Development Partners Working Group on Local Governance and Decentralization

DPWG-LGD

Fiscal Decentralization and Options for Donor Harmonisation

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Niña Boschmann
Paulstr. 23
10557 Berlin
Tel: 0049-30-3933546
Email: Ninabosch1@aol.com
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<tr>
<td>ARR</td>
<td>Annual Revenue Realized</td>
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<tr>
<td>BOT</td>
<td>Build-Operate-Transfer</td>
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<tr>
<td>CDF</td>
<td>Common Development Fund (Rwanda)</td>
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<td>CG</td>
<td>Central Government</td>
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<td>DPWG-LGD</td>
<td>Development Partners Working Group on Local Governance and Decentralization</td>
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<td>DDP</td>
<td>District Development Program</td>
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<td>DIE</td>
<td>Deutsches Institut für Entwicklungspolitik</td>
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<td>DILG</td>
<td>Department of Interior and Local Government (Philippines)</td>
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<tr>
<td>FADEC</td>
<td>Fonds d’Appui au Développement des Communes</td>
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<td>FCFA</td>
<td>Franc CFA</td>
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<td>FIVIS</td>
<td>Fonds d’Infrastructures des Villes Secondaires</td>
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<td>GDI</td>
<td>German Development Institute</td>
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<td>GTZ</td>
<td>Deutsche Gesellschaft für Technische Zusammenarbeit</td>
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<tr>
<td>IRA</td>
<td>Internal Revenue Allotment (Philippines)</td>
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<td>IRS</td>
<td>Internal Revenue Service</td>
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<td>LABSF</td>
<td>Local Authorities Budget Support Fund (Rwanda)</td>
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<td>LGC</td>
<td>Local Government Code (Philippines)</td>
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<td>LG(U)</td>
<td>Local Government(Unit)</td>
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<tr>
<td>LGUGC</td>
<td>Local Government Unit Guarantee Corporation (Philippines)</td>
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<tr>
<td>MC</td>
<td>Minimal condition</td>
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<td>MFMA</td>
<td>Municipal Finance and Management Act (South Africa)</td>
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<td>MINALOC</td>
<td>Ministry of Local Government (Rwanda)</td>
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<tr>
<td>MINECOFIN</td>
<td>Ministry of Economic Development and Finance (Rwanda)</td>
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<td>MOFED</td>
<td>Ministry of Finance and Economic Development</td>
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<td>MTEF</td>
<td>Medium Term Expenditure Framework</td>
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<td>MWUD</td>
<td>Ministry of Works and Urban Development</td>
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<td>PDAP</td>
<td>Provincial Development Action Program</td>
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<td>PEFA</td>
<td>Public Expenditure and Financial Accountability</td>
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<td>P(B)G</td>
<td>Performance (based) Grant</td>
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<td>PM</td>
<td>Performance Measure</td>
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<td>PFM</td>
<td>Public Financial Management</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<td>PPP</td>
<td>Public-private partnership</td>
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<td>PSP</td>
<td>Private sector providers</td>
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<td>RPT(A)</td>
<td>Real Property Tax (Assessment)</td>
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<td>RDA</td>
<td>Regional Development Account</td>
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<td>SDC</td>
<td>Swiss Development Cooperation</td>
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<td>SLA</td>
<td>Subsidiary Loan Agreement (Indonesia)</td>
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<td>TNUDF</td>
<td>Tamil Nadu Urban Development Fund</td>
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<tr>
<td>ULB</td>
<td>Urban Local Government</td>
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<tr>
<td>US-AID</td>
<td>US-Agency for International Development</td>
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<td>VAT</td>
<td>Value-Added Tax</td>
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Executive Summary

1 Introduction

Since the beginning of the 1990s, most developing countries have embarked in a process of subsequent decentralization, combining political, administrative and fiscal aspects. In this context, the Secretariat of the Development Partners Working Group on Local Governance and Decentralization (DPWG-LGD) has commissioned a desk study in the area of Fiscal Decentralization with a focus on local taxation, in order to produce recommendations on two levels: (i) Simplification and optimisation of fiscal systems and (ii) harmonisation of development partners’ interventions.

The desk study has been conducted by an individual consultant from Germany and used sources of information provided by the working group members as well as other sources from her professional experience. Reference is made to positive as well as negative experience in a range of countries, including states at different stages of fiscal decentralization. With regard to revenue generation at sub-national levels, the focus is on real property tax and market fees and taxes. Selected examples regarding innovative modalities for performance-based grants, sub-national borrowing and public-private partnerships are also analysed.

2 General Challenges for Decentralization in Developing Countries

Decentralization is a longer-term gradual process that involves, within an appropriate legal framework, various components, such as political decentralization, administrative decentralization and fiscal decentralization. All three components need to be present. However, the mix of the components may vary and, consequently the prevailing situation may have a bias towards de-concentration or devolution. Assumed benefits of decentralization relate to: (i) the principle of subsidiarity, (ii) improved governance, accountability, democratization and citizen participation, (iii) Increased efficiency with regard to service delivery.

Fiscal decentralization generally refers to the devolution of taxing and spending powers from the control of central government authorities to government authorities at sub-national levels (regional, provincial, municipal, etc). In a very decentralized system, local governments have considerable power to mobilize resources, through taxing authorities accompanied by strong tax bases.

Generally, the devolution of functions and expenditure responsibilities goes along with (or is followed by) the de-concentration of public services and local elections. Most countries on the way to fiscal decentralization have started to develop a (more or less complex) set of legal reforms including a tax code, a new budget law and a treasury law.

There seems to be no agreed overall model for the implementation of decentralization. The states of the world are structured in many different ways. In most countries of the north, the structure of fiscal federalism resulted from historical events rather than as a result of design. The same applies to developing countries. This makes cooperation in establishing decentralization frameworks as well as donor harmonization challenging.
The lack of willingness of the centre to relinquish power has been a major impediment to decentralization in many countries and is possibly more constraining than the creation of an appropriate legal framework. Therefore, the fundamental challenge for good governance in Africa is to strengthen the political will in support of decentralization. In many African countries, clear constitutional principles as well as legislative and regulatory frameworks, which are key for decentralization, are not yet in place. However, there are successful examples of comprehensive legal frameworks, among least developed countries as well as middle-income countries.

**Technical challenges** during the implementation of decentralization relate to primarily to imbalances between the different dimensions of decentralization: (i) if functions are assigned to local governments these need to be elected to be accountable to their electorate, (ii) if governments have been elected, they need financial resources to comply with their functions, (iii) if resources are assigned and transferred, these need to match the expenditure assignments. Further, insufficient capacity constrains the often young LGs. If effective internal and external control mechanisms for local governments are absent, transparency and accountability cannot be established, which opens room for corruption and misspending of funds.

To date, decentralization around the world is being accompanied by different kinds of **imbalances**, which reflect an exaggerated focus on either the revenue side, the political dimensions or the administrative dimension, while neglecting others. This implies **risks** for success in particular rising demands in infrastructure and public service delivery cannot be met. Most local governments are presently delivering only a small part of the **services** of the total that they are supposed be responsible for. A vicious circle is created: While services are poor, and there is little inclination with the public to pay for them. When no payments are received for services delivered, local government is not in a position to improve these services, even if they are entitled to establish cost recovery charges.

### 3 Balancing Intergovernmental Fiscal Relations

In the design of a decentralized system of intergovernmental finances, there is an obvious need for a policy decision on concrete assignment of expenditure responsibilities as well as taxes. Taxes as well as expenditures should be assigned to the lowest level of government that can implement it (Subsidiarity). However, both do rarely match LGs’ needs and capacities. Current Problems with expenditure assignments relate to: (i) Lack of Formal Assignments or fragmentation of responsibilities, (ii) Inefficient Assignments and (iii) overambitious attribution of functions to sub-national governments.

Sub-national **tax autonomy** has often remained limited and capacity to develop existing competences is weak as well. From a technical point of view, for most sub-national governments it is appropriate to rely on property taxes, commercial or business licenses and local retail sales taxes. To date, in most countries LGs lack tax autonomy or suffer from inefficient sharing arrangements. Autonomy in certain areas (such as market fees and taxes) has proven to be vulnerable to inconsistency, duplication of effort, and excessive complexity. Accordingly, in most partner countries, the amount of locally generated revenue is minimal.
Experience across regions indicates that the potential benefits of decentralization will only materialize if intergovernmental fiscal relations are supported by substantial **vertical and eventually horizontal transfers** to local governments in order to compensate for the lack of locally generated revenue and provide stability, equity and efficiency. These transfers can take many forms, with a varying degree of control, conditionality and equalization, which reflect political priorities. In least developed countries, decentralization has mostly taken the form of de-concentration.

At the starting point of decentralization **earmarking** is generally tight and activity specific, while the long-term vision of fiscal decentralization is a system with more discretionary powers. The challenge is how conditionality can be relaxed or reformulated such that they provide local authorities some degree of freedom in the allocation of the resources without increasing fiduciary and developmental risks.

Transfers should be based on simple and transparent **formulae**. However, experience of several countries has shown that the design of the perfect equalization formula is an impossible undertaking. A simple formula cannot take all requirements into consideration, while complex formulae are difficult to share. In addition, efforts in least developed countries have shown that even simple formula may require updated data, which are difficult to generate. In particular in francophone and lusophone Africa the overall amount of resources transferred to sub-national governments is low, not formula-driven and not predictable and data are lacking to feed even simple distribution formulae.

In those countries where intergovernmental transfers have been substantially increased (mostly middle income countries), a continued (or even increased) **Fiscal Dependency** is being observed. This occurs when (conditional or unconditional) transfers are fast increasing while locally generated revenues are not.

### 4 Options for improving Local Revenue Generation

Available evidence allied to best practice for fiscal decentralization suggests that the percentage of local revenues collected compared to overall expenditures remains low in many developing countries. The reasons are (i) weak local revenue base in most African countries and lack of tax authority and lack of administrative capacity; (ii) concentration of locally generated revenue in the larger urban areas, (iii) badly designed transfers and grants which lead to erosion of incentives to locally generate revenues, (iv) interfaces between weak local revenue base and other governance aspects. However, there are substantial local revenue potentials to be tapped.

The following administrative and technical **weaknesses** apply to most African countries but also some more advanced countries: Tax bases of local governments are static, Mechanisms for collecting internal revenues are ineffective; appropriate sanctions or punishment for tax defaulters are absent. Most residents, especially traders, do not feel obliged to pay taxes. The co-operation and exchange of data between the LGs and other public institutions and state agencies seems not to function very well. Transparency in fiscal and financial affairs remains limited and/or financial information does not reach or is not understood by the general public.
Evidence was found for unexploited local revenue potentials with regard to real property tax, and market fees and taxes. Notwithstanding political resistance towards redistributive local tax reform, greater emphasis could be given to the cost-effectiveness of revenue collection. There is generally a need for further simplification of the licence and fee structures by reducing the number of rates and coverage and avoid double taxation and conflicts with national development policies. Several countries in Asia have made significant effort to improve RPT administration but also produced limited results while general fiscal management was not improved.

Privatization of market tax collection has been widely promoted in East Africa but was found to be rather complex and risky. Based on unrealistic fiscal potential analysis lump sum agreements might lead to an either inappropriate profit of the private tax collector or a high loss for the district. Profit margins for private collectors were found to be mostly inadequate, resulting in no significant increase, but occasional decrease in public revenues. Monitoring for districts is apparently difficult.

5 Performance-based grants

Governments and development partners have become aware that simply increasing the level of LG funding – without ensuring that LG absorptive capacity is in place or that funds are spent with a degree of efficiency or effectiveness – may not solve the problems or address the challenges associated with local service delivery. As a response, grants to LGs are increasingly designed to include performance criteria, which are meant to enhance reforms in Public Financial Management and administrative efficiency at LG level. Currently more than 15 countries have one or another form of performance-based development grant system in place.

Performance-based grants (PBGs) link performance in pre-determined areas with the access to and the size of funding applying clear and transparent allocation formulas. Most systems operate with ‘performance measures’, which are used to adjust the grants up and downwards (reward and sanction) to enhance good LG performance. Most of the PG systems have applied generic institutional performance measures, within areas such as planning, financial management, fiscal capacity and tax effort, expenditure prioritization, transparency and accountability. Shortcomings in Project Management, which are also evident, are not directly addressed by this approach. There is a clear tendency to develop and fine-tune the performance-based systems once they are in place, and to elaborate second and third ‘generations’ of the systems.

The lessons from the innovations with the PG systems show there are numerous design and operational challenges, particularly to: i) identify the specific indicators; ii) design the institutional arrangements; iv) involve all key stakeholders; v) ensure high credibility of the assessment, among others. Administrative transaction costs are somehow higher than those of simpler grant schemes, but these costs are easily outweighed by the benefits, if the approach is politically and technically supported.

There have been remarkable improvements in recent years in the coordination of support for LG development investments, establishment of joint donor basket funds and common project designs ensuring a more equitable distribution of funds and procedures mainstreamed with government procedures in many African and Asian
countries. The increase in **donor support** to PG systems has promoted this coordination.

As a surprise, experiences have shown that there is no direct link between general **poverty** and possibilities to improve on institutional performance as long as the indicators for performance are reasonable and well designed. A successful example for the is the FIVIS program in Benin, which has been further developed into a country-wide financing and equalisation mechanism.

While the experience with PBGs is positive with regard to general institutional performance, accountability and amount of infrastructure investment, the implications of the local investments on **operation and maintenance** have remained a great challenge in most developing countries. PBG approach has tried to address this challenge in the grant design in various ways, part of which refer to local revenue generation, inter alia in the determination of the size of the grants (e.g. compared to LG tax potential), increasing the incentives to mobilise LG own source revenues.

However, this is still an area, which leaves room for improvement. Solutions go beyond the PBG design and require reforms in the systems of LG own source revenues in many developing countries. Setting the right **incentives for LGs to collect taxes** (and other own-source revenues) has been a major challenge, especially in East Africa – where countries like Uganda have experienced large increases in the size of intergovernmental transfers in recent years, and where the legal framework for LG tax assignments is often inappropriate. Furthermore, there has often been political interference and a lack of central government administrative support to LGs in the field of local revenue mobilisation.

Transfer systems with tax effort criteria and performance measures for tax collection, have provided some positive results. But decisions to abolish the most important local taxes in several countries and political interference in local tax collection have been more important factors and are potential threats for the sustainability of the entire decentralization process.

Most countries have combined the PG systems with various types of capacity building, either demand driven, supported by genuine capacity building grants to LGs, and/or more supply driven centrally managed “backstopping” support from the centre to LG to enable the LGs to improve the performance and respond to the incentive systems. The requirements for LGs to get access to this support have typically been more lenient to ensure that most LGs get enrolled in the incentive scheme.

Further, there are numerous related performance measurement systems elaborated with various objectives, not linked to the actual transfer of funds to LGs. Examples of these include various forms of citizen’s evaluations and “report-card” methods for assessing the performance of LGs, applied in a number of e.g. Asian countries. These systems are put in place to monitor the development in certain areas of governance and/or to promote sustainable performance in sectors or cross-sectoral areas and improve the dialogue between the LGs and citizens.

6 **Sub-national Borrowing as an Option for the Fittest**

Sub-national borrowing is discussed as an option for infrastructure financing. Through the often externally funded preferential loans, access of municipalities to **financial markets** shall be improved and investment in infrastructure speeded up, which is
essential for improving living conditions. In addition, it is argued that loans contribute to transparency. However, in many countries, particularly in parts of Asia and Latin America, the first generation of municipal loans has not been sustainable.

As a result, most middle-income countries have strictly regulated municipal access to loans and introduced indicators to assess the debt potential. Based on these grounds, at least **25 developing countries** started to (re-) engage with sub-national borrowing. In this context national state guarantees for sub-national debt are generally abolished. Additionally, regulations on budgeting, accounting, reporting, and supply chain management impose discipline on municipalities.

The selection of particularly poor municipalities for loan financing is **not** a viable option for a loan programme as all loans must be financially viable. As a result, municipal loans can complement but not replace or reduce intergovernmental fiscal transfers, which are required to introduce those reforms, which may lead to accessing capital markets. However, a clever mix of moderate government subsidies with financial market tools to can provide incentives for local revenue generation. Further, the application of PEFA assessments at LG level may pave the way for fiscal reforms, which may make more LGs creditworthy.

The **market for municipal bonds** is still nascent with several constraints to growth to be overcome: On the demand side, most local governments have no or only rudimentary understanding of this financing mechanism and there is no secondary market for bonds. Accordingly, municipal experience with bonds is even more limited than experience related to municipal borrowing. For municipalities which are already borrowing, a diversified debt portfolio is an advantage of bonds. Other benefits of bonds are their greater flexibility.

**7 Involvement of Private Providers as a way forward**

From a local governments’ point of view, the major advantage of PPP lies in its nature as an off-budget mechanism for mobilising funds that are not available in the public budgets and as an additional income source for the local budget in the short run. The overall attitude of local governments towards private participation in infrastructure as well as experience is varied between countries. In some countries, foreign investors were particularly welcome, while in others, international contracts on PPP have failed dramatically. Experience indicates that success depends not only on market conditions but also on the negotiation and oversight capacity of LGs or other government agencies, in order to generate the expected revenues and avoid corruption.

In countries, where local financial governance is not strong enough to deal with complex contractual arrangements, there are several micro-level success stories for the application of **gradual approaches**, which relate to (i) doing the easiest things first and (ii) going for gradual involvement of private providers, even If comprehensive privatisation or management contracts are not.
Conclusions and Recommendations

On the modalities of decentralization

Decentralization implementation – though starting from deconcentration – shall proceed to the devolution of tasks, transforming local governments into autonomous institutions, clearly stating their exact responsibilities and sources of income.

Decentralization should lead to planning procedures that are based on perceived needs in the district and respect national policies (not vice versa). Responsibilities have to be made clear and a monitoring system implemented, corresponding to a performance-based approach.

Both traditional authorities / power structures and communication channels should be considered, in order to stimulate accountability. Mechanisms for citizen consultation and management of complaints by elected authorities should be established in order to improve performance of and respect towards assembly members.

Local government must be entitled to establish fees for services on a cost-recovery basis in order to be able to generate income from potentially profitable services

Central governments should consider introducing policies that guarantee desired minimum levels of provision for certain services at the local level. National standards can be enforced by e.g. denying full receipt of block grant money unless certain minimum expenditures and provisions established by the central government are met.

Recommendations to development partners

- Development partners should support joint comprehensive sector reviews for those sectors, which are particularly relevant for service delivery at sub-national level to increase the efficiency of operations as well as public expenditures, before promoting joint modalities of financing

- Development partners as well as governments need to understand that
  
  (i) implementation of national policies at local level requires a well-organized dialogue at sub-national level instead of the often practiced top-down approach and

  (ii) districts and other LGUs need a new type of comprehensive TA /advisory services to be able to balance respect to national policies, felt local needs, technical sector norms and PFM reforms in a professional and cost-effective way.

Matching principle

In order to avoid imbalances, it is important that the budget shares of sub-national governments match the amount of functions assigned.

Imbalances tend to overburden LGs (either with regard to the tasks devolved or with the money to spend). In view of limited administrative capacities, it may be considered to let districts focus on a selected set of activities first, for which they are mandated and bear direct responsibility.
Imbalances imply **risks** for the benefits of decentralization to come true. There is little evidence of donors conditioning support in this regard. Particularly, in the least developed countries, during the first generation of PRSP the spending on the social sectors was a major concern but budget systems were not prepared to follow up whether spending on priority programmes was done at national and sub-national levels.

**To the extent possible, services provided by government should be financed by user charges and fees.** Given the limited capacity of districts to raise own revenues, over the short to medium term, the majority of service delivery will be financed through a series of earmarked grants, whilst block transfers will fund administrative functions at the districts and provide discretionary funds to supplement earmarked allocations to service delivery.

**Recommendations to development partners**

- Development partners should actively follow up the overall amount of funds available to LGs for the compliance with their functions and condition (budget) support in this regard.

- Development partners should support establishing a closer link between fees and services rather than requesting increased discretionary powers, before this condition is met.

**Legal framework**

A specific legal framework for fiscal decentralization in general and for increased local revenue generation in particular is required, which consists of the following **key elements**: a local-government code, local government revenue legislation including a tax code, a new budget law and a treasury law which need to be consistent with the preferred structure of fiscal federalism in the country. If increased accountability is to be achieved, it is preferable that budget laws prescribe transparent procedures for budget formulation and discussion at the local level.

**Recommendations to development partners**

- Development partners should extend their support to establishing legal decentralization frameworks by explicitly referring to the institutionalisation of best practices in terms of transparency, e.g. posting budgets and local revenues, voting on or public debate of budgets, and periodic budget reviews at the local level.

- As for policy dialogue on treasury regulations it is important not to discourage effective management by local officials for the sake of central government control.

**Transfers and performance-based Grants**

In order to increase predictability, transfers should be based on strict **formulae**, targeting transfers to specified criteria, such as population size, surface area, poverty levels, local fiscal effort and others. Rules of transfer systems should be transparent and give incentives for good fiscal performance. LGs should not be penalized for raising additional revenues, by reducing grants. All current direct transfers (including conditional transfers by line ministries to LGs) should be included into the decentralized budgets.
If capacity allows for decentralization to progress from de-concentration to devolution, it is desirable that (i) Conditions will be gradually relaxed and (ii) Unconditional grants will increase at the expense of the conditional grants, both in accordance with capacity at sub-national level.

Central governments should give more incentives to the local administration to make full use of their tax potential. Whichever mode of horizontal allocation is used, the access to the funds by districts could be made subject to meeting one or more particular conditions that are related to performance. This can be activity or sector specific performance or generic performance. There should be incentives and disincentives based on performance for revenue collectors as well as the management staff responsible for the revenue generation at the district.

Revenue incentives of performance grants should be combined with reforms to make a more conducive environment for LG taxation and cautious measures, focusing the efforts on the major tax sources, combined with improvements in the efficient utilization of the collected funds. This requires an enabling legal framework for taxation, as well as capacity building of politicians and staff (especially tax collectors) and strong ‘moral’ support from the top political level.

Capacity development for effective fiscal decentralization requires interventions at all government levels. It is a helpful tool to classify the need for support according to the levels of intervention, in order to define target groups and viable approaches.

Recommendations to development partners

- With regard to capacity development at LG level development partners need to acknowledge that fiscal decentralization is a long term process, which depends on political will as well as technical expertise at different levels and technical assistance in (fiscal) decentralization requires involvement in CB and advisory services on the ground as well as higher government levels

- In view of the embryonic state of intergovernmental fiscal relations in most least developed countries development partners should focus their joint efforts to
  - support road maps for and monitor the increase and predictability of the amounts transferred under either modality,
  - support establishing supervision, quality control and audit mechanisms at sub-national level,
  - assist to improve availability of adequate data for supplying the transfer formula.

- All Contributions from development partners –that constitute a substantial part of the public sector budget in highly aid dependent countries - should be included in the calculation of equalization transfers and partners should provide full information in this regard.

- Development partners should support reform-oriented groups in partner countries by arguing in favour of performance-based grants; they need to acknowledge that the credibility of any performance mechanism depends on the careful choice of indicators and their assessment and communication on the
ground; saving time and effort during this stages is not conducive for LG motivation to make efforts

- Donor support to PBGs requires better linkages with the sector support programs, in order to ensure synergies between LG based programs and Sector Wide Approaches (SWAs) and a gradual merging of scattered bilateral district support programs, with (onbudget) components of capital investment support to LGs within emerging central government genuine development transfer schemes.

- In order to avoid frustration, performance-based grant systems should define realistic transition periods for the achievement of improvement, which are in line with the national reform process

- Any performance-based financing mechanisms (whether related to local revenue generation or not) should facilitate access of LGs to proper support and TA in order to facilitate improvement of scorings; Development partners should encourage partner countries to establish Capacity Building grants (as part of the intergovernmental transfers or in addition) as joint conceptual and financing mechanisms for the TA needed to accompany fiscal decentralization

Local Revenue generation

National Governments who want to increase local revenues in a sustainable and efficient way, must first establish a clear policy framework. If this is given, LGs are to focus on those sources of revenue, which provide a significant potential and a reasonable cost-benefit ratio. There is consensus to focus on (i) real property tax, (ii) licences and fees that can be levied and collected by local administrations, in particular market fees and taxes and (iii) other fees for services (water and sanitation, electricity).

Policy objectives for fiscal decentralization should be scaled back to realistic aspirations and policies be congruent with the real situation in many LGs with limited tax bases and limited revenue raising potential. The legal framework should be adjusted to increase (i) the tax base, (ii) tax yields and (iii) collection capacity at the local and central levels. It should be guaranteed (institutionally or otherwise) that local governments receive their part of the locally generated revenues in a timely manner at the beginning of the budget year without delays and without diversion. Double taxation of the same purpose should be avoided (e.g. parallel existence of RPT and a residential tax or parallel existence of several taxes on agricultural produce).

In order to enhance real property taxes, collection of basic rates, and the costs incurred with solid waste collection and treatment, as well as drainage maintenance, should be collected by means of the property tax. Poverty concerns in this regard should be addressed by (i) establishing a very low or zero property tax for informal dwellings but proceed with registration and collection of basic service fees, (ii) promoting / maintaining low-cost solutions in water and sanitation (e.g. public standpipes, public toilets, public showers) for those groups of the population who cannot afford to connect to urban networks, (iii) offer payment by installment for connection fees. Differential rates of property tax on private and commercial properties should be applied.
Privatizing parts of local revenue collection could be a viable response to corrupt and inefficient public structures, but requires a strong and experienced administration, which is able to oversee the process. As this condition is not generally given at LG level, LGUs should focus on other mechanisms to enhance tax revenues (award and sanctions).

**Recommendations to development partners**

- Development partners should build a joint position with regard to tax sharing and fiscal autonomy in each partner country, based on the experience of donors and specific framework conditions given
- Development partners and Central governments should assist LGs to overcome difficulties to levying and adjusting unpopular taxes; e.g. property evaluation may be carried out by the central tax administration or by a separate valuation agency: Partners and central governments may assist in introducing appropriate IT solutions to establish complete records of commercial and residential properties
- Development partners may build financial incentives for LGs to improve RPT collection and promote good transparency practices (e.g. Giving publicity to the “Top Ten Defaulters”) as part of their operations to support LG financing
- If privatization of collection is promoted this has to respond to be embedded in other initiatives to improve administrative capacities and monitoring, in particular incentives for tax collectors and sensitization of tax payers

**Municipal Borrowing**

Regardless of the degree of local fiscal autonomy in a country, central governments will always need to carefully monitor and project local-government finances. All types of sub-national borrowing should be closely regulated by the central authorities. Besides enforcing the debt limits established by the law, there should be a certification process of the conditions for any bond issues. Loan and bond financing are viable options for a considerable number but not all local governments in all countries.

Access to capital markets requires a sound condition of municipal finance, in order to be able to repay the loan. It is rather a second step, following reforms in municipal financial management. Given the limited interest of the private sector to engage in municipal borrowing, there is considerable merit to the establishment of a sub-national development fund to promote lending to sub-national governments for long-term capital investment. The implementation of PEFA assessments at LGU level may contribute to enhancing PFM reforms, which may lead to creditworthiness.

Grant and loan financing for infrastructure should be clearly defined and separated, and interest rates of development loans in consideration of the prevailing national market conditions, in order to avoid disturbances of the capital market. If special conditions are offered to poorer municipalities, conditionalities should be set for the implementation of FM reforms and improvement of own revenues. The central government as a general policy should not act as guarantor of regional and local government debt issues.
Municipal bond financing can be cost-effective for larger and resource rich municipalities but is rather complex as it requires a certain scale of experience and operations and success also depends on conditions of general markets for bonds.

