KEK CDC CONSULTANTS

Universitätstrasse 69
CH – 8006 Zürich
Tel: +41 44 368 58 58
Fax: +41 44 368 58 00
E-Mail: zuercher@kek.ch
www.kek.ch

SDC MBo/DZu/KWa

Donor Support to Sustainable Municipal Finance
-
A Survey of the International State-of-the-Art

Commissioned by:

Swiss Agency for Development and Cooperation
Division Knowledge and Learning Processes
Freiburgstrasse 130
3000 Bern

Matthias Boss, Dieter Zürcher, Katharina Walker

Zurich, 15 October 2010

TABLE OF CONTENT

ABBREVIATIONS

AFD	Agence Française de Développement
DANIDA	Danish International Development Agency
DFID	UK Department for International Development
DLGN	Decentralisation and Local Governance Network
FDI	Foreign Direct Investment
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
IGFT	Intergovernmental Fiscal Transfers
IPA	Instrument for Pre-Accession Assistance
KFW	Kreditanstalt für Wiederaufbau
MC	Minimum Conditions
NADEL	Nachdiplomstudium für Entwicklungsländer / Centre for Development and Cooperation
NALAS	Network of Associations of Local Authorities of South-East Europe
OECD	Organisation for Economic Co-operation and Development
PBGS	Performance Based Grants System
PBG	Performance Based Grants
PM	Performance Measures
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
UNFPA	United nations Population Fund
UNMIK	Interim Administration Mission in Kosovo
USAID	United States Agency for International Development
SDC	Swiss Agency for Development and Cooperation

1 Background and Rational of Concept Paper

This concept paper forms part of a joint learning project of the SDC division 'Knowledge and Learning Processes' and the SDC 'Decentralisation and Local Governance Network (DLGN)'. Through this learning project SDC wants to promote learning from international and own practice. The issue at stake is how to best support municipalities and districts in order to improve their capacities and financial endowment which enhances their room for manoeuvring and action.

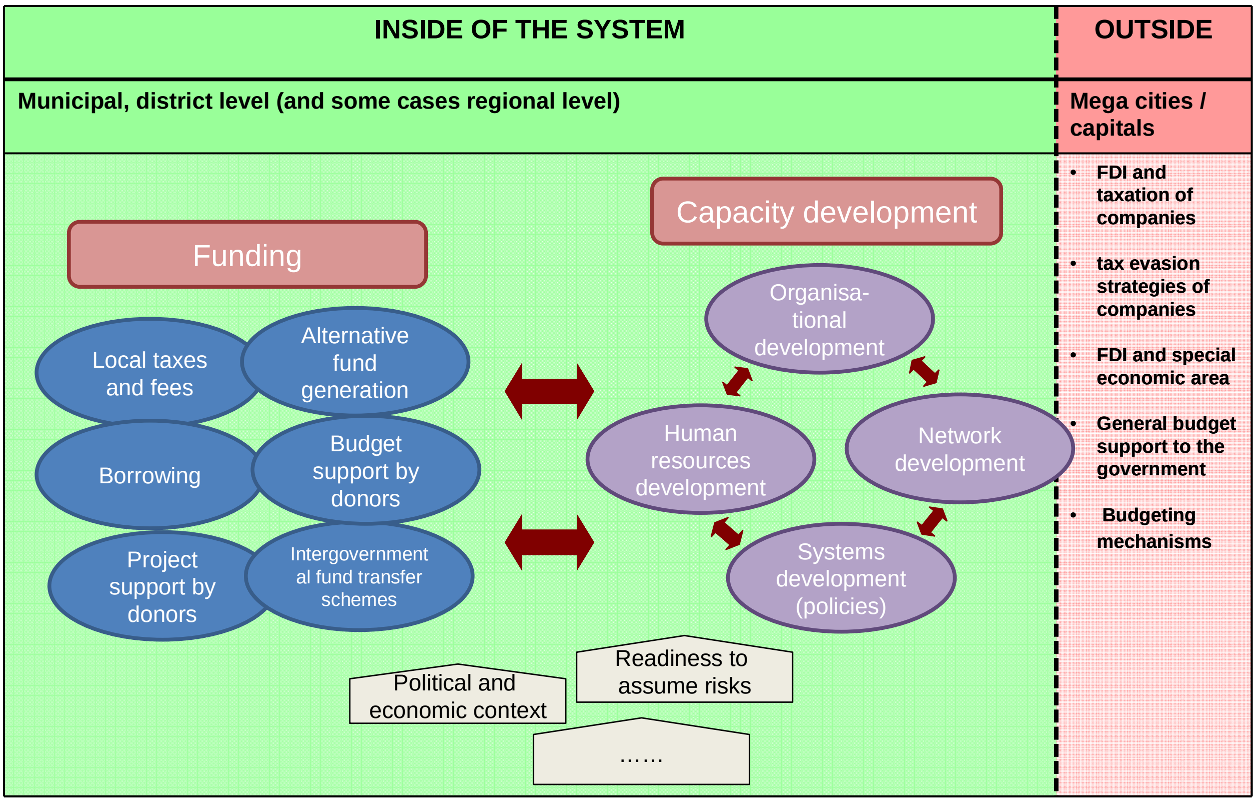
This paper provides a brief review of international experiences on this topic. It forms the basis for DLGN members to reflect on SDC's practices in supporting sub-national governments to improve their capacities and fiscal resources to enhance their scope of action. The aim is that the reflection of DLGN members leads to a series of case studies that highlight the SDC practice.

