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Fiscal decentralisation

A public financial management introductory guide

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Abstract

This public financial management introductory guide defines fiscal decentralisation and discusses how it fits into to wider decentralisation policy. It outlines the reasons why decentralisation is usually undertaken in developing countries and how the administrative, political and fiscal mandates of decentralised government need to be considered jointly in what is usually a long-term change process. This introductory guide also discusses the role of central government in a decentralised system as well as the typical challenges and opportunities that emerge in decisions about financing local governments. It also highlights the importance of carefully sequencing and staging the reform process.

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Public financial management introductory guide

This 'Fiscal decentralisation' paper forms part of a series of introductory guides on key topics in public financial management (PFM). They are written specifically for capacity-constrained environments and provide an overview and discussion of the main issues related to each key topic, highlighting useful literature. Each introductory guide includes practical suggestions on how capacity-constrained governments can approach reforms, together with brief outlines of other countries' experiences of PFM reform. They are not intended to be detailed guides to the design and implementation of reforms. They are based on a review of the relevant literature and the practical experience of ODI staff working in these areas.

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1.1 Introducing fiscal decentralisation

This introductory guide provides practical guidance on meeting the challenges of implementing fiscal decentralisation. It is intended primarily for policy-makers, in this case meaning civil servants and their advisors grappling with the challenges of delivering fiscal decentralisation reforms for their political leaders.

The discussion starts out from the perspective that decentralisation, including its fiscal elements, rarely happens solely because politicians want to improve service delivery. Instead, broader and more complex political factors lie behind the decision of a central government to give up powers and resources to subnational government bodies. At the heart of such a decision are often concerns to improve governance. These can include ambitions to improve inclusion and participation (as in Bolivia and Peru, for example), often in response to major events such as a political or economic crisis (as in the Philippines, Indonesia and Kenya), or as part of a move from authoritarian to democratic rule (as in Brazil, Mexico and South Africa), and/or as a result of the need to strengthen or reconstruct the legitimacy of the state throughout the country following a civil conflict (as in Cambodia, Columbia, Ethiopia, Rwanda and Uganda). Only in a few countries, such as India and Tanzania, has decentralisation been justified primarily as a means of improving service delivery (Faguet, 2014; Eaton et al., 2011).

While decentralisation may be motivated to a greater or lesser degree by political decisions, civil servants are likely to have very different concerns. Civil servants in a finance ministry, for example, may be concerned about the implications of giving financial control to local governments that have lower capacity. Civil servants in sector ministries responsible for education, health, roads and water, on the other hand, may be primarily concerned with improving service delivery. Officials in local government, meanwhile, tend to support reforms that bring them higher budgets, greater authority and more control over decisions.

The main challenge in managing decentralisation is that of finding an appropriate balance between central oversight and local autonomy. The aim is to make best use of both the greater technical capacity of central government and at the same time the greater local knowledge and accountability of local governments.

This introductory guide aims to provide practical guidance on *fiscal decentralisation* in particular, meaning the manner in which control and responsibility for the handling of funds is shifted from central government to subnational government. Two themes recur through this introductory guide. First, there is no single 'blueprint' or best practice that countries can simply adopt in their decentralisation reforms, including fiscal decentralisation. Reforms happen for different reasons and never start with a 'blank slate', meaning that reforms must be adapted to the existing institutional context. Second, decentralisation and its fiscal components needs to be viewed as a *process* and not an end point. Any reform process will take years and must be adjusted as lessons are learnt from implementation.

This introductory guide is structured as follows:

- Section 1.2 puts decentralisation into context, defining what we mean by it and discussing the impact it can have on service delivery.
- Section 1.3 moves onto the first key issue that needs to be considered during a fiscal decentralisation reform process, i.e. the assignment of functions to decentralised governments.
- Section 1.4 discusses how local governments can be financed and how to support improvements in local government public financial management.
- Section 1.5 discusses the functions and role of central government in a situation of fiscal decentralisation.
- Section 1.6 discusses how the fiscal decentralisation reform process is best managed and how to deal with some of the key risks associated with giving up control to local governments. This section also concludes with some guidance for reformers.

1.2 Decentralisation in context

Before addressing the key principles and considerations that should guide the design of decentralisation reforms, it is necessary to define and contextualise decentralisation and to identify its potential impact.

1.2.1 What is decentralisation?

In defining what is meant by decentralisation reforms it is vital to distinguish clearly between *decentralisation* and *deconcentration*.

Deconcentration refers to how responsibilities and staffing are managed *within* central government ministry structures. It is a transfer of responsibilities, powers and resources within the national government, from headquarters to local and regional field offices (PEFA Secretariat, 2013). Unlike decentralisation, deconcentration takes place within central government agencies rather than between central government and a lower tier of government. For example, if an education ministry establishes district offices and disperses some degree of management authority to these district offices, this is deconcentration. In this case all authority still remains with the central government ministry and education officials at district level still report to and remain accountable to the central government education ministry.

Decentralisation, by contrast, is the devolution or reassignment of specific powers 'with all of the administrative, political, and economic attributes that these [powers] entail' from central government to subnational governments which are autonomous within their own geographic and functional spheres of authority (Faguet, 2014). Instead of being accountable to a higher level of government, local governments thereby become accountable primarily to local voters. Returning to the example of a district education office, in a decentralised system this department reports to the elected political leader of the district who is overseen by an elected district council rather than the central education ministry. In such a system the central government ministry of education has no direct delivery role in primary education, since teachers and schools are managed by the local government. Nevertheless, the central government's ministry of education does still have a policy role in a decentralised system, including setting standards, providing guidance to local governments and monitoring how well local governments are delivering.

Decentralisation is often described as having three interrelated dimensions: political, administrative and fiscal. Political decentralisation relates to the *powers of locally elected leaders*. Administrative decentralisation relates to the transfer from higher to lower levels of government of the *powers of local civil servants*, especially in hiring staff. Fiscal decentralisation relates to the reassignment of *expenditure* (or the transfer of funds) *and tax-raising* (and borrowing) *powers* (Pretorius and Pretorius, 2008). This introductory guide focuses particularly on the challenges and opportunities of fiscal decentralisation.

