

[33] In fact, even with balanced budget requirements in place, subnational governments may actually incur a recurrent deficit when actual spending exceeds planned spending, or when actual revenues and transfers fall short of projected revenues and transfers. In some cases, local governments are able to borrow for short-term (cashflow) purposes. However, it is not unusual for subnational governments to deal with such budget imbalances by accumulating budget arrears with vendors and contractors.

There are a number of advantages to allowing subnational governments to prudently engage in borrowing and accessing capital finance. Access to borrowing and other capital financing – whether through loans, bonds, or other financing arrangements, such as public-private partnerships – allows subnational governments to finance "lumpy" long-term capital investments without the need to fund the entire investment upfront from recurrent revenue sources. Because the benefits of long-term investments are spread out over time, financing thus allows for inter-temporal matching of the benefits and repayment costs of the capital investment. Subnational borrowing could thus speed up subnational capital investments and thereby improve public services and catalyze economic growth. But there are also fiduciary risks associated with subnational borrowing. For example, when subnational governments borrow excessively, select capital investments poorly, or when they fail to repay their loans. If allowed to borrow at scale, subnational governments may also crowd out central government borrowing and private sector investment, posing potential macro-fiscal risks.

Due to potential risks, central governments impose restrictions on subnational borrowing. Such limitations may range from requirements for subnational governments to meet certain borrowing standards. These may include debt-to-revenue ratios; preapproval from the Ministry of Finance for loans; only permitting subnational governments to borrow from domestic banks, from the central government itself, or centrally-approved financial intermediaries—such as national investment banks, municipal development funds or local government loan boards (Box 5.1). Although such financial intermediaries have been used successfully in many countries with robust decentralized systems, the governance of such institutions in weaker governance contexts has yielded mixed results.

At the cutting edge of subnational borrowing capital finance are more sophisticated financing instruments—such as public bond issuances or advanced public-private partnerships. These are typically only suitable for larger subnational jurisdictions that have a robust economic base, are politically stable, are administratively well-capacitated, and manage their finances in a prudent and transparent manner (in order to ensure creditworthiness).

Box 5.1 Municipal Development Funds

Municipal Development Funds (MDFs) are parastatal institutions that lend to local governments for infrastructure investments. These are essentially financial intermediaries that provide credit to local governments, and are usually seen as an intermediate step in the way towards self-sustaining municipal credit systems that can access domestic and international capital markets for financing.

There are two main types of MDFs. The first type, currently more widely used in the developing world, functions as a substitute for government capital grants to local authorities. These MDFs provide capital at below-market rates, combining subsidized loans with grants. Usually, these MDFs exploit the favorable terms of their loans to impose strict standards of project preparation and implementation.

A second type of MDFs categirizes those that are used to serve as a bridge between local governments and the private credit market. These MDFs lend at market rates, allocate capital according to decisions of private lenders, transfer all credit risk of municipal loans to private lenders, and keep a record of municipal creditworthiness.

Source: World Bank (2011).

5.3 An overview of non-devolved borrowing and capital finance

As presented earlier in Figure 1.2, it is not only local governments that can engage in borrowing for the purposes of financing capital investments. Central governments, centrally state-owned enterprises or parastatals and, in some cases, local service delivery entities, can engage in borrowing in order to finance capital investments. In other cases, parastatals or off-budget entities serve as lenders to local government or local service delivery entities. Similar to non-devolved fiscal transfers, these non-devolved financing flows are often overlooked in analyses of fiscal decentralization and intergovernmental finance. This is especially the case when both the provider as well as the recipient are off-budget entities—for example, a loan from a parastatal or national fund to municipal utility company.

Given the challenges that local governments or local service providers often encounter in securing private sector finance for capital infrastructure, higher-level governments use parastatal organizations, national authorities or funds, state-owned enterprises, or some other special-purpose vehicle to function as an intermediary to provide local governments with access to financing. Development institutions also sometimes set up mechanisms to facilitate on-lending to the local government level. As already noted, municipal investment banks or municipal development funds (MDFs) are one kind of such funding mechanism, often lending at concessionary rates or providing a mix of loans and grants. Other more targeted funds may also provide local governments with access to financing. For instance, the Green Climate Fund (GCF) can structure its financial support through a flexible combination of grants, concessional debt, guarantees, or equity instruments to leverage blended finance and crowd-in private investment for climate action in developing countries (GCF 2021).

5.4 Common obstacles in borrowing and capital finance: technical challenges

Perhaps the most prevalent obstacle to borrowing from private sector sources in developing and transition countries is that limited own revenue sources and weak financial management practices result in the lack of creditworthiness of local governments. Therefore, relatively few local governments are actually in a position to borrow or issue debt. A second problem in many developing and transition countries is the weakness of the suppliers of credit—financial institutions and capital markets. When one or only a few cities in a country are creditworthy, domestic lending institutions may not have experience in issuing loans to local governments. Likewise, formal markets for municipal bonds and other debt instruments may be weak or absent.

If local government borrowing the domestic and international (private) sources is prohibited, the only alternative local governments have is to borrow from a financial intermediary, such as a municipal bank or urban development fund, especially set up for this purpose. Setting up such funds is not free from technical or political economy challenges.

5.5 Political economy considerations: common obstacles in borrowing and capital finance

As was the case for the previously discussed three pillars of intergovernmental finance, there are strong political economy dimensions to the often weak reliance on local government borrowing and other financing instruments.

<u>Efficient, inclusive, and responsive local governance: borrowing and capital finance</u>. The most significant obstacle to allowing local governments to rely on debt and capital finance is not a technical problem, but rather, the "moral hazard" problem associated with borrowing. This is the risk that local officials will engage in excessive borrowing when they do not bear the full consequences of their choices. The moral hazard concerns are typically exacerbated in weak governance environments.

The most obvious moral hazard aspect of local government borrowing is that local political leaders who engage in borrowing receive most of the political benefits of borrowing, while doing so incurs financial liabilities that will have to be borne by taxpayers and other local officials in future years. Trouble ensues when an incoming local mayor or local council defaults on local debt contracted by the previous local administration, on the argument that the new administration and local taxpayers should not be held responsible for the repayment of funds that were spent unwisely by previous local administrations. In order to prevent such scenarios, higher-level governments tend to restrict the level and scope of—or simply to prohibit altogether—local government borrowing. In the United States, some states require local governments to obtain the permission from the voter directly—through a referendum—before contracting debt.

