Chapter One

FISCAL DECENTRALISATION: AN OVERVIEW

1.1 Introduction

This chapter sets the stage for the substantive discussion of fiscal decentralization that will follow in the remainder of the handbook. It provides an overview of fiscal decentralization for UNDP Officers involved in policy debates on restructuring intergovernmental fiscal systems. In doing so, the chapter, first, defines the concept and pillars (or building blocks) of fiscal decentralization, and also describes the advantages and disadvantages of undertaking fiscal decentralization reform. Following, it proposes a user-friendly methodology to be used to successfully carry out fiscal decentralization reform. Lastly, the paper advises the practitioners of the indicators commonly used to measure fiscal decentralization.

1.2 Defining fiscal decentralisation

In the last two decades, over eighty five countries all around the world have embarked on fiscal decentralization efforts for effective public sector reform management. Indeed, it is important to clarify the concept of fiscal decentralization, as well as its various components.

There are distinct dimensions to decentralization. These can be categorized as the political, administrative and fiscal dimensions. Each dimension has unique characteristics, objectives and conditions for success. In general terms, the political component refers to the transfer of authority from central to local authorities, the administrative component speaks to the transfer of functional responsibilities from central to local authorities and the fiscal component addresses to the financial relationship between all levels of government. At the same time while it is useful to distinguish between the different components of decentralization for the purpose of highlighting its many facets, there is nonetheless considerable overlap between all the components. For instance, in order for economic gains from decentralization to be actualized, it is necessary to have had political decentralization in terms of decision-making authority. However, while it is possible that in one case all of these aspects of decentralisation may operate simultaneously, in another case, it is equally possible that a country may be decentralised in one or two respects, while less so in others.

Fiscal decentralization refers to the public finance dimension of intergovernmental relations. It specifically addresses the reform of the system of expenditure functions and revenue source transfers from the central to sub-national governments. It is a key element of any decentralization programme. Without appropriate fiscal empowerment, the autonomy of sub-national governments cannot be substantiated and, in this way, the full potential of decentralization cannot be realized.

1 This chapter was prepared by Nicoletta Feruglio, December 2007. The chapter was prepared by the author in her capacity of Fiscal Decentralisation Advisor at the UNDP Bratislava Regional Centre
1.3 The pillars or building blocks of fiscal decentralization

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**Assignment of expenditure responsibilities**
The box below summaries the key features of the issue of the assignment of expenditure responsibilities.

**Definition**: Assigning expenditure responsibilities refers to the distribution of functions among the different government levels.

**Why is the allocation of expenditure responsibilities an important issue?**: Financing should follow functions. In addition, it is important to clearly define the assignment of expenditure responsibilities in order to enhance accountability (who is responsible for what), avoid unproductive overlap, duplication of authority and legal challenges.

**A clear definition of the role of the public sector** should be established before expenditure responsibilities can be assigned.

**Which level of Government should be responsible** for specific function and activities belonging to the public sector (central, regional and local).

**Basic Principles for Expenditure Assignment**:
- Efficiency Criteria or Subsidiarity principle: Providing goods and services at the lowest level of government that can efficiently deliver the good or service
- Service or Benefit Area: Delivering Services across political boundaries
- Economies of Scale: The extent to which the provision of a service at a smaller or larger scale affects the cost of the service
- Cultural Values: Some services, such as education and health, may have a high cultural value and requires more centralized or controlled delivery
- Size and Diversity: Geographic and population size and diversity may affect expenditure assignment

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2 Each of the pillars or building blocks of fiscal decentralization will be extensively discussed in the four remaining chapters
No Single Best Assignment, the changes in cost, technology and cultural values may change expenditure assignment

The Clear Choice: National vs. Local Public Goods
Local Public Goods: Municipal Services (e.g. waste collection, water distribution etc.)