Finally, a synthesis document will bring together the findings of this concept paper and the ones of the SDC DLGN case studies.

2 Analytical Framework

2.1 System boundaries

This paper focuses on donor support to capacity building and to improving the fiscal base of municipalities and districts. The system boundaries of this paper and of the learning project as a whole are outlined in the illustration below.



There are differences in understanding among donors in regard to the concepts of capacity development and categories of fiscal resources of local governments. The following paragraphs will therefore outline the understanding of these concepts and categories as they are dealt with in this concept document and the learning project.

2.2 Support to different types of fiscal endowment of local governments

Donors have the option to support different aspects of the fiscal base of local governments. This concept paper builds on the following understanding of categories of fiscal resources:

Local government own revenues: includes local taxes, fees and alternative fund generation (e.g. income generating businesses of local governments).

Intergovernmental fiscal transfers: includes revenue sharing, general, sector specific, equalisation and performance based grants.

*Donor grant*s: includes matching or non-matching and performance grants, tied budget support (e.g. for water and sanitation) or untied budget support.

Local government borrowing: includes direct or indirect access to the financial markets by local governments.

2.3 Capacity development categories

The capacity development that forms the reference point in this learning project is the one of NADEL/Zimmermann, which addresses different intervention levels:

a) Human resource development: to promote individual capacities for learning, abilities and skills development (e.g. tailor-made or standard training)
b) Organizational development and change management: to promote organizational learning and enhanced efficiency and flexibility of an organization (e.g. strategy development of a municipality)
c) Network: to develop partnerships and alliances (e.g. fostering associations of municipalities/districts)
d) Systems development: to negotiate a conducive decentralization policy framework.

Capacity development processes can include different steps: (i) engagement with stakeholders, (ii) assessment of capacities and needs, (iii) formulation of capacity development responses, (iv) implementation of capacity development measures, and (iv) evaluation of changes and results[1].

2.4 Main differences among major donors

There are no clearly distinguishable trends between various donors in terms of instruments and aid modalities. The main difference refers to bilateral vs. multilateral donors, where bilateral donors provide more support to pilot projects whereas multilateral donors provide more support to sector programmes or programmes at national scale.

2.5 Role of context factors

Donor support to sustainable municipal finances takes always place in a specific context. The different context factors play a decisive role when programmes are designed and have a major influence on the results that are achieved by such programmes. Such context factors broadly relate to the history, the social, economic, political and institutional circumstances of a country.

[1] See UNDP approach to capacity development.

Whether donor support operates in an environment where local governments are viewed as agents of the central government, executing certain functions on its behalf, or if local autonomy prevails with local governments having the authority to decide on what they do with their budget makes a large difference. Similarly whether donor support aims at transition countries or least developed countries, rural or urban contexts also effects the nature of donor support.

The political dimension has to be seen as the most decisive context factors of all. Support to local government finances, is often associated with bringing about changes in the political landscape by promoting new power groups who often follow their own political agenda.

3 EMERGING TRENDS IN DONOR SUPPORT TO SUSTAINABLE MUNICIPAL FINANCES

Donors mostly support issues related to municipal finances because of their understanding that fiscal decentralization may ***improve allocation efficiency***. The rationale behind this is that by bringing citizens closer to decision-making their actual needs would be better considered in the services that are finally provided to them. In addition donor support is provided because fiscal decentralization promises under certain circumstances ***stronger accountability*** because citizens' participation and supervision are probably easier to achieve at local level (OECD, 2004).

Many donors support issues related to sustainable municipal finances both at the level of the ***overall system*** (legal framework for fiscal decentralization, development of institutions to handle a fiscal system) as well as at the level of the concrete ***fiscal system*** such as design of formula based intergovernmental transfers or tax allocation procedures and their implementation.

There is general agreement about the need that the overall intergovernmental fiscal architecture is conducive to sub-national governments. It is important that there is a coherent link between expenditure and revenue assignments so that local governments retain a significant share of the tax revenues collected, that there is a clear and conducive legal framework, and so forth (Steffensen, 2010).

3.1 Own revenues

Support to development of local government revenue sources is one of the cornerstones to sustaining the system of local governance in developing countries. Without significant revenue resources local governments will continue to depend on central government/donor transfers, and the important links between service delivery (benefits) and taxes (costs) will continue to be blurred and impact negatively on accountability.

In most developing countries people are reluctant to pay their local taxes because of the lack of transparency of how the local government collects and uses the taxes for service delivery. Therefore, some of the promising donor supported initiatives deal with ***providing information on fiscal issues to the general public***. Such information is disseminated through public meetings in which citizens get the chance of discussing the local government budgets and accounts. These meetings also serve as 'bargaining meetings' in which citizens can bargain that some of their taxes would be spent on addressing their most pressing needs.