Moral hazard concerns related to local fiscal balance and borrowing grow exponentially when local governments and their creditors believe that local government debt is guaranteed by higher-level governments. As such an implicit or explicit guarantee would reduce the risk for banks and other lenders for extending credit to local governments that would otherwise be a credit risk.

Empowering intergovernmental (fiscal) systems: borrowing and capital finance. While moral hazard or political economy challenges associated with local government debt largely play out at the local government level itself, higher-level governments are not always insulated from similar challenges. This is especially true when the higher-level government is seen to implicitly or explicitly guarantee the debts incurred by local governments. For example, central government officials may choose to extend "deficit grants" to cover the budget deficit of local government jurisdictions that are politically or institutionally favored, while declining the same funding to other local jurisdictions.

A similar situation arises when the higher-level government controls the financial intermediary that lends funds to local governments. This may be the case of a municipal development fund controlled by the Ministry of Finance, or a Local Government Loans Board operated by the Ministry of Local Government. Depending on political circumstances, central government entities may relax the repayment requirements for such funds—for instance, in the run-up to an election—which can spell the financial downfall of the institution, if future borrowing depends on the repayment of existing loans.

Box 5.2. Background and resources on local government borrowing, debt and external finance

- **City Creditworthiness Initiative (World Bank)**: citycred.org.
- **Municipal Finances: A Handbook for Local Governments.** Catherine Farvacque-Vitkovic and Mihaly Kopanyi: World Bank, 2014.
- **Guidebook on Capital Investment Planning for Local Governments.** Olga Kaganova: World Bank, 2011.

Implications for policy makers and development partners: improving the intergovernmental fiscal plumbing

6. Implications for policy makers and development partners: improving the intergovernmental fiscal plumbing

Sections 1 – 5 of this primer provide an overview of decentralization and localization; present an introduction to the four basic pillars of intergovernmental finance; and consider the political economy context in which decisions are made with respect to decentralized finance at the national, local and community level. All of this serves as an introductory context for policy makers, policy practioner and development actors in public sector governance, pbulic sector management, as well as in sectors working on services to be delivered at local levels by subnational entities.

Within the range of analytical tools at the disposal of policy makers, policy practitioners, and develpoment advocates, this section aims to: (a) establish a clear link between decentralized public sector finances, effective public sector management and the localization of development; (b) help policy makers and policy analysts place a country's intergovernmental governance and fiscal arrangements within a spectrum of international experiences that allows them to prioritize areas for potential policy engagement; and (c) based on the reform environment, identify specific interventions that might improve the country's intergovernmental fiscal "plumbing."

6.1 Decentralized public sector finances, effective public sector management and the localization development results

An effective, efficient, transparent, and rules-based public financial management (PFM) system is an essential tool for a government in the implementation of fiscal decentralization program. PFM reforms support the fiscal decentralization process by promoting transparency and accountability in the use of public resources, ensuring allocation of public resources in accordance with citizens' priorities, and supporting aggregate fiscal discipline.

A closer look at the evidence indicates that decentralization does not consequentially translate into better outcomes because of waste, corruption, and inefficiencies. In some countries, the money does not often reach the service delivery units (Reinikka and Svensson 2001); in others, the quality of services is very poor (Chaudhury and Hammer 2003). Furthermore, studies on the impact of decentralization on macro-fiscal indicators cannot unequivocally argue for better economic outcomes (Davoodi and Zou 1998; deMello 2000; Fukasaku and deMello 1998; Martinez-Vazquez and McNab 2006; Jali, Harun, and Mat 2012; Palienko, Oleksii, and Denysenko 2017; Albehadili and Hai 2018).

There are several reasons cited in the literature for the mixed results of decentralization programs. Some of these reasons are related to the intergovernmental fiscal framework, such as misaligned responsibilities, badly designed transfer system, and soft-budget constraint. Others are related to PFM arrangements—for example, political capture, weak accountability links, waste, and the lack of safeguarding measures against abuse, misuse, fraud, and irregularities. In designing a decentralization program, sequencing and implementation of both intergovernmental fiscal and PFM reforms are extremely important.

Decentralizing public sector finances has profound implications for intergovernmental institutions, budgetary processes, and financial arrangements underlying central-local relationship in a country. With the implementation of a decentralization program, the legal and political authority to plan projects, make decisions, and manage public functions is transferred from central government and its agencies to subnational governments. But it is important to realize that once the public administrative system of a country is decentralized, ensuring conformity with the rules and regulations, control of expenditure, and monitoring performance become increasingly complex. Therefore, fiscal decentralization reforms should be designed and implemented within the context of of broader public expenditure reforms.

Public expenditure reforms that aim to improve resource allocation and budget formulation and implementation processes have an impact on three levels of public sector outcomes: (a) aggregate fiscal discipline; (b) resource allocation based on strategic priorities; and (c) efficiency and effectiveness of programs and service delivery (PEFA 2005). They cover a wide range of issues from budget preparation to institutions of public expenditure management and public accountability which are fundamental to policy decisions and economic management. A key challenge for countries in decentralizing public sector finances is to develop coordinated budgetary and financial management reform policies across levels of government to ensure correspondence with national macroeconomic objectives for inflation, growth, and fiscal and monetary stabilization (Ter-Minassian 1997). These objectives have guided considerable efforts to improve PFM practices for central governments around the world. But relatively little effort has been exerted to consider the extent to which the design of the intergovernmental fiscal system, as a whole, supports the achievement of each of the three policy objectives of an effective PFM system, or risks the central government achievements of these goals.

Decentralizing public finances aims to move away from a centralized system, with *ex ante* controls, to a more decentralized system, with emphasis on *ex post* monitoring. Without having an effective PFM system at both central and local levels, unintended consequences of a fiscal decentralization program can be fiscal imbalance, weak accountability, political capture, and deterioration in public services.

In many countries, subnational governments lack a coherent PFM structure. Even if they do have one, it might be at odds with the national design. Therefore, as a public administration system becomes more decentralized, there is a need for better coordination of PFM functions across levels of government. This coordination should aim to achieve the following objectives:

- ***First, PFM systems (at all government levels) should ensure that public sector resources are distributed efficiently across the vertical dimension of the public sector.*** Here, the bulk of public sector resources reach the service delivery facilities responsible for frontline public service provision, rather than getting stuck at the central ministry level or at an intermediate administrative level. It is impossible to talk about allocative efficiency in a situation where financial resources get stuck at higher government or higher administrative levels.