One variant of state structure with implications for decentralisation which is frequently distinguished from others is federalism. Federalism can be defined as durably institutionalised decentralisation, meaning that it cannot easily be altered unilaterally by the national government. While '[the] fundamental feature of federalism is decentralization…not all systems of decentralization are federal… [In a federal system] not only must there be decentralization, but that decentralization must not be under the discretionary control of the national government' (Montinola et al., 1995). In simple terms this means that decentralisation is not merely granted by central government – and can thus also be removed by central government – rather it involves legal changes that must also be approved by the decentralised governments themselves. This is typically manifested by decentralisation to subnational units being mandated in a country's constitution, further requiring that any changes to this constitution must have the approval of a majority of subnational units.[1]

1.2.2 What impact can decentralisation have?

While decentralisation may be motivated to a greater or lesser degree by political decisions, the central concern of civil servants in a finance ministry and in sector ministries responsible for education, health, roads and water is often with delivering public services. The question that arises, therefore, is what effects decentralisation can have on service delivery.

The strongest argument for decentralisation is that it will improve government accountability and responsiveness and thereby increase the overall efficiency of government. It does this by altering the structures of governance to increase the voice of citizens and strengthen incentives for public officials to deliver services. The main mechanism for improved service delivery is that decentralisation will increase the accountability and responsiveness of local government and ultimately improve public services (Faguet, 2012).

This argument is supported by recent reviews of the impact of decentralisation on service delivery. These studies emphasise its positive effects, finding that decentralised local governments deliver an increased quality and quantity of public services. Channa and Faguet (2016) have ranked these studies according to their strength of evidence and found that, while the studies show mixed results overall, the highest quality studies show the most positive effects of decentralisation. Martinez-Vazquez et al. (2015) report similar findings. In the education sector, decentralisation improves service delivery, but there are more mixed results in the health sector, including evidence of negative effects of decentralisation on the quality service delivery.

Civil servants in central government ministries may have a range of other concerns about decentralisation regardless of its impact on service delivery. They may be concerned that

1. For example the US has a federal system where the rights and responsibilities of subnational governments are clearly set out in the constitution, and amendments to the constitution require the approval of both the national federal government and three-quarters of the states. In other countries, by contrast, such as Uganda, decentralisation is based on the constitution and a Local Government Act, both of which the central government has wide powers to revise through the national legislature without reference to the local governments themselves.

they will lose control over service delivery and/or resource allocation, and that decentralisation to low-capacity local governments, far from improving services, poses risks to the quality of service delivery. These concerns can lead to actions intended to limit the extent of decentralisation and maintain central control. However, if local governments are not given the policy and implementation space to respond to local demands, then most of the benefits of decentralisation cannot be expected to materialise. One of the main challenges in managing decentralisation is therefore to find an appropriate balance between central oversight and local autonomy.

Box 1: Which services to decentralise?

Some government activities are clearly national in scope and so can only be exercised by the *central* government. These include foreign affairs, defence, trade, and monetary, currency and banking policy. For some activities there is also a clear role for policy-making, standard-setting and oversight by central government, such as business and trade regulation where an internal common market must be maintained within a country.

A number of services are suitable for *local* management because they have primarily local benefits, such as local roads, water, sanitation and waste collection.

However, for a range of other services the exact assignment between local, regional and national governments depends on the trade-off between, on the one hand, the economies of scale or spill-overs that make a service more suited to being delivered by central governments and, on the other hand, the need for local monitoring and information that make a service more suited to being delivered by local government.

Across the areas of education, health, agriculture and roads, therefore, we can expect primary services to be delivered by local governments while central government retains a policy role. However, the assignment of the range of delivery responsibilities between primary services and policy-making will depend on the specific conditions and circumstances faced by each country.

In accordance with the subsidiarity principle, geographic size and population will be a major determinant in deciding which services it is appropriate to decentralise. Larger local government units are more likely to take on a greater range of services, with larger benefit areas (i.e. a greater population), than smaller units.

Source: Shah (1994)

1.3 Functional assignment

Even in the most decentralised system, not all government functions will be decentralised. The first task facing many governments undertaking decentralisation is thus to decide which areas of policy to decentralise – a process known as *functional assignment*. Governments will need to decide, for example, whether primary, secondary and/or tertiary education should be the responsibilities of central or local government.[2]

Two related principles are often used to guide decisions as to which functions are best suited to decentralisation. The first principle is that those functions which affect more than one subnational unit are not typically decentralised, i.e. functions with large spill-overs between subnational units, such as trunk roads or tertiary hospitals. In addition, certain specific functions within sectors might not be suitable for decentralisation because they require high levels of expertise or have economies of scale, such as the procurement of pharmaceutical supplies in the health sector.

The second guiding principle in functional assignment is the principle of subsidiarity, which holds that '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' (Martinez-Vazquez et al., 2006:18). For example, the benefit area for solid waste management is the local community, making this service a good candidate for delivery by local government. Applying the principle of subsidiarity may also lead to the decentralisation of simpler capital investments such as the construction of schools and clinics, since these can be built to standard designs and the level of technical expertise required for their construction is likely to be available in the local economy. By the same principle, functions that require local monitoring and information to be matched to the needs of citizens and which have low economies of scale are usually considered suitable for decentralisation.

Returning to the discussion of the impact of decentralisation, it will be recalled that while there is clear evidence for the positive impact of decentralisation on the delivery of education, the evidence of its impact on health is more mixed. If decentralisation can have both positive and negative effects, the most important issue may be less a matter of *which* functions are decentralised, than of *how* they are decentralised.

Two considerations thus need to be borne in mind in functional assignment, although they push in somewhat opposite directions. The first is that decentralising some parts of a function but not others will limit the extent to which local governments can invest in improved

2. It should be noted that in many countries local governments are also legally accorded a more general mandate to 'secure the welfare' of their residents or 'advance the development' of their locality (or something similar), alongside specific policy responsibilities set down by formal decisions of the central government. This general mandate empowers local governments to undertake a wide range of activities that can be justified with reference to this broad goal, alongside whatever functions have been specifically allocated to them by central government.

service delivery. The second consideration is that, in practice, decentralised service delivery will still involve a major role for central government and inevitably requires collaboration and cooperation between levels of government. These two issues are discussed below.

1.3.1 Avoiding partial decentralisation

It is desirable to avoid very different levels of decentralisation across the major inputs (i.e. salaries, operating costs and capital expenditure) required for the delivery of a specific service. This means that if a function is decentralised then so too should the *salary*, *operating* and *capital budgets* associated with that function.

If this is not done then there are unlikely to be significant benefits from decentralisation, since local governments will not be able to adjust the input mix to respond to local circumstances and preferences. For example, if a local government does not control the salary budget for a particular service and therefore cannot hire additional staff where needed and/or reduce over-staffed units, it will only have limited effective control over the delivery of that service.