Other promising donor supported programmes deal with ***establishing or updating the basis for tax assessment and the tax registers***. One example for this in the Balkans is the establishment of a cadastre system[2] as a basis to assess the local property taxes.

A further trend is to support programmes which encourage local governments to improve their own revenues by ***making donor grants or fiscal transfers conditional on the level of tax collection***[3].

Many donors not only support issues related to the local tax administration but also support governments in ***adapting the legal framework*** to allow local governments to raise more own revenues (i.e Benin: Introduction of 'Taxe de Développement Local' with support from GTZ, UNCDF and others) (Auracher & Nitschke, 2010).

3.2 Fiscal transfers

Intergovernmental fiscal transfer (IGFT) schemes/regulations (grants and equalization systems) have received donor support for some time. This is not surprising since such transfers are usually one of the main sources of local government revenues in developing countries. They usually account for more than 60% of the total income of local governments (Boadway & Shah, 2008). The aim is usually "to develop systems which are transparent, fair, objective, efficient, high yielding, equitable and, at the same time, simple and easy to administer" (OECD, 2004, p. 38).

Donor support to fiscal transfer scheme have to be viewed in the context of different government objectives with such regulations. On the one hand central governments may generally aim at providing more fiscal autonomy to local governments. In such cases government put fewer restrictions on how municipalities are to use central government transfers. Donor support in such cases is geared towards supporting formula based transfer schemes/regulations. On the other hand central governments may aim at keeping as much fiscal control as possible. In such cases the central government may make use of local governments to implement certain programmes, e.g. building of rural market places and will fund the specific programme by transferring earmarked grants to local bodies.

Many different donors, with the World Bank playing an important role, have supported governments in formulating laws and designing formula based IGFT systems. Donors mostly ***support formula-based equalization transfer systems*** which have clear advantages over the prevailing discretionary transfer systems in many countries[4].

Support to IGFT systems often starts with supporting a government to introduce capital or infrastructure development grants to local governments. This trend is described in more detail in chapter 3.3 below. The experiences made with the design and implementation of a formula based equalization system are often the basis for applying such a system not only for financing local infrastructure but also for the wider local government sector[5]. Positive examples in this regard are the 'Implementation Support Fund' that supports the 'Fiscal

[2] E.g. the cadastre reconstruction programme in Kosovo funded by donating countries like Switzerland, Norway and Sweden, and with the support by UNMIK and UN-HABITAT.
[3] Many of the Performance Based Grant Systems apply such conditionalities.
[4] Advantages of such systems: (i) they are the most important means to address regional disparities, (ii) they are based on the evaluation of a subnational government's entitlement on objective variables, and therefore reduce bargaining and lobbying and keep distribution fair, (iii) if well designed they eliminated the disincentives inherent in may transfers systems which encourage overspending and discourage own source revenue generation (Ma, J, 1997, Broadway, R & Shah, A (2006))
[5] This means that sector grants like agriculture, water, education, health etc. are mainstreamed into the local system of financing the local governments.

Transfer Strategy' in Uganda, and the 'Fonds D'Appui au Dévelopment des Communes[6]' in Benin, just to mention two of them (UNCDF, 2006).

3.3 Donor grants

Traditionally, donors have supported local infrastructure through project funding. In some cases, this has taken place through direct funding of infrastructure and in other cases through channelling the funds through central government rural infrastructure agencies.

More recently, donors have started providing grants to local governments for development activities. There is a range of different practices ranging from giving sector specific grants[7] to providing general development grants to local governments.

A trend that has been emerging over the past years points in the direction of providing general development grants to local governments, which are based on formulae and which have performance criteria attached to them. These schemes are often referred to as Performance Based Grant Systems or Output-Based Grant Systems.

There are many different donors[8], which have been supporting such programmes. The leading agency that has shaped this approach the most is probably the United Nations Capital Development Fund (UNCDF) (Romeo, 2003; Boschmann, 2009). UNCDF has piloted local government performance-based grant systems (PBGSs) that are now being adopted in a variety of countries. By linking the level of fiscal transfers to performance, PBGSs can provide incentives for local governments to improve themselves in a range of areas (such as revenue collection, planning, budget execution, downward/upward/horizontal accountability, financial management, and good governance in general) (Tidemand, 2009).

Early experiences were made in Uganda, followed by Kenya, Tanzania and other African countries. In Asia, Bangladesh was the first country to pilot such schemes. By 2009 at least 15 developing or transition countries had introduced PBGS, either on pilot bases or as part of the national IGFT schemes.

PBGS[9] differ from country to country. Most of them have in common that funds are on the one hand allocated to sub-national governments based on a general formula like traditional IGFT (population, land coverage, poverty level etc.). On the other hand the transfers are made conditional depending on the performance of the sub-national governments. The performance criteria can be broadly divided into two categories: (i) Minimum Conditions (MCs) and Performance Measures (PMs).