**Recommendations to development partners**

- Development partners should support for reforms in PFM before promoting municipal loans and assist in the establishment of fiscal screening and rating of municipalities (which may be part of or in addition to a LG performance measurement system)

- Development partners should not mix loan and grant financing; If grant funds are provided in the area of municipal loans, use them for specific purposed, e.g. (i) financing or awarding of reforms, which will facilitate access to capital markets, (ii) as guarantee capital to establish lending institutions with suitable modalities

**Involvement of private providers**

**Public-Private partnerships** are complex modalities, which require thorough ex-ante assessments. They may be viable for improving the fiscal space of municipalities with (i) a strong oversight capacity, (ii) a strong negotiation capacity for fair and transparent contracts, (iii) local markets, which are profitable enough to generate a constant stream of revenue. If these conditions are not met or privatisation is politically sensitive, it is recommended to promote gradual approaches, including e.g. the following elements: (i) get people used to contribute financially at all before promoting cost recovery and focus on fees and charges, which are easy to collect, (ii) Involve private providers for specific tasks on a pilot basis

**User charges** are generally a sensitive issue and may also contradict efforts for poverty reduction. It is therefore recommended to (i) first improve service and afterwards adjust charges (not vice versa), (ii) define and publicly discuss a transparent structure of user charges (not waiting for a private provider to implement a controversial scheme), (iii) establish adequate modalities for low income to benefit from services (e.g. cross subsidization or supply of low cost services)

**Recommendations to development partners**

- Development partners may assist in developing standard contracts for delegation of specific tasks such as maintenance to private providers

- Development partners should deal with PPP as a technical issue, which requires thorough assessment before taking decisions or making recommendations; a confrontation between the PPP concept and the rights based approaches, Discuss evaluation criteria in a transparent manner

- Development partners should critically review experience with privatisation in their countries of origin. If best practices are evident, they should assist partner countries in developing and assessing specific implementing arrangements (contracts with private providers), which LGs are able to follow up.
1 Introduction

Since the beginning of the 1990s, most developing countries have embarked in a process of subsequent decentralization, combining political, administrative, and fiscal aspects. In this context, the Secretariat of the Development Partners Working Group on Local Governance and Decentralization (DPWG-LGD) has commissioned a desk study in the area of Fiscal Decentralization, to which DPWG-LGD members have contributed sources of information available to them.

The study shall analyse intergovernmental fiscal relations in a number of countries, where DPWG-LGD members are active and produce recommendations on two levels: (i) Simplification and optimisation of fiscal systems and (ii) harmonisation of development partners’ interventions. The study shall focus on local taxation and other local revenue, rather than other means of municipal finance and take into account rural as well as urban settings (See Terms of Reference in the Annex 1). Parallel to this desk study, another field study on fiscal aspects in several countries of francophone Africa has been commissioned by the French cooperation, of which another report is available. The two sources are meant to further orient DPWG-LGD’s work on donor harmonisation in the subject matter area.

The desk study has been conducted by an individual consultant from Germany and used sources of information provided by the working group members as well as other sources from her professional experience (See Annex 2). A draft report has been discussed in a meeting of the Working Group in May 2009. The final report is to summarise initial findings as well as further guidance from development partners. The consultant would like to thank all involved parties for their valuable contributions and continued support.

Methodological approach

There are different sources of finance available to sub-national governments, including conditional transfers, non-conditional transfers, own revenues, performance based grants and loan financing (including bonds). Local taxes are part of the local revenues, which shall constitute the focus of the study. On the other hand, there are different approaches how to deal with the decentralization or devolution of tasks to sub-national governments and these approaches relate to different modalities for intergovernmental fiscal relations.

The study therefore includes a brief introduction on the theoretical background and concepts of fiscal decentralization before referring so specific decentralization frameworks in different parts of the world, including explicit references to highly decentralized countries such as RSA, Colombia, India, and the Philippines. Some reference to performance based grants as a means to enhance reforms in Public Financial Management and Accounting as well as loan and bond financing will be made in order to illustrate the place of local revenues.

At first, a brief introduction is given into the rationale of decentralization and different ways of interpretation (Chapter 2). Chapter 3 is dedicated to intergovernmental fiscal relations and in particular the issue of transfers and equalisation. Chapter 4 deals with the generation of own revenues at sub-national level with a particular emphasis on Real Property Tax and market fees. Subsequently, Performance Based Grants are discussed as a means to provide incentives for capacity development of Local Governments (Chapter 5). Chapter 6 gives an overview on the implications of sub-
national borrowing and options for innovative modalities of sub-national borrowing. Chapter 7 highlights the fiscal implications of the involvement of private providers in the provision of municipal services. Corresponding recommendations are added to each of the chapters, where relevant. Recommendations refer to the optimisation of fiscal systems and harmonisation of development partners’ interventions.

With regard to the regional focus, Sub-Saharan Africa is the focal area of development grant financing and reflections on reforms should therefore refer to feasibility of implementation under the conditions given in this region. Some partner countries have launched promising initiatives to reform their municipal finance, including tax reform. Yet, a number of countries, which have further advanced in fiscal decentralization and experienced innovative modalities, are usually not located in Sub-Saharan Africa. The same argument applies to the rural-urban link: Those countries, which have more reliable information are usually the more decentralized and more urbanised.

For this reason, the desk study is referring to positive as well as negative experience with fiscal decentralization from more as well as less advanced countries. The selection of examples was made according to the availability of comprehensive publications in this regard, focussing on the particular characteristics of each country and lessons to be learnt for others. Recommendations on donor harmonisation are mostly limited to experience and reflections of the consultant as very few specific and topic-related information was made available in this regard.

In order to avoid confusion about the variety of terms used to describe sub-national government layers, the study will generally use the term “local government” (LG), unless specific reference is made to provincial or regional governments. If dealing with specific francophone or other non-Anglophone experiences, generic terms will be used (e.g. “municipalities”, “districts”).

2 Theoretical Background

2.1 Dimensions of Decentralization Reform

Decentralization is referred to as a transfer of authority and responsibility of public functions from the Central Government to intermediate and Local Governments (LGs) or quasi-independent government organizations. It is a complex multifaceted concept, which does require substantial reorganization of public sector service delivery and finance in order to become effective. It is generally accepted to make a distinction between at least three main types of decentralization (See JICA 2008):

De-concentration is often considered to be the weakest form of decentralization; it redistributes decision making authority and financial and management responsibilities among different levels of the central government. It can merely shift responsibilities from CG officials in the capital city to those working in regions, provinces or districts,

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1 The quality of a desk study is inevitably limited in this regard. Some information may be outdated. The consultant has made efforts to update any information included, in accordance with comments from partners and within the framework given.

2 Information in this chapter relies on JICA 2008, Gallagher 1998 and van’t Land 2009, including references to the School of Public Policy at Georgia State University and earlier World Bank Publications on decentralization in East Africa.
or it can create strong field administration or local administrative capacity under the supervision of CG ministries³.

**Delegation** is a more extensive form of decentralization. Through delegation CGs transfer responsibility for decision-making and administration of public functions to semi-autonomous organizations not wholly controlled by the CG, but ultimately accountable to it. Governments do also delegate responsibilities when they create public enterprises or corporations, housing authorities, transportation authorities, special service districts, semi-autonomous school districts, regional development corporations, or special project implementation units. Usually these organizations have a great deal of discretion in decision-making. They may be exempt from constraints on regular civil service personnel and may be able to charge users directly for services.

**Devolution** a third type of decentralization. When governments devolve functions, they transfer authority for decision-making, finance, and management to quasi-autonomous units of LG with corporate status. Devolution usually transfers responsibilities for services to municipalities/district councils etc. that elect their own mayors and councils, raise their own revenues and have independent authority to make investment decisions. In a devolved system LGs have clear and legally recognized geographical boundaries over which they exercise authority and within which they perform public functions⁴.

Decentralization is a longer-term **gradual process** that involves, within an appropriate legal framework, various components, such as political decentralization, administrative decentralization and fiscal decentralization:

- **Political decentralization** relates to the transfer of functions or authority from central levels of government to local institutions that are governed by local political representation. It means that certain, well described decision-making powers, but also systems of accountability, are being transferred from central government to lower levels of government

- **Administrative decentralization** refers to the de-linking of line ministry staff from their respective ministries and bringing them under the control of the local authority; which includes procedures for establishing a local pay-roll. It means that local authorities can hire and fire their own staff

- **Fiscal decentralization** relates to the transfer of functions or authority from central levels of government to local institutions regarding local decision-making on the allocation of financial resources (i.e. financial discretionary powers) and the powers to levy local taxes. Full fiscal decentralization requires political decentralization and, at least to some extend, administrative decentralization.

All three components need to be present. However, the mix of the components may vary and, consequently (eg. when administrative decentralization is predominant) the

³ The shifting of responsibilities to CG officials at sub-national levels is generally practiced in francophone Africa, while in parts of Latin America there is substantial autonomy at sub-national level and CG officials focus their interventions on supervision.

⁴ It has furthermore been a common trend within social sectors to delegate or devolve responsibilities to user groups such as health users management committees, school committees etc. The analysis of this modality is beyond the scope of this study.
prevailing situation may have a bias towards *de-concentration*, or, when all three components are present, the features of *devolution* (See Annex 3 for terminology).

### Defining Fiscal Decentralization

Fiscal federalism refers to the structure of financial and broader relationships between central and subordinate levels of government. The process of altering the structure of fiscal federalism by devolving powers to lower levels of government is generally known as fiscal decentralization. Essentially, fiscal federalism is a state of affairs, whereas fiscal decentralization is a specific process meant to alter that state of affairs.

Decentralization essentially is a matter of the devolution of power from the center to the periphery. More precisely, fiscal decentralization generally refers to the devolution of taxing and spending powers from the control of central government authorities to government authorities either at sub-national levels (regional, provincial, municipal, etc). In a very decentralized system, local governments have considerable power to mobilize resources, through taxing authorities accompanied by strong tax bases.

Fiscal decentralization is being promoted by development partners hoping to bring services closer to the people and thus facilitate poverty reduction as well as public accountability.

In fact, each type of decentralization represents a different way of organizing the public sector service delivery, and therefore influences the way that public sector is organized. One form is not per se better or worse than the other, and the option chosen is a political decision, which is usually embedded in the overall political culture of the country. E.g. in Tanzania, in an Anglophone setting and a tradition of local autonomy in different aspects, political discussion is focused on decentralization by devolution. Contrary to this, in francophone Africa, delegation and deconcentration is regarded as more appropriate, in particular in fiscal matters.

Yet, for technicians it is important to have a good understanding in which of the systems they are operating because the *flow of funds* and the way their use is administered (by district staff or delegated staff from CG ministries) will affect accountability at local level. There is a difference between transfers made under the decentralized budget and transfers made by ministries or projects. A transfer made under the decentralized budget is part of a parliament approved allocation for the districts (as fully accountable budget agencies). For the latter cases, the line ministry or the project remain the accounting officer. The first transfer is an ‘entitlement’ for the districts, but for the latter cases districts are dependent on decisions made by ministries and projects during the year. In any case it is crucial for the credibility of decentralization that districts are able to exercise some budget autonomy, and roles and responsibilities regarding autonomy and responsibility be clearly defined.

The devolution of functions and expenditure responsibilities to sub-national governments (in particular municipalities) goes along with (or is followed by) the *de-concentration of public services*. Reforms of the institutional framework are completed by the holding of regular local elections, which shall allow the local governments to function. Under the new mandate, local governments play a vital role in the reduction of poverty and the implementation of the Millennium Development Goals (MDG) and the availability of sufficient financial resources is a major concern.

At the same time, decentralization is assumed to offer a way of *sharing power* more widely within a country, among regions and among various ethnic groups, thereby
providing grounds for political consensus and stability. Overall, a stabilized political system is believed to offer a better foundation for the poor to improve their life. In a decentralized system much of the M&E with regard to actual implementation will be done at the local level, e.g. through the district council and other consultative or civic mechanisms. Political (or democratic) decentralization is expected to offer citizens possibilities of increased participation in local decision-making processes, from which they have previously been excluded, and which is expected to provide them with better access to services.

However, evidence is mixed in this regard. Municipal elections do at least not automatically provide better for better service delivery, as it takes some time for councils and committees to understand their roles and become familiar with administrative mechanisms. Further, civil society is not always well organised as to comply with civic watchdog functions and elected mayors do not always have sufficient administrative staff to comply with their functions. Low levels of general education (such as council members not always being literate) contribute to the challenge.

Recent research (See GDI 2009) is therefore recommended to accepting the reality of iterative phased approaches with integrated fiscal decentralization being a long term goal.\(^5\)

### 2.2 Decentralization and Good Governance

Fiscal decentralization has many proponents, in particular as a strategy to improve service delivery at local level. Commonly accepted objectives for fiscal decentralization include those of an efficient allocation of resources via a responsive and accountable government, an equitable provision of services to citizens in different jurisdictions, and preservation of macroeconomic stability and promotion of economic growth. Particularly during the last two decades, countries throughout the world have been decentralizing responsibilities for infrastructure delivery from the central state to lower spheres of government.

The reason why many developing countries opted for reforms aiming at greater decentralization, is the principle of *subsidarity*, according to which public authority should reside at the lowest level of political organization capable of using it effectively. At the same time, assigned expenditure responsibilities shall always be matched with adequate financing.

Decentralization is believed having a potential to increase efficiency with regard to the use of public funds mainly through *improved governance* as a result of (i) increased ownership, (ii) better fine-tuning to local circumstances, and (iii) increased and more direct mechanisms of accountability. First, decentralization is associated with increased efficiency, as lower spheres of government are more likely to assess demand and to know peoples’ priorities. Second, decentralization may lead to stronger democracy, as it makes local government more accountable for its actions (World Bank 2003; Ahmad et al. 2005, quoted via GDI 2007).

\(^5\) Jörg Faust from German Development Institute has defined Stage 1 as Integrated Fiscal Decentralization across sectors and regions, being in line with expenditure responsibilities, formula-based and performance-based. IFD 2 refers to local political autonomy, local accountability and substantial sub-national resources from taxes and other revenues.
Arguments related to **efficiency advantages** through decentralization in particular refer to higher consumer efficiency, competition, lower transaction costs and more efficient revenue rising. Consumer efficiency relates to the assumption that consumers’ preferences differ within a country; and, therefore uniform levels of services in all municipalities are inefficient. In this sense, decentralized service delivery increases efficiency, as services can be provided according to local preferences.

Second, vertical and horizontal **competition between different government units** can work as an incentive for cost-efficient service delivery, as competition restricts the possibility to endlessly increase taxes. Moreover, transaction costs may be significantly lower when services are provided locally, since local knowledge can be used and decisions can be implemented faster. Lastly, especially in developing countries a large portion of the economy falls outside the tax net. Since sub-national governments are more likely to have reliable information about the tax base, they might be able to capture more individuals for tax-paying.

Decentralization is also assumed to positively affect **democratization**, as it “brings government closer to the people” (Wittenberg 2003: 4). This line of argument comprises several related strands of discussion, including accountability, participation, checks and balances and a greater variety of choices. First, local government is more likely to be accountable to its constituency, since information flows are better in a geographically confined area, and people can more easily control whether local authorities consider their needs (Wittenberg: 2003, 6).

Second, decentralization can increase **participation** of the local population. When immediate beneficiaries (either directly or through representation) are involved in planning for allocation of public resources, it is assumed that interventions were likely to better suit local needs and priorities as compared to a situation where the Central Government plans and delivers on their behalf – hence increasing effectiveness. The presumed positive effects of dispersing responsibility to lower spheres of government may be foiled, however, if inappropriate forms of decentralization are implemented.

Within a democratic system, we generally extend this model to include devolution of power to “the people,” which they can then exercise via **locally elected government**. In countries as varied as the republics of the former Soviet Union, the nations of Central and Eastern Europe, South Africa, Australia, and various developing countries (e.g., Argentina, Bolivia, and Colombia), many see decentralization as an important component of a strategy designed to increase the political power of people, as expressed through local governments. Decentralization may, at the least, be important for political reasons, and it may also improve the welfare of the populace.

Over the last two decades, many countries have opted (as did multinational companies and international organisations) for decentralization of their operations. Countries throughout the world are increasingly recognizing the benefits of fiscal decentralization. In theory – if not always in fact – decentralization makes it possible for people to have greater influence on the decisions of government that affect their lives.

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6 In non-democratic states, decentralization is not an option, but deconcentration may be (See Gallagher 1998).
Two models for analytic reference

Gallagher (1998) has proposed the following categories to assessing depth and nature of fiscal decentralization: In a decentralized context (also called "local choice model", referring to the democratic content) local government is highly autonomous, its leadership is selected via local election, and it is accountable to the local electorate. In the local-choice model, most "normal" local public services are the responsibility of the local government, which has the legal ability to impose "normal" local taxation.

Local legislation or ordinances authorize these local taxes, which nevertheless must be consistent with the national constitution. Residents elect the governments. There is an adequate local economic base and an institutional capacity to enable local governments to both mobilize resources and to use them to provide public goods and services desired by local constituencies. Local governments mobilize their own resources and decide how they will be used. They prepare budgets that are voted on either by local councils or by the broader local electorate.

Contrary to this, in the "principal-agent" model, local government serves at the central government’s behest or at its instruction. Local government may be elected, but it has so few powers or authorities as to make it incapable of providing services other than those mandated and funded by the central government. If these local governments prepare a budget, this is much the same as any central-government budget entity preparing its annual budget request. A local council or constituency need not review this request. Its approval or alteration is in the hands of a central government agency.

Quite obviously, the full local choice is not a condition given in many developing countries and even less in Sub-Saharan Africa. Most countries mix features of the two types. Some highly decentralized countries such as Germany have applied many of these components, although with very mixed results. However, a number of transition processes from the "principal agent” to the “local choice” model have also taken place, of which Colombia is an interesting example (See box)

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**Colombia: Successful fiscal transition without sustainable peace**

Colombia had been a very centralized state. With political liberalization and the free election of mayors in the second half of the 1980s, the country has been moving headlong toward decentralization. Prior to the reform, the president named mayors, and local governments implemented central-government programs with central government funding. Local government was part of the central-government budget system. The Colombians are moving toward the “local choice” model for municipal governments, while the regions and territories have also been decentralized, but toward the “principal-agent” model. Central government’s budget is shared with local and regional governments, which receive transfers and shared revenues amounting to almost **50 percent of the total budget**.

These revenues are transferred to local and regional governments for specific as well as non-specified uses according to a transparent formula. In part, these revenues are based upon the

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8 It is to be mentioned that also centrally funded programmes can be highly effective in developmental terms and it is not assured that all spending is more effective when left to local authorities. In Colombia, one of the most innovative and effective social programmes of the 80s, the establishment of crèches for children in rural areas, was a central government programme
size of the population, the degree of poverty, and demand (e.g. with regard to schooling needs) but performance aspects have also been included (so called “sistema general de participaciones”).

Limits were set to fiscal autonomy after a fiscal crisis around the year 2000. The fiscal state of sub-national governments is closely monitored by the national Ministry of Finance, which identifies the fiscal space for municipal borrowing and interferes in case of emergency, applying compulsory administrative measures.

The model is regarded as rather successful with regard to (i) the effectiveness of transfers and (ii) financial management at central government level. However, due to the amounts transferred, central government is now lacking funds to comply with its own functions. Further, it is to be mentioned that fiscal and political decentralization was not successful to solving the long-lasting security conflict at sub-national level. In various provinces, a significant number of municipalities are politically controlled by paramilitary groups, which do also benefit from the funds transferred.

The agenda of development partners

Last but not least, the understanding of development partners towards fiscal decentralization is not uniform. The states of the world are structured in many different ways. The traditional federal republics often fall closer to the “local-choice” model of the state. The desires for governance are expressed at the local or regional level. A large share of resources is generally collected at the regional level, and a high proportion of spending is made at the regional or local levels. Size matters but cultural preferences and traditions also prevail. Not all large countries are federal republics and not all small countries centrally administered.

It is to be emphasized that in most countries of the north, the structure of fiscal federalism resulted from historical events rather than as a result of design. The same applies to developing countries. Their fiscal systems were mostly influenced by the one of the former colonial power and not consciously reflected by governments after independence. It is to be observed that Southern administrations’ relationship with the former colonial power is quite ambivalent: While cultural and financial independence were important to achieve, it is not typical for governments to start from scratch thereafter and evaluate, which systems suits their needs. Such an attitude is also not common among advisors.

While there is consensus among development partners from the north with regard to the democratic part of decentralization (local elections, citizen participation), the understanding of fiscal decentralization is quite varied (see Box). There is a logical temptation to transferring the respective models of decentralization to partner countries in the south, which makes donor harmonization in this area quite challenging.

Variety of fiscal decentralization among Northern countries

In France the central government is responsible for almost 90 percent of all government spending, compared to two-thirds in Germany and the United States and only one-third in Switzerland. Despite efforts to reform the state in 1982 and 1986, the central government in

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9 US-AID advisors found that Central American governments – if given a choice – were still most interested to learn from fiscal management in the United States, although the USA cannot be compared at all with the small countries in Central America.
France is still quite dominant. The central government establishes the levels and rates of taxation for sub-national levels of government on an annual basis. The role of unconditional grants is rather small compared to Germany and the United States. 

Source: Gallagher 1998

As a matter of fact, the Paris Declaration is only one among several guiding principles for development partners to define their aid modalities. According to the Paris Declaration, integrated fiscal decentralization is enhanced by the pooling of resources for fiscal transfers, budget support for promoting structural decentralization reforms, strengthening of Finance Ministries, among others. However, development partners do also cooperate with line ministries (program-based approaches and others), which may have more capacity to absorb funds but are generally not in favor of devolution. Further, cooperation with a group of sub-national governments (e.g. some cities, all districts in a certain region) is still popular, as it facilitates visibility of bilateral contributions as well as monitoring from development partners’ point of view. To date, there is no facilitating agent as to harmonize the decentralization approach and the sector approach in development cooperation.

2.3 Imbalances as Childhood Diseases of Decentralization

There is still debate on the measurable advantages and disadvantages of decentralization with regards to its impact on poverty alleviation. In any case, for decentralization to deliver up to its promises, a number of conditions and assumptions underpinning the above described impact chain need to be fulfilled. In fact, the link between decentralization and improved service delivery, and thus the link to poverty alleviation, is only valid if certain conditions are met, including, amongst others (i) political commitment at the national level; (ii) availability of financial resources at the local level, (iii) human and administrative capacity; (iv) sufficient information flows, (v) effective participation and consultative mechanisms.

Technically speaking, the matching principle of local finance emphasizes that the financial capacity of local governments should be aligned with the functional responsibilities delegated to them. Often, however, this principle is not met and local governments are assigned with increased responsibilities in providing services that are not accompanied with an accordant transfer of financing means or powers. Additionally, if local governments are too small, this might implicate efficiency losses due to decreasing economies-of-scale in service delivery.

It is a common problem that the financial resources and fiscal competencies assigned to local governments do not match their tasks and responsibilities and are inadequate to meet the rising demands in infrastructure and public service delivery.

At the same time, local governments often lack the necessary capacities to effectively make use of the available resources and competencies assigned. This refers to the capacities of effective revenue-collection as well as to financial management and accounting and the capacities to link budget with development planning and implementation in order to provide effective and efficient infrastructure and other public services at local level.
One of the most vexing problems of newly decentralized systems is the **small size of traditional local jurisdictions**. These jurisdictions are too small to realize economies of scale in the delivery of public services; they may lack adequate fiscal capacity and tax base and also lack administrative and managerial capacity. There is no universal norm for the minimum number of inhabitants per district or municipality but common sense indicates that rural local governments between 2000 and 5,000 inhabitants will probably not be in a condition to provide any substantial service. In an urban context, the ideal population size will naturally be higher.

Observation indicates that within regions those countries with a highly fragmented **LG structure** have more problems in attracting capable staff than those with larger LG units, even if other development parameters are similar. For example, in West Africa, Benin has comparatively larger “communes” when compared to Mali, which facilitates setting up organizational structures. In Rwanda, in 2006 the number of districts was reduced from 106 to 31 through an administrative reform, which has gradually improved the availability of staff.

Although there are some ways to get around the small scale such as outsourcing of services, the creation of special districts, or associations of local governments, the most preferable solution to the problem is the **amalgamation** of smaller local governments into larger units with adequate size and capacity. Unfortunately, this solution (amalgamation) is often politically not feasible. Amalgamation does also not feature very prominently in the political dialogue on decentralization and support to promoting joint LG initiatives is found more in bilateral cooperation projects rather than high level policy dialogue.

Finally, local governments must be held **accountable** on how they deal with public resources to ensure that funds are spent according to the actual needs and development priorities. In the absence of strong and effective internal and external control mechanisms local governments often struggle with low levels of transparency and accountability, which opens room for corruption and misspending of funds.

Inadequate financial resources, combined with poor management of those resources and a low level of capacities and accountability, prevent effective delivery of local services - particularly to the poor. Regarding the infrastructure backlog, especially the current underinvestment in basic infrastructure imposes a major constraint on sustainable development and poverty reduction/pro-poor-growth and thus on the achievement of the Millennium Development Goals.

If (part of) the above-mentioned conditions are not met, fiscal decentralization also bears **substantial risks**, to mention a few: macroeconomic instability if CG is not in a position anymore to comply with its functions, declined investments in social infrastructures if LGs cannot absorb increased transfers. Fiscal decentralization – if not properly designed – may also enhance **conflicts** between municipalities or regions. E.g. the initial conflict which led to the war in former Yugoslavia in the early 90s, was on the modality of fiscal compensation between the different republics. In many resource-rich countries of the south there is civil war, inspired by the lack of or uneven distribution of income from oil and other natural resources (e.g. Nigeria).

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10 The inherent dilemma of a fragmented LG structure was described by a mayor in Burkina Faso during a meeting of the Association of municipalities: We are charged for taking decisions all alone but that’s not the issue. The issue is that we are working all alone”. 

27
If fiscal decentralization is to be a reality, sub-national governments must control their "own" sources of revenue. However, in order to become effective, the different dimensions of decentralization must be developed in a balanced manner, which means (i) if functions are assigned to local governments these need to be elected, (ii) if governments have been elected, they need financial resources to comply with their functions, (iii) if resources are assigned and transferred, these need to match the expenditure assignments. However, this does usually not occur. Decentralization around the world is being accompanied by different kinds of imbalances, which can be regarded as "childhood diseases" in some cases and as political obstacles in others.

The most common imbalances in decentralization processes are the following:

- **Exaggerated focus on the revenue side**: The decentralization movement in many countries of Latin America over the past decade made the mistake of designing a system of decentralized finances, revenue assignments and transfers, in the absence of a clear expenditure assignment, which is to put the car before the horse. Revenues were assigned to sub-national governments and transfers put into place before it was decided what functional competencies would be transferred from the central government to sub-national governments. These experiences led to weak decentralized systems and fiscally overburdened central governments, which in many cases continued to take on most expenditures responsibilities with fewer resources. The focus on the revenue side of decentralization and the neglect of a clearer assignment of expenditure responsibilities has also been a common theme of the decentralization process in countries in transition over the past five years.

- **Focus on the political dimensions**: In many African countries, expenditures have been assigned to local governments and elections held but the availability of financial resources is lagging behind, which puts in danger the democratic potential of the reforms.

- **Focus on the administrative dimension**: In Ethiopia, expenditures have been assigned to municipalities but local elections are often delayed and transfers for municipal functions have not been designed at all, which leads to serious risks in public health and hygiene in urban areas.

On the other hand, there are examples of comprehensive legal frameworks, among least developed countries as well as middle-income countries:

### Rwanda: Low-income country with a convincing legal framework

Despite being one of the poorest countries in the world, since 2000 Rwanda has developed one of the more coherent policy and institutional frameworks in decentralization in Sub-Saharan Africa.

In 2000, the Government launched a National Decentralization Policy. Districts have been accorded a greater role for service delivery across all sectors. The four provinces remain arms of the central Government, whilst districts and cities exercise budgetary autonomy. Boundaries of local governments have been redrawn to consolidate and reduce the former number of districts, thereby strengthening their financial viability.

The current system of intergovernmental fiscal transfers is based largely on three flows of resources from the central Government to sub-national governments: (i) an un-earmarked block grant to finance administrative costs (including salaries); (ii) grants earmarked for the
delivery of specific public services at sub-national level; (iii) a development grant through the Common Development Fund (CDF) to fund capital projects.

Earmarked funds accounted for around 87% of central government transfers to districts in 2007\textsuperscript{11}. The ranking of these three main sources reflects the current status of the decentralization process. Whilst the long-run objective is to devolve services, which are currently delegated to local government level (which implies a progressive decline in the use of earmarking), the requisite capacities of local governments and the associated mechanisms for managing devolution have yet to be established for this in the majority of line ministries.\textsuperscript{12}

The unconditional block grant has recently been increased from 3 to 5% of the previous year’s (central Government) domestic revenue, which provides for little more than the operating costs of local governments. It is expected that this grant will increase in (relative and absolute) importance over time as devolution becomes more effective. It is already high when compared to comparable transfers in francophone African countries (See Chambas et al. 2009).