Similarly, local governments need to be able to control the capital budget if they are to carry out activities such as upgrading, extending and constructing new classrooms, clinics, roads and small-scale water supplies in an effective and efficient manner. Indeed, the capital budget is more likely to be managed efficiently if responsibilities over it are fully devolved to local governments. This is because local governments will have an interest in maintaining and repairing capital infrastructure to extend its working life, rather than relying on central government to rehabilitate and construct new infrastructure (McLure and Martinez-Vazquez, 2004).

The risks of partial decentralisation, or decentralisation in theory but not in practice, are discussed further in section 1.6.2 below.

1.3.2 The importance of defining the role of central government

Functional assignment should not be seen as a simple binary choice between either centralised or decentralised provision of services. The delivery of any service will inevitably require *collaboration and cooperation* between different levels of government. Returns to scale may mean that certain inputs, such as pharmaceuticals, need to be procured centrally and then distributed to local governments. Central government will also maintain a role in setting standards for service delivery, and therefore also a role in supporting the efforts of local governments to reach those standards. In order for decentralisation to support improvements in governance and service delivery it should not simply aim to replace central government functions with local government functions; instead it should seek to harness the different strengths of the various levels of government, matching 'central government's superior resources and technical expertise with local government's superior knowledge of the conditions, needs, and voter preferences of a particular locality' (Khan et al., 2015).

Achieving this balance must be done in a way that ensures there is clarity and stability in functional assignments. If functions are not formally assigned, then neither level of government will be able to budget and allocate resources effectively. Similarly, if there is ambiguity in functional assignments, or if assignments are shared between levels of government, then one level may reduce spending or even withdraw from providing that function, leaving the other level of government to shoulder the burden (McClure and Martinez-Vazquez, 2004). A further issue arising from ambiguity in assignments is that voters will not know which level of government to hold accountable if there is a failure in service delivery.

1.3.3 The role of traditional authorities in decentralised governance

In many developing countries, traditional authorities such as local chieftaincies continue to play a significant role in local communities. Traditional authorities usually have important roles to play in the cultural, religious and social lives of local areas. In some countries these institutions also hold some degree of formal legal authority, for example over certain aspects of local justice or in adjudicating land disputes. These formal legal roles need to be taken into account when designing political, administrative and fiscal decentralisation. In some countries, traditional authorities also wield significant political power and therefore constitute actors with interests to be considered in designing and rolling out a decentralisation programme. If such traditional authorities are taken into account in the design of decentralisation, they can also be used to improve the accountability of local governments. An example of this in the form of oversight committees in Bolivia is described in Box 4 later in this paper.

1.4 Financing local governments

'Finance should follow function' is often cited as the key rule of fiscal decentralisation. This matters in two ways. First, it simply means that local governments should have adequate resources to carry out the functions they have been assigned. In circumstances where local governments are assigned responsibilities but not allocated corresponding resources, this is referred to as an 'unfunded mandate'.[3] Second, the source of local government financing also matters. The degree to which subnational governments are

3. Unfunded mandates are often a way of avoiding responsibility for service provision or of undermining local governments. Central government might want to offload policy responsibility for a function but not pay for it, and/or may even want local government to fail in certain areas so that central government can reclaim those powers.

financed by their own revenues rather than transfers is likely to affect how accountable they are to their residents: '[i]f subnational governments are to be big spenders, they must, in the interests of fiscal responsibility and accountability, also become bigger taxers' (Bird, 2011: 18). The rule that 'finance follows function' thus also means considering the balance between locally-raised taxes and centrally-provided transfers in the revenue mix of local government.

Decentralisation reforms should therefore seek to ensure as far as possible that local governments are provided with a local revenue base of some significance so that they are not completely dependent on inter-governmental fiscal transfers. However, significant dependency on transfers may be unavoidable for all but the richest local governments in the largest cities if they are to be provided with sufficient funds to allow an equitable level of service delivery. When designing fiscal decentralisation, therefore, national governments need to implement well-designed inter-governmental fiscal transfers that provide for some equity between local governments, do not disincentivise local revenue collection, and ensure that the functions assigned to local governments are fully funded.

The remainder of this section discusses three topics in turn: locally-generated revenues; inter-governmental fiscal transfers; and local public financial management.

1.4.1 Subnational revenues

Local governments often have limited revenue bases and are often dependent on fiscal transfers from central government. In developed countries, around a third of total revenues are raised by subnational governments, whereas in developing countries the amount raised by subnational governments is only around 14% of total revenues. In the late 2000s, subnational governments in developing countries relied on transfers to finance 62% of their budgets on average (Gadenne and Singhal, 2014).

The extent to which a local government is dependent on grants is determined not only by the sources of revenue available to that government but also on its expenditure functions. Local governments with limited responsibilities such as basic municipal functions (e.g. waste collection, local roads, and fire prevention and control) will only need a fairly small tax base to be self-financing. The situation is very different when local governments also have large expenditure responsibilities such as education and health (Bird, 2011). Furthermore, an almost inevitable feature of decentralisation is that there will be inequalities between local governments. Typically, urban local governments with significant tax bases will be somewhat less transfer-dependent, whereas poor rural local governments are likely to be dependent on transfers for the vast majority of their revenues.

Dependence on central government transfers is argued to be problematic, leading to reduced accountability to local residents. Reliance on tax revenues, by contrast, provides local governments with incentives to be accountable to and respond to the needs of local residents and taxpayers, to increase the productivity of the local economy to increase tax collection, and to manage this revenue prudently (Pöschl and Weingast, 2015). Such reliance provides more incentives for local governments to raise resources for the kind of services residents are willing to pay for.

How should these considerations affect the taxes assigned to local governments? First, decentralisation reforms should seek to ensure, as far as possible, that local governments are provided with a local revenue base of some significance so that they are not completely dependent on inter-governmental fiscal transfers. However, this dependence may be unavoidable for the poorest local governments if they are to be provided with sufficient funds to allow an equitable level of service delivery. In light of this, the objective should be to ensure that the tax base allows the richest subnational governments to finance the services they provide to their residents largely from their own revenues (Bird, 2011). Furthermore, local governments must be able to set their own tax rates so as to ensure that decisions taken on tax are visible to the local residents who can hold the local government to account (Pöschl and Weingast, 2015). Central government may have understandable concerns that control over tax rates could lead to tax competition between local governments or, alternatively, result in excessive taxation. However, the risk of tax competition can be overcome by central government setting a minimum rate or floor, while the risk of excessive taxation can be avoided by introducing a maximum rate or ceiling (Bird, 2011).