The problem:
- Most goods do not fit these extreme categories (especially health and education)
- Most goods must be evaluated on a multi-dimensional basis (producing a good or delivering a service; providing or administering the service; financing a service; setting standards, regulations or policies guiding the provision of government services)
- Unclear division of functions by level
- Economies of Scale/Spillovers
- Assignment might change over the time

Expenditure Allocation Strategy
- Recognize why you are where you are
- Ensure clear and stable allocation of responsibilities
- Focus on core services, then devolve additional responsibilities incrementally
- Recognize that the allocation of expenditure responsibilities must be linked to capacity
- Recognize that sub-national governments are different in terms of population, expenditure capacity and revenue sources in almost every country. This asymmetric decentralization speaks to the need for performance indicators.
- Phase in additional responsibilities to more competent sub-national authorities
- Establish a ranking system to classify the sub-national governments on the basis of technical financial, administrative and planning and policy capacities
- Monitor implementation and adjust as necessary

Allocating Revenue Sources
The box below summaries the key features of the issue of the allocation of revenue sources among levels of government.

Definition: Allocating revenue sources refers to the distribution of financial resources among the different levels of government.

Why is the allocating revenue sources to sub-national governments an important issue?: It ensures sub-national autonomy, promotes accountability and ownership, realizes decentralization efficiency gains and facilitates cash flow management

Basic Principles in allocating revenue sources:
- Revenue potential (governments must have taxes that can respond to changes in population, income and inflation, as well as those which can provide a stable revenue base)
- Economic efficiency (revenue instruments should be structured to minimize economic distortions in investments, production, consumption and local decisions)
- Equity (system should be as equitable as possible according either to the ability to pay principle, or to the benefits revenue principle)
- Administrative feasibility
- Political Acceptability (acceptable to the various groups in the society, otherwise they will not “voluntarily” pay)

**Indicative distribution of revenues by level of government:**

<table>
<thead>
<tr>
<th>Central Government Sources</th>
<th>Sub-national Government Sources</th>
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</thead>
<tbody>
<tr>
<td>- Corporate Income Tax</td>
<td>- Property Tax</td>
</tr>
<tr>
<td>- Personal Income Tax</td>
<td>- Retail Sales Tax</td>
</tr>
<tr>
<td>- VAT</td>
<td>- Motor Vehicles</td>
</tr>
<tr>
<td>- Custom Duties</td>
<td>- Motor Fuel Tax</td>
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<tr>
<td></td>
<td>- User Charges</td>
</tr>
</tbody>
</table>

**Real revenue autonomy to sub national governments** will enable their discretion over the tax base and rate

**Own source revenues and user fees and charges normally account for 50% + or – 10%** of the total sub-national governments financial resources

**Weak revenue administration** is the primary obstacle to successful sub-national revenue mobilization

**Problems:**
- Lack of citizen credibility
- Lack of political will
- Enforcement practically non-existent
- Revenue base information: lacking, incomplete or dated

Designing Intergovernmental Transfers
The box below summarizes the key features of the intergovernmental fiscal transfers.

**Definition:** the intergovernmental fiscal transfers refer to the transfer of finances from the central government to lower government levels.

**Why is the design of intergovernmental transfers important?:** In general, the revenue assignment never matches the expenditure needs, so intergovernmental fiscal transfers are often necessary to assure revenue adequacy.

**Transfers come in a variety of forms depending on the purpose for which they are used**

**The forms of intergovernmental fiscal transfers include:**

- **General purpose or unconditional transfers** (transfers provided as general budget support)

- **Specific Purpose or conditional transfers** (transfers provided to undertake specific activities)
  - matching vs. non-matching (matching-requires sub-national government to finance a portion of the expenditure through own revenue sources).
  - open-ended vs. closed-ended matching (matching requirement open-ended-the sub-national government matches whatever level of funding provided by the central government; matching closed-ended-the sub-national government matches the funding provided by the central government only up to a pre-specified limit).
  - input based conditionality vs. output base conditionality (input based conditionality-conditional transfers that specify the type of expenditure that can be financed; output based conditionality-conditional transfers that suppose sub-national government to attain a certain level of service delivery).