Earmarked sector grants are determined by and operated through the budget process of the line ministry with oversight responsibility for the function concerned (e.g. Ministry of Health, Education…). In the budget preparation process, line ministries indicate the level of earmarked resources (recurrent and development) to be transferred to each district under the various budget programmes. In most cases, allocation is already based on formulae.

Transfers through the CDF come from the Government budget as well as donors. GoR has committed itself to channel an amount equivalent to at least 10% of the previous year’s domestic revenue collection to the fund, which has not yet been achieved. Though being a multi-purpose grant to which districts are entitled, access to CDF funds requires district governments to go through a project preparation process and to submit documents related to the progress of works before disbursements become effective.

The 2007 PEFA Assessment (See Johnson et al. 2007) has recognized the GoR’s efforts to improve Intergovernmental Fiscal Relations as well as PFM. It has considered the formulae for transfers to districts as sufficiently transparent and rule based and has also acknowledged that the budget process were designed to ensure that local governments receive timely and reliable information on their allocations from central Government. A positive Score A has been attributed to both dimensions. A more hesitant judgement is given on the districts’ reporting on budget execution. The legislative and procedural requirements for reporting are considered as clear and appropriate. However, the environment for this function (skill and experience of staff) as well as the accounting function is regarded as weak and staff was found to have difficulties to handle the formats. An above average Score B was attributed to the PFM-topic “Transparency of Inter-Governmental Fiscal Relations”\textsuperscript{13} as a whole.

\textsuperscript{11} Some of these funds are paid in ways, which encourage local providers to improve service delivery. For example, the Ministry of Education funds primary education through capitation (per capita) grants. So, if enrolment increases, so does the revenue of the school.

\textsuperscript{12} Some observers have criticized that the system were rather deconcentrated than decentralized. However, according to the assessment of the author, this argument is not valid in view of the requirements for gradual reforms, starting from a very different system, and in view of frameworks in other African countries

\textsuperscript{13} However, it is to be mentioned that - notwithstanding a generally coherent framework - the formulas in Rwanda have many flaws and are currently under review.
The Philippines: A decentralized lower-middle income country

The Philippines feature among the highly decentralized developing countries, where the reform process started early with a reasonable degree of comprehensiveness and continuity during the reference period. Comprehensiveness refers to the difference between devolution and deconcentration, which is often discussed when criticizing the decentralization framework in Sub-Saharan Africa.

The **Local Government Code** of 1991 (LGC) represents a major *shift in local governance*. It mandates the devolution of the Local Government Units (LGUs) of many functions previously carried out by the National Government with regard to investment planning and development as well as service delivery. Responsibilities are transferred to the corresponding sub-national levels (Provinces shall assume *area-wide* functions, roles and responsibilities, while cities and municipalities shall coordinate and deliver all *basic*, regular and direct services under their jurisdiction, with a minimum of shared responsibilities, which is a reasonable principle).

The **devolved activities** include the provision of municipal infrastructure such as public markets, bus terminals and roads, water supply and sanitation, solid waste management, school construction, basic health services, social welfare, environmental protection and agricultural extension. Accordingly, the budgets of line ministries such as the Departments of Agriculture, Health and Social Welfare were cut substantially, close to 50% of their staff was devolved to sub-national levels.

In order to cope with these responsibilities, LGUs were provided greater *autonomy in mobilising resources* and allocating these for service delivery. Transfers from national government were increased and fiscal management mechanisms improved in order to provide LGUs with a predictable amount of finance. LGUs receive a fixed share of the central government tax revenues (40%), which is called “Internal Revenue Allotment” (IRA). Transfers to different vertical layers of LGUs are fix as well: provinces and cities receive 23% of the total annual transfer, municipalities 34%, and barangays 20%.

Within each category, individual LGU shares are based on population (relative weight of 50%), land area (25%) and equity considerations (25%).

Intergovernmental transfers grew very fast in the 90s and accordingly, the share of the IRA in total LGU revenues increased from 40% in 1991 to over 60% in the mid-90s. IRA growth rates approached 40% p.a. in the early 90s, declined to 14% between 1994 and 1998 and have been reduced to single digits since 1999. As for the future, revenue allotments are not expected to grow very fast, due to deficit problems of the Central Government, but may still be maintained in real terms, thus providing a considerable level of predictability. The IRA is automatically and directly released to the LGUs on a quarterly basis and minimal restriction is imposed on the use. Only 20% of the IRA are earmarked for investment financing (the so-called Local Development Fund).

Since 2008, the system is under review and there are plans to introduce performance-based grants, in accordance with international trends to providing incentives for LGUs’ good performance (See chapter 5)

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14 Specifically, the LGC’s policy declaration states: “…the State shall provide for a more responsive and accountable local government structure through a system of decentralization whereby local government units shall be given more powers, authority, responsibility and resources”, regulated by a Local Tax Code and the Real Property Tax Code.

15 Barangays are the lowest LG layer, comparable to comunidades, woredas or communes.
**Capacity constraints** are another cause of imbalanced local development, even if the policy framework is comprehensive. Local governments often lack the necessary capacities to effectively make use of the available resources and competencies assigned. This refers to the capacities of effective revenue-collection as well as to financial management and accounting and the capacities to link budget with development planning and implementation in order to provide effective and efficient infrastructure and other public services at local level.

Finally, local governments must be held accountable on how they deal with public resources to ensure that funds are spent according to the actual needs and development priorities. In the absence of strong and effective internal and external control mechanisms local governments often struggle with low levels of transparency and accountability, which opens room for corruption and misspending of funds.

Thus inadequate financial resources, combined with poor management of those resources and a low level of capacities and accountability, prevent effective delivery of local services - particularly to the poor. Regarding the infrastructure backlog, especially the current underinvestment in basic infrastructure imposes a major constraint on sustainable development and poverty reduction/pro-poor-growth and thus on the achievement of the Millennium Development Goals.

**Imbalances due to External Shocks**

It has been discussed whether the process of Fiscal Decentralization is affected by the International Financial Crisis (See Roitmann 2009). Generally, decentralization processes are inherently intricate and mined with challenges, as they must consider conflicting local and central interests and navigate the complexity of simultaneous administrative, political, and economic decentralizations. Financial crises add another layer of complexity, altering the balance of the economy and creating fiscal pressure for both central and local governments.

However, to date very little research exists on the specific effects of financial crises on countries’ decentralization processes. Governments have several policy options in that case: they can maintain their set course, engage in a pro-active agenda of accelerating growth (e.g. Cambodia), implement fiscal stimuli (e.g. Indonesia), or use monetary policy. Further, central governments might use the Financial Crisis as an excuse to cut grants to local governments in order to address general fiscal pressure.

Problems at Federal Level can e.g. be dealt with by devolving revenue-raising responsibilities to local governments, or by re-centralizing spending abilities. The former option is more desirable to maintain decision making closer to users in a democratic fashion, but it is more challenging in a shrinking economy, where local governments are unlikely to be able to increase their revenue.

The crisis can be transmitted to local governments through higher unemployment and social needs, and through difficulties in investment financing. Shrinking economies can result in increasing unemployment that, in turn, prompts urban to rural migration, as has been noted in China, and in the case of Cambodia construction workers in 2008. De-urbanization increases pressure on the provision of local services in rural sectors. Nevertheless, it is not yet possible to predict whether these phenomena will constitute a sustained trend, affecting the general course of decentralization reforms.
2.4 Recommendations

- Development partners should assist partner countries to understand fiscal decentralization as part of a unified and coordinated strategy (including political and administrative decisions).

- For development partners to become aware of their own political-cultural heritage it is recommended to enhance exchange on decentralization modalities in the North and learn from each others’ experience. Specific topics to be addressed could be e.g. the understanding of oversight/control versus support / TA to local governments in the area of fiscal decentralization, the appropriateness of treasury concepts. Development partners – through the DPLF or otherwise – are encouraged to command a specific study to analyse differences between state traditions in Public Financial Management; a systematisation of these specificities and findings would be of great operational value but exceeds the scope of this study.

- Where local government units are too small to realize any economies of scale in the provision of services, development partners should promote the amalgamation of smaller local governments into larger units with adequate size and capacity. Size should respond to the scope and number of services assigned to LGs and assessments be made accordingly. As second best solutions, outsourcing of services, the creation of special districts, or associations of local governments and other common initiatives (such as joint technical teams, joint use of machinery etc.) can also be promoted but are usually less effective in technical terms.

- As the administrative setup is generally influenced by political interest at national and local level, high-level support is needed to induce administrative reforms; bilateral or joint efforts to promote may complement action from CG but cannot replace it. Development partners should use program-based approaches to bring these topics on the agenda.

3 Intergovernmental Fiscal Relations

Intergovernmental fiscal relations must be thought of as a fiscal system, and all the pieces of that system must fit together. It involves more than what is traditionally referred to as fiscal issues. Key elements in any plan for rolling out fiscal decentralization are:

- Expenditure assignments and autonomy;
- Revenue assignment and autonomy;
- Design of the intergovernmental transfer system;
- Provision for fiscal discipline;
- Civil service rules; and
- Political accountability.

16 In the francophone context this refers to e.g. the difference between “contrôle de légalité” and “appui-conseil” and a discussion about the understanding of a modern state and the fitting of the “unicité de caisse” in such a concept.
These different elements do mutually influence each other. As such, the way the system of intergovernmental transfers is shaped can influence the other components of the system. (See van’t Land 2009) The following chapters will deal with the first three components mainly.

3.1 Expenditure Assignments – Who does what?

The first fundamental step in the design of a system of intergovernmental fiscal relations is the assignment of functional responsibilities among different levels of government. A clear assignment of expenditure responsibilities - clarifying who is responsible for what - increases accountability, avoiding unproductive overlapping, duplication of authority and legal challenges.

A stable and meaningful decentralization requires a well-defined institutional framework in the assignment of expenditure responsibilities among the different levels of government together with the sufficient budgetary autonomy to carry out the assigned responsibilities at each level of government.

In any case, a government's strategy and priorities would consider assignments taking into account different weights of the objectives of efficiency, equity, and stability. What is considered the best assignment is likely to change over time with changes in costs and technological constraints, as well as changes in preferences. However, expenditure assignment decisions should be based on a unbundling of each function into sub functions, and for concurrent functions the identification of attributes for regulation, financing and implementation, and then analysis of the viability for each as a central or local responsibility.

There are no hard and fast rules about which functions should be designed to which level of government. However, responsibility for the provision of services should be at the lowest level of government compatible with the size of the “benefit area” associated with those services. This is best achieved by the “subsidiary” principle.

For the various layers of government and their service delivery tasks, this normally means that a local government is best placed to deliver those services for which the delivery area falls entirely within the administrative boundaries of that government unit (See Annex 5 for details). Certain traditionally municipal services can usually be provided better at the local level, including: garbage collection, Street lighting, Street paving (local streets), Traffic lighting and Municipal police. Primary schools could be the responsibility of a village government, while secondary schools could be managed at the sector or district level.

Other functions usually can be provided better at the central government level, such as: National defense, Border controls, International affairs, and Education standards. Expenditures undertaken for the stabilization of the economy such as massive investment or unemployment compensation are by their scale naturally ascribed to the central government. Expenditures undertaken by government for equity or income equalization reasons, such as social welfare or low income housing should fall under the domain of the central government. On the other hand,

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17 Only highly centralized systems, where all government budgets were integrated with the federal budget are able to work without expenditure assignments (Example: the former Soviet Union)
The implementation of social programs can very well be left to local governments, which may have informational and other comparative advantages (see further on).

For conceptual reasons there is scope to distinguish between expenditure assignments for **decentralized functions**, for which, in principle, districts have a certain degree of freedom (or discretion) to allocate the resources, and **delegated functions**, whereby districts simply implement activities on behalf of central government which may lead to efficiency gains, as the managers and implementers are closer to the end-users but for which the core decentralization principle of allocation gains (increased effectiveness) is not applicable. Both types of activities are equally relevant. Though regional and local governments have autonomously elected legislative powers the heads of the executive powers often continue to be appointed by the centre. This has led in many transition countries to an unwieldy mix of deconcentration and decentralization of government activities, which is not conducive for accountability.

### Asymmetric assignment of expenditure responsibilities

If traditional local jurisdictions are too small to realize economies of scale in the delivery of public services, expenditure assignments can also offer an alternative solution: This is the asymmetric assignment of expenditure responsibilities depending on the capacity of local governments. Instead of the uniform distribution of responsibilities at every tier of sub-national governments (which is the international norm) several countries assign or have assigned different packages of responsibilities according to some capacity criteria.

This practice has taken place in Colombia, Ecuador, Japan, or Spain, and more recently in some transitional countries. Larger cities (e.g., 32 largest towns in Croatia) are commonly given a broader scope of functions by elevating their administrative status to the level of districts/counties. In Armenia, rural governments are responsible for primary healthcare points (dispensaries) while local governments in urban areas have no authority over healthcare services.

In theory, asymmetric treatments of jurisdictions in any tier should be temporary because local governments will have an incentive to use all the technical assistance provided so that they can graduate and assume the competencies assigned to their peers. However, in practice asymmetric assignments can be long lasting.

*Source: UNCDF*

### Common Problems with Expenditure Assignments

The failure to establish by law a clear assignment of expenditure responsibilities for each government level can become a source of conflict between the central and sub-national governments and can lead to an inefficient provision of public services. The lack of specific and clear assignments of expenditure responsibilities necessarily conditions the adequacy of any tax revenue assignment and fiscal equalization mechanism. Without a specific expenditure assignment, revenue availability will dictate the responsibilities of each government level. This leads to institutional instability and again to an inefficient provision of public services.

Problems with expenditure assignments can be classified as follows:
• **Lack of Formal Assignment:** The lack of a formal assignment of responsibilities is a common problem in countries in transition. While a great deal of attention has been given to issues of revenue sharing and government transfers in the first years of the transition, much less attention has been given to the first logical first step in a system of intergovernmental finances: an efficient and stable assignment of expenditure responsibilities to particular levels of government. The experiences of countries such as Kazakhstan, the Russian Federation, and Ukraine show how the lack of formal assignments may be a destabilizing factor in intergovernmental relations. In these countries, early in the transition, expenditure assignments had been continuously reworked by the central authorities simply for fiscal convenience as a tool of fiscal deficit containment. From a fiscal management perspective, a formal expenditure assignment also introduces an important element of certainty for budget planning at all levels of government.

• **Inefficient Assignments:** A second problem also common to transition economies, is the assignment of expenditure responsibilities is the inefficiency of the assignments. The problem in the early years of the transition, which has been slowly solved, but also common to other countries, has been the assignment of all capital expenditure responsibilities at the central level, independently of the level of government responsible for the provision of the services associated with the capital infrastructure. This assignment was guided either by the capacity to finance large projects or by the belief that only central government officials are qualified to make capital investment decisions. However, the full assignment of capital expenditure responsibilities to central government is not justified.

• Another second important set of problems comes from the assignment of expenditure responsibilities for social protection and welfare to local governments. This is especially wrong when the responsibility for funding is assigned to regional and local governments out of general budgets. There is much less of a problem if social protection services are provided by the sub-national governments but financed by the central government. Local governments may have a comparative advantage for the efficient delivery of these services, given their proximity to local residents. But regional and local government financing responsibility for these services runs against the ultimate objective of helping the neediest because the need for social welfare and assistance is so much higher in poorer jurisdictions, which are at the same time the least able to provide the necessary funds to cover social protection needs.

Other areas where there have been problems with expenditure assignments include the responsibility for **public utilities** such as water and sewerage at the central level when these services should be assigned at the sub-national level. Ideally, this type of service would be provided by **corporate entities** dependent upon or regulated by sub-national authorities and with full-cost-recovery pricing.

Despite the ambiguity in assignments, remarkably few open conflicts or **disputes** have taken place between the central and sub-national governments in terms of assignment of expenditure responsibilities. From the operational side, conflict and negotiations vary from country to country.
However, the actual assignment of functional responsibilities is often quite different from what it appears to be in the “formal” assignment established by law or practice. Even though, in terms of actual expenditures going through the budget, education would appear to be for the most part a local (or regional) activity, many key decisions in educational policies are carried out at the central level in many countries. More in particular the Ministry of Education may be responsible for the construction of school buildings, curriculum design, teacher recruitment and training, and design and production of textbooks. Activities that are preserved at the local level may be limited to the maintenance of school buildings.

At times, the local government may be given the authority for appointing principals, school inspectors and teaching specialists. However, even in these cases local authority is limited because of the dual subordination of school officials to both the Ministry of Education and to the sub-national government. In many countries in transition as well as developing countries, even the head of the district administration is ultimately a central government appointee. Similar issues to those in the education sector arise in other sectors such as health.

The co-sharing of responsibilities between different government layers within a particular public service is likely to cause confusion leading to inefficiencies. Co-sharing of responsibilities may not be a problem when particular functions and tasks in a common area are clearly assigned to different levels of government. However, it is a common practice to leave responsibilities unclear when they are assigned to more than one level of government. These are the so called common competencies or functions which often has led to conflicts in service approach and to less than adequate coverage in different parts of the world.

It is important to introduce the concept of costing of expenditure responsibilities (How to arrive at the expenditure needs that are associated with the expenditure assignments?). Otherwise, in difficult fiscal conditions, spending less or even withdrawing from common competencies is more defensible for both central and sub-national governments. It is likely that a relative disproportion of funds will be spent on salaries and much less on other operation expenditures; similarly, maintenance may be reduced to a minimum, in particular if no specific source of funding is assigned.

Given the limited capacity of districts to raise own revenues, over the short to medium term, the majority of service delivery will be financed through a series of earmarked grants, whilst block transfers will fund administrative functions at the districts and provide discretionary funds to supplement earmarked allocations to service delivery.

A Methodology for costing services

In a TA to the Government of Rwanda, UNCDF has proposed the following methodology for the costing of expenditure responsibilities:

1. One choice is the range of expenditure functions over which to measure the needs. All public services should be included or at least those sectors, which have most direct implications for the achievement of the MDGs, such as Education, Health, Agriculture and Water.

2. In the sectors identified for the exercise, the specific services selected will be “local” in nature and refer to services that in international experience lend themselves to decentralized
delivery. Within the selected sectors core services should be demarcated (for education this may be primary education)

3. The assessment should pragmatically focus on the expenditures that are made in the delivery of services, regardless of the level involved in particular aspects of the service. Data from various tiers of governance should be broken down in various types of costs – capital, operational and maintenance and direct (e.g. for the schools) as well as indirect administrative/governance overhead costs, monitoring and supervision costs.

4. Expenditure needs can vary across districts, for mainly two factors: need differences and cost differences. Identifying relative need/cost factors, assigning relative weights using direct imputation methods or regression analysis. The list of criteria and the weight used need to be carefully assessed and also thoroughly discussed with all stakeholders to ensure that the main causes for substantial differences are included. Indeed, the selection of factors and the weights are a political choice.

5. Allocating total expenditures on each service across districts on the basis of their relative costs and needs for each function and review savings from various efficiency enhancing measures

7. Review the funding system and available amount of funds for local service delivery (taxes, revenues, other local sources and grants) both in terms of sector specific revenues such as user fees and charges and general untied funding,

8. Review the relationship between the available funding and the required sources to comply with the targets in a phased manner.

**Source:** UNCDF/MINALOC: SERVICE COSTING EXERCISE, Kigali 22 October 2008

### 3.2 Revenue Assignments to Local Governments

**Revenue assignment** refers to the question of vertical sharing of public resources (what share of the total government budget should be decentralized?). Contributions from development partners should be included as well, as those resources normally become available at the national level, while part of this is meant to fund activities that fall within the expenditure assignments of local governments.

**General considerations**

If fiscal decentralization is to be a reality, sub-national governments must control their "own" sources of revenue. Sub-national governments that lack independent sources of revenue can never truly enjoy fiscal autonomy. The question, then, is which revenue sources (including taxes) can and should be assigned to sub-national levels of government and how these assignments are to be effected.

As distribution and stabilization functions are also commonly assigned to central government, the related taxes should follow this function. Even if sub-national taxation achieves some redistribution within a given sub-national jurisdiction, interpersonal inequalities may persist across jurisdictions. These can be addressed only by national policies. In some cases it may be better to use intergovernmental grants to address differences in average income levels in various sub-national jurisdictions than to use taxes and transfers to individuals.
If sub-national governments cannot much affect macroeconomic conditions nor easily adjust to wide swings in revenues, it is appropriate for them to rely relatively heavily on revenue sources that are relatively insensitive to macroeconomic conditions. These include taxes on consumption, such as general sales taxes, excises, and property taxes. Sub-national governments should levy taxes but not generally rely on corporate income taxes – and that access to revenues from these taxes should be made available to sub-national governments only subject to rigid controls.

Each level of government should be assigned taxes that are related to the benefits of its spending. Thus, the proper assignment of taxes that are related to benefits depends on the assignment of expenditure functions. In general terms, the central government should be responsible for expenditures having benefits that extend across sub-national boundaries or that are characterized by economies of scale not realized at the sub-national level. The following taxes are usually reserved for the central government:

- Import duties,
- Value-added taxes, and
- Corporate income taxes\(^{18}\).

Certain taxes are usually, and for good reason, collected mainly by local governments, including:

- Property taxes,
- Commercial or business licenses,
- Industrial cess, and
- Local retail sales tax.

To the extent possible, services provided by government should be financed by user charges and fees. This is both fair and efficient, in the sense of encouraging responsible use of the nation's economic resources. A fee-based approach allows beneficiaries to pay for identifiable public services that might otherwise not be provided. Among the best examples of benefit-related taxes are those levied on motor vehicles and motor fuels and used for the construction and maintenance of roads and highways.

Related to the local-government revenues or tax code is the issue of revenue sharing. Revenue sharing (same as shared responsibilities) has a number of advantages and disadvantages. One of the major concerns, however, is how a system of revenue sharing would fit in with the style of the desired system of intergovernmental relations. In some countries property taxes are imposed and collected by central government but are wholly or partly transferred to local government, which does not provide obvious advantages. Revenue sharing also takes place with regard to the value-added tax (VAT).

Tax assignment should exhibit the following characteristics.

- Own revenues: First, sub-national governments must have enough “own” revenues to finance the services they provide. If a sub-national government

\(^{18}\) Nevertheless, there are several examples of LGs with income taxes, which are functioning well, e.g. the systems in e.g. Scandinavian countries.
legislates and collects its own taxes, protected by meaningful constitutional safeguards of its right to do so, it clearly has a source of own revenues.

- **Marginal revenues**: Even if sub-national governments have own revenues, they may not be able to affect the amount of revenue they receive. This is true, for example, if the central government shares revenues from certain taxes with sub-national governments. By comparison, if sub-national governments legislate and implement their own taxes – or even if they are allowed to impose surcharges on the taxes levied by the central government at rates they choose, they can affect the amount of revenues they receive. This distinction is crucial, because sub-national government must be assigned sources of marginal own revenues—own revenues whose level they can control—if they are to be truly autonomous.

- **Subsidiarity in taxation**: It is commonly accepted that expenditure responsibility should be assigned to the lowest level of government that simultaneously reflects the geographic scope of benefits of public services and achieves economies of scale; this is commonly called the principle of subsidiarity. A similar principle can be evoked in the area of tax assignment: a given tax should be assigned to the lowest level of government that can implement it (or for which it can be implemented) and for which it is not inappropriate. Compliance with this principle is important to minimize the tendency towards vertical imbalance, which exists because sub-national governments have difficulty implementing many taxes, but higher levels of government can implement almost any tax that a lower level of government can implement.

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**Alternative Methods of Revenue Assignment**

A variety of methods of assigning revenues to sub-national governments can be distinguished. These methods differ in the degree of fiscal autonomy they provide sub-national governments, their ease of compliance and administration, the fairness and neutrality they are likely to produce, and the degree of redistribution they can accommodate. In discussing these alternatives, it is convenient to distinguish four features: (a) which level of government chooses the taxes from which sub-national governments receive revenues, (b) which defines the tax base(s), (c) which sets the tax rate(s), and (d) which administers the tax(es). From the viewpoint of sub-national fiscal sovereignty, the capacity to set rates is clearly the most important of these; it is what allows sub-national governments to choose the level of public services.

**Independent sub-national legislation** and administration provides sub-national governments the most fiscal autonomy. Under this approach sub-national governments choose the taxes they levy, define the tax base(s), set the tax rate(s),
and administer the tax(es). This is the approach followed in the United States; subject only to very general constitutional limitations (e.g., due process and non-interference with interstate and international commerce) and almost no statutory limitations, the states can do virtually anything they want in these four areas.

Carried to the extreme, this approach is vulnerable to inconsistency, **duplication** of effort, and excessive complexity of compliance and administration. These problems can occur if different jurisdictions choose radically different taxes (e.g., if some levy retail sales taxes, but others levy value added taxes), define their tax bases in different ways or administer the same taxes in different ways. Inequities and economic distortions can also occur if the tax systems of various sub-national governments do not mesh, resulting in gaps or overlaps in taxation.

Within limits, these problems – which differ in importance from tax to tax – may be tolerated in the interest of gaining the benefits of decentralized government. But serious complexities, inequities, and distortions can and should be avoided. This objective can be achieved, without greatly compromising the fiscal autonomy of sub-national governments, through intergovernmental compacts among sub-national governments or the imposition of uniform ground-rules by a higher level of government, for example, rules for the definition and division of the corporate income tax base. Alternatively, sub-national surcharges on national taxes can be employed\(^\text{19}\).

**Tax sharing** is generally much less attractive than sub-national surcharges. Under this approach sub-national governments receive fixed fractions of revenues from particular national taxes originating within their boundaries; commonly the sharing rates are uniform across jurisdictions (though not across taxes), but this is not necessarily the case. As with surcharges, formulas may be needed to determine the deemed origin of tax revenues. In many less developed countries (LDCs) and countries in transition (CITs) the data needed to share revenues (e.g., data on consumption, by sub-national jurisdiction, needed to divide revenues from the VAT) may not exist or may not be reliable.

This approach also avoids the problems that arise from extreme sub-national independence in tax policy. But it does so in a way that severely restricts fiscal autonomy of sub-national governments. Individual sub-national governments have autonomy over how to spend a given amount of revenue, but not the power to alter the amount of revenue they receive from shared taxes; thus they cannot control the level of public spending.\(^\text{20}\)

**Revenue sharing** assigns revenues of higher levels of government to lower levels of government on the basis of formulas. Though the origin of revenues can be reflected in such formulas, it is more common for formulas to be based, inter alia, on population, tax capacity (inversely), or measures of need, such as per capita income. Since revenue sharing is not based on the origin of revenues, this approach offers an alternative that does not exist (or exists only in attenuated form) under the three

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\(^{19}\) Under this approach a higher level of government defines the tax base and collects both its own tax and surcharges set by sub-national governments. This approach ideally avoids the problems that occur when different sub-national jurisdictions define the tax base in conflicting ways.

\(^{20}\) While all sub-national governments, acting as a group, can attempt to affect their share of revenues from these taxes, no sub-national government, acting unilaterally, can hope to do so. In Germany the central and sub-national governments engage in an annual struggle over the split of revenues from certain taxes.
methods of revenue assignment just discussed: redistribution of fiscal resources between jurisdictions.

Some governments (Ethiopia, Rwanda) ceded the income tax on rental income to the local authorities, at a time when capacities of their national revenue authorities was low and when local authorities needed a revenue stream. Regardless of the reasons, DFID advisors came to the conclusion that such an arrangement – apart from being unusual - is definitely sub-optimal:

Firstly, it is not regarded efficient for the income tax to be split amongst different agencies (national Revenue Authorities and local authorities). Purchase of property is a common means of concealing funds that have been illegally siphoned off from a business. Involvement of different taxing authorities means that there is a ‘disconnect’ on the reporting of assets and income. A taxpayer siphoning income from his business and using that income to purchase housing for rent is not immediately obvious to either institution.