Overall there will need to be some form of collaboration between central and local government in determining the revenue framework for local government. The central government could, for example, set out a standard taxation framework stipulating which taxes local governments can levy and on what basis those taxes are to be assessed, while leaving the choice of rate to individual local governments (perhaps within limits, as proposed above).

Second, the decision as to the kinds of taxes that are devolved to local governments will depend heavily on the local context. The standard advice for determining the best kind of local government taxes is that they should rely most heavily on property tax, as this is a tax on an immobile factor, and on user charges, where the beneficiaries of a service pay directly for that service (Bird, 2011).[4] This standard advice is appropriate for local governments responsible for only basic municipal functions, but local governments with broader responsibilities may need additional revenue sources

4. By contrast with immobile factors, if a local government increases taxes on mobile households or firms this could lead to employees and firms relocating to a neighbouring local government region with lower taxes.

in addition to property tax and user charges. The most promising option is a local business tax levied on turnover at a low and uniform rate (Bahl and Bird, 2008). A further common local tax is the taxation of motor vehicles (Bahl and Bird, 2008). Concerns about a possible proliferation of locally-introduced 'nuisance taxes' that can adversely affect local businesses means that there is a role for national government in defining the tax base that local governments can access, as discussed above.

1.4.2 Inter-governmental fiscal transfers

Even with significant sources of local revenue, central government grants[5] are likely to play a major role in the financing of subnational governments. How these grants are designed and implemented by central government will significantly affect local government performance. A core objective of most inter-governmental transfer systems is to create a greater degree of equity between local governments. At the same time, however, transfer systems must be carefully designed so as not to disincentivise revenue collection (Pöschl and Weingast, 2015). A further key design consideration is whether to give local governments the choice of how to spend the grants ('discretionary') or to earmark grants so they can only be spent for specific purposes ('conditional').

Total allocation to subnational governments

The first decision to be made in designing a transfer system is how much of the national budget to transfer to local governments (what the total allocation of central government funds to local governments will be). The overall aim is to ensure that the level of financing matches the level of responsibilities that have been decentralised. The proportion of the budget to be decentralised will therefore depend on the functions that have been devolved and the extent of local revenues.

The amount of financing to local governments should not only match the level of responsibilities decentralised but should also be stable over multiple years. Such stability is needed to give local governments a level of certainty that can provide a sound basis for planning and budgeting. Ideally the amount should be fixed as a proportion of total central government revenues, adjustable every few years. As well as providing stability and certainty to local governments, this approach also provides some flexibility for central government to adjust the amount as circumstances change.

By contrast, simply determining the amount to be shared in an *ad hoc* manner through the budget process each year is far less desirable. This approach will neither provide certainty to local governments nor encourage them to budget responsibly. And while an *ad hoc* process may give flexibility to central government, it also opens the door for local governments to try to bargain for larger shares, or to 'game' the system by generating budget deficits that need additional support (Bird and Smart, 2002). One mechanism that countries have adopted to overcome these risks is to set a fixed minimum percentage of revenue to be transferred to local governments. Another approach is to establish independent or arm's-length grant commissions that review local government finances and make recommendations on future allocations.

The use of formulas to determine fiscal transfers to local government

The value of transfers to local government should be 'formula-driven', meaning that transfers should be calculated according to a transparent formula that takes into account the variables considered relevant to local service delivery. Much of the attention on fiscal transfer regimes focuses on the distributional consequences of the formula applied. (This is discussed in Box 2, below.) In practice, however, in many low-capacity environments it is more important for transfers to be reliable and timely, both in terms of actual disbursement, and in terms of medium-term certainty over resources for local governments, than to get the allocation formula perfectly right. This is because the precise nature of the formula adopted will be of little importance if funds do not flow reliably.

Conditional and unconditional grants

A further issue to consider is whether grants should be general-purpose 'block transfers' that local governments can choose how to allocate, or conditional or earmarked in some way so they can only be used for a specific purpose. The degree of earmarking within grant systems varies significantly across countries, as shown in Figure 1, which contrasts two countries where the bulk of local service delivery is funded through conditional allocations (Tanzania and Uganda) with two countries where delivery is mainly funded though unconditional transfers (Kenya and South Africa).

However, a shift from one system to the other can take place over time if conditional grants increase faster than unconditional grants (or vice versa). As noted above, decentralisation – including fiscal decentralisation – is a process that allows for changes to be made in the direction of travel over time. Such changes can include rebalancing the share of conditional and unconditional grants in a local government transfer system. This has been the experience of Uganda, for example. As decentralisation in Uganda proceeded, total transfers to local governments more than tripled in real terms between 1995/96 and 2001/02, allowing for the expansion of education, health and water services.

5. The terms 'transfers' and 'grants' are used interchangeably here to refer to financial flows from central to local governments.

Box 2: Designing a grant allocation formula

A key objective of many grant formulas is to equalise the fiscal capacity of local governments for service delivery. This objective requires taking account of (a) revenue capacity, (b) expenditure needs, and (c) the differential costs of providing services in different areas. While estimating expenditure needs is a relatively simple task, estimating revenue capacity and differential costs is much more difficult. This suggests that the focus of the formula should be on (b) expenditure needs.

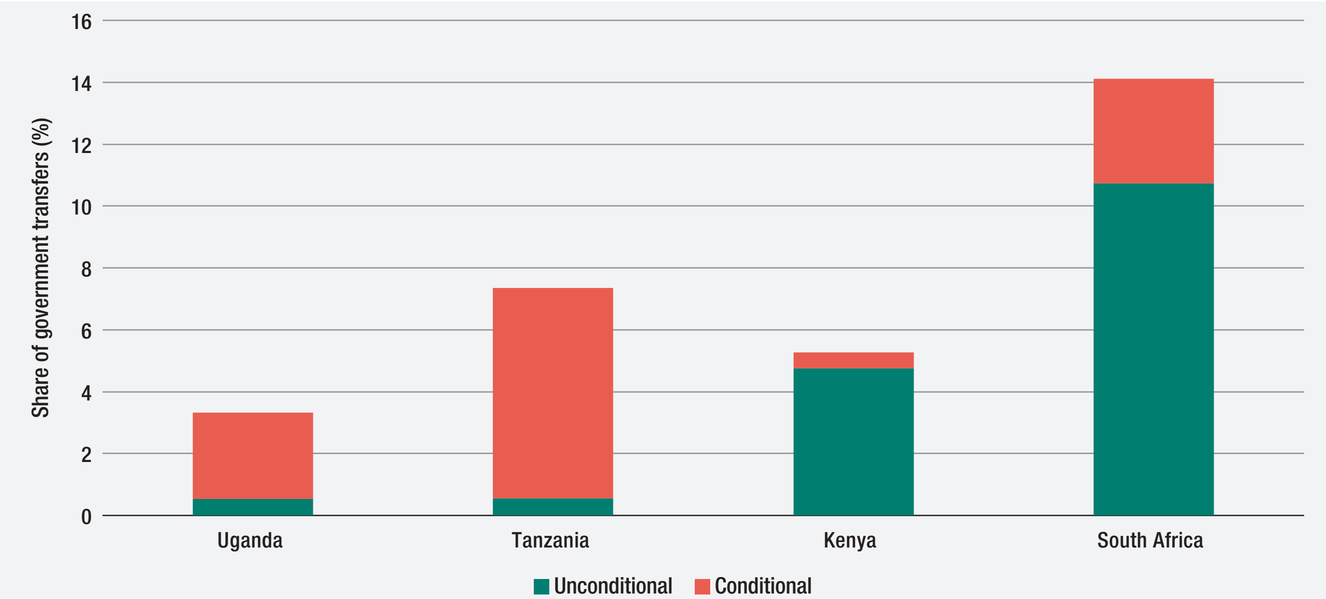
Expenditure needs can be calculated fairly simply for each service a local government is responsible for. In the case of financing primary education, for example, the calculation can be based on the school-aged population (Shah, in Kim et al., 2010:59).[6]