Minimum Conditions need to be met by sub-national governments in order to qualify to access Performance Based Grants (PBGs) or parts of it. MCs are usually designed to ensure minimum capacity of local governments to absorb grants and function as a 'minimum safeguard' for being able to handle the fiscal transfers. The MCs are generally derived from statutory requirements for sub-national governments like: (a) development plans approved by local government council on time, (b) decision making committees and core staff of local government in place, (c) financial statements produced on time, and (d) no serious audit queries (Steffensen, 2010).

[6] The mechanisms of the 'Fonds D'Appui au Dévelopment des Communes' is succinctly described by Auracher and Nitschke 2010.
[7] E.g. grants for water supply and sanitation as in the case of the DANIDA funded Hygiene, Sanitation and Water Supply Programme (HYSAWA) in Bangladesh.
[8] World Bank, UNDP, Norway, Ireland, Germany, UK, Australia, European Union, Denmark, Netherlands, Ireland, Canada, Belgium, Finland, Japan, France, African Development Bank
[9] For more details on PGBS please refer to Steffensen, J. (2010).

Performance Measures are the basis on which sub-national government, which fulfil the MCs, qualify either for an increased or decreased grant[10]. While these criteria have a very broad range, some of the common ones are mentioned here: (a) participatory planning process followed, (b) prioritization of expenditure to certain sectors and the poor/disadvantaged, (c) accountability measures in place, and (d) own revenue mobilization initiatives (Steffensen, 2010, Shotton, 2004).

PBGS often come in the form of capital grants for discretionary spending on capital investments and service delivery in various sectors. Usually, a part of the grant is allocated for investment servicing costs. There are also countries which use PBGS not only for funding capital but also for recurrent costs. All PBGS have capacity development for sub-national government built into the system (see chapter 3.5) (Pyndt & Steffensen, 2005).

3.4 Borrowing

Most local governments in developing countries get their capital budget from intergovernmental transfers or donor grants. In some countries[11] districts or larger cities are able to borrow from financial institutions or the bond market. In other countries local governments are not allowed to borrow[12]. In most of the poorest developing countries, where donors are most active, (rural) local governments find it difficult to access the capital market at reasonable costs.

Especially in transition countries there are donor initiatives which support sub-national governments' access to loans. These initiatives broadly fall into two categories: (i) supporting the framework for local government bond issuance, and (ii) supporting local government development banks.

With regard to issuing of bonds, the Municipal Support Programme North-Eastern Serbia, implemented by the Delegation of the European Union, was mentioned as a possible example of donor support. No further details on what the exact donor support looks like could be found though. In India, USAID has provided support to develop a municipal bond market for large cities. A methodology for rating municipal bonds was established by the Indian Credit Rating Agency, municipalities and the finance sector were exposed to the concept of a municipal bond market. Within a couple of years the first large cities raised considerable amounts through issuing of bonds (Blore, Devas, Slater, 2004). Although there are positive examples no trend is emerging in regard to donor support to this municipal financing modality.

Local government development banks have been established with donor support[13] in different countries[14]. These banks, which are usually controlled or regulated by the central government, allow local governments to access loans for infrastructure projects. Good examples of such banks adopt objective appraisal techniques for municipalities and their fiscal soundness, charge adequate interest rates and enforce repayment[15].

3.5 Building of capacities

International practice shows that any donor support to sustainable municipal finances must be backed up by well-designed options for capacity development.

[10] Although MCs are meant to be the basis to qualify for performance grants, political interference at times results in a situation where local governments get access to performance grants without meeting the MCs. An example for this is Tanzania.
[11] E.g. Argentina, Brazil, Colombia, South Africa, Albania
[12] This is often because central governments fear that they would have to bail-out local governments in case of their insolvency.
[13] The French and GTZ are among those that have been supporting such initiatives
[14] E.g. Morocco (Fonds d'Equipment Communal - supported by KFW, USAID, World Bank), Tunisia (Caisse des prêts et de soutien des collectivités locales – supported by AFD, World Bank)
[15] Interview with François Yatta & Gabor Peteri

Donors have recognized that capacity building with regard to supporting sustainable municipal finances in particular and local governance in general must go beyond training and address broader questions of political and institutional changes, leadership and public participation (Svensson, 2009). Donors started to understand that with regard to supporting sustainable municipal finances, capacity development needs to consider *the* ***overall governance system development*** *level* (e.g. fiscal decentralization framework), ***the organizational development level*** (e.g. enabling organizations like LG bodies to fulfil their roles), ***the human development level*** (e.g. developing skills and experiences of people working for a local government), as well as ***network development*** (e.g. fostering networks of municipalities).

At the level of system development a good donor practice is to ***support reforms of the budget cycle as well as the budgeting process***, which affect national as well as sub-national fiscal governance. These reforms deal with the (i) predictability of transfers, (ii) timely preparation of budgets at all relevant levels, (iii) inclusiveness and transparency of the budget, (iv) proper accounting, (v) and broad reporting and smooth flow of information (Boschmann, 2009) [16].