Secondly, there is the definition of what constitutes business income vis-a-vis rental income. Many taxpayers have more than one property let. Clearly with many properties rented, taxpayers are effectively engaged in business, rather than simply in receipt of casual rental income. As such they should be registered with the National Revenue Authority and obliged to return their rental income as business income. The confusion between business rental income and casual rental income is likely to lead to a significant overall revenue loss. Instead, rental income is recommended to be added to other income and emoluments and often pushes the taxpayer into a higher tax rate band with the consequence that more tax is paid.

Thirdly, the revenues from the retention of tax on rental income are insignificant and not viable when compared to the costs of collection and the lack of capacity to asses and collect at the local administrations. It is assumed that local authorities do not have the technical expertise to effectively assess this income, given that included in this category are all the rentals paid by embassies and international institutions, often in foreign currency and often to offshore bank accounts in respect of private housing (likely to be a very large sum).

3.3 The need for a legal framework to define fiscal relations

With regard to the required overall political commitment for fiscal decentralization some advisors recommend consolidating decentralization by constitutional reform as a sign of broad consensus since it usually requires much more political support than does ordinary legal reform (constitutional reforms were e.g. applied in Nicaragua and Colombia to give more powers to sub-national governments). Whether there is constitutional reform or not, there is a need to clearly specify rules of governance. Laws specifying the composition of local government — which, how, and how often local officials and councils will be elected — are basic, and due attention must be paid to them.

21 These arguments were collected from a policy dialogue between the Rwandan Government and DFID on new tax legislation and confirmed by the author’s own experience from appraisal missions in the emerging regions in Ethiopia.
Usually a general *local-government code* is developed, either by a central-government entity in unitary systems (e.g. Philippines, Burkina Faso) or by a state or regional entity in federal systems (e.g. India). The respective superior level of legislature then passes these codes into law.

Local government *revenue legislation* will be necessary to clearly define the limits to which local governments will be able to tax and collect other fees. In some countries, say, where there is less local choice, local revenue plans must be approved by the central government. In other countries a single local-revenue law specifies taxing and fee powers for all local government. In still other countries, enabling legislation provides broad parameters within which local governments may act. Related to the local-government revenues or tax code is the issue of *revenue sharing*.

As part of the decentralization process, the central government will often need to amend the current *budget law* or even write a new one in order to appropriately regulate the budget process at the local level as well as interfaces between national and local level during the budget cycle.

The *structure of the budget law* needs to be consistent with the preferred structure of fiscal federalism in the country. Where local governments are to be given greater autonomy, greater *accountability* is often a prerequisite. Budget laws can prescribe transparent procedures for budget formulation and discussion at the local level. Posting budgets, voting on or public debate of budgets, and periodic budget reviews at the local level are usually important aspects of this type of law. Where the principal-agent model is dominant, the budget law may prescribe how, within central-government regulations, local budgets will be developed, presented to central-government authorities, and included in the central-government budget submitted to the legislative branch for approval.

In addition to the budget law, most countries have a *treasury law*, which regulates how fiscal funds are to be managed, who will manage those funds, how public debt will issued, and how cash balances will be managed. In federal systems, or systems of extreme local choice, central-government treasury systems are irrelevant to local-government treasury operations, although these are usually regulated by regional (state or provincial) legislation. In some countries, even where local choice is strong or considered desirable, treasury operations for local governments are managed by the central government.

In any case it is very important that treasury regulations not discourage effective management by local officials. If local governments that are efficient in collecting and remitting tax receipts are made to subsidize less well-managed municipalities or even the central government without receiving adequate compensation, there will be undesired consequences.

### 3.4 Intergovernmental Transfers

**Intergovernmental transfers**

Because of the imbalance of revenue-generating advantages at the central-government level and certain spending advantages at the local-government level, fiscal decentralization usually includes the *transfer of financial resources* from
central to local government. These transfers can take many forms, with a varying degree of control and conditionality.

In general, transfer laws in countries where the preference is toward local choice will seek to impose few restrictions on municipalities regarding how they use these resources. In addition, transfer laws in these countries will usually be based on strict formulae, including targeting transfers to specified criteria, such as population size, surface area, poverty levels, local fiscal effort. (Such criteria were specified e.g. in the distribution formulae in the Philippines, Rwanda and Colombia, to mention a few).

In other countries, where the revealed preference is toward the principal-agent model, transfers are designed with specific central-government objectives clearly stated. In such cases, local governments may be seen as having certain advantages in implementing specific programs, such as road construction, but the central government funds the program and “hires” local government as an implementing agent. An interesting but quite unique example of this is the Ethiopian separation of state and municipal functions (see Box further on).

Regardless of preferences, some transfer systems are just not transparent or not efficient. For instance, in francophone Africa in the past, the overall level of transfers is generally low, not known to local governments and in addition transfers are not predictable within the budget year\(^\text{22}\).

In many countries, the equalization function of grants is considered as most important. And surely it is, also in view of poverty alleviation objectives. However, the design of equalization mechanisms is not easy. Firstly, the basic concepts involved in

\(^{22}\) It is to be mentioned that these shortfalls have been analyzed and more comprehensive decentralization efforts are underway in a number of countries (See the Benin example in chapter 5). A systematic update would require specific case studies.
equalization i.e. fiscal capacity, fiscal (or expenditure) need and fiscal effort, are not easy to understand. Secondly, the question needs to be asked: What is being equalized? Quite often, the required hard data to make the concepts operational are lacking.

Over the longer-term, the equalization aspects of the unconditional grants becomes even more important, as it will need to cater for the residual differences not addressed by the ‘expenditure needs estimates for the sector grants. It could even be argued that the sector grants only equalize partially, while the major chunk of it is assumed through the stronger pro-poor bias in the formula for the unconditional grant – and whereby poor districts can top-up the sector grants through contributions of the unconditional grant.

There is wide consensus in literature that the potential benefits of both decentralization in general, and fiscal decentralization in particular, will only materialise if such an allocation system relies on a stable, equitable and efficient horizontal allocation mechanism, in order to provide stability, equity and efficiency. As such, **formula-based grants** can be an important component of intergovernmental fiscal relations. Further, there is consensus among fiscal experts, that rules of transfer systems should be clear and transparent and should encourage behavior consistent with good management practices / give incentives for good fiscal performance and not encourage LGs to “remain poor” to receive more funds. The World Bank’s PEFA assessments (Public Expenditure and Financial Accountability) do also favor formula based transfers.

Formulae are mostly based on the idea that (i) districts with a higher population deserve a higher allocation; (ii) districts that are poorer deserve a higher allocation. In some countries, further aspects are added: (iii) that districts that improve their local revenue collection (as compared to the previous year) deserve a bonus; and finally (iv) that districts which have a larger gap between what they locally collect and what they need for staff expenditure deserve a large allocation.

The following guidelines are often given for defining appropriate **allocation formula**:  
• Keep it as simple as possible;  
• Keep it transparent and objective (i.e. the outcome can not be manipulated by any of the involved parties by manipulating the data for the variables);  
• Variables need to have an unequivocal relation with the purpose of the grant; and should not be related  
• Variables should be avoided that create disincentive to enhance performance in either revenue or expenditure sides.

Allocation formulae are meant to provide an overall allocation to all districts, whereby the districts, with flexibility to make decisions, can fine-tune the allocation to local circumstances. In any case, grants intended to offset vertical imbalance or horizontal disparities should not penalize LGs for raising additional revenues, by reducing grants.

There are some topics in the literature on fiscal decentralization, whose relevance may be overestimated in view of realities:  
• The relative weight of **local tax effort** in formulae: Even if taxes were reasonably assigned to sub-national governments, it is likely that the revenue
will not be adequate to finance the provision of services assigned to those governments or that they will result in horizontal fiscal disparities. If so, it may be desirable to use grants from higher level governments to compensate for vertical fiscal imbalance or to offset horizontal fiscal disparities. (on performance-based grants see chapter 5)

- Experts like to engage in controversial discussions, which country’s reform process goes towards true decentralization and which one may only reach deconcentration (See Annex 4 for definitions). Changes need to be gradual over time. It is not possible to decentralize the entire budget, and notably not the entire development budget immediately. Considering the limited capacities at the district and sub district levels, this would just not be realistic. Over the years, it is desirable that (i) Conditions of the sector grants will be increasingly relaxed and (ii) Un-conditional grants will increase at the expense of the conditional grants.

- Transfers can partially compensate for unequal spatial development but they are not replace social protection policies. Therefore, formulae can only very partially be used for targeting the poor and poverty reduction. Conditional transfers can favor the financing of priority programs of the PRSP (e.g. basic education, possibly with a gender focus) and the distribution formula can make sure that a higher share of these funds is allotted to poorer areas; formulae cannot make sure that the poor will actually access the services and be satisfied (this is an oversight task of sector ministries). The use of multi-purpose grants can be targeted to a certain extent by list of eligible measures but even within this scope there is room for LG trial and error.

Part of the controversy relates to the amount of conditionality. In a centralized (and even in a de-concentrated) system, central governments typically treat local governments as agents in implementing national policies that use central government funding for narrowly defined activities (this is also in line with the PRSP approach, which defines a number of national priority programmes).

Such an attitude is not fully comprehensive with the theory of a decentralized system where local governments should be able to flexibly allocate resources in response to local needs and priorities, in which the local authorities are accountable to the local communities for the services they provide. The challenge is how conditionality can be relaxed or reformulated such that they provide local authorities, within the frame of national policies and set standards, some degree of freedom in the allocation of the resources.

Thus as part of the decentralization reform, government (together with the line agencies) has to decide in how far it wishes to rely on conditional transfers (the de-concentration model) or whether it wishes to go the route of increasingly unconditional transfers – whereby, as a long-term policy objective-in the end conditional transfers are only used for those activities that are considered important for the general good, but which would never be undertaken by local authorities on their own free choice (issue of externalities).

By adding grant conditionalities as a third dimension to be considered in the design of a system of intergovernmental transfers, in addition to the dimensions of the vertical and horizontal allocation, this yields three policy dimensions along which
government have the opportunity to make policy choices (Boex and Martinez, 2003).

In developing as well as industrialized countries, the conditions (and level of earmarking) attached to transfers do vary widely. At the starting point of decentralization, earmarking is generally tight and activity specific. In a decentralized model, the long-term vision of fiscal decentralization is a system in which local authorities, through a combination of local revenue generation and transfers have enough resources to adequately deliver, in an autonomous or semi-autonomous manner the services according to mandates given to them, while central government ministries set policies and standards local authorities have to go by.

Experience of several countries has shown that the design of the perfect equalization formula is an impossible undertaking, due to the complexity of the dimensions involved. Frequent changes are commendable as it shows willingness to improve, but on the other hand, there is the disadvantage that frequent changes undermine the credibility of any formula, while it also prevents the transfers becoming predictable (See box on Ethiopia). A simple formula cannot take all requirements into consideration, while complex formulae are difficult to share with any audience beyond fiscal experts. In addition, efforts in least developed countries have shown that even simple formula may require updated data, which are difficult to generate.

**Ethiopia: Controversial reforms of distribution formula**

*Vertical block grants* are meant to contribute equalizing access to vital services between regions and / or local governments. Accordingly, the *distribution formula* is in Ethiopia a controversial issue and has been changed several times. Equalization efforts started as early as 1995, based on population, location, area and resource mobilization. Later, the level of development and own revenue generation were included. The formula in place until 2005/06, had a strong equalization impact towards large and under-populated regions, among them two of the four emerging regions (see graph below).

A *new formula*, which was approved by the House of Federations, is currently being introduced. It intends to build on the Australian model and consider expenditure needs of regions (besides population and tax effort), which requires heavy data input. Up to Fiscal Year 2010/11, 100 % of block grants will be distributed according to the new formula. As the new formula builds on the “cost of service concept” instead of surface area and data availability is limited for peripheral regions, several of the emerging regions will be disadvantaged (Afar, Gambella). This does not directly affect the delivery of municipal services but limits the overall relative availability of funds at local level. It has been argued that such effects be outweighed by the increasing overall amount of block grants. However, the affected regions are concerned.

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**Rwanda: Simple formulae for Intergovernmental transfers but lack of data**

Rwanda in common with every democratic state will continue to provide significant central fund allocations to LGs. The categorisation of these funds can be:

- Block grants
- Earmarked funds; or
- Limited discretionary funding.

At present, the allocation formula for the recurrent grant LASBF is based on four variables being population (20%), poverty index (20%), a bonus for revenue collection (20%) and the
financing gap (40%). The allocation formula for the LABSF has been changed a few times over the years, but deserves to be revised again. This is mainly because, firstly the formula is too complicated to be widely shared and understood, and secondly because for several of the variables used, no accurate data are available, while proxy data as used at present provide a perverse incentive to revenue collection.

The allocation formula for CDF (which is the intermediary to finance district development projects) is, in principle, more straightforward and simpler (population 20%, area 10%, poverty index 40% and infrastructure index 30%). It is observed that that neither the data nor the calculations are widely shared (if at all).

Finding reliable data sets that can be used for allocation formulae is problematic. Even population data, for example, are (until data from the identity card project will become available otherwise until the next census) based on the Census of 2002, recalculated for the present district boundaries. As it is a first data set, population growth data are simply not available, apart from the fact that due to the genocide and the return of refugees, population dynamics are expected to be more unpredictable than one would expect in normal circumstances.

Latest figures show that the sources of revenues for Districts are:

- Own Revenues – 15%
- Block Grants – 11%
- Earmarked Transfers – 74%

Source: DFID Technical note; It is to be mentioned that the system is changing.

### Adverse effects after increasing transfers

With regard to the understanding of decentralization as a process it is important to emphasize that increasing transfers is a pre-condition for improving local service delivery but will not immediately and not automatically address concerns related to local governance, to mention a few:

Following efforts to increase intergovernmental transfers, in many if not most decentralized countries a continued (or even increased) Fiscal Dependency is being observed (See Box). This occurs when the amount of (conditional or unconditional) transfers is fast increasing while locally generated revenues are not. Performance-based grants try to deal with this and other adverse effects by linking the amount of transfers to local governance. The experience with this approach will be dealt with in a separate chapter (See chapter 5).

### Indonesia:

**Increasing Intergovernmental Transfers and continued fiscal dependency**

With a new fiscal framework, which was introduced after decentralization, and increasing transfers from the central government, the revenues of Indonesian local governments rose continuously in the past years. The transfers from the central government to the local governments (General Allocation Fund (DAU), Special Allocation Fund (DAK) and Revenue Sharing Fund (DBH) rose from 19 % of the total central government expenditures in 2000 to an estimated 34 % in 2007. Thus, the financial situation of the local governments has improved strongly facilitating increased expenditures.
However, in all ten cities (of the sample in question, NB) the revenue side of the local budgets is strongly dominated by transfers from the central government. In 2006 intergovernmental transfers reached from 53.1% of total revenues in Surabaya to 90.1% in Pare Pare. In all cities except Balikpapan the intergovernmental transfers are the strongest revenue source. In almost all cities the locally generated revenues are rather small, with an average value of 14.5%. With 34.5% Surabaya has the highest share of locally generated revenue (Source: German Development Institute 2007).

Second, most local governments are presently delivering only a small part of the services of the total that they are supposed be responsible for. This is particularly valid for rural municipalities and emerging cities. This is sometimes due to incomplete devolution of responsibilities, and sometimes due to lack of capacity and capital to invest in basin infrastructure. Therefore, very few revenues are generated from services such as water and electricity, which may potentially produce a surplus or at least be managed on a cost-recovery basis etc..

While services delivered by local government are poor, and there is little inclination with the public to pay for them. On the other hand, when no payments are received for services delivered, local government is not in a position to improve these services, even if they are entitled to establish cost recovery charges. This is particularly true for services, which require a huge prior investment, like in drainage and waste management. On the other hand, there are promising developments in urban areas of middle income countries (See Box).

**South Africa: Lower fiscal dependency and higher revenues from service charges**

On average, South African municipalities obtain 86% of their income from their own resources (IDASA 2005, 1). However, it is important to keep in mind that the share of own source revenue varies significantly among the municipalities. While the six metropolitan municipalities generate about 97% of their budget through own revenues, smaller municipalities with annual budgets of less than 300 million rand generate on average only 65% through own revenues. Municipalities in poor, rural areas sometimes even generate less than 10% of their income through own resources.

Most of the own-source income of local and metropolitan municipalities comes from user charges and taxes. Thereby, user charges are the biggest source of revenue of the operating budget. The lion’s share of the income can be generated through surplus-services like electricity and water, some through break-even services such as waste disposal or sewerage.

Source: GDI / DIE 2007

Notwithstanding the establishment of social investment and municipal development funds in many partner countries, as well as vertical transfers for various purposes, there is a structural shortage of funds for major capital investment at district level. According to the observations of the authors, donors have shown a certain

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23 As far as water delivery is concerned, e.g. in Ghana only rural wells are decentralized, but the income derived would never exceed the cost of maintenance. In Ethiopia, responsibility for water supply is shared between regions, cities and woredas (a layer similar to districts / municipalities), which is not favourable for promoting investment and sustainable service. In Nicaragua – to mention a good practice – the responsibility for promoting rural water was transferred to the Municipal Development Fund FISE some years ago, as FISE was better in a position to support municipalities in this function than the sector ministry.

24 Basic health and Primary education are sometimes also included in the category of revenue generating services. However, according to the author, this is (i) unrealistic and (ii) creates confusion with regard to local priorities and the overall priority to reach the MDGs.
preference for investing in social sectors (such as basic education, health and rural water). Revenue generating infrastructure (markets, slaughterhouses, bus terminals) is now gaining ground but still, investment relevant to public hygiene and environment is included in comparatively few lines of financing. Small annual allotments of funds to LGs, which are common to many municipal development funds, have further favored smaller investments (such as schools), which can easily be financed from these allocations and allows to split funds into several smaller projects.

Third, the importance of the role of council members for the quality of local governance is often underestimated. In countries, where elected local governments are new, community feeling is often absent (e.g. Ghana, Burkina, Ethiopia). In many countries, civil society organisations are poorly developed in the districts and are therefore not able to play a watchdog or advocacy role. There appears to be also no structural exchange of experiences between districts, Associations of Local Government Authorities often being weak and without well-defined functions  

3.5 Conclusions and Recommendations

Guiding questions for assessing depth and nature of fiscal decentralization

Gallagher (1998) has proposed the following approach to assessing depth and nature of fiscal decentralization and checking of assignments are matching.

Expenditures:

1. Which level of government decides the nature of public intervention and expenditure? Where is the legislative competence (e.g., national parliament or local ordinance)?
2. Which level of government is competent or has the power to administer a function? Does local government administer central government programs?
3. Which level of government will budget and maintain financial control over the expenditure in question?

Revenues:

1. Who has legislative competence with respect to certain revenue laws? For instance, is local taxation authorized by national legislation or by local ordinance?
2. Which level of government will actually collect the specific tax?
3. Which level of government will budget these revenues? For instance, does shared revenue get budgeted by the central government?

As long as central governments provide the funds, there is a trade-off between tight control and strict earmarking of funds, which will constrain the opportunity for the emergence of efficiency and effectiveness in resource allocation based on local priorities, and thereby achieving the overall objectives of decentralization (notably devolution).

In the general passion for decentralization the matching principle has been neglected and imbalances created, which tend to overburden LGs (either with regard to the

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25 This is particularly alarming as many such associations have been supported by development partners for a long time. The French cooperation is active in francophone Africa in this regard and GTZ has a long history of supporting associations of districts and municipalities in Latin America and Anglophone Africa.
tasks devolved or with the money to spend). Given the capacities and human resources at LG level, it is generally unrealistic to expect that all possible activities, which fall under the mandate of districts, can be decentralized at short term. In view of limited administrative capacities, it may be considered to let districts focus on a selected set of activities for which they are mandated and bear direct responsibility i.e. to let them focus on the implementation of activities from own resource and the decentralized budget. Always a balance needs to be struck between national directives and local discretion.

Technical Recommendations

On the process /modalities of decentralization

- Decentralization implementation – though starting from deconcentration – shall proceed to the devolution of tasks, transforming local governments into autonomous institutions, clearly stating their exact responsibilities and sources of income.

- Decentralization should lead to planning procedures that are based on perceived needs in the district and respect national policies (not vice versa). Responsibilities have to be made clear and a monitoring system implemented, corresponding to a performance-based approach.

- When introducing modern forms of representative democracy, traditional authorities / power structures and communication channels should be considered, in order to stimulate accountability. Mechanisms for citizen consultation and management of complaints by elected authorities should be established in order to improve performance of and respect towards assembly members. Promotion of specific pressure groups and effective civil society associations should be stimulated.

- Local government must be entitled to establish fees for services on a cost-recovery basis in order to be able to generate income from potentially profitable services (water, solid waste, liquid waste and drainage, which need to be dealt with in a combined way). As these services mostly require comparatively huge investments with long maturity periods and are highly relevant for health as well as environmental purposes, governments and donors should consider establishing adequate financing modalities (whether on a grant or on a loan basis).

- Central government should give more incentives to the local administration to make full use of their tax potential. A stronger link between revenue generation and transfers from the central government should be created. Districts need a clear sense of direction in order to generate revenues. There should be incentives and disincentives based on performance for revenue collectors as well as the management staff responsible for the revenue generation at the district. If local government staffs are well remunerated, the highly qualified

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26 This is quite different from the often practiced promotion of non-governmental multi-purpose organisations, which claim to defend needs or rights of civil society (as a non-profit activity) but offer their services as (often not so professional) consultants and trainers as well.
personnel will chose to work there knowing the benefits that will accrue to them\(^{27}\). (GTZ 2006)

**On Expenditure Assignments**

- Expenditure assignment needs to be the first and fundamental step in the design of a decentralized system of intergovernmental finances.

- To the extent possible avoid mixing decentralization and deconcentration and shared responsibilities: Assign responsibilities to LGs, which fit their comparative advantages and fundamental rules for the ideal assignment of responsibilities in a decentralized system of government.

- If fiscal decentralization is to be a reality, sub-national governments must control their "own" sources of revenue. The question, then, is which revenue sources can and should be assigned to sub-national levels of government and how these assignments are to be effected.

- Expenditure responsibilities should be specified in the law. Some countries do so in the Constitution but many others do so in particular laws such as the law on the budgetary system or the law on sub-national budget and self-government. The latter is the preferred alternative because changing the Constitution is much harder, and it should be expected that as technology and conditions change in a country there will be a need to change expenditure assignments.

- **Targeted assignment of selected expenditure responsibilities according to subsidiarity:** The central government should assume 100 percent responsibility for expenditures in national defense, including the national guard, while sub-national governments should assume responsibility for public utilities.

- **Reassignment of Capital Investment Responsibilities:** Responsibilities for capital infrastructure should be placed at the level of government responsible for the delivery of the specific services including the operation and maintenance of those facilities. This will encourage a more efficient use of resources. Only those capital infrastructure facilities actually desired by sub-national governments will be built and sub-national governments will have an interest in maintaining and repairing the capital infrastructure.

- Central governments should consider introducing policies that guarantee desired minimum levels of provision for certain services at the local level. National standards can be enforced in several ways such as enticing local governments with a matching grant program. But national standards may also be enforced by denying full receipt of block grant money unless certain minimum expenditures and provisions established by the central government are met. Programs in which national standards may be required include not only social welfare but also education, health, sanitation, and the environment. But restrictions should be imposed sparingly to protect local autonomy which, in general, is very desirable.

\(^{27}\) As a better remuneration of public servants requires far-reaching reforms in public service, innovative modalities are also required in this regard. The Rwandan government has decided to pay a 30 % extra salary (taxable) to all public sector employees involved in financial administration and management.
The priority for public expenditures in most countries should remain in investment in human resources through good levels of education and health, and strengthening the safety net. There are also significant changes that need to be made in these sectors to increase the efficiency of operations as well as public expenditures. These measures should be considered within the context of well defined sectoral policy objectives now lacking in many transition countries. Governments should proceed with comprehensive reviews of the housing, education, health, and social welfare sectors.

Financial responsibility for social welfare expenditures is thoroughly to be discussed. For equity considerations, it is recommendable that central government takes the financial responsibility even if service delivery is performed via local governments on a reimbursement basis, a grant program, or another of several means.

On decentralization of expenditures:

- Integrate – as much as possible – all current direct transfers (including conditional transfers by line ministries to LGs) into the decentralized budgets.
- To review existing earmarking arrangements for transfers with the objective to provide a well-defined scope for districts to adjust investment to local circumstances and priorities, providing LGs with some general ceilings and menus as a reference for technical and budget planning.
- National Governments / Line ministries should consciously reflect, which degree of decentralization they are really ready to support; if the preference is towards de-concentration or delegation (rather than full devolution) adequate contractual modalities should be defined, in order to avoid overburdening LGs.

On equalization formula

- Use a transparent equalization formula, which may even be included in the constitutional arrangements; balance equalisation concern with regard to poorer local governments and the need to maintain some incentives to improve local revenues (Chambas 2009).
- Introduce one horizontal allocation formula (for equalization between LGUs) and avoid having one for each activity/sector.
- Whichever mode of horizontal allocation is used, the access to the funds by districts could be made subject to meeting one or more particular conditions that are related to performance. This can be activity or sector specific performance or generic performance.
- A balance needs to be struck between local discretion and the need for the national government to set parameters to ensure minimum quality standards as well as adherence to national objectives.
- Typically, systems with more autonomy for local governments in resource utilisation, will usually be supported by stronger performance-measurement-based incentive systems. It means that in a situation, where decentralization is gradually being put in place by the various line ministries, there is the challenge to gradually replace the strict earmarking by performance measures.

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28 Most of these recommendations refer to van’t Land 2009 but are viable on a larger scale.
• Often, PB grants are criticised because they would not be ‘pro-poor’. Regarding this point, two remarks can be made. Firstly, in the long run, the poor are not well served by an underperforming local government. In one way or the other, even local governments in poor districts have to get their act together. Secondly, the relationship between poverty levels in a district and the performance of a particular district government may not be that straightforward. Quite often district administrations in poor districts do better than their counterparts in richer districts (provided the performance indicators are well chosen).

• A sustainable process of decentralization must balance local autonomy with accountability whereby local governments are gradually given more fiscal autonomy by relaxing transfer conditions while accountability mechanisms are being put in place.

• Such gradual relaxation could include replacing conditional grants with unconditional (or relatively unconditional) sector grants, provided local governments are able to assure and demonstrate adequate system for (participatory) planning, transparency in the budget process and compliance with financial rules and regulations.

• More long-term it could also mean a gradual increase of the unconditional grant(s) at the expense of the earmarked grants.

**Recommendations to development partners**

• Development partners should support joint comprehensive sector reviews of the housing, education, sanitation, health, and social welfare sectors, which are particularly relevant for service delivery at sub-national level to increase the efficiency of operations as well as public expenditures, before promoting joint modalities of financing

• Development partners as well as governments need to understand that (i) understanding of national policies at local level requires a well-organised dialogue instead of the often practiced top-down approach and (ii) districts need a new type to advisory services to be able to balance respect to national policies, felt local needs and technical sector norms in a professional and cost-effective way and produce comprehensive planning documents accordingly.

4 How to improve Local Revenue Generation

4.1 The Causes of poor Local Revenues

Local governments’ own sources of revenue play an important role, especially in funding and maintenance of local public infrastructure. The capacity and ability of local governments to leverage own revenue sources is thus a core element of good financial governance on the local level. Appropriate mechanisms and procedures need to be in place in order to optimize the assessment and collection of local taxes, to set and collect appropriate levies, fees and tariffs for services and to minimize related administrative costs.
Available evidence allied to best practice for fiscal decentralization suggests that the percentage of local revenues collected compared to overall expenditures remains low in many developing countries. Efforts to introduce fiscal decentralization nationwide are not producing the desired policy outcomes.

A number of studies have dug into the causes of increasing fiscal dependency under decentralization. The above-mentioned recent fiscal study in West Africa (See Chambas 2009) has identified four phenomena, which apply to all countries involved:

1. Weak local revenue base in most African countries due to lack of tax authority and lack of administrative capacity
2. Concentration of locally generated revenue in the larger urban areas
3. Transfers and grants which lead to erosion of incentives to locally generate revenues,
4. Interfaces between weak local revenue base and other governance aspects

Evidence was found for unexploited local tax potentials with regard to Real Property Tax, professional taxes, market fees and taxes and vignette automobile. Revenue generation from services continues to be weak. Not all taxes due are assembled, fees and rates are very low and/or not all collected, and basic rates are insignificant. Concerning property tax, there appears to be a lack of insight in the exact number and sizes of the properties. Moreover, the setting of the fee levels is not based on the actual cost, but often on what government has dictated decades ago or the assembly considers as politically feasible.