However, taking account of revenue capacity and differential costs is difficult to achieve in practice. Taking account of revenue capacity can produce poor incentives if done incorrectly: a local government that improved its revenue might be punished by a lower grant, for example, thereby removing any incentive for further improvement. To overcome this problem, tax capacity as measured by a 'representative tax system' can be used to calculate what a local government has the *potential* to raise rather than what it actually does raise (Shah, 2006). This is more technically complex, however, and consequently rare in practice.

More generally, negative incentives for local government behaviour are widespread in allocation formulas.[7] The process for setting an allocation formula should therefore pay careful attention to the incentive the formula will create.

Estimating cost differences between local governments is also not a simple and straightforward task. Many countries only provide additional resources for small or sparsely populated regions where services are certain to cost more to deliver (Kim et al., 2010). For example, Nepal has developed a rough cost index that is applied in the general grant system (Steffensen 2010a), and Bhutan has factored in a distance factor (i.e. the distance between specific local governments and major cities) in its grants for capital spending. Similarly, Switzerland adjusts transfers by a factor that recognises the additional costs of providing public services in mountainous terrain (Schroeder and Smoke, 2002).

Figure 1: Distribution of conditional transfers



Source: Authors' calculations; Kenya County Revenue Allocation Act 2013/14; South Africa National Budget 2013/14; Tidemand et al. (2014); Williamson et al. (2014)

6. There are two other, more complex approaches, to calculate expenditure needs. One equalises against a set of 'standards' or 'norms' set by the central government (e.g. Japan, Australia). The main objection to the first approach is that norms and standards are highly subjective and the central government cannot know what local governments 'need'. The other tries to calculate need based on spending preferences in local governments and actual average costs of various types of users/population age groups etc. (e.g. Denmark). This approach is criticised on the grounds that estimates of preferences calculated using recent spending patterns reflects historical practices rather than needs. It is also difficult to separate differences in spending caused by need from those caused by local government inefficiency

7. All systems will be subject to some extent by 'gaming', whereby local governments try to maximise returns from the system while minimising effort (Hood, 2006). Besides incentives to collect less local revenue so as to boost central government transfers, other common pitfalls of transfer systems are financial incentives to maintain inefficient practices, to increase spending unsustainably, and/or to discourage investment in or maintenance of the infrastructure.

However, 'the bulk of resources were made available as conditional grants, and not unconditional grants. These reinforced vertical lines of accountability to the centre, and undermined local discretion' (Steffensen, 2010b:13). Reform is now underway in Uganda to consolidate and reduce the number of earmarked grants in the current system.

The extent of centrally-determined conditions in a grant system is another example of how the challenge of decentralisation is achieving a balance between central oversight and local autonomy. Systems with mostly unconditional transfers give a higher degree of autonomy to local governments to deliver services in accordance with their perception of priorities. If local autonomy is diminished too far through the use of conditional transfers, many of the advantages of decentralisation will be lost. However, where local government PFM functions are especially weak, central government may be concerned that local government will not allocate sufficient funds to their service delivery functions and therefore some form of conditionality is required. In this case, the conditions attached to grants should be as broad as possible, giving local governments discretion to spend within wide sectoral parameters. Detailed conditions controlling specific expenditures are likely to be extremely administratively burdensome, both for central government to monitor and for local government to implement. Moreover, such detailed conditions risk forcing local governments to spend funds in ways that do not match local needs, undermining a key objective of decentralisation.

National government capacity

Conditional grants require greater information about what local governments are spending in order to monitor their degree of compliance with the rules. Establishing such information systems inevitably adds costs for both local and national government. As a result, national government should be careful not to put conditions in place that are costly to monitor, or indeed conditions that the government is simply unable to monitor and enforce. If monitoring systems are weak and/or central government oversight capacity is limited, the role of conditional grants should be limited accordingly (Ahmad and Searle, 2005).

1.4.3 Supporting improvements in local government public financial management

Developing effective local government PFM capabilities is a key part of the decentralisation process. A country's finance ministry, alongside the ministry of local government, has a key role to play in setting standards for local government financial management and in providing oversight. An important part of this role is to design incentives for local governments to improve their PFM systems and develop their PFM capacity.

Basic principles for supporting the strengthening of subnational PFM include the following:

- *Ensure that the PFM systems being established are appropriate for local governments.* Local PFM systems should be appropriate to the level of capacity of local governments, the complexity of their financial operations (which are often simpler than at national government level) and the technological capacity of local institutions (Pretorius and Pretorius, 2008). For these reasons, subnational governments should not automatically follow the PFM systems of central government.[8] However, it is desirable for central and local government to share at least a standard chart of accounts to ensure the comparability of expenditures reporting,[9] although it may need to be simplified or customised for local governments.

Box 3: The challenges of local government financial management information systems

Establishing an automated financial management information system (FMIS) is often seen as a key step in improving financial management at both central and local government levels.

However, these systems are typically difficult to implement even at central government level, and the record on FMIS implementation is poor. Indeed there is an 'almost universal failure to implement and sustain FMISs in [developing countries]' (Diamond and Khemani, 2005).