- ***Second, PFM systems (at all government levels) should ensure that public sector resources are distributed efficiently and equitably across the national territory.*** This ensures that places with greater public expenditure needs receive proportionately greater resources. A public sector that does not optimally distribute its financial resources across the national territory in proportion to subnational expenditure needs,vwhether through centralized or decentralized mechanisms, is at risk of underfunding public sector services in certain locations and thereby failing to be allocatively efficient.[34]

- ***Third, the intergovernmental fiscal and financial framework should ensure that once funds arrive at the regional or local level (through any mechanism), these resources are efficiently transformed from resources into service delivery and development results.*** The exact requirements for improving public sector efficiency in different countries and in different locations within a country depends heavily on the specific country context, and care should be taken not to assume that centralized spending is by definition more efficient than devolved spending.[35] It is universally true that a public sector which does not optimally transform its public sector resources into development results in different places across its national territory—in a way that is responsive to different conditions in different locations—fails to achieve operational efficiency.

In order to ensure that fiscal decentralization is structured in a way which enables sustainable development outcomes, it is possible to analyze each of the four pillars of fiscal decentralization in the context of these three elements: vertical fiscal balance across

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[34] One example of this is the economic loss associated with underfunding public education in rural areas, which can result in "lost Einsteins" and slower economic growth (Bell et al 2018).

[35] For instance, in many developing and transition countries, public sector payrolls (for teachers and healthcare workers) are largely controlled or managed in a central fashion. In these cases, to the extent that public sector salaries represent the largest category of central government spending, to what degree do absenteeism and other human resource challenges result in inefficient service delivery in different locations?

different government levels; horizontal fiscal balance among subnational jurisdictions at different levels; and the efficient use of resources at the subnational level to attain sustainable development outcomes as highlighted below in Table 6.1.

Table 6.1 Fiscal decentralization and results-based public sector management: implications for the pillars of fiscal decentralization

	Assignment of functions/ expenditure responsibilities	Revenue assignment/ own source revenues (OSR)	Intergovernmental fiscal transfers (IGFT)	Borrowing and capital finance
Vertical fiscal balance (between center and subnational levels)	Devolved functions raise subnational expenditure needs; centralized functions require more central funding	Revenues are typically more centralized than expenditures (based on the subsidiarity principle)	Primary role of IGFT is to improve vertical fiscal balance, but can be used to encourage priority spending on certain functions	SNG borrowing provides access to finance, but not to funding (does not alter LT vertical fiscal balance)
Horizontal fiscal balance (among subnational jurisdictions)	The horizontal incidence of expenditure needs differs considerably across functions (and between recurrent / capital)	Revenue decentralization often benefits areas (incl. urban areas) with strong economies / natural resources	Unconditional or conditional grants can be equalizing; the mix and incidence of IGFTs is often politically driven	Poorer regions and localities are less creditworthy and have limited funding access
Efficient use of resources to attain development outcomes	The production function of public services differs across sectors and localities, and so do appropriate levels of devolution	Under right conditions, devolved finance offers accountability and links revenues and expenditures	The IGFT system may provide disincentives for OSR collection and expenditure efficiency	Private capital finance may impose a degree of market discipline

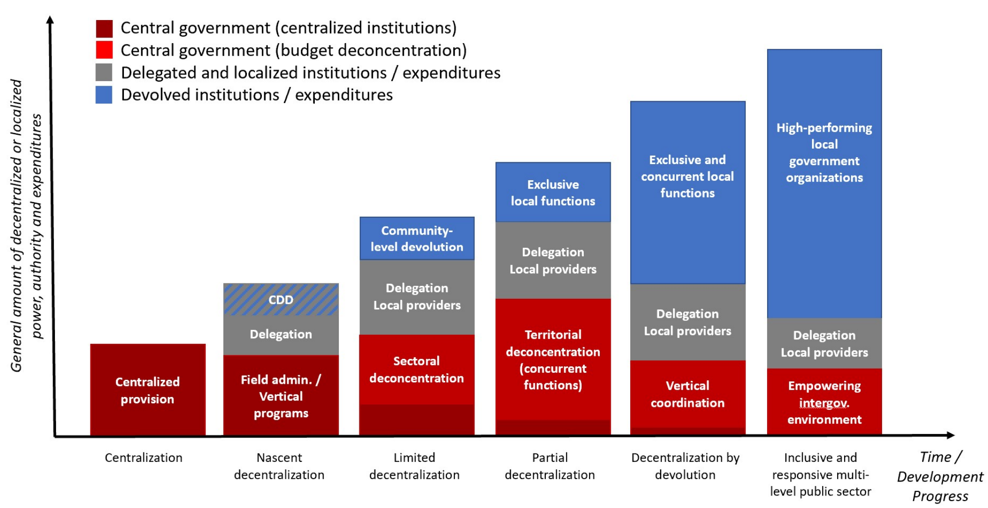
6.2 Placing country practices within a spectrum of intergovernmental institutional and fiscal arrangements

Although decentralization and localization are not linear processes, and even though each country's decentralization trajectory is unique, it is useful to consider that the general nature and composition of intergovernmental institutional and fiscal arrangements tends to evolve over time and with a country's state of development from more centralized to more decentralized.[36] No two countries are exactly alike when it comes to the nature of their state of decentralization or intergovernmental arrangements. In addition, there is nothing automatic about the evolution of intergovernmental arrangements as economic

[36] For further background and details, see: *Decentralization, Multilevel Governance, and Intergovernmental Relations: A Primer* (LPSA/World Bank 2022).

and social development takes place in a country. Nonetheless, it might be useful to specify six different generic types of decentralization and localization that reflect a typical" state of institutional and fiscal arrangements or expenditure approaches along the intergovernmental spectrum (Figure 6.1).

Figure 6.1. A typology of intergovernmental institutional and fiscal arrangements



Source: Authors.

The generic typology in Figure 6.1 presents six "textbook" types of intergovernmental arrangements. These range from evolving from a highly centralized institutional and fiscal system, where the central government is paramount and the public sector's budgetary resources are contained in the budget of the central government without any further decentralization or localization, to gradually more decentralized or localized institutional and fiscal approaches, which typically form intermediate steps on a long-term trajectory from more centralized to more decentralized public sector institutions and expenditures. As suggested by the typology, it is often the case that within a country, and even within the same sector, there is a messy and simultaneous mix of central implementation, delegation, deconcentration, and decentralization happening all at once.