In 2006, the Swiss Development Cooperation commissioned several case studies on the issue of Development and Taxation, gathering information from seven countries (Burkina Faso, Bosnia-Herzegovina, Macedonia, Mozambique, Nicaragua, Peru and Tanzania).(See SDC 2006)

Notwithstanding different administrative setups, it was observed that all partner countries had made important efforts to decentralize responsibilities related to the provision of public goods and services. This power shift reinforced the local and regional governments, especially in the area of infrastructure financing, local economic development and public service provision.

Most central governments are open to discuss political and administrative decentralization, especially in ‘soft sectors’ such as public utilities (e.g. water & sanitation) and education. However, there are exceptions to this trend29.

**Lack of delegation and lack of advocacy for fiscal autonomy**

In a nutshell, the tax collection responsibilities devolved to LGs may not be appropriate and fiscal decentralization objectives may be unrealistic

Unlike political and administrative decentralization, the majority of central governments does not support fiscal decentralization and the delegation of tax collection to local and regional governments. There are different reasons why central governments are not open for speeding up fiscal decentralization implementation.

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29 The present Nicaraguan central government prefers to centralize power and is not open to support decentralization efforts. Bosnia-Herzegovina is a special case because of its complicated federal government structure (See SDC 2006)
Apart from the overall lack of human and financial capacities, in particular at the local level, some countries had difficulties to reform the centralized state structures from the colonial era. An example is Burkina Faso, which inherited extremely centralized colonial structures from the French system. Regarding fiscal decentralization, central governments additionally fear the loss of political power and the sovereignty over national revenues.

The widespread disinterest and ignorance of many other actors (political parties, CSOs and the private sector) on decentralization favors the status-quo. However, the position of central governments and administrations towards decentralization is rarely uniform. Often, there are differences in opinions between ministries, depending if they would gain or not from decentralization. In addition, there can be divergences in the views of central governments and central administrations.

Actors, which traditionally are favoring decentralization, are local governments and bilateral and multilateral agencies. The position of the private sector and of NGOs is mixed. Unlike the matter of political decentralization, NGOs are often unaware of fiscal decentralization or not interested in the subject. Technical aspects may also contribute to indifference at local level: Local tax sovereignty has often been diminished in the efforts of simplifying of tax systems. As tax reforms often involve a limitation of the number of taxes, such a step can lead to a dry up of local revenues sources.

The record of revenue generation is mixed. Very generally speaking, recent performance of tax systems improved at the central but not at the local level. In all countries observed, the tax system at the central level evolved positively in terms of its ability to raise expected revenues. However, there is still space for significant improvement.

Undeniably, central governments have done efforts to reform their tax systems. In almost all countries observed, the central government is active in reforming the legal framework of the tax system in order to improve performance. Measures in this direction include adoption of a general fiscal code, establishment of (semi-) autonomous revenue authorities, introduction of flat tax rates, etc. Further, revenue instruments have been diversified and some countries use tax-sharing arrangements. All central governments use sophisticated instruments, such as VAT and income taxes. However, policy frameworks are often not comprehensive with regard to LG revenues.

**Ethiopia: Few incentives for local revenue generation**

According to recently conducted studies, the existing policy framework for local revenue generation has some major conceptual gaps. One example of this is Ethiopia (See Nghuyen-Than 2007):

a) There are no in-built incentives for ULGs to attract the full tax potential, because no general tax sharing exists although local authorities collect taxes on behalf of the regions (and to a lesser extent on behalf of the central government).

b) The local authorities have no significant revenue autonomy, because the majority of the taxes and fees are restricted by the regions

c) Local administrations do not clearly distinguish between taxes, fees and licences, which can be observed for example in the common phrase “local service taxes”. 
d) Local authorities suffer from a high turnover of their staff and due to the lower salary level compared to the regions and the central government they have problems in attracting well qualified administration staff.

e) Further, Block grants do cover only part of the costs of the so called state functions and none of the municipal functions.

As a consequence, the majority of the ULGs have to request the region to cover their deficit. If this is not possible, the budget is simply not executed as planned. Recent studies in the central regions have revealed that in some ULBs even subsidise state functions that incur a deficit from revenues generated by the municipal functions. It is uncertain as to why this is occurring. As a matter of fact, actual capital expenditure spending in relation to that budgeted for municipal functions is low. (Source: Nguyen-Than 2007). Regional BOFEDs are generally busy with the woreda budgets and do not have a mandate to assist in consolidating city budgets or even municipal budgets.

Local governments are less active in the process of tax reform. Many tax issues are regulated by national legislation and therefore are perceived to fall in central government’s responsibility. For instance, local governments normally do not have the authority to levy taxes on their own. In other cases, they don’t have the necessary capacities or know-how. Some of the countries observed collect only marginal revenues at the local level and others presently do not know local tax collection at all. In some cases, the situation at the local level has worsened due to recent tax reforms, which centralized taxing power, lowered overall tax rates or abolished certain tax instruments.

Lack of specific know how may also be a reason for the relative inactivity of NGOs/CSOs. Tax reform is perceived to be very technical and does not represent a top priority for many NGOs. Reference to the general principles for the establishment of local taxes is rarely made. (See Box)

**Principles for a LG tax system:**

1. Revenue autonomy, subsidiarity and connectivity (local accountability)
2. Transparency of the tax system and direct impact of the tax burden (tax-benefit link)
3. Reference to local conditions and neutrality of the taxes with regards to the private sector
4. Tax bases, which are not affected by economic fluctuation and are also viable
5. Simplicity of tax system

Source: Ngyuen-Than 2007

However, even tax experts admit, that these elements are not easy to apply and neither a federal nor a unitary country in the world has implemented a local public

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30 Borrowing is generally not accessible to ULGs for investment financing, in view of their delicate financial condition.

31 However, there are exceptions such as private sector lobbies in Tanzania, the Union of local self-government units in Macedonia and a SECO supported association (CIFOEB) in Burkina Faso. Bilateral and multilateral agencies are very active in the tax reform process and carry out activities of technical assistance, policy dialogue, General Budget Support (GBS), Sector-Wide Approach (SWAP) and capacity development for (central and local) governments and administrations.
finance system that fulfils these five principles completely. Various countries have chosen different ways to reach these goals and thus the conception of financing the local services differs (See Nguyen-Than 2007).

4.2 How much does fiscal autonomy matter?

There is consensus that LGs need a certain amount of fiscal autonomy in order to improve their revenues. However, the phasing of and interfaces between different reform dimensions (autonomy versus capacity development for accountability) are sometimes controversial. It has been argued that autonomy were a precondition to collect experience, which will finally improve governance over time, while other donors pinpoint at the fiduciary risk involved with increased local autonomy.

Tanzania is currently implementing a local government reform aimed at improving public service delivery. An important component of the reform is to increase the fiscal autonomy of local authorities. This policy is encouraged and partly initiated by the donor community. Odd-Helge Fjelstad from Chr. Michelsen Institute in Norway has conducted several studies to verify whether increased fiscal autonomy will improve the efficiency and responsiveness of the public sector.

The author concludes on various occasions (see Fjelstad 2003 and 2004) that it is unrealistic to expect that the present administrations in many local authorities in Tanzania have adequate capacity and the required integrity to manage increased fiscal autonomy. In fact, there is a real danger that, in the absence of substantial restructuring of the current tax system combined with capacity development and improved integrity, increased autonomy will increase mismanagement and corruption.

The following key indicators are used as reference points: (i) the degree of fiscal autonomy; (ii) financial management, including budgeting, accounting and auditing; (iii) methods of revenue collection; (iv) transparency in fiscal and financial affairs; and (v) tax compliance and fiscal corruption in the case councils. With regard to fiscal autonomy, the rationalisation and abolishment of many local revenue sources in June 2003 has most likely reduced the already limited fiscal autonomy of rural district councils even further; only urban districts are less dependent.

Transparency with respect to budgets and accounts is regarded the heart of local government accountability. However, in the case of Tanzania transparency in fiscal and financial affairs remains limited: All the case councils report that they disseminate information on financial and fiscal affairs to the public through meetings organised by the council, including full council meetings, ward and village meetings. Local authorities publish information on revenues collected and allocations of funds, as they are obliged to according to the Local Authority Financial Memorandum 1997.

However, at present much of this information does not reach or is not understood by the general public. Public notices gazetted in newspapers or posted on notice boards at the council headquarters are often presented in a relatively complicated and technical way, which is hard to understand by ordinary citizens. Few of the respondents in a recently conducted citizens’ survey, covering 1260 respondents in the case councils, said they had seen some information about local government finances. As many as 86% of all the respondents said they had never received
information on the amount of tax revenues and user charges collected in their area, while publicity on HIV-AIDs was well known.

**Tanzania: No compliance to unfair taxes**

In all the case councils in Tanzania, taxpayers’ unwillingness to pay taxes and fees (tax compliance) was reported as a major obstacle to enhancing local government revenues. The citizens’ survey provided some indications on factors that impact on taxpayers’ compliance behavior.

The most serious problem perceived by a majority of the respondents (58.4%) was that the money collected was not spent on public services. 48 % of the respondents found taxes to be too high and 46 % had doubts about the honesty of tax collectors. Dissatisfaction on poor linkages between taxes paid and service delivery showed no rural-urban divide.

In general, taxes were widely perceived to be unfair. Firstly, only 9% of the respondents agreed with the statement that ‘most of the tax revenues collected in the area is used for reciprocal services’. Secondly, the majority of all respondents (51%) held the view that people should deny paying taxes until services improved. Thirdly, 73% of the respondents said they would be willing to pay more taxes in exchange for improved services.

Source: Fjelstad 2003 and 2004

Corruption was perceived to be a problem in all the six case councils. The most frequent reason given for this attitude was the view that ‘all civil servants are corrupt and they protect each other’. This attitude reflects that much is left to be done to build trust-relations between the local authorities and citizens.

A recent analysis made by a GTZ-supported Revenue Mobilization Support Programme in Ghana hints to the fact that local tax systems may have design faults although sufficient tax authority and autonomy may have been given to districts (See GTZ 2006).

- Interpretation of the powers of LGs often rests with the central government, which makes local tax initiatives risky. Even beyond the coherence of the national framework, relations between politicians and administrators may be characterized by confusion, overlapping functions and interference in decisions.

- **Tax bases** of local governments are static because of weak databases for determining revenue potentials; areas within the districts where revenue could be generated are not well identified and therefore revenue collection is not optimized. There are no reliable tax registers and therefore tax potential is not known.

- **Mechanisms for collecting** internal revenues are ineffective. For instance, revenue collections from property rates are low because properties have not have been properly valued. As an Internal Revenue Service (IRS) report outlines this is mostly due to a lack of funding for revaluation, naming of streets and numbering of houses. However a lack of general experience in revenue administration relating to record-keeping, tax collection and debt enforcement also causes revenue losses from property rates.

- There are inadequate numbers of **revenue collectors** in most districts. This problem is further exacerbated by the poor logistics (means of transport) assigned to revenue collection. Inadequate resources and absence of trained and competent personnel limit the capacity for local initiatives and development. Key positions in finance departments are often vacant, and/or staff involved in local
revenue collection exercise, have little formal education and lack appropriate skills for records maintenance, public relations and enforcement.

- **Appropriate sanctions** or punishment for tax defaulters are absent. Most residents, especially traders, do not feel obliged to pay taxes. There are no appropriate incentives both to the revenue mobilisers and taxpayers and the tax administration is not adequately supervised. Rewards and sanctions are often not based on performance, and not extended to financial management staff, who is responsible for overseeing revenue generation at LG level.

- The co-operation between the District Assemblies and other public institutions and state agencies seems not to function very well. In the case of Ghana, the district revenue department has only a **limited data exchange** with the Land Valuation Board and Internal Revenue Service. It is often the case that one building is valued several three times, due to bureaucratic “traditions.”

**Lessons learned from Tanzania**

A fundamental requirement when further redesigning the local tax system is greater emphasis on the **cost-effectiveness of revenue collection**, taking into account not only the direct costs of tax administration, but also the overall costs to the economy, including the compliance costs to the taxpayers. In addition, losses through corruption and tax evasion need to be reduced.

To achieve these aims, there is a need for further **simplification** of the licence and fee structures by reducing the number of rates and coverage. Fees and licences that have regulatory functions, such as hunting and business licences, should be harmonised with central government taxes, to avoid **double taxation** and conflicts with national development policies such as employment creation and environmental protection. Furthermore, uniform rates on agricultural taxes are necessary to minimize distortions.

A main challenge is therefore to **provide information** on fiscal issues in ways which are understandable and which reach the general public. The successful dissemination of information on HIV/AIDS prevention may provide useful lessons for how to design and disseminate information on budgets and accounts to the communities. Written and oral methods of dissemination should be combined, including information submitted at service outlets such as schools and dispensaries, and at village and ward offices. Urban councils would in general require additional measures compared to rural councils, due to the often high mobility and turnover of residents that make it more difficult to reach citizens with such information.

Improved information to the public on budgets and accounts may improve the opportunities for citizens to exercise their voice and hold local authorities accountable. It is, however, important to stress that encouraging citizens and the civil society to engage in fiscal and financial monitoring at the local level does not imply that such measures should replace formal auditing and accounting mechanisms. On the contrary, it can strengthen the legitimacy and standing of local authorities in the

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32 In Ghana, such habits lead to the general office of the Land Valuation Board makes a valuation for the determination of the value stamp tax, the District Land Valuation Board for the property tax, and the IRS for the capital gains tax.

33 Double taxation is a sensitive issue as it is not supposed to exist. Recent field studies of the author in Ethiopia revealed similar practices, which were impossible to discuss with local nor national officials.
communities by contributing with complementary measures to improved control of revenue collection and expenditure.

4.3 Property taxes – the untapped potential

A property tax, based on the assessed value of all properties located in a given area, is generally regarded an appropriate tax for local authorities.\textsuperscript{34}

The Anglo-Saxon countries like Canada, the USA and the United Kingdom provide their local authorities with a very extensive system of property taxation. A local property tax has the advantage that a direct link between benefit and cost of the public goods can be established. This direct link between the preference of the citizens in local public goods and the policy makers, who have to provide the local public goods, cannot be created by grants or transfers.\textsuperscript{35} On the other hand, the concept is not easy to apply as many African countries don’t know the concept of property tax at all, which may be due to a different concept of land-ownership. (See Box on Ethiopia)

Ethiopia: Country without Real Property Tax

In Ethiopia no private land right exists as all land is owned by the state. Private households as well commercial and public companies can only lease the land from the ULG; a private person can lease the land for 99 years, while companies are able to lease for a maximum duration of 70 years. Furthermore, the ULGs are not completely independent in fixing the land lease. Regions determine a minimum fee per square meter for different zones, which does not provide incentives for city administrations to profoundly consider the issue. Further, fees are not linked to inflation.

In addition, no nation-wide cadastre exists and due to the fact that all properties are leased and not owned by private households or companies, the possibility of evaluating the property value by the selling prices of the property does not exist either. Therefore, the establishment of a property tax system for Ethiopian ULGs is a complex undertaking.

Countries in East Africa share a common British heritage yet have distinct property tax policy structures. Yet, the tax base, assessment basis and the tax rates vary considerably. (See Kelly 2000). Tanzania taxes only buildings, Uganda taxes both land and buildings, while Kenya taxes only land. Despite these differences, each faces similar problems of weak administration. Tax base coverage is incomplete, valuation rolls are out of date, collection rates are low, enforcement is virtually non-existent, and taxpayer service is poor.

The East African experience suggests that the primary obstacle to effective property taxation is not policy but administration. Property must be identified, with the

\textsuperscript{34} This is valid for all regions, including countries under transformation: The property tax has been and still is the own source of revenues of municipalities in Macedonia. Although this tax has had a small participation in the total fiscal collection at the state level, it has been and can be a significant and stable source of revenues for the local self-government units (Stamatova 2002)

\textsuperscript{35} Besides a local property tax, a group of European countries – namely Switzerland, Belgium, Croatia and the Scandinavian countries – give significant tax autonomy to their local authorities and therefore a local surcharge on the personal income tax is common. Furthermore, a third possibility to finance local authorities has been chosen by Austria, Germany and Poland, which developed a local tax system with its own revenues as well as tax-sharing. Nevertheless, vertical grants are also needed in the Anglo-Saxon model and the Scandinavian model and the German model.
information systematically collected and maintained. Properties must be valued. The tax must be assessed and billed. The bills must be delivered. The tax must be collected and properly accounted for and enforcement must be timely and effective. Simultaneously the government must work with stakeholders to ensure that necessary information and services are provided. Successfully combining these administrative components is critical for an effective property tax system.

The experience in East Africa shows that these administrative components are not effectively managed, leading to low revenue yields and inequity. Improved property valuations alone are not sufficient to generate the necessary revenues. Rather there is a need for a comprehensive improvement of all administrative aspects. Strong political will and improved administration efficiency are prerequisites to improved revenues and equity.

Property tax systems in East Africa exhibit distinct policy differences, yet all face administrative constraints limiting their ability to generate significant revenues for local governments. To overcome these constraints, these countries have embarked on property tax reform efforts. Tanzania and Uganda in the early 1990s adopted the classic “valuation-pushed” strategy—focusing solely on the creation of valuation rolls in their capital cities. Tanzania was fortunate that the new valuation rolls were introduced in 1996 simultaneously with the new City Commission which combined the new revenue potential with strong political will and improved collection efficiency. Uganda, on the other hand, brought in their new valuation rolls for Kampala in the mid-1990s only to see their total property tax revenue fall by over 30 percent.

This drastic result forced Kampala in 1999 to shift their reform implementation strategy to a more “collection-led” approach. Kenya is the last to undertake reform, just now embarking on a “collection-led” property rates reform implementation strategy linked to the broader Kenya Local Government Reform Programme. Countries in Asia have made significant effort to improve RPT administration but also produced limited results while general fiscal management was not improved.

A lessons learned from Tanzania is that more realism is required when it comes to the implementation of a well functioning property tax system (See Fjälstad 2004). It is, therefore, a need to reassess the basis of the property tax in urban councils and to implement a more simple and coherent approach to the valuation provision, which takes into consideration administrative capacity and capability constraints facing the councils. Moreover, the experiences from urban councils advocate cautiousness when extending property tax to rural district councils.

Annex 6 provides a shortlist on what local governments can do to improve RPT collection.

Having said that, the adequacy of the approach chosen depends on conditions of the partner country. In the Philippines for example, the legal framework is comprehensive in this regard: In order to create own sources of revenue, LGUs have been given more responsibility for operation of the Real Property Tax. Furthermore, they can levy taxes, fees and charges such as business and amusement taxes, fines

36 “The municipalities’ capacity and capability to administer the property tax have, in general, proved to be inadequate. Hence, it has been difficult for many councils both to maintain the current property valuation registers and to continue the property valuation exercises.”
and penalties, garbage and water fees, permit and licence fees and fees for selling on 
public markets. The LGC has expanded the potential tax base of LGUs and increased 
the maximum allowable rates of most local taxes. Further, the establishment of a 
Property Tax Collection has been promoted for decades.

The “Local Government Performance Measurement System”, which is rolled out since 
2004, has identified comparatively ambitious indicators as determinants of an 
efficient system of RPTAC (see box).

<table>
<thead>
<tr>
<th>Philippines: Advanced Performance Indicators for Real Property Tax Administration</th>
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</thead>
<tbody>
<tr>
<td>1. Use of an updated Local Revenue Code as a guide, which should not be more than three years old</td>
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<tr>
<td>2. Utilizes the latest RP Tax maps for property identification;</td>
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<tr>
<td>3. Employs an indexing system that facilitates, at the very least time possible, access to records of real property owners per barangay according to name, location, status of property, and other relevant information;</td>
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<tr>
<td>4. Provides on-line computer-based information to taxpayers;</td>
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<tr>
<td>5. Operates in a network that is interlinked with the computers in the offices of the city assessor and the treasurer;</td>
</tr>
<tr>
<td>6. Involves the participation of local officials and other key sectors in the information dissemination to ensure that the people are properly consulted prior to the imposition of the RPT, and that they are updated with the schedule of market values used for the assessment of their properties;</td>
</tr>
<tr>
<td>7. Offers an incentive program for local officials or personnel involved, and for the taxpayers (e.g. giving of cash and other forms of rewards and publication of names) to promote efficiency of RPTAC;</td>
</tr>
<tr>
<td>8. Enforces revenue collection program both for current taxes and delinquencies; and. Imposes penalties or sanctions to delinquent taxpayers.</td>
</tr>
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</table>

Notwithstanding the vanguard function of this approach, development partners complain that their support succeeded only in shifting the point of evasion from assessment to collection. Other interventions, particularly in the computerization of real property tax administration (RPTA), increased collections but there was also a corresponding increase in expenditures. The schedules of market values are usually not updated (as required by the law) and thus the potential of this source was not fully exploited. (See Final report of a US-Aid supported project to improve RPTA)

The productivity of the real property tax system is not encouraging. “Collection efficiency”—defined as the ratio of actual current collections to potential collectibles based on total assessed value of all taxable properties—of municipalities in sample provinces ranged from a low of 6.7% to a high of 74.8%.

Further, the Property Tax on plots and buildings is collected jointly with the (equally compulsory) contributions to a “Special Education Fund” (SEF), which is used for the equipment and routine maintenance of local schools. This may be practical in terms of collection but does not contribute to the transparency of local budgets and may not raise the motivation of landowners to accept increases of the RPT.
In a nutshell, it is not easy for a local government to fully realize the redistributive potential of the Real Property Tax as interests of real property owners are generally well organized at the same local level. Technical solutions are feasible but require strong political backing and requests for accountability from the public.

From a practitioner point of view it may be more rewarding to focus on increasing revenue collection rather than changing the whole local fiscal system, as the speed of collection of taxes with the purpose of improve cash flow management of local governments. The reality of annual budgeting makes cash flow within the tax year very important. Methods to improve cash management may e.g. include discounts for early payments, bank direct debits and sanctions, such as publishing lists of RPT defaulters in the press or the internet.

Annex 6 provides a shortlist on what local governments can do to improve RPT collection.

4.4 Privatization of Collection - The Case of Market Fees

Following previous experiments in other countries of the EAC, Rwanda in 2006 has declared privatization of market tax collection an official policy. Objectives of a privatization of market tax collection can be summarized as follows:

- Improvement of efficiency & efficacy of the local fiscal administration;
- Mobilization of fiscal revenues;
- Strengthening of private sector; and
- Increase in transparency.

The advantages of the Private Agent versus previous practices are attributed to (i) the supposed reduction of collection costs; (ii) the promotion of competition for the market; and (iii) increase in transparency.

This policy has been implemented on a pilot basis in several Rwandan districts since then. Tax collection was tendered and subsequently awarded to a private collector for a monthly lump sum. To date, the following modality has been applied: The district is contracting out the market tax collection service to a private enterprise, with whom the duration of the service contract is normally 1 calendar year. The entrepreneur is obliged to first transfer the total amount collected before he is being remunerated for services rendered. The remuneration of the entrepreneur is defined as a percentage of the total amount collected; and the percentage is the key criteria for the selection of the bid. The following advantages are attributed to private tax collection: The district saves labor cost and receives a predictable amount of internal revenue, while new jobs may be created in the private sector and the risk is transferred to the collector.

Basic Modalities for privatized Collection of Market Fees

a) The tax collection is delegated to a private enterprise in the form of a service contract.

b) The enterprise is obliged to first transfer the total amount collected onto the account of the district before being remunerated.

c) The enterprise is paid on the basis of an agreed percentage of the total amount collected and transferred onto the account of the district.
d) The LG Finance Department remains responsible for monitoring the tax collection and for the administration of fiscal revenues. It equally remains responsible for the pursuit of any form of tax evasion and fraudulent actions.

e) The district remains responsible for the management and the maintenance of the markets.

f) The enterprise is obliged to respect the tax rates defined by the District Council.

g) The district is obliged to conduct a fiscal potential study before the privatization of the tax collection.

In contradiction to this optimistic forecast a recent analysis done by German technical advisors to the Rwandan Institute of Administration and Management and the Association of Local Government Authorities found the issue of privatization to be much rather complex and successful implementation goes far beyond routine implementation of a cabinet decision. (See Ralga/Riam 2008)

First, external factors determining the general conditions the districts have an impact on the revenue potential: Though having a privileged geographical location and a significant economic growth, which was favorable for broadening the tax base, the current tax base in the two districts in question is narrow and volatile due to a certain vulnerability of main commercial activities and agricultural production to force majeure, which is a typical condition for many rural districts in Africa. Despite the favorable economic situation of the districts, management of public markets is not particularly effective: Markets are unattractive, due to insufficient electricity and water supply, creating difficult hygienic situation. Official market days are limited in number and not well chosen, leading to suboptimal exploitation of fiscal potential.

A general tendency for tax evasion and corruption is also there, which corresponds to a shortage in human resources. Relevant tax information is partly not accessible or incoherent. Tax payers database are not fully functional. Tax collection on market is characterized by specific weaknesses: Tariff structures are complicated and complex, particularly with regard to the variety of taxable units; in addition, tariffs are not always applied in a correct manner caused by insufficient knowledge or fraudulence of tax collectors, which always attend to the same market. To summarise, there is a lack of transparency on market taxes and unequal treatment of tax payers. Insufficient fencing of market area eases tax evasion.

Under these circumstances, it was found that privatization of tax collection would bear considerable risks and probably not produce the expected results. Based on unrealistic fiscal potential analysis lump sum agreements might lead to an either inappropriate profit of the private tax collector and a high loss for the district or vice versa.

Experiences from other African countries (Uganda, Ghana, Mozambique) have raised similar doubts: Profit margins for private collector s were found to be mostly inadequate, resulting in no significant increase, but occasional decrease in public revenues. Monitoring for districts is apparently difficult.

Uganda: Concerns on Privatization of Market Tax Collection

Present initiatives for local revenue enhancement in Uganda advocate a larger role of the private sector in tax collection. Norwegian researchers question the narrow remit of this policy
debate, and the absence of careful analysis of how local government systems for private tax collection actually work.

Under present routines for assessing markets and procedures for tendering rights to collect taxes, the prospects for local bureaucrats to extract bribes are positively correlated with the value (i.e. the profit or rent) generated by a contract. The rent or contract value, in turn, is inversely related to the tender price, that is the local council’s share of the total revenue from a particular tax item such as a market. This is the core of the incentive problem. At present, private tax collection involves redistributive transfers from rural and often poor taxpayers and into the pockets of the local “elite”.

The six rural markets surveyed by the Norwegian study are all fairly well-organised. Officially, a large number of tax rates are usually imposed on the various tax bases. The nature of rural markets, usually weekly events rather than permanent institutions, makes this large number of official rates hard to implement in practice. In the typical rural market a complex official tax system has been replaced by a pragmatic and less administratively costly solution.

Nevertheless, The discrepancy between agreed bids and the estimated revenue potentials of the six rural markets covered by the study is striking, and comparison of the agreed bids and market revenue yields illustrates the poor performance of the private tax collection system in Uganda: The gap between total revenue collected and agreed tender can be divided between two categories: (i) the 20% margin private tenderers are permitted to realize on their collections in some districts, and (ii) an amount representing the ‘lost revenue’ to councils, that is the additional revenue the councils would have obtained if the revenue potential of each market had been correctly assessed.

In the six markets in question, the ‘lost revenue’ amounted to between 25% and 74% of total revenue collected in each market. Moreover, the actual gross margins realized by private tenderers caused by this undervaluation of market yields varied between 71% and 970%. On average, 53% of all revenue collected from vendors in the markets could be interpreted as pure redistributive transfers to members of the local elite.

The distributional effects of the system of private tax collection, as it currently operates, are therefore highly questionable. A more effective solution could be to move the responsibility for market assessment out of district administrations by establishing an independent body responsible for such assessments.

As clean bidding processes are unlikely in the short-to medium-term, a properly assessed reserve price provides an important check in the presence of expected bid rigging. It is also possible to consider more fine-tuned incentive mechanisms that link remuneration of local bureaucrats to revenue enhancement goals.