Central government FMISs may not be appropriate for local governments for the following reasons: because subnational governments have a lower level of human capacity; because financial operations are simpler at local government level and they do not require such a complex system; and because connectivity may be too weak to maintain a reliable link so that there is little point in trying to implement a system that enables real-time integrated reporting. As such, simpler systems may be more suitable for local governments and may also be considerably cheaper.

Given these considerations, it is recommended that the focus should be on an incremental process of procedural reform *supported* by information technology rather than on comprehensive process reengineering *driven* by information technology (Peterson, 2006).

8. A further reason is that central governments, especially in federal systems, may not have the legal powers to compel local government to follow specific procedures, and so may therefore only be empowered to set the framework and minimum standards.

9. The IMF requires consolidated financial statistics for the general government sector that show total expenditure by both central and subnational governments (see IMF, 2011).

- *Ensure that inter-governmental transfers support the strengthening of local government PFM systems rather than setting up parallel systems*. Grants and transfers should be reported on through the standard local government system rather than requiring separate and additional reports. This is because such parallel systems will detract from building up the primary system and add complexity to overall local financial management.
- *Embed accountability mechanisms into PFM reform*. PFM reforms should not be limited to improving planning, control and reporting systems but should also include mechanisms to improve accountability. This should be achieved both through formal government accountability mechanisms, such as regular audits, and through social accountability mechanisms, such as community scorecards or other social accountability techniques. Performance grants with allocations partly based on local government performance in these areas provide a promising basis for institutionalising these practices. These are discussed in greater detail in Box 4, below.

1.5 The functions of central government in a decentralised system

Moving from a centralised system of government to a decentralised system of government requires a shift in the way that central government relates to local government institutions that become responsible for providing and directly overseeing services. Adapting to this new role can be as much of a challenge for central government as for local government. This section highlights two critical roles for central government: first, collecting information to allow for the monitoring of local government performance; and second, coordinating the process of decentralisation reforms.

1.5.1 Providing information and monitoring performance

In a centralised system there is a direct bureaucratic chain of command from the central level right down to local service managers. Once services are decentralised, this chain of command no longer exists. The relationship between central and local government must shift from day-to-day administration to strategic policy-making and high-level management of outcomes through setting standards, undertaking monitoring and ensuring oversight. Instead of command-and-control, the role of central government must move towards setting incentives for performance and monitoring.

To achieve this shift, central government must collect and provide information. This is crucial for two reasons: first, so that central government can play its policy-making role; and, second, so that information can be used to create incentives for local governments to improve performance.

Central government access to relevant information is especially important for general policy-making in specific sectors, but is also particularly relevant for financial oversight. Central government will need financial information in order to decide on any further decentralisation of functions or to introduce any modifications to grant allocation formulas, as well as to determine how local governments' decisions on spending are affecting national policy objectives. Access to local government financial information is also important so that

Box 4: Improving accountability in subnational governments

To improve the performance and accountability of local government, Uganda introduced a local government performance assessment together with a performance-based local development grant. In combination, these provided incentives for local government to improve accountability.

Eligibility for the grant, as well as part of the grant allocation, depended on the results of the performance assessment. As a result, it was in the interests of local governments to adhere to the required legal frameworks and deliver investments in a participatory and transparent manner. The annual assessment of local government performance promoted the involvement of beneficiaries and encouraged transparency through a number of strategies, including: public notices of the grant allocation and use of grants; clear project signs setting out the funder and implementer; disclosure of the results of the performance assessment; and indicators in the local government assessment system that incentivised local government openness and the involvement of citizens in all phases of the PFM and project cycle, including the establishment of community-level project implementation/ monitoring committees (Steffensen, 2010b).

In Bolivia, formal community oversight has been built into the structure of local government. The 1994 Law of Popular Participation established 'oversight committees' in addition to democratically elected local councils. These committees are made up of representatives of local groups and are designed to involve traditional governance structures (such as community or tribal structures) in improving the governance of modern state structures. The oversight committees can propose projects and oversee municipal expenditure. However, their main power is to request the suspension of the disbursement of funds from central government to the local council. This is designed to give the oversight committees an effective veto power over local government activities, ensuring that local government takes their views into account. However, it is also designed as a power to be used as a last resort, encouraging the collaborative development of solutions to identified problems (Faguet, 2012).

the central government can be sure that local governments do not represent a fiscal risk to central government (further discussed in section 1.6.2 below). This oversight capability is also necessary to help assess the need for technical assistance to support financial management (Bahl, 1999).

As well as supporting central government's supervision of local government finances, clear financial information can support accountability. Public provision of information can influence how people assess their local government, as well as stimulate competition between local governments and lead to improved public service delivery (Capuno et al., 2015). Central government can take actions to encourage public access to information, for example by establishing league tables of local government performance, or by making key local government fiscal information publicly available online.

1.5.2 Coordination of reforms

Decentralisation is a complex and multi-faceted task involving political, administrative and fiscal pillars. Fiscal decentralisation must consider the expenditure and revenue functions of local government and the system of inter-governmental transfers, and how these are designed will inevitable affect, and be affected by, decisions taken on the other pillars. The implementation of these three different pillars must therefore be coordinated effectively, and this requires cooperation from a variety of other public sector institutions (Litvack et al., 1998). Implementation will further require awareness of any other relevant public sector reform programmes that may be taking place at the same time (Smoke, 2015).

Given this complexity across three pillars, a government department responsible for each pillar must be at the heart of the coordination of reforms in order for central government to coordinate decentralisation reforms effectively. In undertaking fiscal decentralisation reforms, this typically requires the strong involvement of both the ministry of interior or local government which is in charge of the administrative pillar (and often also the political pillar) and the finance ministry which is in charge of the fiscal pillar. A centre-of-government agency such as the president or prime minister's office may also be responsible for the political pillar and for ensuring coordination between government agencies. However, coordination is often difficult to achieve because of tensions between these agencies. For example, finance ministries may feel that ministries of local government or interior ministries are seeking to take over the financial oversight of local governments, while local government or interior ministries may feel that the finance ministry is unreasonably blocking decentralisation reforms.

All actors need to understand that 'for decentralisation to work effectively a broad range of actors with different perspectives and levels of influence must be accommodated' (Fedelino and Smoke, 2013). The role of the finance ministry is especially critical, since if the fiscal decentralisation arrangements are not resolved correctly then decentralisation will not be properly financed and is therefore unlikely to be effective. Indeed, while interior and local government ministries might have overall policy responsibility, very little of real substance will happen if the finance ministry is not on board and committed to making fiscal decentralisation a reality. The lead ministry on decentralisation must therefore seek to build a good working relationship with the finance ministry and must understand the ministry's concerns and respect its mandate over matters of financial management. In the same vein, finance ministries must fully engage in decentralisation processes and seek to understand the trade-offs between central control and local autonomy rather than simply presuming the need to maintain central control. Finance ministries must further understand the need to tailor PFM systems to local government requirements and to build on existing systems rather than simply transferring national systems to the local level.