Another emerging donor practice at this level is to support setting up independent local government finance commissions[17], which has promising implication for intergovernmental relationships. The role of these commissions is similar to the role of the local government finance commission in Uganda which is 'to have oversight on all fiscal decentralisation issues in the country and advise the government and other stakeholders on appropriate framework to achieve the intended objectives of Uganda's decentralisation' (http://www.afdevinfo.com/htmlreports/org/org_39593.html).

At the level of organizational and human development capacity building programmes for local governments have commonly been supply-driven. This has led to criticism, especially because of the lack of ownership by local authorities and a failure to address their genuine needs. This has resulted in a recent trend (in donor support) away from mandatory and supply-driven capacity development for local governments to a ***more demand-driven modality*** (Shotton, 2004; Boschmann, 2009)[18].

One option followed is to build capacity development into a PBGS. This fund can be used by local governments to fund various capacity development activities (such as trainings, learning visits, restructuring, etc.). The idea of such grants is to allow local governments the choice both over what sorts of capacity need to be built and from which institutions the inputs should be obtained. For quality-control purposes, certain limits are placed on this discretionary power, with central government agencies playing a fundamental role in determining training standards, certifying training providers and ensuring transparency in procurement etc. Often demand-based capacity development is supplemented by supply-driven capacity development. Such supply-driven capacity development typically provides local governments with training in priority areas (planning, budgeting, procurement, accounting, reporting etc.) (Steffensen, 2010; OECD, 2005; Boschmann, 2009).

With regard to ***network development***, donors have supported associations of municipalities in different continents. In the South-East Europe such support has led to strong and thriving municipal associations, which are again linked in a regional network called Network of Associations of Local Authorities of South-East Europe (NALAS). In Africa, Latin America

[16] Among the donors supporting such reforms of budget cycles are DFID, DANIDA, UNDP, the World Bank, GTZ etc.
[17] E.g. in Uganda, Malawi and Nepal
[18] The key test case for demand-driven capacity building support is the District Development Project in Uganda.

and Asia there are also examples of well-functioning networks[19]. These networks usually play different roles: (i) lobbying and advocacy for members in relation to central government and donor; (ii) providing services to members like trainings, problem solving, information; (iii) dissemination of good practices (OECD, 2004; Pyndt & Steffensen, 2005).

Another capacity building mechanism, which is cited less frequently in the literature, is ***cross-border local government/community twinning initiatives***[20]. These are partnerships usually based on mutual needs and are thus, effectively demand-driven. They involve transfers of knowledge, skills and experiences through staff exchange, study and teaching, and on-the job training programmes (GSDRC, 2008a).

4 ANALYSIS OF SUCCESS FACTORS

The issues that underline the success of donor support to municipal finance can often also be seen as main challenges that need to be overcome. The points covered in this chapter are therefore also relevant for the following one in which the main challenges and critical issues for donor support to sustainable municipal finances are described. The success factors described in this chapter may also be treated as hypothesis for enhancing the financial room for manoeuvring of local governments.

Much of the success of donor support depends on the specific context. It is therefore crucial, in all aspects of donor support to municipal finance, that the context factors are considered. In resource-poor areas support looks different then in economically well-endowed urban areas. Where there is broad political support to improve municipal finance support looks different to where there is political resistance and interference at different levels of government. Understanding of the context factors requires a thorough analysis of the country's situation including the political economy of fiscal reforms.

Own revenues:

The following are some of the key issues addressed by successful donor support programmes to improve local government own source revenues. This is not an exhaustive list and many of these issues can be either seen as a pre-condition or an important issue to be addressed by projects:

- ***Conducive legal framework*** that governs the local governments' tax authority including a positive incentive system behind the collection of own source revenues (e.g. incentives for own revenue generation in fiscal transfer systems).
- ***Reliable tax management*** *system* including a sound database for tax assessment (e.g. updated cadastre plan, identification of taxpayers through taxpayer identification numbers).
- ***Transparency of local government*** towards citizens in how it assesses taxes, collects taxes, its plan, budget, procurements, reporting etc. Furthermore, local authorities need to be able to make people understand/experience the direct ***link between local taxes and local service delivery***. This leads to enhanced trust in the local government and improves tax compliance.

[19] E.g. the Uganda Local Authorities Association, supported by DANIDA, Uganda; the League of Municipalities of the Philippines supported by GTZ, USAID, Asia foundation UNFPA etc.; Municipal Associations in Bolivia
[20] The EU supports such twinning projects in the frame of the Instrument for Pre-Accession Assistance (IPA) in Albania, Serbia, Croatia, Macedonia & Turkey

Fiscal transfers:

Like for all other donor support in regard to sustainable municipal finance, there needs to be a strong ***national ownership and a political*** will to improve the intergovernmental fiscal transfer system (World Bank, 2008, DFID, 2008).

The general principle to make a ***clear link between the assignment of expenditure responsibilities and the allocation funds*** to local governments needs to be pursued.

The national budget that is ***assigned for fiscal transfers to local governments should be stable and predictable*** (e.g. as a percentage of the overall national budget) in order for local governments to have planning reliability.

