

Fiscal Decentralisation

Rationale, core elements and theoretical concepts

Prepared by
Roland Fischer & Stefan Pfäffli

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1. Meaning of the Idea

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Basic idea of fiscal decentralisation

- Transfer of expenditure and revenue authority from central government to subnational entities where possible
- Based on **Subsidiarity Principle**
Functions should be allocated at the lowest possible state level. Higher state level take over responsibility only in case of overstraining lower tiers. Allocation at higher state level must be justified by higher effectiveness.
Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy (European Charter of local self-government, 1985).
- In accordance with the **Decentralisation Theorem**
In the absence of cost savings from centralization¹ and inter-jurisdictional externalities², fiscal responsibilities should be decentralized. (Oates, 1972).

¹refers to “economies of scale”

²refers to “spill-overs”

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Types of decentralisation

Fiscal decentralisation is only one type...

- **Political decentralisation**

More power for local citizens or their representatives in local decision making, e.g. local elections of mayors and council members, strengthening of local legislatures, development of a pluralistic party system

- **Fiscal decentralisation**

Transfer of spending and funding authority towards the local level, improving the adequacy of local finances, including local borrowing, and reforming fiscal equalisation

- **Administrative decentralisation**

Clarification of roles and responsibilities of central and local governments, agencies or public enterprises, etc. with the fulfilment of functions especially with regard to planning, execution, financing, reporting, oversight for specific functions. Reallocate administrative authority in the sense of the subsidiarity principle.

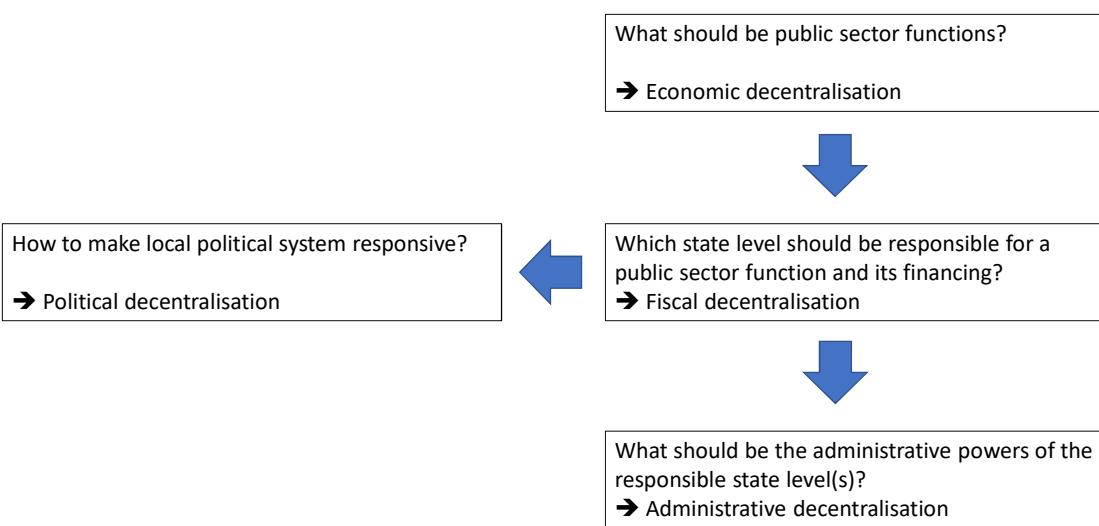
- **Economic/market decentralisation**

Shifting responsibility for functions from the public to the private sector through privatisations of service provision by private businesses, community groups, NGOs, etc. and through deregulation reducing the influence of the public sector and leaving more room for coordination via market mechanisms.

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Relation between types of decentralisation



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Three forms of administrative decentralisation

- **De-concentration**

Allocation of specific responsibilities for the fulfilment of public functions **at lower levels of central government**

Example: Regional directorate of ministry of agriculture is responsible for forestry.

- **Delegation**

Transfer of specific responsibilities for the fulfilment of public functions to **semi-autonomous organizations**, such as public enterprises or cooperations, etc., or to **lower levels of government**. These executing entities usually have substantial discretion in the way how to execute the function. However, the central state remains responsible for the function and its financing; typically, the central state or one of its ministries makes the strategic decisions. Executing entities are accountable to the central state or the respective ministry.

Example: Contract of ministry of agriculture with provinces or with regional semi-autonomous forest agencies on the execution of the forestry function

- **Devolution**

Transfers of the complete responsibility for the fulfilment of specific public functions to the **lower state level**.

Example: Provinces or municipalities are fully responsible for the forestry function including strategic decision making, investment decisions, financing and execution. Downward accountability to local citizens.