The variety of institutions involved in decentralisation means there needs to be some way of institutionalising coordination. Many countries have established a coordinating body such as a decentralisation task force or secretariat to coordinate reforms. These bodies often attract donor funding or other forms of technical support. However, the establishment of a coordination mechanism – even when supported with external funding – is not sufficient to guarantee that effective policy coordination in decentralisation will occur in practice.

1.6 Getting the reform process right

Two points should be apparent from the preceding discussion. First, there is no single or fixed blueprint for decentralisation. Decentralisation happens as a result of specific political motivations in each country and therefore the form of decentralisation must also be adapted to each country's context. In addition to different drivers for change, reform never starts with a blank slate and the existing institutional set-up will need to be taken into account as reforms are designed.

> *There is no consensus about ideal intergovernmental distributions of power and competencies, and enormous empirical variation across countries in these arrangements. But this, we hold, is as it should be. There should be no common model. Fiscal arrangements should be carefully tailored to each country's fiscal, political, and economic characteristics, and should be expected to differ as much as the countries do themselves. (Faguet and Pöschl, 2015:11)*

Second, in addition to there being no predefined blueprint for countries to adopt, decentralisation needs to be viewed as a *process* and not an end point (Smoke, 2015). Any reform process will take years and must be adjusted as lessons are learnt from implementation. Accordingly, the objective of this discussion is not to provide a blueprint but rather to set out some key lessons to inform the design of decentralisation reforms and to highlight some risks that have emerged in other countries and that need to be avoided.

This section discusses three key risks in implementing decentralisation. First, it discusses the risk of fiscal irresponsibility on the part of local governments and the need for monitoring and clear rules to prevent such irresponsibility. Second, it discusses the risk that if central government maintains too tight control over local government spending, the benefits of decentralisation in improving service delivery and responding to local needs will not materialise. Third, it notes that lack of local government capacity should not be used as an excuse to delay decentralisation but should be seen as a challenge to be managed during the decentralisation process. The final section discusses the overall considerations that need to be taken into account in a fiscal decentralisation reform strategy.

1.6.1 Fiscal irresponsibility

A key risk involved in decentralisation is irresponsible public spending by local governments. This may take two forms. First, local governments may spend on the 'wrong' things. They may underspend on providing public goods and services and instead seek to divert funding in a way that provides private benefits to politicians or bureaucrats (such as spending on staff benefits and allowances or engaging in nepotistic hiring practices). Second, local governments may simply overspend in aggregate, perhaps by borrowing excessively.

To promote responsible spending on appropriate areas, central governments may seek to impose conditions on local government grants and reduce the amount of discretion afforded to local governments. However, this may come at the cost of undermining local autonomy and detailed conditions can be hard to monitor. Instead, it may be simpler instead to establish fiscal responsibility rules that set a maximum percentage of the budget that can be spent on salaries, or a minimum percentage to be spent on capital (or development) expenditure. Effective audit and financial monitoring systems can support adherence to these rules. Central governments should also ensure that local governments have transparent finances and are able to raise local taxes. This is necessary in order to promote accountability to local residents, as was discussed in section 1.4.

Regarding aggregate overspending in total, a key risk is that subnational governments with excessive fiscal deficits and debt-financed expenditure may ultimately require a central government bailout, which can threaten national macroeconomic stability. Preventing this from happening is a key concern of finance ministries. As an example, overspending occurred in several Latin American countries, including Argentina and Brazil in the 1990s and early 2000s, as newly empowered local governments spent and borrowed excessively and eventually had to be bailed out by central government. This issue was effectively solved by a series of reforms that required more fiscally responsible behaviour. Fiscal responsibility laws were imposed to set limits on subnational spending and borrowing and stronger accounting rules were introduced to increase the transparency of accounts, while at the same time greater autonomy was afforded to subnational governments to raise local revenues (Grazzi and Jaramillo, 2015). The key lesson is that fiscal decentralisation itself does not threaten macroeconomic stability, but it can if it is badly designed.

1.6.2 Decentralisation in theory but not in practice

Central governments (like any bureaucracy) may simply not like giving away power, even in cases where local government is perfectly capable of managing funds. This may lead central governments to maintain controls over local government spending that undermine the primary rationale of decentralisation reforms, i.e. the aim of enabling local governments to respond better to local conditions and demands.

As an example of partial decentralisation, services may be only nominally decentralised to local governments while control over staffing and capital projects remains with central government. This leaves local governments in charge of only small amounts of recurrent expenditures (perhaps a few thousand dollars each month), and thus with little capacity to make substantial change. This is bound to lead to frustration, especially if the population has high expectations of local government following decentralisation.

Central government controls over the hiring and deployment of staff in particular can contribute to major inefficiencies in service delivery. Preventing local governments from controlling salary budgets can lead to large inequalities in staffing between local areas, particularly between rural and urban environments. Central control of human resources can also prevent local governments from tackling the problem of poor performance by staff who nominally report to them, but who are hired and fired by, and therefore ultimately answerable to, central government.

The problem of partial decentralisation has been demonstrated in a recent review of decentralisation in Sierra Leone. This review concluded that:

> *the main problem with decentralization in Sierra Leone today is that only a small share of 'local' resources is managed by local councils, while the continued centralized management of local human resources and development [i.e. capital] expenditures by line ministries is preventing the public sector from being responsive to the needs of people at the local level, and is limiting the accountability of local officials. (World Bank, 2014:9)*

Central control over staffing has led to large inequalities between local governments in Tanzania. Staff are centrally recruited and allocated to local governments, and salary transfers are based on the actual allocation of staff. However, staff are able to arrange reallocation away from under-served and remote areas, sometimes without ever reporting for duty (Tidemand et al., 2014). In contrast, Rwanda decided to decentralise the hiring of health staff, and to link the financing of salaries to the health facility rather than the employee, which led to better retention of staff in remote areas. In this arrangement, if staff want to relocate, they need to leave their job and look for a position elsewhere; unlike the case of Tanzania, they are not able simply to request a transfer to a less remote area. (Pose and Samuels, 2011).