Source: Fjelstad et al. 2006

To summarize, out-sourcing of local tax collection may increase revenue (although that is not always the case), as well as saving the local government the costs of collection. However, such contracts have to be very carefully specified, there has to be an effective and transparent system of competitive tendering, and there have to be arrangements for contract monitoring and enforcement in the event of non-compliance to preventing fraud in revenue collection. These may require new skills from local government staff in the area of procurement and contract management. It is also essential that the tariff structure and regulations are clearly and publicly specified, to avoid the risks of “tax farming”.
4.5 Progress in fiscal reform in West Africa

Deficiencies of local fiscal systems and the lack of effective transfer mechanisms have resulted in extremely low investment of local governments of less than 10 EUR per inhabitant per year. This occurs in particular in francophone West Africa, where local governments are still young (some administrations are in their second term only).

Nevertheless, even in this regional context and range, spending of LGs is varied, reflecting the relative success of reform efforts made. As revealed in the recent study of Chambas (2009), in francophone West Africa spending of sub-national governments per inhabitant varies between 6000 FCFA per year (Ivory Coast) and less than 1000 FCFA (Burkina and Niger) with Senegal, Mali and Benin occupying middle ranges.

**Senegal** was one of the first west-African countries to start comprehensive tax reform since 2004, in order to address high cost of collection and low output and to generally strengthen local revenue collection in rural areas. Before the reform, LGs collected only 4% of national taxes leading to extremely high fiscal dependency. Further, the sharing of taxes led to cash flow problems at LG level: It took years for sub-national governments to receive from central government their share of taxes, resulting in high dependence of LGs on foreign aid, a situation not uncommon in the region.

Changes in the general legal framework (Code général des impôts) have allowed sub-national governments to strengthen their fiscal capacity. At local level, tax reforms have focused on the real property tax by drastically reducing tax exemptions and exemption periods and establishing a lumpsum RPA for buildings and commercial establishments. Commercial taxes and added value tax have been regrouped and merged into the «Contribution globale unique>>, of which LG are entitled to receive 40%.

Problems with the retransfer of locally collected taxes, which are a typical phenomenon induced by the francophone fiscal system plus slow administrative procedures, were addressed by introducing advance transfers from the Ministry of Finance to the communes, relying on previous collection results. Extraordinary advance payments were also introduced. A transfer mechanism to provide districts with an investment budget on their own is also foreseen.

**Benin** is also going for reform of local taxes. While urban areas do have a certain direct tax potential to develop (RPT, business taxes), similar options do not exist in rural areas. A number of taxes are applied to certain products in certain areas and not in others, creating confusion rather than transparency. The government intends to increase rural tax bases and harmonize collection efforts by introducing an indirect rural development tax (taxe de développement locale TDL) on the trade of agricultural produce. Modalities of assessment and collection are still under discussion. In the same spirit, a simplified registration of informal and small scale business and simple but effective arrangements for lumpsum taxation (called “impot synthétique”) are under preparation. Several development partners are supporting the establishment of data banks with real property information, which is a precondition for increasing RPT collection.
4.5 Conclusions and Recommendations

If fiscal decentralization is to be a reality, sub-national governments must control their "own" sources of revenue. One major administrative problem today for many LG councils is their inability to collect fully the revenue due to them. Fundamental issues to be addressed in this context are to (i) redesign the current local revenue structure and to (ii) strengthen financial management. Moreover, measures are required to enhance (iii) taxpayers’ compliance and to (iv) improve the accountability of tax collectors and councillors.

National Governments who want to increase local revenues in a sustainable and efficient way, must first establish a clear policy framework. If this is given, LGs are to focus on those sources of revenue, which provide a significant potential and a reasonable cost-benefit ratio. There is consensus to focus on (i) real property tax, (ii) market fees and taxes, possibly via involvement of private providers and (iii) other fees for services (water and sanitation, electricity).

Privatizing parts of local revenue collection could be a viable response to corrupt and inefficient public structures, but can’t replace a weak administration. Private tax collection still requires a strong and transparent administration to minimize the loss from the contributions of the population. A “sufficient remuneration” of collectors, private or public, to avoid corruption appears unachievable.

Technical recommendations

On the tax policy framework

- Prepare a detailed local government tax policy paper, defining sources of revenue of local governments as well as proper sharing arrangements so that their revenue needs are addressed.
- As a general recommendation, laws concerning local revenues should contain only those provisions/articles that establish the policy principles and provide a clear enabling framework for implementation.
- Implementing modalities should be consigned to secondary or tertiary regulations that do not require full adoption procedures every time a change is made. Mention of fees, charges, penalties or other matters that are likely to be subject to frequent change should be excluded from primary legislation. These items can be set annually by the competent authorities and published as secondary or tertiary rules/order/regulations etc.
- Scale back policy objectives for fiscal decentralization to realistic aspirations. Adjust fiscal decentralization policies so that is congruent with the real situation in many communities with limited tax bases and limited revenue raising potential. Introduce changes to the legal framework to increase (i) the tax base, (ii) tax yields and (iii) collection capacity at the local and central levels.

Many of the below-mentioned recommendations have been developed in a recent policy dialogue between development partners and the Government of Rwanda, which is being facilitated by a DFID policy advisor in the Ministry of LG. Recommendations have been exchanged by Emails and informal papers. Many of the recommendations are supported by the above-mentioned fiscal study financed by the French cooperation (see Chambas 2009).

"Sharing arrangements" refer to transferring part of the centrally collected taxes to local authorities (such as VAT, rental income tax), not vice versa, as currently practised in several countries.
and as a result assist in achieving the fiscal policy objective of increasing the levels of local resources to meet local responsibilities.

- Legal frameworks should not provide high levels of tax relief / exemptions at national level, which may limit overall tax income as well as sharing arrangements to benefit Local Governments.
- As Real Property Tax has the largest untapped revenue potential for local governments in developing countries, a modern property tax law should be developed as an appropriate income stream for local authority financing.
- The Legal framework should have a separate and stand alone organic law setting out the types of licences and fees that can be levied and collected by local administrations.
- It should be guaranteed (institutionally or otherwise) that local governments receive their part of the locally generated revenues in a timely manner without delays and without diversion.

On tax priorities (See Chambas 2009)

- In order to ensure proper planning, forecasting and collection of revenues, there is the need to improve databases used to construct the nominal roll. District assemblies should be assisted to undertake a survey of businesses and economic activities as well as the social and demographic situation in their respective areas of jurisdiction. This will aid in the establishment of a central tax register, which would be of mutual benefit to both the district administration and other revenue authorities, especially on taxpayer location. A unique Taxpayer Identification Number (TIN) could be issued (GTZ 2006).
- Collection efforts should be concentrated on taxes with high productivity. Tax items should be ranked considering cost of collection and share of total revenues. Inefficient fees and rates should be abolished: the practice of districts collecting taxes that have cost of collection rates over 100 percent should cease. Realized savings should be directed to collection efforts for more productive revenue sources (GTZ 2006).
- If assessment of real properties is not possible / surpasses capacities of the administrations, a small per-capita residential tax or development tax may serve the same purpose and broaden the tax base (See Chambas 2009).
- Local tax systems should consider the investment needs of fast growing urban areas; in this regard, efforts should focus on direct taxes and arrangements on RPT and urban transit (vignette automobile ou une vignette sur les vélomoteurs) should be flexible to allow adjusting to changing conditions. (See Chambas 2009)
- Double taxation of the same purpose should be avoided (e.g. parallel existence of RPT and a residential tax).
- User charges on water and electricity should also be flexible.
On property tax collection

- Collection of basic rates, and the costs incurred with solid waste collection and treatment, as well as drainage maintenance, should be collected by means of the property tax.
- Co-operation between the Districts and national agencies could help to overcome district assemblies’ difficulties to levying and adjusting unpopular taxes; e.g. property evaluation may be carried out by the central tax administration or by a separate valuation agency (GTZ 2006); it is highly recommended that one authority be assigned the responsibility of property valuation.
- Poverty concerns in this regard should be addressed by (i) establishing a very low or zero property tax for informal dwellings but proceed with registration and collection of basic service fees, (ii) promoting / maintaining low-cost solutions in water and sanitation (e.g. public standpipes, public toilets, public showers) for those groups of the population who cannot afford to connect to urban networks, (iii) offer payment by installment for connection fees. Empower the local authorities to effectively collect the property tax through capacity development and introducing appropriate IT solutions.
- If local tax assessment and collection capacities are to be strengthened through training then these initiatives should be targeted at improving the rate of collection of Property Tax solely as this source of revenue is under exploited throughout many countries.
- Establish complete records of properties and then assessing and collecting tax on these would provide a significant and sustainable source of revenue for many local communities. A comprehensive data base of all (private and commercial properties is a pre-requisite to an efficient Property Tax system.
- Apply differential rates of property tax on private and commercial properties. This is a common concept as commercial and private residences typically have different market and use values.
- Build financial incentives for LGs to improve RPT collection (See Box on Tamil Nadu in Chapter 6 and Annex 6) and promote good transparency practices (e.g. Giving publicity to the “Top Ten Defaulters”)

On private collection of market fees and taxes (See Fjelstad 2003 and 2004)

The privatization approach has to respond to the following general challenges in order to avoid failure:
- be embedded in other initiatives to improve administrative capacities and monitoring
- Create incentives for tax collectors
- Sensitize for tax payers compliance and understanding

39 See also checklists on RPT collection in Annex 6
40 Several IT solutions for local government tax administration are being promoted by private providers as well as German Technical Cooperation (e.g. GTZ-product ITAX, Philippines).
Despite all reservations, privatization could help to overcome shortages in district administration and help increase revenues, given

- a comprehensive planning of the process, incl. a viable tax potential analysis
- strong monitoring procedures
- a transparent and complete fiscal reporting system

**Recommendations to development partners**

- Develop a common position with regard to tax sharing and fiscal autonomy in each partner country, based on the experience of donors and specific framework conditions given
- Support including the capacity to generate local taxes in general LG capacity assessments in order to specify administrative versus political weaknesses
- Conduct an independent evaluation of different IT solutions for sub-national finance and tax collection on the market, in order to avoid biased financing

### Ghana: Requirements to increase locally generated revenues

“The implementation of recommendations (to increase locally generated revenues) requires certain minimum standards of competence and skills in public financial management. Logistical support in the form of computers and software for the development of financial management information systems is also crucial. A pilot project to undertake a comprehensive capacity assessment of selected districts could be done to ascertain their capacity to implement the recommendations. The result of the capacity assessment could constitute the basis for technical support to the District Assemblies. Clearly, the main challenges facing decentralization in Ghana are the issues of political will and commitment; the resistance by bureaucrats and technocrats; divided loyalties; overlapping role of key players; …” (GTZ 2006)

5 **Performance-Based Grants for Capacity Development**

5.1 **Challenges for LG Performance and Capacity Building**

As shown in chapter 4 there are a number of reasons why the resource base of many local governments is limited and reforms will take time to become effective. On the other hand, there is increasing evidence that large increases in grants, without sufficiently considering the incentives/disincentives they create, will lead to unforeseen problems in terms of LG performance and longer-term sustainability.

Governments and development partners have become aware that simply increasing the level of LG funding – without ensuring that LG absorptive capacity is in place or that funds are spent with a degree of efficiency or effectiveness – may not solve the problems or address the challenges associated with local service delivery. As a response, grants to LGs are increasingly designed to include performance criteria. These approaches are globally referred to as performance based grants (PBG) and are intended to introduce incentives for improving LG capacity and performance.
Institutional challenges

Capacity development for local governments has often suffered from unclear institutional responsibilities. In most countries, the Ministry of Finance is in charge of PFM reforms, which are an essential requirement for fiscal decentralization with limited fiduciary risk. On the other hand, the political advocacy for decentralization as a whole is generally with another Ministry (Ministry of Local Government or similar). This implies to make sure that (i) A democratic and accountable system of local government is in place with an effective administrative structure, (ii) Planning is comprehensive and services to communities are delivered in a sustainable manner, (iii) Social and economic development at a local level is sustainable and based on felt needs of the local communities. Service delivery concerns the line ministries, while the establishment of an effective administration often requires a reform of public service, which may concern again another Ministry (Ministry of Labour or Fonction Publique).

In this regard, the Ministry in charge of decentralization needs to have a strong coordinating mandate in order to comply with its crosscutting function. This is not generally given. Often, the Minister of Local Government is among the weaker members of the cabinet and certainly not as influential as the Minister of Finance.

An ongoing study on Ethiopia found: "An obstacle for the decentralization is the fact that at federal or regional level no agency has the overall responsibility for driving the decentralization and capacity development process and ensuring compliance with agreed visions and policies. Four ministries (MCB, MWUD, MoFED and MoFA) play roles in this regard, which favours overlaps. Regional disparities have posed practical problems in the decentralization process in particular within those regions labelled as "emerging".

Overlaps affect the organisation of the badly needed capacity development for districts and other layers of local government. An effective national capacity development programme with a related basket-financing supported by several donors does not yet exist.

PFM Reform as a precondition for fiscal decentralisation

Improving Public Financial Management at sub-national is a precondition to fiscal decentralization, in order to reduce fiduciary risks. Despite the fact, that the Ministry of Finance is mostly one of the more capable partner agencies there is a lot of room for capacity development efforts to support PFM reform at LG level.

First, reforms of the budget cycle as well as the budgeting process are required, which affect national as well as sub-national fiscal governance. These reforms refer to (i) the predictability of transfers, (ii) timely preparation of budgets at all relevant levels, (iii) inclusiveness and transparency of the budget and (iv) accounting, (v) reporting and the flow of information.

The predictability of transfers goes along with well planned expenditures and usually, Medium Term Expenditure Frameworks are introduced to local governments at this stage and local governments must be enabled to develop an MTEF process that is similar to and integrates with that for central Government. In order to facilitate PRSP monitoring, capital (investment) expenditures must be clearly separated from recurrent (ordinary) expenditure. LGs must follow the same programme and sub-
programme structure. Programmatic budgets and related standard charts of account are required, which are usually new to national as well as local governments.

Budget reforms are usually accompanied by changes in accounting practice (shift from simple cash based to modified cash-based or accrual-based accounting. LGs usually practice cash based accounting, the double entry concept is not generally known and depreciation of fixed assets is not common (in fact, before decentralization in rural areas there were not too many fixed assets to be depreciated). This constitutes a mayor change for LGs as most accounting staff were trained under a different system (if staff at local level is trained at all)\(^{41}\) **There is a huge need for retraining in order to meet requirements for transparent and complete budgets at LG level.**

During budget execution, Districts have to provide regular reporting on budget execution and performance achieved. This is a challenge in term of quantity and quality of reports.

Challenges for local governments in partner countries with regard to such systems are multi-fold: First, there is a “generation gap” to switch form manual to electronic systems, second, power supply and internet connectivity are not that reliable, particularly in rural districts. Thirdly, local governments are usually not trained in filing and have difficulties to provide the required information in a timely manner. Last but not least, the lack of anti-virus protection is one of the most neglected risks for successful introduction of PFM reform at LG level, according to field visits of the author.

First, **manuals and guidelines** need to be updated and validated at national level. The impression of the author is that to date there is not much exchange of information between Anglophone and francophone reform supporters. It might be worthwhile to systematically check and compare tools and training content used to support PFM reform in different countries and give more attention to less strategic aspects such as filing and antivirus protection. The implementation of decentralized financial management is a gradual process, which will require additional efforts in capacity development at local level for a longer time. The experience of South Africa, which is quite advanced in several aspects of fiscal administration, may be a realistic indication for that (See box)

### South Africa: Capacity constraints in an advanced middle income country

Even in more advanced African countries capacity constraints at municipal level are endemic: According to a recent study there is a severe scarcity of well-educated financial managers and engineers, leading to high vacancies in municipalities’ administrations and a lack of qualification of decision makers. Some municipalities in a given sample did not have a chief financial officer for months, and suffered from vacancy rates of up to 50 %. Additionally, high fluctuations among the staff and a weak succession planning further disable a consistent policy.

Other figures indicate that of the 231 local municipalities 42 had only one technical professional (i.e. civil and transport engineer or technician) on staff and 79 municipalities had none. The lack of financial management capacity directly impacts the ability to borrow as it leads to an inability

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\(^{41}\) In francophone countries there are generally vocational schools for administrative staff in place, which follow the French model (e.g. ENAM and ENAREF in Burkina Faso). However, district staff is not usually graduated from these schools.
to understand and deal with debt instruments. Many municipalities do not have the expertise to write the necessary reports, which lenders require.

See DIE / GDI 2007

**Project Management Skills as a Strategic CB area**

While support to (participatory and other) LG development planning has received a lot of attention (mainly through support to municipal and regional development plans), project management skills of LGs have not been upgraded accordingly. This area was not essential, while most LGs had no funds to implement major investment projects on their own and donor-sponsored projects were mostly implemented by the respective donors.

During the high season of Social Investments Funds and AGETIPs (Agence traveaux d’intérêt public), municipalities were initially not systematically involved (Latin America) or were non-existent (West Africa). According to the status of local governments, tasks related to the management of sub-projects were either done by the funds themselves or partly delegated to local communities.

With the subsequent devolution of responsibilities as well as funds to local governments, this has changed fundamentally. Municipal development funds (= third generation social funds, e.g. in Central America) as well as the emerging national LG financing systems (such as ANICT in Mali, Fonds Permanent in Burkina Faso, CDF in Rwanda) regard cities and municipalities as owners of their investment projects, whose costs should also appear in LG budgets.

However, most local governments of most developing countries (except for the major cities and urban LGs of middle income countries) are not in a condition to fully manage project cycles without support, due to lack of skilled staff, lack of experience or high turnover. Weaknesses relate to linking plans to budgets, conducting feasibility studies for investments, procurement and tender evaluation, contract management, supervision of works, internal audit, operation and maintenance of related services. If weaknesses are evident from the beginning, funds may just accumulate on district accounts; if they become evident midway, contractors may abandon construction sites before completing works; if operation is not dealt with at an early stage, works may be ok, but still no satisfactory service resulting. The issue for CB is how to guide and capacitate local governments to gradually learn taking over these tasks without wasting public funds.

In different countries, different approaches have been tried but it seems that interventions are rather guided by governments and development partners preferences and traditions in their countries of origin rather than empirical assessments of results:

- In francophone Africa, municipalities can delegate part of the project management to a consultant, who is paid by the fund/financing system (maîtrise d’ouvrage délégué; the modality has proven to be efficient with regard to the completion of works but does not cover subsequent phases of operation and maintenance; further, according to the experience of the author, the difference between maîtrise d’ouvrage and the delegation mode is not always clear to LGs. This means, that transfer of knowledge may not be effective.
• In Central America, municipalities have been assisted to establish multidisciplinary technical teams to manage investment projects, supported by a regressive financing of salaries; this approach was successful in a period of growing transfers to municipalities, which facilitated the take-over of staff by LGs; secondly, trainings to local communities were conducted to participate in the maintenance of structures, with limited success.

5.2 The PBG mechanism as a response to Capacity Concerns

PBGs link performance in pre-determined areas with the access to and the size of funding applying clear and transparent allocation formulas. The system is a move away from tight ex post control of LGs to strong performance-based incentives, coupled with ex ante monitoring and assessment. PG systems may be “multi-sectoral”, aimed at improving the overall generic institutional/organisational performance of the LGs, or “sector-specific”. Most experiences from developing countries have been within the first category.

Performance grants require that this allocation is not an entitlement: the funds are only actually disbursed if the beneficiary LG performs according to a number of pre-established criteria, typically called ‘minimum conditions’ (MCs) which are to be seen as ‘minimum safeguards’ for handling of funds.

Most systems operate with ‘performance measures’, which are used to adjust the grants up and downwards (reward and sanction) to enhance good LG performance. Examples of these may be the extent to which LGs have ensured an open access to the budgeting process, has made financial materials available for the public, has made environmental assessments, etc. Most of the PG systems have applied generic institutional performance measures, within areas such as planning, financial management, fiscal capacity and tax effort, expenditure prioritisation (reward for poverty focus in expenditure allocation), transparency and accountability.

A number of countries have initially applied only minimum conditions for eligibility and during subsequent phases some of these have introduced more qualitative and complex performance measures. There is a clear tendency to develop and fine-tune the performance-based systems once they are in place, and to elaborate second and third ‘generations’ of the systems. On the other hand, performance-based grants, which are accessible to a limited number of LGUs, may operate with more and more complex indicators, while the effort of data assessment becomes more relevant after roll-out at national level (See the experience of Benin further on).

The lessons from the innovations with the PG systems show there are numerous design and operational challenges, particularly to: i) identify the specific indicators for LG performance; ii) design the institutional arrangements; iii) ensure a strong communication of the objectives behind the system; iv) involve all key stakeholders in the grant implementation schemes; v) ensure high credibility of the assessment; and vi) decide on possibilities for QA of the assessment, options for complaints, etc. The lessons learned have however also shown that these challenges can be overcome with proper design and a careful strategy for roll out. The administrative transaction costs

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42 Most of this section relies on the following source, if not quoted otherwise: Steffensen, Jesper (forthcoming publication by UNCDF): Perfomance Based Grant Systems – Concept and International Experiences, Final Draft, 2009
are somehow higher than those of simpler grant schemes, but these costs are easily outweighed by the benefits.

Further, PG systems are designed on the premise that financial institutional incentives (rewards and/or sanctions) have an impact, and that there is a minimum LG downward (vis-à-vis the citizens) and/or upward (vis-à-vis the funding agencies) accountability, which can be addressed by the instrument.

For a PG to be effective, the performance of the targeted units has to be regularly (e.g. annually) assessed. Obviously, this kind of grant requires more substantial administrative infrastructure than for example an unconditional block grant, but assessment can be contracted in on a seasonal basis. A lot of effort has been made to ensure that the actual assessment of the LGs is surrounded by a strong credibility and integrity and accepted as valid and highly professional by all parties involved, i.e. the citizens (and NGOs/CSOs), the LGs, the central governments and other contributing agencies/donors. The experiences have also shown that it is vital that the assessments of the LG performance are surrounded by a very strong credibility and integrity and accepted as valid and highly professional by all parties involved, i.e. the LGs, the constituencies, the central governments and other contributing agencies/donors.

There have been remarkable improvements in recent years in the coordination of support for LG development investments, establishment of joint donor basket funds and common project designs ensuring a more equitable distribution of funds and procedures mainstreamed with government procedures in many African and Asian countries. The increase in donor support to PG systems has promoted this coordination. However, to transform the PG systems/programs to the general intergovernmental fiscal transfer system has been, and will be, a future challenge in several countries.

5.3 Specific country experience

Currently more than 15 countries have one or another form of performance-based development grant system in place – as pilot or country-wide (See Steffensen 2005 and 2009) and their number is increasing.

One of the first countries to introduce this type of grant system was Uganda, through the District Development Programme (DDP) in 1997. From 2003 on it became a countrywide system covering all types of LGs in the country. Since 2007, these grants have been entirely funded out of the Government of Uganda’s consolidated budget, but other components, such as the assessments, are financed by a joint donor basket fund arrangement.

The system in Uganda has inspired many other countries and further countries are currently in the process of introducing new PBGs or revising earlier types of PBGs (e.g. the Philippines, Bhutan, China, Pakistan, Indonesia). Several Asian countries are starting pilots (e.g. Nepal, East Timor, Laos, Bangladesh). The performance criterion in the new Philippine system will have about 40 indicators and be part of the other grant allocation criteria, such as size of population, poverty level etc. (integrated in the basic allocation formulae). The performance criterion will have a weight of 50 %. It will focus on relative performance of the local governments.
As a surprise, experiences have shown that there is no direct link between general poverty and possibilities to improve on institutional performance as long as the indicators for performance are reasonable and well designed. The German financial cooperation program *FIVIS II in Benin* is financing infrastructure investment in a number of medium-sized towns and the allocation of funds is made in accordance with the performance of local governments (See FIVIS 2006). Consulting services are provided to strengthen management capacities of the target group. Performance is measured against two groups of indicators:

- financial indicators
- qualitative indicators

The total available funding is put in a basket, from which target cities can draw funds on an annual basis. These drawing rights of local administrations are established according to the performance reached in each indicator and the relative weight of this indicator, which may be changed over time, in accordance with progress reached.

The increase of local revenues against total revenue and per inhabitant features among the most important financial indicators, which is a strong incentive to improve their governance in this regard. Further, local governments must commit themselves to properly operate the facilities financed, which improves the motivation for generating revenues from economic infrastructures such as markets.

Performance evaluations are done by project management but discussed in open forums with all concerned LGs. Experience has shown, that the cities accept the mechanism and are actually competing with each other. Quite obviously, such a comparatively detailed set of indicators and obligations requires close insights and follow-up and can only be applied to a group of LGs with comparable conditions. The following table provides an overview on the choice and the relative weight of indicators, as applied since the start of the programme.

**Table: Bilateral performance-based grants for a limited group of LGs:**

**Performance criteria of FIVIS in Benin**

<table>
<thead>
<tr>
<th>Financial Indicators</th>
<th>Point max.</th>
<th>Relative Weight 2006</th>
<th>Relative Weight 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own revenue / total revenue</td>
<td>20 points</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own revenue /inhabitant</td>
<td>20 points</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenditures</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maintenance expenditures / total expenditures</td>
<td>20 points</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operation expenditures / total expenditures</td>
<td>20 points</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operation expenditures /inhabitant</td>
<td>20 points</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL Financial Indicators</td>
<td><strong>100 points</strong></td>
<td><strong>60%</strong></td>
<td><strong>50%</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Qualitative Indicators</th>
<th>Point max.</th>
<th>Relative Weight</th>
<th>Relative Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establishment of an adequate organisational setup for the provision of services (number of staff)</td>
<td>30 points</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quality of relevant staff</td>
<td>30 points</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effectiveness of operation of relevant services</td>
<td>40 points</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL Qualitative indicators</strong></td>
<td><strong>100 points</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Compliance with commitments concerning previously financed projects | Point max. | Relative Weight 2006 | Relative Weight 2007 |
| Compliance with cofinancing obligations | 25 points |
| Establishment of a proper user association + office for markets and commercial infrastructure | 30 points |
| Timely presentation of reports | 25 points |
| Compliance with the FIVIS partnership agreement | 20 points |
| **TOTAL Compliance** | **100 points** |

Source: FIVIS 2006

Since 2008, a *country-wide financing and equalisation mechanism* in Benin, the « Fonds d’Appui au Développement des Communes » (**FADeC**) is being set up, which has taken over part of the “performance model” of FIVIS but chosen different indicators, which pays credit to the variety of conditions of LGs as well as challenges in the measurement of data.

FADeC is being used as a mechanism for conditional as well as non-conditional transfers for investment and recurrent costs. Conditional transfers refer to budgets from sector ministries, which are made available to LGs to cover functions, which have been delegated to them. Non-conditional transfers are channeled through the Ministry of Local Government in several tranches with a permanent commission supervising its operations.

Non-conditional transfers, which are composed of a general purpose grant, are composed of several shares, including a block grant, an equalization grant and a performance grant. The equalization grant is calculated according to population, surface area, poverty and urbanization, while the performance grant is distributed according to the performance of LG in the following areas:

- Quality of operation of LG organs (number of council meetings and documentation of the work of permanent commissions, timely approval of the budget, timely presentation of annual accounts)
- Quality of operation of the municipal administration (compliance with procurement regulations, compliance with accounting procedures, timely delivery of birth certificates following the reception of birth statement forms)
- Local Finance (increase of own revenue, increase in maintenance expenditures / recurrent expenditure, increase of the investment budget through cuts in the recurrent budget). Increases of these indicators and ratios are rewarded by
extra points up to a certain limit, which is regarded as feasible. While local taxation is not explicitly addressed, there is a certain fiscal incentive for LGs to increase the local revenues in order to receive higher grants.

The FADEC transfer mechanism was started in 2008 with government funds but up to now only part of the indicators are operational. Current discussions between the government of Benin and development partners focus on possibly mechanisms for external control and quality assurance, which are able to cover all communes and possibly several fields of intervention.

5.4 Linkages to local revenue generation

While the experience with PBGs is positive with regard to general institutional performance, accountability and amount of infrastructure investment, the implications of the local investments on operation and maintenance have remained a great challenge in most developing countries.