- **Revenue sharing** (it is also considered as a transfer because local government do not have control over the tax base, tax rate, tax collection or the sharing rate)

**Objectives of the fiscal transfers:**

- Bridging the vertical fiscal gap
- Improve horizontal fiscal balance
- Fund national priorities
- Compensate for spillovers or externalities (Health vaccinations)

**Correlation between objective and design of a transfer:**

<table>
<thead>
<tr>
<th>Objective</th>
<th>Transfer Design</th>
<th>Best Practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Gap</td>
<td>Tax base sharing</td>
<td>Canada</td>
</tr>
<tr>
<td>Horizontal Fiscal Balance</td>
<td>Equalization Transfer</td>
<td>Australia, Germany</td>
</tr>
<tr>
<td>Fund National Priorities</td>
<td>Block transfers¹, conditions on service standards</td>
<td>Brazil</td>
</tr>
<tr>
<td>Spillover or Externalities</td>
<td>Matching transfer</td>
<td>South Africa teaching hospitals</td>
</tr>
</tbody>
</table>
**Transfers can create perverse incentives for fiscal management and accountability. The important is the design of the intergovernmental fiscal transfers to avoid these negative impacts.**

**Several key lessons for designing an intergovernmental system:**
- keep the transfer simple (this refers among others to the transfer formula that must be transparent, based on credible factors and as simple as possible)
- Focus on single transfer objective
- Introduce sunset clauses (especially in transitional arrangements)
- Introduce output based conditional transfers
- Introduce fiscal equalization transfers
- Develop an institutional arrangement for broad based consultation

**Intergovernmental Fiscal Transfers normally account for 25% + or - 10% while shared taxes accounts 25% + or – 10%of the total sub-national governments financial resources**

**The institutional framework to overlook fiscal transfers:**
- Grant commission
- Intergovernmental forum
- Intergovernmental forum with participation of the civil society

**Structuring Sub-National Borrowing/Debt**
The box below summaries the key features of the sub-national borrowing/debt.

**Definition:** Sub-national borrowing/debt refers to the capacity for sub-national governments to borrow money to cover their expenditure responsibilities

**Why local borrowing for sub-national governments:** Financing capital infrastructure expenditure and tax flows and to foster political accountability

**Sources of borrowing for sub-national governments:**
- Direct borrowing by central government and on-lending to sub-national tiers
- Through a public intermediary a state-owned financial institution
- Direct borrowing from capital markets national or foreign markets
- Through market decentralization of public services, where possible

**The risk connected to sub-national borrowing is macro-economic instability.** However, the literature and the empirical evidence does not suggest a priori a connection between local government borrowing power and the central government ability to maintain fiscal discipline and macroeconomic stability

**To overcome negative effects of sub-national borrowing, the key element is the design of the regulatory framework under which borrowing powers are decentralized**
IV. The benefits and the risks of fiscal decentralisation

It is important that national governments and UNDP officers involved in fiscal decentralization reforms bear in mind the positive effects, as well as the risks connected to fiscal decentralization, in order to maximize the benefits and avoid negative side effects through appropriate designing and implementing a fiscal decentralization reform.

The positive effects of embarking in a fiscal decentralization reform can be summarized as follows:

Improved efficiency (or economic benefits): This argument is linked to the notion of improved efficiency in the use of public resources, which is also related to increased competition for better use of public resources. Specifically, it can be persuasively argued that decisions about public expenditure, that are taken by a level of government closer to the people it is serving, are more likely to reflect the actual demand for local services, and thus appropriate resource allocation, than a one sized fits all approach more typical of a central government (allocative efficiency). Different sub-national governments offer different mixes of tax-expenditures, and local constituencies are supposed to locate themselves accordingly to their preferences (Tiebout, 1956). Therefore, fiscal decentralization promotes competition among subnational governments for limiting taxing power and maximizing their service delivery.