The aim needs to be to ***integrate all current direct transfers*** (incl. those of line ministries to local governments) ***into the decentralised budgets*** to allow local governments make one plan and budget and follow uniform budgeting processes and requirements.

Existing conditional transfers with strict earmarking should gradually be relaxed and *replaced by* ***relatively unconditional – performance related transfers***. The condition needs to be that local governments are able to assure and demonstrate adequate system for planning, transparency in the budget process and compliance with financial rules and regulations.

Any good transfer system should ***distribute funds on the basis of a formula***. Discretionary or negotiated transfers are always undesirable. The equalisation formula should take into consideration both need and capacity (performance). The formula should be kept simple, reliable, and transparent as possible (Bird & Smart 2001, Chambas 2009).

There needs to be a ***balance between local discretion*** over the use of transferred funds and the need for the central government to ensure minimum quality standards ***and to pursue national objectives***.

Donor grants

One success factor of performance-linked funding is that it opens an avenue for ***developing a systems and incentives to improve downward accountability.*** It provides scope for improved checks and balances by building in systems of control and interaction between the local government councillors, the local government administration and the citizens (Pyndt & Steffensen, 2005).

Another such success factor is that PBGS provide a strong ***incentives to comply with legal requirements*** and have strong ***potential for promoting performance*** and ***strengthening of capacity of local governments*** in key intended performance areas (Steffensen, 2010).

There are a number of basic conditions that should be in place prior to supporting and introducing of a PBGS. These include:

- Peace, stability, a minimum local government capacity.
- Front-line service delivery and other staff should ideally be controlled by local governments in order to make them accountable for their performance.
- Clear expenditure assignment between tiers of government.
- Appropriate system of local government revenue assignments to make sure that operations and maintenance costs associated with capital investments can be covered.
- A review of the political economy prior to launching of a PBGS should be part of any design (Steffensen, 2010; Boschmann, 2009).

Furthermore the following design and operational issues need to be carefully dealt with in order to make PBGS a success:

- Identification of the indicators for local government performance.
- Design of the institutional arrangement with effective linkages to the overall decentralisation reform process.
- Integration of capacity building into the PBGS.
- Ensuring transparent and extensive communication in all phases of PBGS design and implementation.
- Ensure high credibility of the (performance) assessment.
- Ensure that complaints are objectively dealt with. (Steffensen, 2010, Boschmann, 2009)

Successful donor support further takes into account the issues that were discussed in regard to fiscal transfers (see chapter 4.2).

Borrowing

Most municipalities in developing countries and particularly the resource poor ones are not in a position to borrow in order to finance part of their infrastructure. Successful donor support therefore needs to concentrate on issues of supporting sound conditions of municipal finance, which are always a precondition for borrowing.

Capacity building

The following are some of the success factors related to capacity development:

- Need to acknowledge that supporting sustainable municipal finances is a ***long term process***, which depends on political will as well as technical expertise at different level.
- ***Capacity development is required on all government levels.*** There is also a need that capacity development addresses the vertical linkages of different tiers of government (Romeo, 2004; Boschmann, 2009, Arn).
- Supply driven capacity development to establish basic capacities needs to be supplemented with ***demand driven capacity development*** approaches.
- Linking trainings of civil servants with the one of political representatives to minimize the gap between politics and administration.
- ***Alignment of capacity development programmes*** with the one of the client country and harmonisation among donors. Support to national strategy on capacity development rather than conducting parallel capacity building programmes.
- Need to consider ***gender and diversity issues*** in capacity building.

5 CRITICAL ISSUES AND PRELIMINARY HYPOTHESIS FOR ENHANCING THE FINANCIAL ROOM FOR MANOEUVRING OF LOCAL GOVERNMENTS

The critical issues that are highlighted in this chapter only represent a selection of challenges that are faced in regard to donor support to sustainable municipal finances. These critical issues can again be treated as hypothesis for enhancing the financial room for maneuvering of local governments.

General issues

Supporting sustainable municipal finances is a complex issue. There seems to be a general lack in donor support of a **systematic approach** that address all aspects of municipal finances, like the legal framework, the fiscal and institutional framework, local government incentive systems and related capacity development requirements (OECD, 2004).

Own revenues

- Local government tax assignment is often of a nature which makes it difficult to raise taxes with adequate transaction costs (e.g. low yielding taxes on agricultural produce and small enterprises). Donor support to improve tax revenues in such a situation may not be cost effective. It may furthermore not result in improved accountability towards citizens because tax income may be too low to create the link between services received and taxes paid.
- Where there is political interference and tax evasion without sanctions donor support may not achieve the intended outcome as this generally leads to reduced tax compliance.
- As of today many central government fiscal transfer system and donor grant programmes create disincentives to improve local government own revenue mobilization because those transfers have the effect of crowding out local revenues to finance the budget of the municipalities.
- The challenge is to make people understand and experience the direct link between taxes paid, and services that reflect the people's priorities received. As long as this link is not established people will be opposed to paying taxes.
- Interference by central governments, e.g. setting of ceilings for SMEs whereby growing business become tax liable to central instead of local government (Albania).