PBG approach has tried to address this challenge in the grant design in various ways, part of which refer to local revenue generation: i) in the determination of the size of the grants (e.g. compared to LG tax potential); ii) reviewing the absorption capacity and links to the allocation criteria; iii) increasing the incentives to mobilise LG own source revenues; iv) support from the CG to improve LG planning procedures; and v) by the development of incentives (rewarding measures) for improved LG planning and budgeting practices, rewarding LGs which incorporates concerns on O/M. However, this is still an area, which leaves room for improvement. Solutions go beyond the PBG design and require reforms in the systems of LG own source revenues in many developing countries.

The establishment of the right incentives to collect LG taxes has been a great challenge in many countries and experience indicates that these initiatives cannot alone ensure that the local revenue potential is realized in times with various strong pressures against local revenue mobilization especially in the cases with large increases in transfers from the CG in recent years, non-conducive legal framework for LG tax assignments, political interference in tax collection, etc..

Setting the right incentives for LGs to collect taxes (and other own-source revenues) has been a major challenge, especially in East Africa – where countries like Uganda have experienced large increases in the size of intergovernmental transfers in recent years, and where the legal framework for LG tax assignments is often inappropriate, while there is frequent political interference in LG tax collection. To encourage own-source revenue mobilization, PBGSs have typically included three main measures:

1. LG co-funding obligations (5-10 %) and
2. Minimum conditions/and or performance measures to boost the LG revenue mobilization
3. CB support to improve LG revenues

In Kenya, for example, LGs are rewarded for preparing revenue enhancement plans and debt recovery strategies. The focus on revenue enhancement strategies and debt recovery, combined with adjustments to and improvements in tax legislation seem to have generated some positive lessons. In Uganda, it has been deemed necessary to strengthen the tax effort incentives in the PBGS to halt the downward trend in LG
revenue mobilisation. Thus, one particular condition – “no decrease in LG own source revenues” – was put into place as a condition for access to the development grants – but was later changed to a softer measure – “three year local government revenue enhancement plans” – due to changes in LG tax assignments that included abolition of a major LG tax (the graduated tax). In several other countries, tax effort is included as a performance measure to provide incentives for LGs to focus on own source revenues and thus ensure sustainability and LG absorptive capacity.

However, it is important to note that increased revenue mobilisation is not an objective per se and that various tools should only be introduced when there is a real concern that there is a larger untapped revenue mobilisation potential at the local level which can be utilised in a fair, efficient and poverty sensitive manner to improve sustainability, participation and ownership in the local activities.

The PBGS approach has tried to address this challenge in the grant design in various ways, including:

i) In the determination of the size of the grants (ensuring they are commensurate with LG tax potential (and other revenue sources e.g. recurrent grants) and resources to cover the O&M costs);

ii) Reviewing the absorptive capacity of LGs. This will depend on the vertical (how funds are allocated across tiers of LGs) and horizontal (how funds are allocated across the LGs within a tier of LGs) allocation criteria;

iii) Increasing the incentives in the MC/PM system for LGs to mobilise own source revenues (Uganda, Tanzania, Kenya Nepal and Bangladesh). Such incentives range from awarding scores for increases in revenues from one year to another (Philippines), to awarding scores for “softer” instruments such as the drawing up of revenue enhancement plans, debt recovery plans, and the like (as in Kenya);

An appropriate system of LG revenue assignments is also important for the success of the PBGs, particularly to ensure that sufficient funds are available to cover the operations and maintenance costs associated with capital investments. Some countries have introduced incentives for LGs to increase their own-source revenues, but at the same time have constrained their options for doing so by circumscribing LG revenue assignments (abolition of core LG taxes). Furthermore, there has often been political interference and a lack of central government administrative support to LGs in the field of local revenue mobilisation. This has created severe problems in areas such as co-funding, the funding of O&M costs, etc and impacted negatively on the sustainability of the entire LG funding system.

Transfer systems with tax effort criteria and performance measures for tax collection, have provided some positive results. But decisions to abolish the most important local taxes in several countries and political interference in local tax collection have been more important factors and are potential threats for the sustainability of the entire decentralization process. It is therefore important that any incentives built into the PBGS are combined with reform measures to ensure a more conducive environment for LG taxation and considerations on how to ensure a poverty-sensitive and efficient framework for LG taxation. This requires well-planned reforms, an enabling legal framework for local taxation, capacity building of politicians and staff (especially tax collectors), and last – but not least – strong “moral” support from the highest political levels.
5.5 Capacity-building Grants

Most countries have combined the PG systems with various types of capacity building, either demand driven, supported by genuine capacity building grants to LGs, and/or more supply driven centrally managed “backstopping” support from the centre to LG to enable the LGs to improve the performance and respond to the incentive systems. The requirements for LGs to get access to this support have typically been more lenient to ensure that most LGs get enrolled in the incentive scheme.

UNCDF adopted in some countries a specific Capacity Building Grant Fund accessible to local governments. Five countries (Uganda, Tanzania, Ghana, Mali and Pakistan) have a specific capacity building grant scheme included in the system, combining the supply and the demand driven dimensions to CB support, thus allowing LGs to spend funds on their own CB priorities (See Box). A similar modality is financed by the World Bank in Ethiopia (the PSCAP). The challenge in this case is for LGs to properly identify their CB needs and go through the foreseen process, which already requires a certain level of comprehension.

The Capacity Building Fund in Tanzania

In Tanzania, Districts are responsible for many services that are vital for the poor—such as water, health, education and land development. The capacity building fund CBF is intended to assist Districts to improve their technical and managerial capacity to implement those services efficiently. All Districts are in principle eligible for the CBF but must comply with certain minimum Conditions: Districts must have an acceptable capacity building plan and account for other grant/fund disbursement in an acceptable manner. Compliance with these conditions will be duly assessed.

The menu for the CBF is left fairly open to allow Districts to tailor capacity building to meet their needs. However the following conditions apply and must be followed in budgeting for the use of this grant: Minimum 50% of CBF funds shall be used for Skills development for Mayors and Vice Mayors, Councilors and staff, and approximately 15% each for TA and study tours, Professional career development and procedures development. In addition a minimum of 40% of the CBF should be utilized at the sub-district level; that is Sectors, Cells and Villages.

Good Practice from South Africa: Transfer payments for capacity development

The transfers to municipalities in RSA can be separated into three basic types of grants: Besides the usual unconditional transfers (the “equitable share”), which are determined by a poverty-based formula and conditional infrastructure transfers, conditional capacity transfers have been introduced as a third category. They are intended to assist municipalities improve their capacity or restructure their operations, such as the Restructuring Grant, the Financial Management Grant, and the Municipal Systems Improvement Grant. These capacity related transfers accounted for only 4% of total transfers.

5.6 Other Related Performance Measurement Systems

There are numerous related performance measurement systems elaborated with various objectives, not linked to the actual transfer of funds to LGs. Examples of these include various forms of citizen’s evaluations and “report-card” methods for assessing the performance of LGs, applied in a number of e.g. Asian countries (E.g. the
Philippines, Pakistan and Thailand). These systems are put in place to monitor the development in certain areas of governance and/or to promote sustainable performance in sectors or cross-sectoral areas and improve the dialogue between the LGs and citizens.

Further, most countries have elaborated more project specific M&E systems, which track the progress in specific areas. Third, many countries have elaborated detailed compliance inspection and supervision systems, with performance indicators, typically performed by the Ministry of Local Government, which are important in the relationship between central and local government; and more or less sophisticated M&E systems to track the development in outputs (e.g. service delivery) and outcomes/impact (e.g. poverty reduction).

In Rwanda: the planning and budgeting process is linked to the outcome of administrative reform through the signing of performance contracts between local (and other) government staff and the President. They are meant to describe what the districts plan to achieve over the year in terms of outputs and the inputs that are required for these. Logical links between inputs and results are not always defined to perfection and results do rather pass the output level (which means: do not give answers regarding the outcome of interventions). Nevertheless, it is a highly innovative approach for Sub-Saharan Africa and public servants feel tremendously pressured to comply with what has been agreed. Results are evaluated annually through the Ministry of Local Government and best performing districts receive a lot of publicity, which creates a certain competition between districts.

A common yet simple single item performance mechanism used in development programs with a limited amount of funds is to reward fast project implementation. Available funds are distributes into several “envelopes”: Only those local governments, which have successfully implemented projects worth their first envelope, can access the next one with remaining funds being distributed among the best performers. Such a mechanism is easy to apply and acts as an incentive to speed up project implementation (+ related disbursement) at LG level. However, it does not contribute to improve service delivery and is opposed to equalization efforts as poor LGs would usually have most difficulties to efficiently manage projects.

Finally, there are a number of countries, e.g. the Philippines, Uganda and Tanzania, which are in a process of developing comprehensive LG computerized M&E systems, with the main aim of informing decision-makers (LG and centrally) about areas in need of attention -as a general management tool.

**Philippines: A complex system of Local Government Performance Measurement**

The LGPMS is a consolidation of the various performance standards and assessment mechanisms generated for LGUs in the past 20 years. It is developed and managed by DILG’s Bureau of Local Government Supervision. Primarily, it serves as a self-assessment and management tool. The first national roll-out of LGPMS in 2005 featured the first complete voluntary capture of data from different LGUs based on a pre-defined set of 107 performance indicators categorized into five Performance Areas and 17 Service Areas. The results of the first national data entry of LGUs were published in 2006, based on the data input of 117 cities. It gave quite an optimistic picture and revealed that self-assessment may increase ownership but not necessarily realism.
In any case, the system is still under development and can provide a lot of "food for thought" for other countries interested. Performance Areas relate to Governance, Administration, Social Services, Economic Development, and Environmental Management. **Performance** indicators refer to:

(i) **Administrative Capacity**, which consist of the underlying capabilities of cities in terms of readiness of structure; effectiveness of policies, guidelines, and administrative systems; availability of managerial and technical competencies, and; accessibility of tools, facilities, equipment and financial resources;

(ii) **Productivity**, which refer to the availability and quality of basic services delivered by the cities to their respective constituents; and

(iii) **Development Condition**, which refer to the socio-economic and environmental information obtained from the cities during the assessment year.

Administrative capacity is strongly biased towards local revenue generation in the LGPMS: The presence of a (i) Comprehensive **Revenue Generation Plan** (CRGP) and (ii) The efficiency of the **Real Property Tax Assessment** and Collection (RPTAC) have been defined as main indicators. As there are important aspects for the strengthening of fiscal decentralization, the underlying logic and sub-indicators are presented.

The presence of Revenue Generation Plans and the efficiency of RPTAC system are used as determinants in measuring the administrative capacities of cities in generating sufficient local revenues for their development and delivery of services. The existence of a CRGP provides strategies for a city to achieve high revenue generation. The RPT has always been a major source of local income hence, the efficiency of the system for assessment and collection will help a great deal in generating enough resources for local development and service delivery.

In order to determine the productivity of the cities regarding revenue generation, the following LGPMS indicators are used, among others: (i) The percentage of annual revenue realized (ARR), (ii) Real Property Tax (RPT) collection efficiency rate, (iii) The percentage of IRA to total income.

The rates of attainment of the revenue targets of the cities determine not just their efficiencies in realizing their incomes but also their capabilities to come up with feasible targets\(^{43}\). The Real Property Tax (RPT) being the largest source of local revenues of LGUs, the performances concerning RPT collections affects the levels of independence from National Government - both imaginary and real – in terms of their own revenue generation.

The presence of ordinances or resolutions in a city is the principal criterion of legislative productivity. As of 2004, improvements in financial and economic development conditions resulted from the issuance of Revenue Codes (= collection of tax ordinances) in over 100 cities. The productivity of the cities concerning customer service is measured in terms of the readiness and promptness of the systems used in processing business permits and RPT documents.

An efficient business permit processing procedure is boon to business and industry development. Businessmen and investors usually look for fast and well-organized procedures

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\(^{43}\) To determine the productivity levels of the cities, the following scheme for target accomplishment was used: (i) 81% and above target accomplishment rate - very high, (ii) 61% to 80% - high, (iii) 41% to 60% - medium/ benchmark, (iv) 21% to 40% - low, (v)20% and below – very low
for permits processing. Another area where cities could excel was the processing time of RPT documents. About 38% of a total or 44 cities had established RPT processing in 30 minutes or less. Around 51% or 59 cities had established RPT processing time of 30 minutes to at most one day.

Experiences have shown that although these systems may supplement each other in a mutually strengthening manner, it is important to make the objectives clear in the design phase and ensure clear links between the indicators for measurement in each system and its objectives.

5.7 Conclusions and Recommendations

Technical Recommendations

- Capacity development for effective decentralization requires interventions at all government levels. It is a helpful tool to classify the need for support according to the levels of intervention, in order to define target groups and viable approaches, e.g.:

  Macro Level: Support to establishing a regulatory and administrative framework, including roles and responsibilities of different stakeholders, support to coordination, negotiation and decision making in the overall reform process, support to establishing revenue and expenditure responsibilities need to be assigned.

  Intermediate level: Support to establishing financial and technical support mechanisms for fiscal decentralization, such a Municipal Development Funds or financing Systems

  Local level: Support to establishing effective and participatory planning and control mechanism.

- In general terms, the revenue incentives of performance grants should be combined with reforms to make a more conducive environment for LG taxation and cautious measures, not just to mobilize revenue for the sake of revenue enhancement, but also to do it in a poverty sensitive, development-oriented fashion, focusing the efforts on the major tax sources, combined with improvements in the efficient utilization of the collected funds. This requires an enabling legal framework for taxation, as well as capacity building of politicians and staff (especially tax collectors) and last, but not least, strong ‘moral’ support from the top political level which needs to be enhanced by development partners in a joint effort.

Further technical recommendations on the design of PBGs are included in Annex 9.

Recommendations to development partners

To transform the PG systems/programs to the general intergovernmental fiscal transfer system has been, and will be, a future challenge in several countries. Donor support to PBGs requires better linkages with the sector support programs, in order to ensure synergies between LG based programs and Sector Wide Approaches (SWAps) and a gradual merging of scattered bilateral district support programs, with (on budget) components of capital investment support to LGs within emerging central government genuine development transfer schemes.
Two risks needs to be addressed by development partners in this regard. First, development of fragmented, multiple, highly conditional and earmarked systems of sector specific (categorical) transfers may potentially undermine the incentives in the PG system if the right balance is not achieved, i.e. if the funds in the PG are too small to provide incentives and/or to small for meaningful planning, budgeting, local priorities and project implementation.

Second, the linkage to off-budget funding flows, like social action funds, requires attention as these systems pose risks of undermining the incentives in PG systems if alternative funding in a larger scale is available for investments. If there is a large transfer of funds to localities, by-passing the LG system and (accountability) procedures, and if these funds are supposed to be used within the LG mandatory functions, the planning, budgeting and implementation capability of LGs and incentives (and pressure) to improve may be considerably reduced.

With regard to capacity development at LG level development partners need to acknowledge that fiscal decentralization is a long term process, which depends on political will as well as technical expertise at different levels and CB in (fiscal) decentralization requires involvement in CB and advisory services on the ground as well as higher government levels.

In order to avoid frustration, performance-based grant systems should define realistic transition periods for the achievement of improvement, which are in line with the national reform process.

Development partners need to acknowledge that the credibility of any performance mechanism depends on the careful choice of indicators and their assessment and communication on the ground; saving time and effort during this stages is not conducive for LG motivation to make efforts.

Any performance-based financing mechanisms (whether related to local revenue generation or not) should facilitate access of LGs to proper support and TA in order to facilitate improvement of scorings.

Development partners should make additional efforts to construct joint conceptual and financing mechanisms for the TA needed to accompany fiscal decentralization.

6 Sub-national Borrowing as an Option for the Fittest

6.1 Rationale for Sub-national Borrowing and risks involved

As a result of decentralization policies, sub-national spheres of governments face increasing responsibilities for infrastructure service delivery. In this context, a controversial international debate has emerged, whether to allow sub-national governments to borrow in order to finance part of their infrastructure and to what extent. Skeptics argue that sub-national borrowing bears a high risk of over-borrowing, while proponents argue that access of sub-national governments to capital markets were a logical further step to meet financing demand.
Through the often externally funded preferential loans, access of municipalities to financial markets is improved and investment in infrastructure speeded up, which in most cases is environmentally relevant and essential for improving living conditions. Infrastructure is crucial for economic growth and spurs the achievement of the Millennium Development Goals (MDGs). Infrastructure services like electricity, roads, water, and sanitation are main drivers of economic activity. Social infrastructure, such as health and education, but also access to clean water and sanitation, lead to direct positive impacts on the quality of life and reduce mortality and morbidity.

The rationale of a positive impact of all kinds of loans (including commercial ones) is that the exposure of local governments to capital markets can significantly speed up infrastructure development and in addition requires municipalities to be transparent and leads to lenders exerting a certain control function on local government finances. This link is established through four processes: External assessments such as ratings, the tender process, reporting and monitoring.

However, in many countries, particularly in parts of Asia and Latin America, the first generation of municipal loans – often backed by state guarantees or financed by government financial institutions, have not been sustainable (see Box). Municipalities became so used to avoiding repayment of loans that in Latina America the paradox term “prestamo no reembolsable” (a non repayable loan) was created.

The Philippines:

A changeable history of municipal borrowing with effective incentives

In the 1980s, prior to the passage of the Local Government Code, the delivery of basic services and other activities of the LGUs were financed from resources provided by the National Government. LGUs turned to the Government Financial Institutions for their support to intermediate credit finance requirements and this lending served the LGUs well until many LGUs began to default on their obligations (due to a severe economic recession resulting from the political uncertainty in the country). Unpaid obligations rose to Ps 2.1 billion in 1985, which led to the cessation of lending to LGUs. The national government had to carry out a debt relief programme for the LGUs.

After a more comprehensive approach to decentralization in the early 90s, the legal framework for LGU’s access to loan financing was liberalised again. Local governments may access any form of loan with any government, bank or lending institution (bonds and other investment schemes included). As a lesson learned from the debt crisis of the 80s and in order to assure fiscal viability of the loans, the amount of appropriation for debt servicing “shall not exceed 20% of the regular income of the LGU concerned”.

In order to encourage the use of loans and lending to LGUs, up to 20 % of Central Government Transfers to an LGU may be used as a collateral for loans. This mechanism (called IRA intercept) has started in the early 90s and is growing since then, as internal revenue allotments have also increased substantially. It has met the expectation as lending has been fast increasing and default rates are under control.
6.2 Strict Regulatory Framework to avoid Over-borrowing

As a result, most middle income countries have strictly regulated municipal access to loans and introduced indicators to assess the debt potential (see Annex 8 on loan regulations). Based on these grounds, at least 25 developing countries started to (re-)engage with sub-national borrowing. Those are mainly (Lower) Middle Income Countries (MICs), such as South Africa, India, the Philippines, to mention a few, which have reached a certain degree of political and administrative decentralization, along with a level of economic development.

In many countries, local governments are only allowed to borrow from the central government. In other countries, local governments are not specifically allowed to borrow at all. In still others, local governments, states, regions, and municipalities all have the authority to borrow from private lenders. In some countries, state or regional governments impose borrowing restrictions on local governments, restricting them only to borrowing for “revenue anticipation” needs or to specific capital infrastructure needs.

It was learned that municipal loans require a regulatory framework, which encourages actors to borrow or lend for infrastructure, by imposing rules that give municipalities clear guidance and provide lenders with predictability, clarity and confidence. In this context national state guarantees for sub-national debt are generally abolished, increasing municipalities’ responsibility and self-reliance. South African lawmakers have e.g. successfully diminished some of the previously perceived uncertainties by introducing a set of regulations of which the centerpiece is the Municipal Finance and Management Act (MFMA), which was implemented in 2004.

It must be assured that long-term loan capital is actually used for infrastructure investments debt can only be raised to finance capital expenditure and not to finance current expenses. Additionally, regulations on budgeting, accounting, reporting, and supply chain management impose discipline on municipalities. Inevitably, the workload of municipalities’ administrations will increase while financial reforms are implemented but improved transparency may also increase credibility of the administration.

The concept of creditworthiness

The market potential for municipal loans depends (i) on the general creditworthiness of LGUs and (ii) on the unused debt capacity. Creditworthiness of sub-national entities is a demand-side requirement for sub-national borrowing. Generally speaking, creditworthiness refers to the ability and willingness of a borrower to repay the debt. Creditworthiness leads to a good credit rating, which enables sub-national entities to attract lenders and borrow at reasonable prices. Information about creditworthiness is a key factor for a working sub-national borrowing market.

This refers to key financial indicators like

- total debt burden,
- the ratio of debt to revenue,
- debt per capita and the financial deficit.

Municipal loan applications (as well as any other loan) can be positively assessed, if debt service can be financed from the overall (municipal) cash flow balance and sufficient funds be left for recurrent expenditures. These are logical restrictions. Calculations on the financial viability of revenue generating projects (= projects related to services
where user charges are applicable) in a wider sense (including water and sanitation) should rather be based on assumptions about the connected population, user charges and collection efficiency, for cost recovery to be achieved in the medium or long term.

In poorer and more rural municipalities in developing countries, there are no historical records about the capacity and willingness to connect and pay, as services are established for the first time. This makes calculations more risky for both the lender and the borrower. Further, loans for water and sewerage projects are restricted to the ULB’s willingness to review user fees and often cost-recovering charges are considerably higher than the existing water ones. Deposit payments for water and sewage house connections are an additional burden for low-income households, which has to be considered.

Determinants of the general local economic performance also influence the creditworthiness of sub-national entities. Important in this context are, for example, demographic factors, growth prospects, key industries, poverty, employment levels, and the diversification of the local economy. Local institutional-political factors comprise the quality of governance, and financial management capacities like accounting, planning, reporting, public disclosure, and marketing skills.

### Why South African LGs can access loans while others cannot

South African municipalities are advanced in terms of fiscal decentralization since they have significant and stable income sources. They receive many transfers from national government and some have their own income sources, making them less dependent on the national government. Fourth, with the DBSA, South Africa has a strong public development bank. Such a public lender is valuable to play a lead role in developing a municipal market, leading municipalities to the capital markets, and in addition, one can observe strong private banks that increase competition. There are diverse financing instruments employed by public and private lending institutions.

South Africa does not only have unusually many actors on the financing side but also an unusually high level of liquidity in the financial sector. Moreover, the good national government budgetary situation has allowed South Africa to increase intergovernmental transfers for infrastructure service delivery. Such a strong financial sector with a long history of long-term investment lending in the local currency is nonexistent in many developing countries.

Source: GDI / DIE 2007

Thirdly, efficient lenders and innovative financing instruments are necessary for a functioning sub-national capital market. Notwithstanding an increasing number of countries, whose municipalities are actually borrowing without defaulting, recent studies indicate that access to capital markets is a slow process, on the supply-side as well as on the demand side.

A recent study on South Africa (GDI 2008) found that debt capital is not evenly distributed across municipalities, but concentrates on the metros (six biggest cities of South Africa) and some secondary cities. Generally, there are few competitors on the LGU loan market. For example, in the Philippines, approximately 40% of LGUs have taken up loans, which refer to only three Financial Institutions. GFI lending is focused on short and medium term ventures such as public markets, heavy equipment, terminals and small water supply systems, while financing of large infrastructure projects is limited through the medium-term duration of most loans.
According to recent studies in Indonesia, the motivation for long-term borrowing at market rates is very limited. Sources of previous loans have been the Subsidiary Loan Agreement (SLA) and the Regional Development Account (RDA). Only few cities have received loans from commercial banks. These loans were mainly short-term and they were used to manage volatility in the cash-flow of the local budgets.

Several Indonesian cities could be regarded as creditworthy, provided their arrears will be settled and they comply to the legal requirements such as reporting and auditing procedures. This means most cities must settle old debts before taking a new loan. Several larger cities have a debt-service-ratio below 5%. However, the majority of cities prefer other funding sources for financing local infrastructure. Loans will only be considered as option for financing infrastructure needs if the conditions for loans are easy to fulfil, which includes low interest rates and fast and easy access.

On the positive side, municipal borrowing in South Africa was found to impact positively on local governance in terms of transparency, accountability and financial management. This, in turn, was assumed to result in a more efficient and needs-oriented use of resources and therefore in improved infrastructure service delivery.

The development of intermediate financing institutions and mechanisms is often an important step towards sub-sovereign lending. So called ‘credit enhancements’ shall diminish potential credit risks, prepare local governments for future lending and contribute to the development of local financial markets. Municipal Development Funds, financial intermediaries established in a considerable number of countries, usually integrate different credit enhancement instruments and provide a platform for joint and coherent financing interventions of partner countries and donor institutions.

Further, there are innovative pilot projects of borrowing to urban LGs, if a certain willingness to improve fiscal governance is visible (although not yet achieved). AfD for example has provided a substantial loan to the city of Dakar, Senegal, without insisting on state guarantees, after a PEFA assessment was done on the city’s financial management.

6.3 Municipal Loans and Poverty Considerations

In view of the need of general coverage of basic services and the limited creditworthiness of LGUs it is worthwhile asking, whether loan financing can be used to improve the situation of poor municipalities or if it rather discriminates against the poor.

The selection of particularly poor municipalities for loan financing is obviously not a viable option for a loan programme as all loans must be financially viable. In the case of preferential loans, specific covenants regarding the quality and poverty orientation of Local Development Plans as well as the establishment of common facilities might be viable but are not common and not easy to assess.

As a result, municipal loans can complement but not replace or reduce intergovernmental fiscal transfers, which are required to introduce those reforms, which may lead to accessing capital markets. Access to capital markets (without state guarantees) requires a sound condition of municipal finance, in order to be able to repay the loan. Further, in order to avoid disturbances of the capital market, conditions and interest rates of development loans should generally be set in consideration of the prevailing national interest rate level taking into account the specifications of the urban
infrastructure sector (long repayment period plus a certain grace period of up to five years).

Space for poverty oriented manoeuvring is therefore quite limited and it may be argued that loan financing will not be a viable option for most municipalities in Sub-Saharan Africa or even Latin America in the medium term, except for some larger metropolitan areas. However, it is worthwhile to look at the experience of the Indian State of Tamil Nadu, which is applying a clever mix of moderate government subsidies with financial market tools to provide reform incentives for revenue generation and create a soft equalization bonus for poorer municipalities (see Boxes).

Tamil Nadu I: How to combine moderate subsidies and loans at market conditions

Under the World Bank-financed TNUDP, a special financial tool (the so-called Grant Fund) was created to facilitate the participation of poorer Urban Local Bodies (ULBs) in a loan scheme. A certain part of the loan to the Government of India is transferred to beneficiary ULBs as a grant, which means that financing costs are covered by the national government in order to promote municipal loans. ULBs with an above-average share of poor population are eligible for a certain amount of co-financing from the Grant Fund.

In order to enhance local revenue generation, financial assistance under the Grand Fund is subject to the condition that (i) 80% of property tax should have been collected in the past three years prior to the project investment year and (ii) the local body should have repaid all loan dues for two years prior to the project investment year. Urban Development Plans are financed under a similar facility.

As a starting point, the chance of all ULBs has been improved through state government reforms in urban governance, in particular reforms of the Property Tax (comprehensive assessment of plots and buildings). The Grant Fund is like a subsidy from the GoI, facilitated by the German and IDA funds, which has boosted local tax collection through the in-build conditionality.

The Grant Fund Mechanism leads to a reduction of debt service for poorer ULBs and thus increases the fiscal space for this range of local governments. A positive impact on access to service is probable, if additional funds were reasonably used. It is an adequate response to facilitate loan access to poorer ULBs but does not contribute to better poverty-targeting of sub-projects.

Tamil Nadu II: Do infrastructure loans discriminate the poor?