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2. Rationales for Fiscal Decentralisation

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Economic Rationales

- **Improved effectiveness** of the public sector. Services more in line with local preferences. Better responsiveness to local preferences.
- **More efficiency** through less complexity, shorter and faster, less bureaucratic decision making paths, locally adequate solutions.
- Advantages for **regional economic growth**
- **Improved distributive effects** of budgetary allocations
- **More system efficiency** through innovations and competition among systems

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Political Rationales

- **More participative decision making** and community empowerment; greater voice of local citizens in the allocation of budgetary resources
- **More accountability** to local voters
- **More checks and balances** in the political power game and more stability and resilience in case of political changes
- **Concession in case of local efforts for autonomy** or even independence campaigns
- **More freedom** to make choices in a diverse society

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Rationales of fiscal decentralisation and reality

- Does fiscal decentralisation lead to better results regarding service provision, poverty reduction, economic development, etc.? Positive effects are not guaranteed.
- What matters for success is that
 - Decentralisation reform is done comprehensively
 - Local governance including public financial management is functional
 - Civil servants are well qualified
 - Higher and lower state level adopt a collaborative attitude
 - Citizens and their representatives are empowered
 - Media are free, pluralistic democracy is in place
 - State supervision and judiciary is functional
 - Sense of community is developed locally and nationwide

Discussion: What if things are missing?

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3. Theoretical Public Finance Concepts

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The meaning of functions

- In our context, when we say functions, we mean **government functions** like health, education, defence, protection of environment, etc.
 - The **functional classification** offers an overview of these functions. Internationally, this classification follows the standardized COFOG classification.
 - In addition to the government functions, **management functions** do exist. These are planning, financing, implementation, etc. In the first place, when we talk about the allocation of functions, we discuss the question of which state level is responsible for which government functions. However, joint responsibilities of different state levels are frequent. In such cases, it is needed to clarify which state level is responsible for which kind of management function.

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Economies of scale

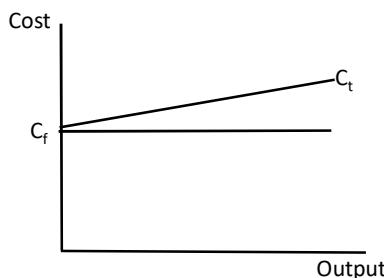
Definition

Saving in costs per unit by increasing the level of production

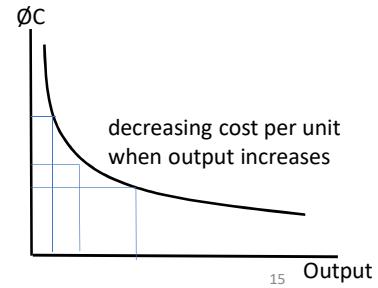
Example

Number of student per class

Affects allocation (and financing) of functions



C_f : fixed costs like classroom, teacher
 C_v : variable costs like school books
 C_t : total cost = $C_f + C_v$
 $\varnothing C$: cost per unit



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Spill-over effects

Definition

Impact of own activities or facilities on third parties, beneficial or adverse.

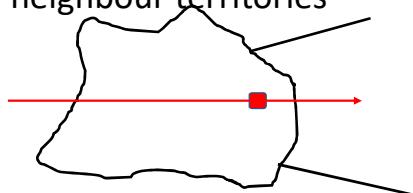
Affects allocation (and financing) of functions

beneficial

- Inner-city park, museum, library, sport facility or public transportation system subsidized by inner-city government but frequented also by population from outside.
- Afforestation paid by local government.

adverse

- Particle emission from waste incinerator blown to neighbour territories
- Noise from airports for neighbour territories



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Further principles considered

- **Disentanglement principle**
=> Avoiding overlaps and duplications
- **Fiscal equivalence principle**
=> Each function of government should be financed at the level at which it is consumed. In addition, this state level must have the power to make the necessary decisions on the services provided and on its funding
- **Finances follow functions principle**
=> Allocation of functions based on decentralization criteria first
=> Reallocation of functions = reallocation of costs → revenues must follow suit
- **Cooperation principle**
=> Effective cooperation in case of shared or delegated functions or horizontal collaboration

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4. The Pillars of Fiscal Decentralisation

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Overview of main fiscal decentralisation pillars

Allocation
Of
Functions

Allocation
Of
Revenues

Fiscal
Equalisation

Empowerment of people – strengthening of local governance

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4.1 Allocation of Functions

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Basic ideas of functional allocation

- Allocation of functions = first pillar; starting point
- Allocation of functions includes to a large extent allocation of expenditure
- Disentanglement of functions as much as possible
- Subsidiarity principle as reference point
- In cases where full disentanglement is not possible, clear allocation of administrative powers and financial responsibilities

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Main considerations for the allocation of functions