At the lowest state of development, when the central public sector has an extremely limited capacity, as in an immediate post-conflict scenario, the public sector tends to organize itself in a highly centralized manner in order to use its scarce human and financial resources as efficiently as possible. However, highly centralized and concentrated public sectors tend to have major challenges in effectively localizing public services and achieving community engagement. Under such conditions, a first step in improved public services and the legitimacy of state institutions can be achieved through the development of an effective field administration, along with the introduction of vertical sector programs and community-driven development interventions (CDD), and/or delegation of service delivery functions to dedicated service delivery authorities.

In turn, each next step in the typology resolves a common (binding) constraint in the preceding intergovernmental arrangement as countries tend to progress toward a more decentralized and localized public sector as social and economic conditions evolve with the overall level of development. For instance, there tends to be a somewhat natural progression in the nature and organization of the central public sector over time, where at each stage of decentralization, the public sector tries to resolve the main binding constraint of the previous one. This sees the sector move from a fully centralized institutional and fiscal structure to administrative deconcentration, to vertical (sectoral) budgetary deconcentration, and eventually, horizontal (territorial) deconcentration. In turn, a well-functioning system of horizontal deconcentration is also often considered a precondition for effective devolution (Bahl and Martinez-Vazquez 2013).

Similarly, the nature and level of spending by devolved local governments tends to be associated with where countries are on the development spectrum. In low-capacity development contexts, devolution efforts are likely to focus on community-level local jurisdictions – for example, communes or villages – and often involve a limited set of functional responsibilities. As the institutional potential of local governments tends to grow along with the state of development, local governments in more advanced development contexts are able to incrementally take on a more prominent role in public infrastructure development and service delivery.

While it is possible to "jump" one or more stages of the decentralization process, doing so does typically complicate the decentralization or localization reforms. For instance, in recent years, both Kenya and Nepal started their constitutionally-driven devolution reforms with subnational government entities that were created *de novo* rather than relying on preexisting territorial-administrative jurisdictions. This meant that they had to "build the car while driving it"—building the institutional capacity of subnational governments from scratch at the same time as functional responsibilities were transferred. The decentralization process in these countries posed significantly greater challenges—and risks to service delivery outcomes—when compared to more sequential reforms. For example, the district-level local government organizations empowered by the "big bang" decentralization reforms in Indonesia in 2001 built on previously established (territorially deconcentrated) district administration units. This meant that despite a considerable change in the local political system, the basic management of local administration and local service delivery continued largely uninterrupted.

6.3 Improving the intergovernmental fiscal plumbing: general guidance

Once a public institutional and expenditure review has been conducted in order to identify the exact status and nature of decentralization and localization of a country's public sector, and once the status can be placed on the spectrum of international experiences as per Figure 6.1, national governments need to consider two possible directions for decentralization reforms.

First, it might be possible to shift towards a more decentralized intergovernmental disposition if there is political momentum for wholesale reform of the entire system of intergovernmental relations. An example is the post-conflict revision of constitutional arrangements. This was the case in the major decentralization reforms in Indonesia, Kenya, the Philippines, and South Africa. In such cases, it is possible to come up with general guidance with regard to possible areas where development partners might contribute in terms of strengthening intergovernmental (fiscal) arrangements (Table 6.2).

Alternatively, in the absence of such momentum or whether the country is merely trying to improve the functioning of the public sector at the margin. Making the existing system work better—by taking where a country is on the decentralization spectrum and improving intergovernmental the system—may involve tweaking or clarifying functional assignments or expenditure management arrangements; improving the collection of local own source revenues; reducing the fragmentation of the transfer system, or improving the ability of local governments to access capital financing as appropriate, in line with the discussions in Section 2-5 above.

However, where policy forces align to not just "improve in place" but take a step toward more effective public sector management and greater decentralization, Table 6.2 can provide useful—although generic—guidance on what steps might be taken at different stages of decentralization and development progress.

In interpreting the guidance in Table 6.2, it should be noted that forward progress may entail not only improvements in devolved intergovernmental finance and strengthening local government financial management. Additionally, it should involve improving the role of the central public sector in a multilevel governance framework, including through better deconcentration and delegation, and by being a better intergovernmental coordinator. Naturally, the general guidance contained in Table 6.2 should be adjusted and operationalized based on a careful assessment of the country's situation and based on the specific policy objectives for pursuing decentralization or localization. In particular, decentralization and localization reforms may be pursued in order to achieve one or all of the following:

Table 6.2 General guidance on strengthening of intergovernmental (fiscal) relations (depending on state of play and direction of reform)

		Centralization	Nascent decentralization	Limited Decentralization	Partial decentralization	Decentralization by devolution
Current Status of Decentralization	**Nature of central gov. / deconcentration**	Centralized	Field admin (admin decon.)	Sectoral deconcentration	Territorial deconcentration	Residual functions only Vertical coordination
	Nature of delegation and last-mile provision	None / limited	Limited (e.g., community management of local facilities)	Delegation to parastatals Facilities embedded in sectoral deconcentration	Delegation to parastatals Facilities embedded in territorial deconcentration	Delegated functions shifted to local governments where possible
	Nature and extent of devolution	None	Nascent (e.g., grants to community groups or quasi local governments)	Limited devolution to village/community-level local governments	Devolution of exclusively local functions to local governments	Devolution of exclusively and concurrent functions to local governments
General Guidance	**General guidance re: central gov. reforms**	Support specific localization and administrative deconcentration reforms	Move toward sectoral budget deconcentration Establish/strengthen delegate modalities	Move from sectoral to territorial deconcentration	Transition line ministries to policy/backstopping role Mitigate central opposition to devolution	Ensure empowering intergovernmental environment (incl. data)
	General guidance local government reforms	Support development of quasi-local governments	Establish basic (community-level) local governments	Support (modest or full) devolution reforms Increase role of elected subnational council	Support (full) devolution reforms	Achieve "high performing" LG organizations Increased facility-level autonomy
Specific Guidance	**Functions and expenditure assignment**	Introduce and strengthen: - Field administration - Vertical sector programs - Delegation	Pursue effective sectoral (budget) deconcentration Allow community-level LGs to manage community-level priorities	Pursue effective territorial (budget) deconcentration Devolve exclusively local functions to local governments Strengthen local PFM	Devolve as per subsidiarity principle Ensure that *de facto* exp. assignments match *de jure* Strengthen local PFM	Clarify functional assignments Ensure effective vertical coordination
	Revenue assignment and administration	Community contributions to CDD schemes	Community contributions and user fee payments to facilities/community groups	Ensure basic own source revenue administration	Strengthen own source revenue administration	Advanced (customer-oriented) own source revenue administration
	Intergovernmental fiscal transfers	CDD schemes (set up as quasi-transfer schemes)	Establish basic local development fund	Strengthen (performance-based) local development fund Ensure formula-based distribution of deconcentr. sectoral resources	Ensure adequate sectoral funding (sectoral grants?) as functions devolve	Ensure effective mix of unconditional and conditional grants
	Subnational borrowing	--	--	--	Allow limited local borrowing (e.g., through national intermediary)	Advanced borrowing and capital finance possible (bonds, etc.)