Improved political and financial accountability: This is related to the notion that increased authority at the sub-national government level may increase democratic accountability by giving citizens greater opportunities for input and participation. In addition, to the extent that sub-national services are financed through own revenues, the citizens tend to closely monitor sub-national authorities.

Improved effectiveness: This argument supportive of decentralisation reflects the principle of subsidiarity, which is the view that government functions should be carried out at the lowest level that can perform those functions effectively and efficiently. This is linked to the notion that decentralisation can lead to improved service delivery, because local officials, as compared to the central government, due to their knowledge of local needs and the incentive to use this information, are better equipped to respond to local variations in conditions, standards and requirements for services and infrastructure. In addition, in order to meet local needs, decentralisation may also encourage experimentation and innovation in public policy and service delivery, as individual jurisdictions have both the incentive and freedom to develop and implement new approaches or have incentives to copy successful sub-national governments.

The potential consequences of inappropriately designed fiscal decentralization are as follows:

Macro economic instability: Fiscal decentralisation can potentially bring about macro economic instability because in a fiscally decentralised system, the control of the central government over public resources is not necessarily suitable. In this framework, indeed,
sub-national debts could have national repercussions and the central government might not be able to react to economic shocks introducing monetary or fiscal policies.

Declined investment in social infrastructures: Sub-national governments are accountable to their constituencies and compete among themselves to maximize spending while minimizing taxing. Thus, sub-national governments, in deciding to undertake a particular activity or project, consider the cost of their decision. Therefore they tend not to invest in social infrastructures (e.g. regional roads) whose benefits go beyond their geographical boundaries.

Increased horizontal inequities and conflicts: Sub-national governments in a given country are different in terms of natural resources, level of economic activities, size, population and revenue capacity. Therefore, some sub-national jurisdictions will generate more revenue than others and provide to their citizens more or better quality services than is provided in poorer sub-national governments. In addition, inter-sub-national inequalities may foster politically destabilizing forces.

Collapse of the safety net (poverty): This risk comes from the sub-national governments’ inability to redistribute resources within their jurisdiction. Indeed, because of individual mobility, if sub-national governments attempt to redistribute from the rich to the poor, an emigration of rich and immigration of poor may follow.

Increased corruption: In sub-national governments officials are more likely to be subject to the pressures coming from local elites or other interest groups. In addition, sub-national officers have more discretion than national ones. Lastly, sub-national governments’ institutions are less developed and skilled than the ones at the central level. so they may be less capable to control abuses of power/resources by public employees and officials.

However, the impact of fiscal decentralization – its effect on the efficiency of public services, on equity, and on macroeconomic stability – depends very much on the specifics of the case. The main challenge is to choose the degree and type of decentralization which is best suited to the circumstances of the country

IV. How to design and implement a fiscal decentralization strategy
The appropriate design and implementation of a fiscal decentralization strategy can mitigate the side effects of fiscal decentralization discussed above.

The literature (Bahl, 1999 et Bahl and Martinez-Vazquez, 2006) has put forward some guidelines to successfully carry out fiscal decentralization reform. This section relies on this literature and proposes a user friendly methodology that UNDP officers can apply to support national governments in reform state structures.

At the country level, some pre-conditions should exist to provide a suitable environment where fiscal decentralization can effectively be translated into improved governance and service delivery: The pre-condition can be described as follows:
Political will: There should be a strong political will supporting the decentralization reform, because indeed, political factors are the most powerful drivers of fiscal decentralization

Legal framework: appropriate legal framework for decentralization, clearly empowering sub-national governments and describing their rights and responsibilities vis-a-vis the central authorities, local communities, the courts, and other important stakeholders

Institutional structures: the organizational structures of central and sub-national government bodies need to be aligned with their new functions

Systems and procedures: procedures and systems as inter-bureaucratic management tools

Central and sub-national capacity: training, technical support, and other capacity building measures for appropriate sub-national and central government officers

Central, sub-national and community oversight: support for the civil society and private sector partners who can ensure sub-national government accountability and help realize the satisfactory delivery of sub-national public services.