As the Sierra Leone example indicates, the argument against partial decentralisation applies to capital spending as well as spending on salaries. If there is too much central control over capital funding, and/or very low levels of discretionary funding (i.e. if most grants are conditional), then local governments will have limited capacity to improve the delivery of local services.

1.6.3 Lack of capacity

In addition to the risks of fiscal irresponsibility and partial decentralisation, there may also be a perception that local governments simply lack the necessary capacity to take on the complex functions required by decentralisation. Central government may perceive that the quantity and quality of local government staff, including financial management staff, leaves public resources exposed to unacceptable risk.

While each context will vary, this risk may be more apparent than real. Many tasks that are decentralised to local governments are technically fairly simple. Indeed, in many countries these services are often not really being delivered at all by a distant central government in the first place (Faguet, 2012). The real risk may be that these services cannot be effectively delivered without the local knowledge and accountability that only local government can generate. The key challenge in designing decentralisation is how to balance these two risks, not to focus on the risk of low local government capacity at the expense of the risk that central government does not have the local information and accountability structures to provide local services effectively.

A further issue is that lack of capacity in local government is a 'chicken and egg' dilemma (Bahl and Martinez-Vazquez, 2013). If decentralisation does not take place because of lack of capacity, the necessary capacity will never be developed. Part of the process of decentralisation is for local governments to 'learn-by-doing' (Faguet, 2012). This can be supported by designing capacity-building projects alongside decentralisation. It does not make sense simply to wait for decades for capacity to appear organically at the local level. Capacity-building measures should aim to support this learning-by-doing process. Intensive classroom-based training courses are unlikely to be sufficient, however, and will need to be supplemented by ongoing on-the-job training, coaching and mentoring (Fedelino and Smoke, 2013).

Central governments must therefore avoid the temptation of retaining excessive control. Many concerns can be addressed through a well-designed oversight system. For example, if the concern is over the quantity of local government spending, then this can be combatted, as discussed above, by setting fiscal rules and by devolving more revenue powers. If the concern is that there will be over-hiring, then this could be supplemented by additional rules on headcount levels and/or on salary spending. All of these options mitigate risks while still allowing local governments to retain powers to tailor human resources to local circumstances, whilst mitigating risks. Maintaining detailed central control over local government, by contrast, means that decentralisation is very unlikely to bring substantial benefits.

1.6.4 Implementation strategy

Fiscal decentralisation reforms are challenging because they involve a wide number of dispersed actors across central government and local governments as well as agencies spread throughout the country. Research has demonstrated that PFM systems involving a large number of actors across government tend to be weaker than those that involve fewer players (Andrews, 2010). Furthermore, as noted above, key actors within the process typically share different objectives and interests, often within the context of generally low capability throughout the public sector.

Decentralisation reforms involving a large number of actors therefore require a carefully considered implementation strategy. Importantly, reforms are unlikely to be successful if implementation is driven by a fixed and comprehensive top-down blueprint formulated by only a few central actors who then attempt to rapidly impose it across the system. Instead, reform processes dealing with complex problems such as decentralisation should ideally be 'problem-driven'. This approach to reform involves a process of 'muddling through', motivated by identifying agreed problems and seeking solutions through experimentation and learning led by multiple agents, in the overall direction of an agreed policy goal (Andrews, 2013; Andrews 2015; Williamson, 2015).

This suggests that instead of having a single 'once and for all' decentralisation strategy that is expected to be implemented over a short period, governments should have a clear direction of travel for reform but follow a flexible plan that can be reviewed, updated and amended in the light of ongoing experience in implementing reforms. This will require ongoing dialogue between the key agencies involved in steering the decentralisation process to facilitate an 'organic' process of resolving policy issues within and across sectors in pursuit of broad policy goals.

2. Annotated bibliography of key sources

2.1 Introduction to decentralisation

Faguet, J. P. (2014) 'Decentralization and governance', *World Development* 53: 2-13.
In this paper, Faguet sets out the broader political context around decentralisation reforms and argues that they can improve governance and accountability.

Gadenne, L. and Singhal, M. (2014) 'Decentralization in developing economies', *Annual Review of Economics* 6: 581-604.
This article sets out the patterns of fiscal decentralisation across the world, highlighting the fact that developing countries are less likely to have decentralised revenues than developed countries.

2.2 Functional assignment

McLure, C. and Martinez-Vazquez, J. (2004) *The assignment of revenues and expenditures in intergovernmental fiscal relations*. Washington, DC: World Bank.
This paper provides a detailed examination of how revenues and expenditure responsibilities should be assigned between levels of government, setting out general principles, common problems and information from a variety of countries on how functions have been assigned.

2.3 Revenues and grants

Bahl, R. and Bird, R. (2008) 'Subnational taxes in developing countries: The way forward', *Public Budgeting & Finance* 28(4): 1-25.
Bahl and Bird provide a comprehensive overview of local taxation that sets out which taxes are most desirably decentralised to subnational governments and which powers local governments should have over taxes. The article also includes a discussion of each of the major tax sources that could be decentralised.

Shah, A. (2006) 'A practitioner's guide to intergovernmental fiscal transfers'. Policy Research Working Paper No. 4039. Washington, DC: World Bank.
In this paper Shah aims to distil the core policy lessons from the wider literature on inter-governmental grants. He sets out lessons to ensure that grants provide the right incentives for prudent financial management and improved service delivery. The paper also identifies practices to avoid.

2.4 Project implementation

Bahl, R. W. and Martinez-Vazquez, J. (2013) 'Sequencing fiscal decentralization', *Annals of Economics and Finance* 14-2(B): 623–670.
This article sets out extensive and detailed considerations of what an 'optimal' strategy for sequencing fiscal decentralisation would look like. As the authors themselves acknowledge, however, this may be considered excessively demanding and politically unrealistic. The article highlights many issues that should be considered by reformers. It further identifies both high-risk sequencing choices as well as sequencing mistakes which are of lower risk.

Bahl, R. (1999) 'Implementation rules for fiscal decentralization'. International Studies Program Working Paper 99-1. Atlanta, GA: Andrew Young School of Policy Studies, Georgia State University.
This short paper provides a guide to implementing fiscal decentralisation in the form of twelve rules.

Fedelino, A. and Smoke, P. (2013) 'Bridging public financial management and fiscal decentralization reforms in developing countries'. In M. M. Cangiano, M. T. Curristine and M. M. Lazare (eds.) *Public financial management and its emerging architecture*. Washington, DC: International Monetary Fund.
This book chapter sets out key considerations in coordinating PFM and decentralisation reforms, and includes case studies of Indonesia, Kosovo and Uganda. It concludes with six lessons for reformers to consider.

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