1. Improve the overall (allocative and technical) efficiency of the public sector; this is especially relevant in cases where the central public sector is considered to be under-performing.
2. Ensure a more inclusive, responsive and democratic public sector.
3. Ensure a stable and legitimate public sector, where political economy forces are balanced in a way that prevents (violent) conflict.
4. Promote the improved and results-based delivery of public services and achieve development in a socially, economically, and environmentally resilient, inclusive, sustainable, and efficient manner.

In pursuing fiscal decentralization and localization reforms, it is important to remember that the four pillars of intergovernmental finance are not only interrelated with each other, but that in turn, key aspects of fiscal decentralization are inter-related with the political and administrative aspects of decentralization. Something that appears as a technical challenge in the fiscal space—for example, local budget plans consistently favoring community-implemented infrastructure or livelihoods schemes over sectoral investments—may be caused by problems in the intergovernmental political or administrative (planning) context. Likewise, it is critical to review any decentralization or localization reform proposal through a political economy lens. Who are the winners and losers in the proposed reforms, and will key stakeholders, through the narrower lens of their own political or institutional interests, agree to the proposed reforms?

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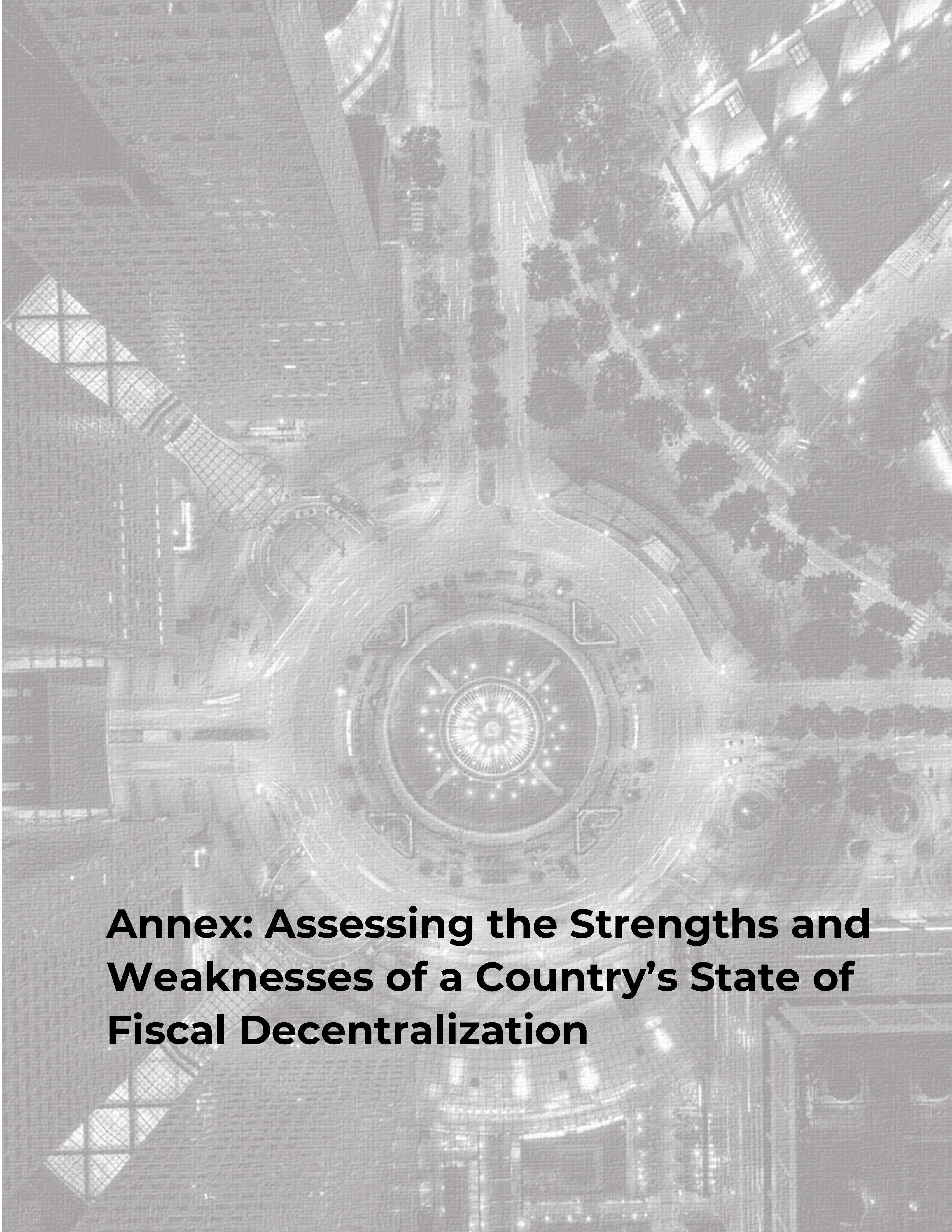

Annex: Assessing the Strengths and Weaknesses of a Country's State of Fiscal Decentralization

Annex. Assessing the strengths and weaknesses of a country's state of fiscal decentralization, local public sector finance and intergovernmental fiscal systems

An assessment of the strengths and weaknesses of a country's state of decentralization—including the state of its intergovernmental fiscal architecture and intergovernmental fiscal systems—requires a solid understanding of each of the four pillars of fiscal decentralization, as reflected in each of the four sections of this annex.

For each pillar, leading questions or assessment indicators are grouped to reflect three perspectives. First, are empowering intergovernmental systems in place? Second, within their intergovernmental context, do local governments (or local administrations) act in an efficient, inclusive, and responsive manner? And third, are citizens and civil society engaged in a constructive manner with the local public sector in a way that ensures the people's empowerment over the public sector and in a way that promotes inclusive and sustainable development?