Fiscal transfers

- Fiscal transfers need to be accompanied by capacity development. Where this is missing there is a risk that local governments cannot handle the funds received and allocation efficiency remains low.
- Wherever (sector earmarked) development funds are not integrated in the local government budget, this leads to a lack of transparency in resource allocation and a fragmentation of local government planning and budgeting.
- Central government or political interference in local government planning may lead to weak downward accountability, less effective resource use and declining local participation.
- Fiscal transfers need to be accompanied by wider local government reforms like the transfer of human resources to local governments and reforms to the local own revenue base.

Donor grants

- Many PBGS and other donor grants operate outside the general intergovernmental fiscal transfer system. It is a great challenge to transform these grant systems into the national fiscal transfer system.
- PBGS should be aligned with the central and local government budget cycle. If they are not aligned this may result in late announcement of the volume of grant allocation

and/or late transfer of the grants to local governments. Such a situation may in itself be the cause of poor performance of local governments, since they may not have adequate time to do their planning, budgeting and implement their plans.

- There is a need for better coordination between general donor grants to local governments, donor support to sector programmes, and scattered donor support to district development programmes. Local governments in some countries are faced with more than 20 reporting and multiple auditing systems. The aim must be to merge different donor support to local governments within central government transfer schemes and support general audit and control institutions to improve accountability and sustainability.
- Simply increasing the level of local government funding, without ensuring that local government have the required absorptive capacity and that they spend the fund with a degree of efficiency or effectiveness, may not solve the problems associated with local service delivery.
- Large increase in grants without sufficiently considering the possible disincentives (e.g. local own source revenue generation) will lead to undesirable outcomes.
- Long-term commitment of donor grant is often missing making it challenging for local governments to implement medium and long-term development plans.
- A critical aspect regarding the sustainable impact of investments financed by donor grants is how local governments in the long term can be enabled to cater to the recurrent costs of infrastructure investments.

Borrowing

- Since many local governments in developing countries are not yet in a position to borrow from the capital market, donors should in the meantime invest in improving the financial management. A transparent and solid financial management of local governments is always a prerequisite to access loans.
- In view of the difficulty of accessing the capital market, donors may support the establishment of municipal development banks to promote lending to local governments to fund large infrastructure projects.

Capacity Development

- Capacity development and fiscal transfers (incl. donor grants) to local government must go hand-in-hand. Capacity development without the transfer of funds may lead to frustration of local governments and participating citizens. Fiscal transfers without capacity development may result in low degree of efficiency and effectiveness in the use of the transferred funds.
- Capacity development in regard to municipal finances always has to be aligned with national government capacity development programmes and priorities. Ideally, donors should support/follow national standards and strategies for capacity development and work through mandated national capacity building organisations.
- There needs to be a balance between demand- and supply-driven capacity development support.

Annex A: Bibliography

Auracher T. & Nitschke U. 2010, *Die richtige Balance*, in Entwicklung und Zusammenarbeit Nr. 9, 2010

Bird, R & Smart M (2001), *Intergovernmental Fiscal Transfers: Some Lessons from International Experience*.

Blore I, Devas N, Slater R (2004*), Municipalities and Finance, A Sourcebook for Capacity Building*, Earthscan, London

Boadway R & Shah, A (2008*), Intergovernmental Fiscal Transfers, Principles and Practice*, World Bank, Washington

Boschmann N (2009), *Fiscal Decentralisation and Options for Donor Harmonisation*.

DEGE Consult (2006), *Survey on Support to Local Governance and Decentralisation for the Informal Donor Working Group on Local Governance and Decentralisation*.

DFID (2008), *DFID's Contribution to Decentralisation and Local Governance (D/LG): A Stocktake*, London.

European Commission (2007), *Supporting Decentralisation and Local Governance in Third Countries,* European Commission, Brussels

GSDRC (2008a), Helpdesk Research: Demand-Driven Technical Assistance.

IDS (2007), *How Does Taxation Affect the Quality of Governance*, IDS Policy Briefing, Issue 34, IDS, Sussex

OECD (2004*), Lessons Learned on Donor Support to Decentralisation and Local Governance*, OECD, Paris

Pyndt H, Steffensen J (2005) *World Bank Review of Selected Experiences with Donor Support to Decentralisation in East Africa*, Local Government Denmark.

Romeo L. G. (2003), The Role of External Assistance in Supporting Decentralisation Reforms in Public Adminstration and Development, John Willey & Sons Ltd, New York

Shotton R. (2004), *Local Government Initiative:Pro-Poor Infrastructure and Service Delivery in Rural Asia, A synthesis of case studies*, United Nations Capital Development Fund, New York

Steffensen, J (2010), *Performance Based Grant Systems, Concepts and International Experience*, UNCDF, New York

Tidemand P (2009), *Sector Budget Support in Practice, Desk Study, Local government Sector in Tanzania*, Overseas Development Institute, London

World Bank (2008), *Decentralization in Client Countries, An Evaluation of World Bank Support, 1990–2007*, Washington

http://www.afdevinfo.com/htmlreports/org/org_39593.html

Annex B: Experts interviewed

Experts contacted for interviews:

Daniel Arn	Partner of Advokatur Arn Friederich Strecker
Jamie Boex	Senior Public Finance Expert and Chief Executive Officer, Public Finance & Development Solutions, LLC
Bernard Dafflon	Professor, Public Finance, University of Fribourg
Gabriel Ferrazzi	Decentralisation and governance expert
Richard Gerster	Director of Gerster Consulting
Mary Hobley	Consultant
Roy Kelly	Professor of the Practice of Public Policy, Standford School of Public Policy
Wolf Linder	Professor (Emerit), Institute of Political Science, University of Berne
Gabor Peteri	Executive Director of LGID
Jesper Steffensen	Senior Partner and Consultant, DEGE Consult
Arne Svensson	President of Professional Management
Per Tidemand	Senior Partner and Consultant, DEGE Consult
François Yatta	Regional Councilor for Local Finance and Economy at the Municipal Development Programme

Experts interviewed:

Daniel Arn	Partner of Advokatur Arn Friederich Strecker
Richard Gerster	Director of Gerster Consulting
Wolfgang Linder	Designation, University of Berne
Gabor Peteri	Executive Director of LGID
Arne Svensson	President of Professional Management
François Yatta	Regional Councilor for Local Finance and Economy at the Municipal Development Programme

Annex C: Guidelines for the elaboration of the case studies

Introduction

The SDC "Decentralisation and Local Governance Network" (DLGN) and "Knowledge and Learning Processes" (KLP) divisions are implementing a learning project on successful approaches of capacity development and financial support for municipalities and districts.

The project analyses five main categories of financial/technical resources:

- Local governments' own revenues
- Intergovernmental fiscal transfers
- Donor grants
- Borrowing
- Capacity development

KEK-CDC Consultants and LerNetz were mandated by SDC

- to write a concept note summing up the international good professional practice;
- to facilitate an experience capitalization of SDC funded programmes; and
- to present the results in a user-friendly, learning-oriented format.

Approach of the learning project

The experience capitalization of SDC funded activities shall be conducted in a participatory way by partner and SDC staff:

- The main experience capitalization and learning phase of the project will take place in November and December 2010. Participants are expected to reflect on their experience while participating in an electronic discussion, investing roughly half a day per week for 8 weeks. Including the write-up and editing of case studies the total time needed to participate in the project will be 5 to 10 days during those two months.
- There will be a coaching of KEK-CDC during the elaboration of the case studies.
- English is the main working language. However, if necessary, case studies and comments can also be written in French or Spanish.
- The SDC experience will be compared by KEK-CDC with the international good practice. The results of the entire learning project will be integrated by LerNetz into a "LernBuch" (literal translation: learning book). This platform will be built in January/February 2011.
- The project results and the LernBuch will be presented and validated in a half-day workshop during the March 7th through 11th 2011 DLGN f2f meeting in Sarajevo.
- The DLGN wiki workspace will be used for uploading documents in regard to the learning project.

Steps regarding the elaboration of case studies

- Participation in the learning project is based on three different levels: (i) writers of a case study, (ii) predefined peer-review, and (iii) peer review by participants of the learning project.
- The predefined peer groups[21] shall support each other in the process of developing the case studies.
- The writing of the case studies will be carried out by tandems (teams) in each country. The teams are composed of those persons who committed to contribute to the learning project in the same country.
- The case studies will be elaborated in the following manner:
  1. Draft outline on the content of the case study (bullet points in the template)
  2. Writing of a first draft of the case study by the tandem writers
  3. Review of the first draft by the pre-defined peer group
  4. Revision of the first draft by the tandem writers
  5. Second peer review by an enlarged group of peers (participants of the learning project)

  There will be continuous feedback and support from KEK-CDC.
- The writers of a case study will base their case study on the following three pillars:
  1. the concept paper written by KEK-CDC;
  2. the hypotheses formulated by the tandem writers in their case study; and
  3. the writers' own experiences in the field of the case study.
- The writers of a case study **shall follow the structure of the template** and directly type their text into the template.
- The peer review of the case studies will be carried out in the following manner: The predefined peer group firstly gives an overall feedback of 1 page on the case study. Secondly, it comments the case study in "track changes" mode with corrections and comments directly in the original text of the case study.
- In a second round, the case study will be sent to all participants of the learning project. This larger group will respond with their own comments on the case study. Subsequently, the writers of the case study will finalize it, duly taking into account the feedback and comments of the second round of the peer review.
- Lastly and only if needed, KEK-CDC will edit the final version of the case study.

Schedule

What	Who	Deadline	Role of KEK-CDC
Draft outline	Writers of case study	10 November	Coaching
First draft	Writers of case study	20 November	Coaching
1st peer review	Predefined peer group	3 December	Coaching
1st revision	Writers of case study	10 December	Coaching
2nd peer review	Participants of learning project	31 December	Coaching
Finalization	Writers of case study	9 January	Coaching
Final editing	KEK-CDC	16 January	Final editing

[21] The peer groups will be decided by SDC and KEK-CDC and communicated by early November.