According to findings in Tamil Nadu, deposit payments for new sewerage connections may exceed the monthly income of households below the poverty line (so-called BPL population). The Tamil

44 The same mechanism applies to a new operation of the German Development Bank KfW in Tamil Nadu (See Boschmann 2008).
45 For basic services, grant assistance is made available if more than 20% of project beneficiaries are people living below the poverty line. The total quantum spent shall not exceed 30% of the cost of the sub-project subject to a maximum of Rs.10 crores per project. Grant towards Viability Gap funding shall not exceed Rs.10 crores.
46 For example, in 2003-04, the total demand for property tax in Salem, a city of 0.8 million inhabitants, stood at Rs. 3131 Lakhs (both arrears and current). Only Rs 1516 Lakhs had been collected. The overall collection performance was 48 %. Following the establishment of the Grant Fund, Salem city administration was able to collect about 25 % of the arrears demand during the period 2003-04 and over 80 % of the current debt was collected (See City Corporate Plan 2004).
Nadu Urban Development Fund (TNUDF) is aware of this challenge. Calculations on the financial viability of municipal loans for such projects are based on conservative assumptions. TNUDF does not take into account any deposit or charges from BPL population, which means that feasibility is assured, even if none of the BPL population (e.g. 30 % of households) will go for house connections. This procedure is regarded sufficient to protect BPL population from undue pressure to find funds for deposits. ULBs’ announcement to offering payment of the deposit by instalments as an incentive to the low income population is also promising. Further savings of expenditures will occur after the closure of the existing septic tanks. The risk of BPL populations not getting connected could be further mitigated if the coverage of common facilities were assessed and possibly further improved, while not the whole population can access house connections.

6.4 Municipal bonds for diversifying the Debt Portfolio

Bank credits and bonds both have strengths and weaknesses. Since bond issuance goes along with many disclosure requirements, bonds contribute to more transparency in local government, from which the public would profit as much as lending institutions. Thereby, the monitoring function of the public may contribute to strengthening accountability. However, other LGs might rather avoid the modality for that particular reason.

To have a more diversified debt portfolio is another advantage of bonds. This was one reason for the emission of the first Johannesburg bond in RSA (See box). The main motive for bonds, in addition to publicity reasons, is the need to diversify funding sources. Other benefits of bonds are their greater flexibility since a city can eventually buy back debt at a lower rate on the bond market, and their ability to catalyze further investment.

In the long run bonds may be cost effective, if they are launched with a good rating. However, this advantage depends on the current situation of both, bonds and loan markets. Bonds may also be more expensive to service than loans, which is the case since 2008. Further, bonds have higher fixed costs (for road shows and administration as well as for listing fees) and many municipalities felt that they were too small for issuing a bond. It does not make sense to issue a bond smaller than a certain amount due to the fixed costs that arise. In addition, it is necessary to get an expensive rating from an international rating agency such as Fitch, Standard & Poor’s, or Moody’s.

The market for municipal bonds is still nascent with several constraints to growth to be overcome: On the demand side, most local governments have no or only rudimentary understanding of this financing mechanism and there is no secondary market for bonds. Accordingly, municipal experience with bonds is even more limited than experience related to municipal borrowing.

Even middle income countries are hesitant in this regard: While bank credits are a common municipal financing instrument in South Africa today, municipalities in RSA are reluctant to issue bonds. Issuing bonds had been a common instrument of municipal financing in RSA prior to 1994. One reason is that South African pension funds were required to invest in municipal bonds. However, the municipal bond market has virtually disappeared. This is due to the uncertainties of the transition phase and also because the pension funds are no longer required investing in bonds.
A recent study on **Indonesia** (GDI 2007) is also hesitant to predict a fast take off of municipal bonds although there is a large potential market: The regulations on issuing municipal bonds were found to be too restrictive as bonds cannot be secured by intergovernmental transfers or similar funds. **Corporate bonds** of municipal enterprises as a special case of municipal bonds are solely backed by corporate assets and revenues without further explicit public guarantees. Consequently, municipal bonds cannot be used as a general financing instrument for municipalities, but are restricted to the financing of projects. Projects that cover their full operating cost and generate a surplus covering the interest payments of the bond such as toll roads, toll bridges or investment projects of the very few municipal water enterprises which cover their operating costs.

Yet with this restriction, those Indonesian cities, which were assessed in the sample, did not take the issuing of municipal bonds for infrastructure investments into consideration. The main and most stated reasons were “unclear regulations”, “too much bureaucracy” and the awareness, that there were no investment projects readily available that fulfil the conditions for bond issuance. Several cities indicated that asset evaluation were a major problem (which relates to capacity to implement PFM reforms).

An exception from this trend is the launching of bonds by the metropolitan administration of Johannesburg, which is considered a success story (See Box).

**Johannesburg: A metropolitan experience with municipal bonds**

In April 2004, Johannesburg was the first (and so far only) municipality to launch a bond after the breakdown of the municipal bond market in 1994 due to the transition process. The issue was widely praised both nationally and internationally, animating a vivid debate on municipal bonds as a means to finance development in emerging economies. The issue in the amount of 1 billion rand even scooped the Bond of the Year-Award from the Bond Exchange of South Africa (Besa). Being 1.5 times oversubscribed, the bond certainly can be seen as a success, especially considering the cities pioneering in this respect.

Only 40 % of the proceeds of the first two bonds are used to finance the city’s capital expenditure program. The rest is used to refinance existing, more expensive debt that Johannesburg had accrued in the late 1990s, when it was experiencing financial distress. As banks were overexposed to Johannesburg, the City had reached its credit limits with almost all banks and basically had to go the bond route to obtain more funds. The refinancing of the onerous debt arrangements through the bonds will save the city interest payments of about 20 million rand annually over the next 6 years. However, with 230 basis points over the government benchmark bond, Johannesburg paid a high price for that success, as it certainly pays a higher interest compared to bank lending rates at that time.

Only two months later, the City issued a second bond, again worth 1 billion rand. COJ02 was an innovative issue, as it was accompanied by a 40 % guarantee from the International Finance Corporation (IFC) and the DBSA (20 % each). The enhancement was necessary to guarantee investors confidence for the longer maturity of 12 years and led to an 3-notch rating uplift (from A- to AA-), thereby allowing for a better pricing than the first bond in spite of the longer maturity. Although it was a success to reduce basis points, the bond remained expensive compared to loans.

Source: GDI / DIE 2007
Innovative initiatives: Guarantees for municipal bonds

Several countries have launched initiatives to make the launching of bonds more attractive to both municipalities and investors. Two mechanisms shall be mentioned in this regard:

- The Local Government Unit Guarantee Corporation (LGUGC) in the Philippines
- The Pooling of Bonds in the South Indian State of Tamil Nadu

The Local Government Unit Guarantee Corporation (LGUGC) in the Philippines was established in 1998 to develop the primary and secondary markets for local government debts through guarantees for municipal bonds. It operates as a private sector corporation. Equity shares are owned by one of the major development banks of the Philippines (DBP) and 21 financial institutions. With a total equity capital of Ps 216 million, 12 LGU bonds of more than Ps 2 billion have been floated and guaranteed up to 2004\(^{47}\).

Financing is limited to revenue-generating projects in a wider sense such as a slaughterhouse, a jetty port and terminal, two housing projects, several markets, an academic centre and a hospital. Prior to making a decision to insure a proposed LGU bond, LGUGC performs its own client analysis. 500 LGUs have been screened and around 20 rated. Screening is done to broadly assess the political as well as the developmental risk of lending. Rating categories range from “triple A” (highest credit standing) to “C” (poor standing). Among the 20 LGUs rated, only five got a “good credit standing”, while nine were classified as “below average”, which indicates a limited market even in a large country such as the Philippines.

The project cycle consists of a preparatory process and the proper bond issuance process. The preparatory process resembles the one for loans. LGUs approach the guarantee corporation with an approved feasibility study and a financing plan at hand, which are evaluated in-house and then referred. LGUGC will contact private banks, which might be interested to buy the bonds to be floated. As for collaterals, bonds are secured by the projected revenues, project assets and central government transfers\(^{48}\).

Debt service is to be paid from the project’s revenues. Interest rates are based on the Treasury Bill Rate plus a spread of up to 3 %. However, the effective costs of bond flotation involve additional upfront fees. The LGU bonds floated to date have maturities of up to seven years, which is realistic for convincing investors but is still very limited for complex projects.

Results may appear quite moderate when compared to the overall capital needs of local governments. On the other hand, LGUGC has supported some economic success stories, which would otherwise not have been implemented. The most well-known is the bond launched by a small visayan municipality to finance the jetty pier on the tourist island of Boracay. The improved infrastructure has significantly contributed to attracting 4- and 5 star resorts, which has increased revenues by

\(^{47}\) An update of this figure was not made available to the consultant but may not be essential in the context of this study as the message is to mention the tool as such.

\(^{48}\) This mechanism might change as the transfer system is currently under review and LGUs might not be entitled anymore to transfers, as in the past.
dimensions. (Whether or not this kind of development is socially desirable, surpasses the scope of the study).

A pilot securitization initiative for infrastructure financing in water supply have been supported by donors in Indonesia. USAID has developed a concept for financing the investment requirements of water utilities that involves a strategic partnership between donors (USAID, JBIC), the Ministry of Finance and an investment bank (PT Danareksa). The IWF (Indonesian Water Fund) provides long-term loans in local currency, backed by partial credit guarantees. The debt service of the water enterprises is to be made affordable by mixed financing from donors on favourable conditions and domestic medium-term funds at market rates. However, the water utilities would have to agree to cost-covering water tariffs, which hints to the restriction to economically viable projects. Another obstacle is the prevalent double taxation on Asset Backed Securities which increases the cost to the borrower.

Innovative initiatives: Pooled bonds in Tamil Nadu

Beyond the launching of municipal bonds by individual municipalities, further innovative procedures are under development to broaden the range of beneficiary LGUs. An interesting example is the promotion of pooled bonds in the state of Tamil Nadu (India).

Pooled bonds are to achieve a three fold impact of (i) funding / refinancing municipal infrastructure, (ii) at an affordable cost of funding and (iii) establish a non-guarantee mode of raising resources for urban infrastructure. Bonds can save a sizable amount in the debt servicing of the ULBs, thereby freeing up the resources of ULBs for further augmentation. The concept of catering to a wide range of smaller ULBs through pooled bonds is meant to generate substantial multiplier effects (as a long-term vision).

Pilot experiences of the financial intermediary, the Tamil Nadu Urban Development Fund (TNUDF) have shown that this is not an easy market\(^49\). Only one out of two pooled bonds has been fully subscribed, while the other is meeting a number of systemic constraints, related inter alia to an unfavorable overall market situation, political interference and investors expectations. The lesson to be learned is that TNUDF would not push the issuing of bonds unless overall conditions were improved.

The guarantee of such pooled bonds, which is promoted by the German Financial Cooperation, is regarded only as a marginal element, compared to market forces. Further, according to TNUDF officials, pooled bonds are not prime tool to enhance good governance. The performance of the bonds may reward responsive local policies and project management to a lesser extent and may mainly relate to conditions on the bond markets in general.

This argument was confirmed by recent studies on loan financing in South Africa and Indonesia (GDI / DIE 2007 and 2008). Interviewees in RSA believed that bonds are no longer preferred because low-interest loans were available. Interviews in Indonesia revealed that past experiences with regional bonds\(^50\) will not be repeated for the time being, due to lack of demand for long-term funds at market interest rates.

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\(^{49}\) See Nina Boschmann 2008 on Tamil Nadu in India.

\(^{50}\) Bonds issued between 1991 and 1997 by BPD with maturities of up to five years were backed by general revenues of regional governments and issued to refinance loans to local governments for small-scale infrastructure projects. Six bonds were issued.
6.5 Conclusions and Recommendations

The central government, as the unit of government most responsible for developing and enforcing macroeconomic stabilization policy, has considerable concern about the extent to which borrowing by subordinate levels of government takes place. Regardless of the degree of local fiscal autonomy in a country, central governments will always need to carefully monitor and project local-government finances. Legislation with regard to the borrowing powers of local government must also be reviewed. Direct access to capital markets by sub-national governments will take time to develop. Loan and bond financing are viable options for a considerable number but not all local governments. Access to capital markets requires a sound condition of municipal finance, in order to be able to repay the loan. It is rather a second step, following reforms in municipal financial management. Municipal bond financing can be cost-effective for larger and resource rich municipalities but is rather complex as it requires a certain scale of experience and operations and success also depends on conditions of general markets for bonds.

Technical recommendations

- All types of sub-national borrowing should be closely regulated by the central authorities. Besides enforcing the debt limits established by the law, there should be a certification process of the conditions for any bond issues.
- Before promoting municipal loans, start comprehensive support for reforms in PFM
- Establish a system for fiscal screening and rating of municipalities
- Loan financing requires specific expertise; don’t institutionally mix grant and loan financing for infrastructure, establish clear rules which source of finance is accessible to which category of LG
- In order to avoid disturbances of the capital market, set conditions and interest rates of development loans in consideration of the prevailing national market conditions
- If softer conditions are offered to poorer municipalities, make it conditional t implementing FM reforms and improvement of own revenues
- The central government as a general policy should not act as guarantor of regional and local government debt issues. Special circumstances such as the borrowing in foreign currency from international lending institutions, which may require central government guarantees should be handled directly by the Ministry of Finance. In these cases, the central government should institute mechanisms to ensure repayment by the local government.
- Local governments should be allowed to issue non-guaranteed or limited liability debt for investment in public utilities. These “revenue bonds” will be repaid from revenue proceeds associated with tariffs set at full cost-recovery levels. Bonds should not be encouraged, unless proper conditions are given
- Given the limited interest of the private sector to engage in municipal borrowing, there is considerable merit to the establishment of a sub-national development fund to promote lending to sub-national governments for long-term capital investment. This may be the only effective way to allow small local
governments to fulfill their capital investment responsibilities. The desirable structure for such a sub-national development fund is that of an autonomous institution that takes direct and final responsibility for borrowing and investment projects. The bulk of funds for this institution should come from direct bond issues in the capital market. The central and local governments could contribute initial capital shares. The institution should be managed by independent professionals who answer to a managing board composed of central and local government representatives.

Recommendations to development partners

- Don’t mix loan and grant financing for infrastructure: If grant funds are provided in the area of municipal loans, use them for specific purposed, e.g. (i) financing or awarding of reforms, which will facilitate access to capital markets, (ii) as guarantee capital to establish lending institutions with suitable modalities; loans should be provided only to creditworthy LGUs

- However, development partners could promote PEFA assessments to be conducted at sub-national level on a wider scale, in order to first analyze bottlenecks and then promote reforms of PFM, which will enhance creditworthiness

- It is desirable that loans to LGs must not be secured by state guarantees. Development partners should actively enquire about and promote modalities which allow for neglecting these guarantees.

7 Involvement of Private Providers as a way forward

7.1 Rationale for PPP

Privatisation, and public-private partnerships (PPP) are used as alternative service delivery arrangements to traditional public procurement. Private sector involvement in the delivery of public services is not a new concept; PPPs have been used for over three decades, predating the contracting out initiatives of 1970s in the USA. Initially focussing on economic infrastructure, PPPs have evolved to include the procurement of social infrastructure assets and associated non-core services. PPPs have extended to housing, health, corrective facilities, energy, water, and waste treatment.

The arguments put forward to support PPP initiatives are primarily based on economy efficiency gains and reducing government overload. Ideally, the PPP arrangement should have led to an improved state-citizen relationship, especially in fragile states. End users need to be happy with the service they receive, and with government. On the contrary, opponents of PPPs regard it as a way of relieving the government of its responsibilities, and they would argue that there is the risk of diminishing the welfare state.

From a local governments’ point of view, the major advantage of PPP lies in its nature as an off-budget mechanism for mobilising funds that are not available in the public budgets and as an additional income source for the local budget in the short run.

As many infrastructure services possess the characteristics of public goods, the private sector alone will not feel motivated to sufficiently provide them. Some responsibility
remains in the hands of the state. Even after deconcentration or devolution of responsibilities and powers to sub-national government, fiscal imbalances are common and governments not effective as service providers. Higher current own-source revenues and municipal borrowing could be complemented by public-private partnerships to rebalance responsibilities and financial resources at the sub-national level.

7.2 Risks involved in PPP

The specific challenge of PPP in the context of decentralization is that the capacity to assume this new role is often not sufficient, especially in emerging markets and fragile states. (See Palmer 2009). The key capacity challenges that local authorities face include

- the capacity to engage the private sector in infrastructure projects, that is, the ability to procure services from the private sector;
- to identify service sectors for private sector involvement;
- to create adequate policies and institutions in support of private sector in service delivery;
- to regulate service sectors and to ensure inclusive participation of users;
- to specify outcomes and monitor performance of private providers through adequate contractual arrangements;
- the capacity of local civil societies to complement the government’s efforts in service delivery as well as oversee their implementation.

Local authorities may also struggle to develop revenue support arrangements for PPP projects. PPP do not appear to be a viable solution for all local governments nor for all the sectors (PPP will be more attracted to lucrative markets than to basic services in deprived regions and zones).

Further, the ability to make investments and borrow or repay debts depends on laws and regulations that govern the appropriation of returns, property rights and contracts. In developing countries, these laws and regulations are often incomplete, and subject to change, thus limiting the ability of local authorities to do business.

The current international financial crisis might even reduce the perspectives for successful PPPs, as the private sector generally borrows to finance the infrastructure. The credit crisis means that banks and investors are much more reluctant to lend to private companies, as a result, companies are practically unable to borrow money to finance PPPs. For existing PPPs, the financial crisis has meant lower revenues due to falling demand, especially for concession-type PPPs. This in turn has affected their ability to refinance their original debt. This argument applies to PPPs with local governments or central government bodies.

The overall attitude of local governments towards private participation in infrastructure as well as experience is varied between countries. A recent study from GDI (2007) reports largely positive attitudes from Indonesian local governments, due to positive experiences with recent and ongoing PSP projects which constitute a promising “win-win-situation” for both the local government and the private investor. It was emphasized that due to their superior financial strength, foreign investors were particularly welcome.
Contrary to this, in several Latin American countries, the topic of private sector participation in water supply is highly politicized (e.g. Bolivia, Nicaragua); after complete failure of a poorly negotiated PPP in El Alto, the Bolivian Government has even decided to terminate an international contract by force; Nicaragua’s Sandinista government has strongly rejected any kind of management contract for a long time. Driven by promises of positive cash flow, local administrations overestimate the willingness of private investors to engage in long-term projects with higher operational risks and underestimate the complexity of contracts and risk-sharing arrangements for PSP in infrastructure projects with uncertain revenue streams.

Usually, systems in Latin America have a high share of unaccounted for water and efforts to increase water charges are highly unpopular. The understanding of popular movements is, that water is a public good, which should not be used to generate a profit. In order to ensure reliable revenue streams, some investors have negotiated a predefined rate of return, which could later not be achieved, as systems required more investment and consumers more protection than anticipated. An “ideological argument” is also there as private electric companies and related user charges are generally accepted without arguments. Interestingly, in West African countries, which are all low-income, water charges seem to raise less fundamental public concerns when compared to parts of LA.

The experience of a higher middle-income country (Colombia) in the water and sanitation sector indicates that municipal water utilities as well as private ones can provide satisfactory service at reasonable cost, if a strong state run oversight agency is in place.

In order to avoid the inherent risk of taking over the management of an existing network the most popular model of PPP is “Build-Operate-Transfer” (BOT) with land provision to the investors as public contribution. Local governments prefer the BOT-model as it is simple in structure, mode of operation and control of results. The structure is similar and simple: government provides public land, the private investor constructs, finances and operates the project and receives regular revenues during the operating period which lasts up to 30 years. Contracts may even be negotiated without a tender and investors provided unsolicited proposals without much effort in terms of project development for the municipalities.

The benefits for the local governments can be fourfold: an annual rent, income from taxes (building tax, market tax etc.), parking fees in the case of the frequently built markets and shopping malls, and a negotiable part of the investors’ returns. The BOT-model incorporates zero-risk from the local government’s point of view and ensures constant revenue streams over a long period. With the provision of public land, the local government eliminates the most severe constraint that keeps away investors: the question of property rights and land use. Obviously, this relatively simple BOT-model can be used for commercial projects only and not for basic infrastructure projects with uncertain revenue streams.

With regard to the complexity of PPP contracts and the know-how required, German local governments have recently learned a bitter lesson: Those who went for the sale and lease back-modality for their municipal assets in order to generate a positive cash flow, have now been confronted with high financial risks, unknown before the international financial crisis.
Indonesian: Small space for Public-Private partnership in infrastructure financing

In Indonesia, BOT-projects are mostly used for markets, shopping malls and public buildings. **PSP-projects in Indonesia are relatively small, limited to a few sectors and are rarely used for the provision of basic infrastructure.** PSP in traditional markets is the most prevalent form of private involvement. Besides this, often cited examples for PSP were housing, hotels, bus terminals, public buildings, city street lights, and a few private hospitals and schools. The study team was not able to find out details about the volume of the private-public profit-sharing.

There are a number of sponsorship models for sanitation, social infrastructure and education. In Yogyakarta, private enterprises have built parks and invested in sanitation facilities, getting the permission to advertise in these facilities or carry out promotion activities. The maximum volume of this kind of projects is still small (around Rp. 2 billion) but the demand seems to be huge. In Pontianak, every company which wins a public tender has to sponsor a school or a hospital but there are no minimum requirements on how much to “invest”. It appears that local officials have a rather wide definition of public goods and see the provision of hotels, water parks and entertainment facilities as a public responsibility. However, there are practically no PSP activities in basic infrastructure. PSP projects in basic infrastructure with long capital amortization periods have not been realized yet.

Source: GDI 2007

Further, a recent study on Indonesia found that the PSP-approval process is particularly prone to **corruption practices.** As a result, the expected gains for the public by involving the private sector in the provision of infrastructure may not materialise. Quite obviously, the relevance of this point depends on the overall quality of local financial governance, which goes much beyond the specific cooperation modality.

### 7.3 Gradual approaches to improve service and revenues

As indicated above experiences with PPP have been mixed and municipalities do not have a common position towards innovative management concepts.

There are several micro-level success stories for the application of **gradual approaches**, which relate to (i) doing the easiest things first and (ii) going for gradual involvement of private providers, even if comprehensive privatisation or management contracts are not. Doing “the easiest things first” relates to the avoidance of politically sensitive issues and focus on other feasible improvement. The administration of the water utility in the capital Quito had substantially been improved over the years, using a gradual approach of first implementing less controversial reforms (such as improved leak detection and reduction of the unaccounted for water) before touching the sensitive structure of water charges. Some medium-sized municipalities in Nicaragua have applied the same strategy and thus managed to avoid local “wars on water”.

This is in line with a recent study of the French cooperation on the improvement of local revenues in West Africa (Chambas 2009), which highly recommends focussing on revenues, which are easy to assess and to collect.

The following examples relate to gradual involvement:
Feasibility Studies conducted on behalf of the German Development Bank KfW in the water and sanitation sector of rural municipalities of Ecuador in 2000 revealed that many of these local water markets may not be profitable for private sector involvement in the form of BOT or even management contracts. Still, there was room for improvement with regard to revenue generation through the outsourcing of specific tasks, e.g. collection of user charges.

A similar policy is now followed by the Rwandan Government, which is promoting the privatisation of market tax collection. The process has been supported by German Technical cooperation but it is too early to know the results. A lesson learned was that the analysis of the market revenue potentials itself was sometimes quite controversial and met stiff resistance from local officials, which again indicates the links between local revenue generation, fiscal transparency and good governance at a whole.

Generally, ULBs are in charge of operation and maintenance. In rural municipalities of Burkina Faso and Nicaragua, the fee-based involvement of local private craftsmen in the maintenance of public water supply systems is successfully being promoted. The privatisation of O+M of new public facilities and services is also foreseen in Tamil Nadu. However, concepts for this are still under development and it is too early to assess impacts.

In the Indian State of Tamil Nadu, a Grant Fund has been established as a part an IBRD line of credit for providing Technical Assistance to Urban Local Bodies and Statutory Boards, it will be used to explicitly assist ULBs in the preparation and / or supervision of more complex and innovative projects such as PPPs and BOTs, for such project and technologies which can reduce the cost of services.

Ghana’s new Local Government Finance Bill intends to establish a comprehensive financing and TA mechanism for local governments, which shall overcome the constraints of existing services: The Bill provides a comprehensive Law on how private capital and other resources can be channelled to District Assemblies in order for them to undertake infrastructural development and provide other services more efficiently. The proposed Local Government (Finance) Bill seeks to provide a comprehensive law to guide MMDAs in raising private capital, enter into partnership ventures and mobilize other financial resources. It empowers MMDAs to systematically move away from over-reliance on central government transfers to undertake productive infrastructural development and provide other appropriate services more efficiently. (see draft from July 2008).

The Government of Ghana intends to establish a multi-purpose Local Government (Finance) Authority as a vehicle for accessing funds for investment projects and pool, manage and minimise the risk of local government borrowing. At the same time technical and financial advisory services shall be provided to District Assemblies.

The new Authority is expected to borrow from domestic and international sources and on-lend to a District Assembly for the developmental needs of the District Assembly; facilitate direct and indirect access to wider sources of funds including the use of innovative financial instruments; assist a District Assembly to establish innovative partnership arrangements with the private sector and other public institutions;
support the capacity of a District Assembly to initiate and manage investment projects, among others.

### 7.4 Conclusions and Recommendations

Privatisation of public services may be a viable option for improving the fiscal space of municipalities with (i) a strong oversight capacity, (ii) a strong negotiation capacity for fair and transparent contracts, (iii) local markets, which are profitable enough to generate a constant stream of revenue. Quite obviously, this is not a typical situation for many municipalities in developing countries (and even not for industrialised countries); PPP should thus be regarded as a complex modality, which requires a thorough assessment of the local market, feasible revenue potential and financial interests involved before taking decisions.

**Technical Recommendations**

- It is crucial to the success of a PPP that risks are allocated properly between the government and private contractors. Risk allocation has to be cost-effective so that risks are allocated to the party that is best able to manage them and respond to the incentives they offer. Where capacity to deliver is difficult to ascertain, local authorities can adopt an incremental approach.

- Governments should design accountability mechanisms into the partnership; contractors must be primarily accountable to government, whether donor-funded or not. The mechanism should also promote information sharing from the government to citizens for users to accept the validity of the PPP arrangement. They need to feel they are paying fair prices for the services received.

- Often, inadequate attention is paid to the costs of managing the contracting out process and the contractor’s compliance. Transaction costs should be factored into the overall cost of the project. Further, a sound legislative and regulatory framework is needed for PPPs to succeed. There is the need to evaluate existing legislature to ensure that it has the appropriate corporate and commercial laws in place to support private investment. to avoid cost overrun during the operation phase of the project.

- There is no fixed model for a successful partnership, it is critical to understand the political opportunities and constraints that surround each case. Developing countries can take advantage of the learning curve through which PPPs have passed in developed countries and development partners can facilitate this process.

- Governments should promote the use of ongoing benchmarking to ensure continuing value for money from existing projects. “Performance” audits should be carried out on sectors and PPPs by external auditors as this may be useful in keeping check of the project. The PPP contract should be sufficiently flexible to take account of any new targets and future monitoring and reporting requirements that may develop over the lifetime of the project.

- Local authorities must ensure that private contractors do not “cherry pick” only the most attractive neighbourhoods or projects. Users need to be given a voice; local authorities should promote user forums and feedback mechanisms. A
detailed assessment of the risks transferred to the private sector should be conducted.

- Local governments and donor deciding whether to engage in PPPs should consider how to build on existing capacity rather than impose ready-made solutions.

- If the above-mentioned conditions are not met or privatisation of a politically sensitive issue, it is recommended to promote gradual approaches, including e.g. the following elements:
  - Before investing energy in how much to charge, get people used to contribute financially at all
  - Involve private providers for specific tasks on a pilot basis, which can easily be controlled (e.g. maintenance works, collection of fees); in this case, financing or technical assistance agencies may e.g. develop standard contracts for delegation of maintenance to private providers
  - Focus on fees and charges, which are easy to collect (avoid that collection cost exceeds the amount collected)

- User charges are generally a sensitive issue and may also contradict efforts for poverty reduction. It is therefore recommended to
  - First improve service and afterwards adjust charges (not vice versa)
  - Define and publicly discuss a transparent structure of user charges, which does not favour or discriminate against part of users
  - Assess the ability to pay of low income groups / informal business and define low minimum contributions, which can be met by these groups; cross subsidization and transitory supply of low cost services may be viable options
  - Avoid huge increases of user charges within a short period

Recommendations to development partners

- Avoid a confrontation between the PPP concept and the rights based approaches, but deal with PPP as a technical issue, which requires thorough assessment before taking decisions or making recommendations

- Discuss evaluation criteria in a transparent manner (What shall be achieved for whom? What are the costs and benefits? Who shall pay?)

- Assist partner countries in developing and assessing contractual arrangements with private providers, which they are able to follow up

- Analyse experience with privatisation in your own country before making recommendations to Africa!