A.1 Assessment indicators: assignment of functions and expenditure responsibilities

Effective assignment of function and expenditure responsibilities – empowering intergovernmental systems

- What is the nature of the vertical or intergovernmental structure of the public sector? How many government levels or administrative tiers exist? Do local entities have the characteristics of a local government, or should they be considered a local administration? [37]
- According to the legal framework, are functions and expenditure responsibilities assigned to different government (or administration) levels in line with the subsidiarity principle?
- Is the legal framework clear with the assignment of functional responsibilities? Is there consistency between different pieces of legislation, or are there contradictions—for example, Local Government Act *versus* sector legislation?

[37] Local governments are often understood to be defined by four characteristics: (1) the entity is a separate legal entity or body corporate (can sue and be sued in its own name; can own and transact property; etc.); (2) the entity has authoritative decision-making power over public functions in a local jurisdiction (i.e., its own political leadership); (3) the entity has control over its own officers and staff; and (4) the entity has the power to prepare, approve and execute its own budget.

- In practice, what is the share of public sector expenditures that is devolved to subnational governments (on a function-by-function basis, if possible)?
  - What amount or share is devolved for exclusive local functions?
  - What amount or share is devolved for concurrent functions?
  - What is the share of centralized, deconcentrated, and/or delegated spending, if known?
- In practice, do local governments have meaningful expenditure discretion over their functions and expenditure responsibilities, or are they merely a "post office" for spending that is determined at a higher government level? For exclusive and concurrent functions, do local governments (or local administrations) have ***authoritative control*** over the different sub-system expenditures related to their powers and functions, including:
  - Salary and wage expenditures, as well as the resources necessary to engage in staff development? Can local officials hire, promote and fire staff without higher-level authorization.
  - Non-wage recurrent spending, including procurement of good and services, as well as supplies used in the delivery of services?
  - Capital/development or infrastructure investment decisions?
- Does the *de facto* assignment of functional authority match the *de jure* responsibility of local governments, in a way that allows local governments (or local administrations) to be accountable for their performance?
- Have minimum service delivery norms or standards for local service delivery been formulated for different local government services? Are these norms affordable within the general resources available to local governments, or are the norms and standards set by the higher government level primarily aspirational? Are unfunded mandates imposed on subnational governments by the higher-level governments?
- Are effective intergovernmental budget formulation processes in place to empower subnational governments to exercise meaningful discretion in expenditure prioritization? Or are individual local governments' budgets scrutinized (and subject to revision) by higher-level government officials as part of the budget approval process?
- Do local governments receive their final, authoritative grant ceilings – for example, as approved by parliament – with adequate time to prepare their own budgets? Or do local governments only receive preliminary grant ceilings as part of the budget formulation process, while the final grant allocations are not approved by parliament until local governments have already substantively completed their budget formulation process?
- Is an effective intergovernmental framework in place for local budget execution that empowers subnational governments to execute their budgets in an effective, responsive, and accountable manner? An effective intergovernmental framework for local budget execution would ensure that local governments have access to suitable local financial management processes and systems, including accounting systems;

internal controls; financial reporting systems; payroll and human resource management systems; and procurement systems.[38]

- Beyond the regular (central-local) intergovernmental budget processes, are there effective mechanisms in place to coordinate (during budget formulation and execution) with relevant public sector institutions at different government levels to ensure that these support rather than duplicate or compete with effective frontline service delivery? Such "other" institutions may include different types of national authorities, including parastatal entities, state-owned enterprises, and national or regional investment banks as well as local or frontline service providers with some degree of budget/expenditure autonomy. These may be owned and/or operated under the purview of higher-level governments, the local government itself, or by the community.
- Do the national audit office and the national accounts committee, as relevant, perform their functions with respect to local expenditure oversight in an effective and timely manner?

Effective assignment of function and expenditure responsibilities – efficient, inclusive and responsive local governments / local administrations

- Do local governments (or local administrative bodies, as the case may be) generally follow a timely and orderly annual budget formulation, approval and execution process?
- Are local government budgets structured appropriately, allowing the allocation and use of resources to be tracked by function and department down to the facility level—for example, with each facility as a cost center?
- Do local governments prepare strategic plans, other periodic plans, such as a medium-term development plan, and/or sectoral development plans? If so, is there a connection between local plans and local budgets?
- As they develop their annual budget, to what extent do local officials have the ability to allocate budget resources across/within program categories—do subnational governments have the flexibility to shift expenditures within their budgets? Alternatively, are they prevented from doing so because of excessively conditional grants, or would they need higher level approval to do so?
- If the local budget is results-based, are appropriate service delivery norms used to prepared the budget estimates and to allocate the available resources? Are the service delivery targets realistic given the available resources?

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[38] Depending on the size (scale), scope and institutional capacity of local governments or other local entities in a country, it may be appropriate to give considerable discretion to local governments with respect to budget execution, as long as certain fiduciary standards are met. In other countries, local governments lack the size, scope or capacity to develop and implement their own PFM systems, and may need to be supported by national-level systems in order to operate efficiently.

- Does the local government have the basic capacity to manage the different aspects a well-functioning local financial management system, including accounting / recording of financial transactions; commitment controls; monthly bank reconciliation; internal controls and/or internal audit; human resource management/payroll management systems; and procurement management systems?
- Does regular and timely within-year financial reporting to the local chief executive, chief finance officers and/or council take place? Does regular and timely within-year financial reporting to higher government levels take place as appropriate?
- Is there regular—monthly or quarterly—local government political oversight over budget implementation, for instance, by the local council's account committee? Is there appropriate local government and/or community oversight over local procurements?
- Are local budgets and finances generally managed in a participatory and transparent manner? For example, are monthly/quarterly budget oversight hearings public?
- Are local governments expenditure out-turns consistent with the original approved budget, in aggregate, and/or by main functional department?
- Are local governments required to comply with a standard Chart of Accounts as well as clear and uniform accounting standards? Do they?
- What is the quality and timeliness of annual financial statements?
- Does the local executive/local administration and/or the local council follow up to resolve audit findings in an effective manner?

Effective assignment of function and expenditure responsibilities – local facilities /providers

- Do local facilities/providers have their own planning and budget formulation process? Are they appropriate and fit-for-purpose? Does the planning and budget process allow adequate facility-level discretion in order to respond to community needs within the facility's catchment area/provider's service delivery area?
- Do local facilities/providers have their own bank accounts and/or financial management processes? Are they appropriate and fit-for-purpose? Is there adequate oversight by local government? Is there adequate oversight by higher-level government regulators?