The practitioners, after having assessed the status of the pre-condition at the country level, can move to the design and implementation of a fiscal decentralization reform. The steps to undertake the reform are summarized below and particular attention should be paid in the activities as well as in the chronological order that these are presented.

**Step 1**

Establish a political negotiation process to design decentralization goals and strategy
- Need a champion
- Need fair process, with adequate representation and checks and balances

Link all the decentralization dimensions (political administrative and fiscal)

Decentralisation is ultimately a political decision, not a technical one. The national debate about fiscal decentralisation should be as broad as possible involving ideally all the groups that see the pros and cons of decentralization. The discussion will be led by the government and within the government there must be a key institutional player able to develop the coalition necessary to enact the reform.

A successful decentralization strategy should be comprehensive, and should cover the political, administrative and fiscal aspects.

**Step 2**

Design and implement country specific strategy

- Recognize the dynamic and flexible character of the strategy
- Recognize differences in local governments
- Link all the four pillars, phase in activities, and make the link to local capacity, fiscal discipline, performance and accountability

The decentralization strategy varies depending on the political, social and economic context prevailing in a country at a given time and, thus, the decentralization strategy should be country specific. Fiscal decentralization reforms should be flexible and dynamic in the sense that central government must be able to adjust according to variations, such as increased differences among sub-national governments. The strategy must likewise be designed and implemented in a comprehensive and consistent manner, since a given fiscal decentralization component (e.g. assignment of own revenue sources) cannot be designed separately from related components (e.g., assignment of expenditure responsibilities). In particular financing should follow functions. The strategy should also be consistent in the sense that the central government must honor its commitments to decentralization by following the rules it makes. Lastly, not all the fiscal components need to be taken simultaneously, though coherence among the components should be assured. It is important in the design and implementation of the fiscal decentralization components to consider the differences among sub-national governments, and eventually decide to take an asymmetric approach.

**Step 3**

Focus on both intergovernmental aspects (political, fiscal and administrative) and local government specific reform aspects (governance, financial management and service delivery)

Ensure strong but enabling central government

A fiscally decentralized system requires a strong central government. Ideally, the distribution of tasks among the central key institutional players should be as follows: the Office of the President to take care of intergovernmental political aspects, the Ministry of Finance looks after intergovernmental fiscal policy and operations, the Ministry of Local Government to undertake specific local government reforms, as well as the Ministry of Planning and the other line ministries to integrate sector policies and decentralization. These institutions should provide guidance and monitoring, as well as evaluate the performance of sub-national governments in their respective area of work. The system of monitoring the decentralization process should involve the routine tracking of key information in different service areas on inputs, processes, outputs, and outcomes that are expected to change as a result of a range of interventions launched under the decentralization programme. It should be understood that monitoring and evaluating are processes are intended to collect information on a decentralization program to ensure that policy making, strategic planning, and assessments of performance are conducted on a sound empirical basis.
### Step 4

Enable and empower sub-national governments

- Establish political mechanism to determine local preferences and to establish accountability
  - Political elections for accountability
  - Local budgeting and choice making mechanisms
  - Local autonomy on tax rate
  - Innovative solutions based on civil society empowerment

Accountability is a key feature of any fiscal decentralization reform design. In any fiscal decentralisation process, it is essential to build downward accountability to sub-national constituencies to ensure that the economic benefits of decentralization are achieved. Central and sub-national governments, in a variety of countries, are experimenting with different solutions to reinforce formal accountability mechanisms. Disseminating best practice is also emerging as an important tool to enhance accountability.

### Step 5

Build local institutional, managerial and technical capacity and systems to deliver services

- Planning and Implementation capacity and systems
- Budgeting and financial management capacity system
- Monitoring and feedback capacity and systems

Provide local access to adequate financial resources

- Local revenue policy and administration
- Access to intergovernmental transfers

Capacity building activities at the sub-national level should be accompanied by appropriate systems and procedures in planning, budgeting, implementation, monitoring and evaluation (e.g. sub-national mid-term expenditure framework). Improving sub-national development planning and management practices while providing adequate levels of regular financing is an essential point of any fiscal decentralization reform design. Beyond training alone, it is this systemic approach and practical experimentation that make for a successful fiscal decentralization reform.