Effective assignment of function and expenditure responsibilities – engaged citizens and civil society

- Is the local government budget formulation process inclusive, participatory, and transparent while ensuring coherence of plans and budgets across the local jurisdiction? For instance, is the local executive's budget proposal made public and discussed in public hearings before local council approval is sought?

- Is the local government's budget execution process inclusive, participatory, and transparent? Are budget documents transparent and publicly available, preferably online? Is there regular public reporting on budget execution?
- Are citizens and civil society included in financial management oversight where appropriate, for example, via facility user committees?
- Does the local government, through the local administration and/or through dedicated council committees, monitor the performance of local service delivery departments? Does the local government use participatory and transparent oversight mechanisms such as Community Score Cards?
- Do the elected leadership of the local government, separate from any complaint process of the service delivery units themselves, have an effective mechanism in place to receive and resolve complaints about local services?

A.2 Assessment questions: revenue assignments and local revenue administration

Revenue assignments and local revenue administration – empowering intergovernmental systems

- Is there a clear assignment of revenue sources to each level of government?
- What share of revenues is collected by each government level? If the country is primarily deconcentrated, are local revenues retained in local accounts, or are they deposited into the central treasury?
- To what extent does the central government assign revenue sources to subnational governments in a way that matches the assignment of functional responsibilities—in line with the correspondence principle? Revenue assignment could be considered to include shared revenues; local piggyback taxes collected on national tax base; and local taxes or local user fees.
- Is the overall assignment of revenue sources efficient and in line with good revenue assignment principles such as the subsidiarity principle, as applied to revenue authority and administration?
- Within the own revenue space assigned to the local level, are local governments free to create/define their own local revenue instruments—for example, can they specify new user fees, adopt new revenue instruments, or modify existing local revenue instruments?
- Within the own revenue space assigned to the local level, to what extent do local governments have the right and authority to set the tax base and/or tax rate for their revenue instruments?
- To what extent are local governments responsible for setting tariffs and fees for local services, including services directly or indirectly under the local governments purview, such as health fees and water and sanitation fees?

- To what extent are local governments given meaningful and effective revenue enforcement powers or mechanisms for instance, compared to the national revenue authority?

Revenue assignments and local revenue administration – efficient, inclusive and responsive local governments / local administrations

- Do local officials recognize the value of revenue collection as an instrument for funding local public services in line with priorities expressed by local constituents? To the extent that local officials have control over local tax rates, do local officials set local tax rates in line with the relative demand for (exclusive) local public services?
- Does the local government budget accurately project local revenue collections as part of the budget formulation process, or do local governments systematically overestimate (or underestimate, as the case may be) their own source revenue collections?
- For non-tax revenue instruments that fund specific services or activities, do local officials set tariffs and charges and fees in a manner that ensures (recurrent or total) cost recovery, where relevant?
- Do local governments (or local administrative units) effectively and equitably collect property tax revenues? This would involve the effective registration of taxpayers/maintenance of a property cadaster; regular valuation of properties, as relevant; annual invoicing of property taxes; an appropriate process for administering revenue collections; and follow-up for arrears.
- Do local governments (or local administrative units) effectively and equitably collect other (tax and non-tax) own source revenues (OSRs)? This would involve the effective registration of taxpayers; assessing the amount of revenue due; invoicing; revenue collections; and follow-up on arrears, as relevant.
- Do local utility companies and/or local service delivery providers effectively and equitably collect tariffs, fees and charges? This would again involve the effective registration of customers; assessing the amount of revenue due; invoicing; revenue collections; and follow-up on arrears, as relevant.
- Does the local government track revenue compliance and revenue collection performance in a granular manner for instance, by neighborhood?
- In line with modern revenue administration practices, are overall collection efficiency, and customer service orientation of local revenue administration understood as critical?
- Does the local government have an effective follow-up mechanism for the collection and enforcement of tax (/revenue) arrears?

Revenue assignments and local revenue administration – local facilities /providers

- Do local facilities or providers collect any facility-level revenues from clients – for example, tariffs, user fees, or community contributions? Are these revenues recorded as local (on-budget) revenues?
- Do local facilities hold these revenues in their own accounts external to the local government's budget/bank accounts? If so, is there an appropriate local control and oversight mechanism in place to ensure that local facilities/providers manage these resources as intended?
- To the extent that facility-level revenues (earmarked revenues) are deposited in local government accounts, are adequate mechanisms in place to ensure that the funds are returned by the local provider/service delivery unit to be used for improved service delivery?
- Do local facilities or providers receive any direct payments from other off-budget sources – for example, from national parastatals, national investment funds, national and health insurance funds – in a way that bypasses local government accounts? If so, is there an appropriate local control and oversight mechanism in place to ensure that local facilities/providers spend the resources as intended and follow any conditions?

Revenue assignments and local revenue administration – engaged citizens and civil society

- If the local government has a degree of rate-setting authority over local taxes or non-tax revenues, is there a discussion of local tax rates and user fee as part of the budget formulation process? Is there a local forum for discussions on local revenue policy?
- Do local taxpayers generally understand the importance of local taxation as their financial contribution to local public services?
- Are there electoral mechanisms for ensuring citizen empowerment of local taxation or rates. For example, do local tax rate increases require voter approval?
- Do local governments proactively communicate the service delivery benefits of local taxation for instance, through a Citizen's Budget, or through billboards at road construction sites, parks, and other service delivery sites?
- Do local service providers such as local utility companies proactively communicate to their users how tariffs and/or user fee revenues are used to fund the provision of services?
- Does the local government have an effective dispute resolution mechanism regarding local revenue administration – for instance, property valuation appeals – as appropriate?
- Is the property tax administration process transparent, allowing taxpayers to see that their tax payments (and other taxpayers' payments) have been collected? For

property taxes? For other local government revenue sources? For tariffs, user fees, and off-budget local revenues?

A.3 Assessment questions: intergovernmental fiscal transfers

Intergovernmental fiscal transfers – empowering intergovernmental systems

- Does the transfer system achieve a degree of vertical fiscal balance? For instance, do local governments receive adequate general-purpose (unconditional) and/or conditional grants/transfers from a higher-level government to support local administration and to provide basic local services for all residents? [39,40]
- Is the vertical allocation of (transfer) resources stable over time? For instance, is the subnational share of transfers fixed by a sharing rule in the constitution or by law? Or is there a tendency for the central government to reduce local-level resources when the central budget has limited fiscal space?
- To what extent can transfer resources (from different transfer flows) be reallocated across/within program categories? Do subnational governments have the flexibility to shift grant resources within their budgets, or do they need higher level approval? Given the strengths and weaknesses of political, administrative and fiscal institutions at all levels, does the transfer system provide an appropriate mix of general-purpose (unconditional) and conditional grants? Or is the transfer too unconditional or too conditional?
- Does the central government rely on allocation formulas in the horizontal distribution of shared revenues and transfer resources? Is this true for all types of transfers and grants? Does the grant system generally achieve an equitable horizontal allocation of resources?
- Does the structure or nature of transfer schemes create (unintended) negative incentives for subnational behavior? For instance, is it possible to increase future transfers by overspending, under-taxing, etc.? Alternatively, do transfer schemes provide incentives to spend their available resources inefficiently – for example, rewarding spending on capital infrastructure?
- Does the structure or nature of transfer schemes provide positive marginal incentives for subnational behavior, for instance, through performance conditions, or through a matching requirement?
- Does the legal structure and timing of the intergovernmental transfer systems effectively empower subnational governments to plan with a clear hard budget

[39] Note that shared revenues should be considered general-purpose transfers when the recipient government has no control over the tax base, rate, administration, or sharing rate.
[40] Even though deconcentrated budget allocations do not meet the definition of an intergovernmental fiscal transfer, many of the same questions can be asked to assess the soundness of subnational resource allocations in a deconcentrated system.

constraint and exercise meaningful discretion in expenditure prioritization? For instance, are transfer ceilings authoritatively determined in a timely manner at the beginning of the budget formulation cycle in a way that empowers local governments to prepare their budget plans in a participatory manner?

- Does the national budget document (or related documentation) clearly specify when transfers will be disbursed to local governments, and the conditions (if any) of their release?
- During the budget year, do local governments receive transfers from the higher-level government in a complete and timely manner, without unnecessary administrative impediments?
- Can financial reporting requirements for (conditional) grants be met using regular local financial management systems, or do they require duplicate (off-system) reporting?

Intergovernmental fiscal transfers – efficient, inclusive and responsive local governments / local administrations

- During the budget formulation process, do local governments plan and budget their fiscal resources covering both own source revenues as well as transfer resources as part of single, integrated budget process?
- During the budget execution process, do local governments manage their grant resources in efficient and integrated manner as part of a single, integrated financial management process? Do local governments apply fund accounting for conditional grants or donor resources? Do local governments have mechanisms in place to ensure grant conditions are followed during budget formulation and execution, where relevant?
- If required by higher-level authorities, do local governments regularly report on the utilization of (conditional) grant resources in a transparent and timely manner, as part of their regular financial management systems and processes?
- If required by higher-level authorities, do local governments regularly report on the receipt and utilization of extrabudgetary grants and fund flows, such as grants and receipts of local utility companies and frontline providers?

Intergovernmental fiscal transfers – local facilities /providers

- Do local governments receive any intergovernmental fiscal transfers from higher-level governments that have to be partially or fully passed on to facilities or providers? If so, is there an appropriate administrative mechanism in place to ensure that these funds are transferred onward to the facility level in a complete and timely manner?
- Do local facilities or providers receive any direct intergovernmental fiscal transfers from higher-level governments. bypassing local government accounts? If so, is there

an appropriate local control and oversight mechanism in place to ensure that local facilities/providers spend the resources as intended and follow any grant conditions?

Intergovernmental fiscal transfers – engaged citizens and civil society

- Are transfer schemes effectively leveraged—when needed or appropriate—to ensure community participation and oversight, for example, as part of conditional grant requirements, or as part of a performance standards being considered under a performance-based grant scheme?
- Is performance information submitted for performance-based grants publicly available without any barriers? Is performance information validated by the community, where relevant?

A.4 Assessment questions: local government borrowing, debt and capital finance

Local government borrowing, debt and capital finance – empowering intergovernmental systems

- Do local governments or other local entities generally have access to credit from public or private financial institutions (or from bonds) to fund local capital infrastructure expenses?
- To what degree does the central government have the legal authority to limit local government borrowing? For instance, does the central government have the authority to:
  - Ban all borrowing, or require central government approval on a case by case basis?
  - Ban foreign borrowing?
  - Limit the magnitude of borrowing, for example, by placing limits on annual borrow and/or debt size, for instance, in proportion to local revenues?
  - Limit how debt can be used—for example, specify that borrowing can only be used for investment purposes?
- Is there a formal mechanism to coordinate public sector borrowing across different government levels?
- Are there public sector financial intermediaries for local governments and authorities such as a Municipal Investment Bank? Municipal Development Fund? Local Government Loans Board? If so, are these financial intermediaries run in an efficient, transparent, and accountable manner?
- If there are credit ratings, do they correspond to real fiscal outcomes, or do they reflect the creditworthiness of the public sector as a whole?

- Does the central government legally or formally guarantee the debt of local governments, in case a local government fails to repay its debt? Do creditors believe that local debt is ultimately guaranteed by the central government?
- Are there perverse incentives for subnational fiscal imbalance? For instance, does the central government provide *ad hoc* deficit grants?
- Are there formal (intergovernmental) rules or regulations regarding the timely payment of contractors and suppliers?
- Are there any formal, legislated rules about local government bankruptcy?
- Does the central government monitor subnational debt? Is the information gathering system dynamic; can it pick up and signal an evolving or emerging fiscal crisis?

Local government borrowing, debt and capital finance – efficient, inclusive and responsive local governments / local administrations

- Do local governments occasionally or regularly run up arrears to public or private suppliers and/or personnel? If so, how frequently and how much?
- Do local governments borrow from the central government/ higher-level public financial institutions? If so, how much?
- Do local governments borrow from (domestic) private banks? Do local governments borrow from local public enterprises or local (publicly-owned) banks?
- Do local governments issue domestic or international bonds?
- Do subnational governments borrow abroad?
- Do local governments repay their loans on a regular basis and timely manner, or are local government loans defaults common?

Local government borrowing, debt and capital finance – local facilities /providers

- Are local facilities/local service delivery providers able to borrow separately from their parent government?
- If so, do local facilities/local service delivery providers borrow prudently, with appropriate control and oversight by their parent government?

Local government borrowing, debt and capital finance – engaged citizens and civil society

- Does the local government consult with the community before contracting debt? Or do local governments need voter permission before contracting debt? In practice, do local governments submit their borrowing plans to a local referendum?
- Do local governments have to worry about reputational risks within the community or the business sector? For instance, do local governments have any reason to worry about credit ratings? If so, are such issues communicated to constituents?