### Step 6

Establish a mechanism to guide and monitor the fiscal decentralisation system and providing intergovernmental transfers (e.g. Grant Commission)
Creatively use intergovernmental transfers to improve local governance, service delivery and financial accountability (e.g. closed-ended transfers)

Without regular, systematic information on local government performance, it would be impossible for the central government to monitor sub-national government finances and to provide a reference for the performance of individual municipalities for promoting competition among them. In addition, without access to such information on comparable municipalities (benchmarks) it would be impossible for sub-national communities - through NGO and private sector organizations- to hold sub-national officials accountable. The roles of the “Commission” could be: a) policy design, analysis and recommendation; b) monitoring and oversight of the local government especially monitor of local government finance (local government compliance with basic expenditure norms, intergovernmental grant conditions and local revenue collection guidelines); and c) dialogue and communication. The commission could serve as a space to communicate, discuss and coordinate policy issues, or solve disputes between the central government and the sub-national governments.

V. Measuring Fiscal Decentralisation

Two indicators commonly used to measure fiscal decentralisation and to make cross-country analysis of fiscal decentralisation throughout the Europe and CIS region are 1) the sub-national expenditure as a share of GDP or a share of the total government spending and 2) sub-national revenue as a share of the total government revenue. The sub-national expenditure as a share of GDP or a share of the total government spending does not capture the sub-national autonomy in the allocation of expenditure. Thus, expenditures that are mandated or delegated by the central government appear as sub-national expenditure. Similarly, the sub-national revenue as a share of the total government revenue does not provide information about whether taxes are collected through shared taxes, piggybacked taxes, or locally determined “own source” taxes or what proportion of intergovernmental transfers are conditional as opposed to general purpose transfers.

Therefore, these two indicators are imperfect measures of fiscal decentralisation that should be used bearing in mind their limitations, especially once comparing the degree of fiscal decentralisation across countries.

Table 1.1: Analysing the sub-national revenue as a share of the total government revenues

<table>
<thead>
<tr>
<th>Country</th>
<th>Revenue Share</th>
<th>Composition of Sub-national Revenues</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Tax Revenue</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Own-Taxes</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>20.8</td>
<td>3.9</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
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<tr>
<td>----------</td>
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</tr>
<tr>
<td>Hungary</td>
<td>26.7</td>
<td>16.3</td>
</tr>
<tr>
<td>Poland</td>
<td>28.8</td>
<td>10.6</td>
</tr>
<tr>
<td>Estonia</td>
<td>22.1</td>
<td>6.3</td>
</tr>
<tr>
<td>Latvia</td>
<td>25.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Lithuania</td>
<td>22.8</td>
<td>0.0</td>
</tr>
</tbody>
</table>

OECD 1999

The first column of the table shows the sub-national governments’ shares in the total government revenues. The other columns reveal the composition of these aggregate figures.

In the case of Czech Republic, the percentage of sub-national governments’ share in the total government revenues is 20.8% but the 43.8% of this percentage is tax sharing, a tax on which sub-national governments do not have autonomy over the tax base and tax rate and 16% is the conditional or purpose specific grant. Therefore, local governments in Czech Republic have very little control over their revenues. This conclusion can be extended to the other countries. Thus, the table demonstrates that the sub-national governments share of total government revenues are indeed an imperfect indicator of fiscal decentralisation.

VI. Conclusions

Fiscal decentralisation is essentially a political decision. The key is in the strategy design and implementation. Strategy must be country specific and dynamic. In addition strategy must integrate intergovernmental and intergovernmental (sub-national) components to realize the potential benefits of fiscal decentralisation. The following chapters will discuss in details the technical design of the pillars of the fiscal decentralisation strategy.