- **Allocative efficiency**
Do the right things!
 - => Who should decide on the how much of what?
 - => Consider spill-over effects!
- **Operational efficiency**
Do the things right!
 - => Who should implement and decide on the how to produce?
 - => Consider economies of scale!
- **Equity**
 - Should everybody have a fair share of a particular service whether he/she can pay for the service or not?
 - => For whom?
 - => Is there a need for quality standards?
Example:
Good education or health services for everybody
- + Economic stability + economic growth concerns

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Simplyfied Criteria for the Allocation of Functions FRHW5

	Yes	No
Are there economies of scale?	<ul style="list-style-type: none"> • Allocation at higher government level, or • Horizontal collaboration with earmarked grants 	Allocation at lowest possible level
Are there spillover effects?	<ul style="list-style-type: none"> • Allocation at higher government level, or • Horizontal or vertical collaboration with earmarked grants 	Allocation at lowest possible level
Are there large disparities between subcentral governments and/or equity concerns?	<ul style="list-style-type: none"> • Allocation at higher government level, or • Horizontal or vertical collaboration with earmarked grants • Allocation at lowest possible level combined with fiscal equalization 	Allocation at lowest possible level

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Types of functions

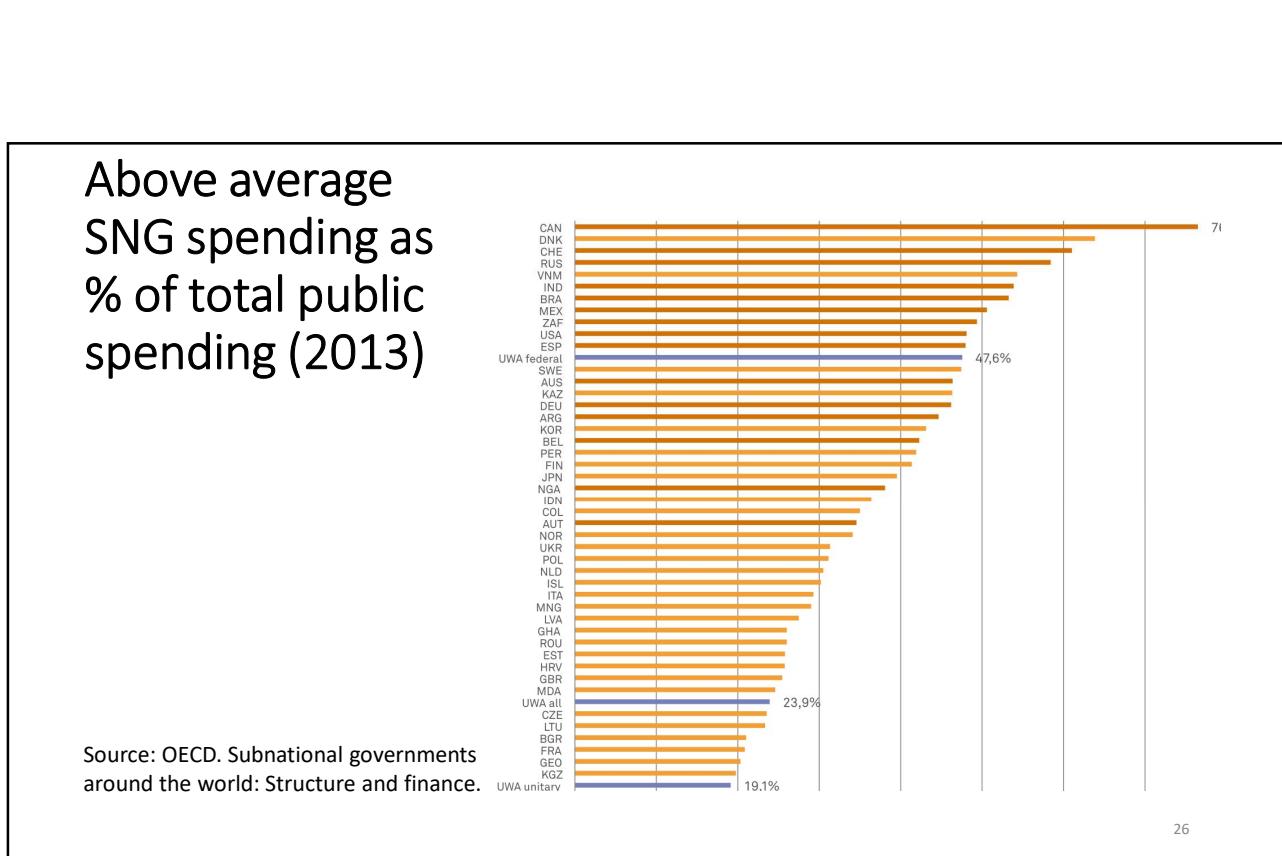
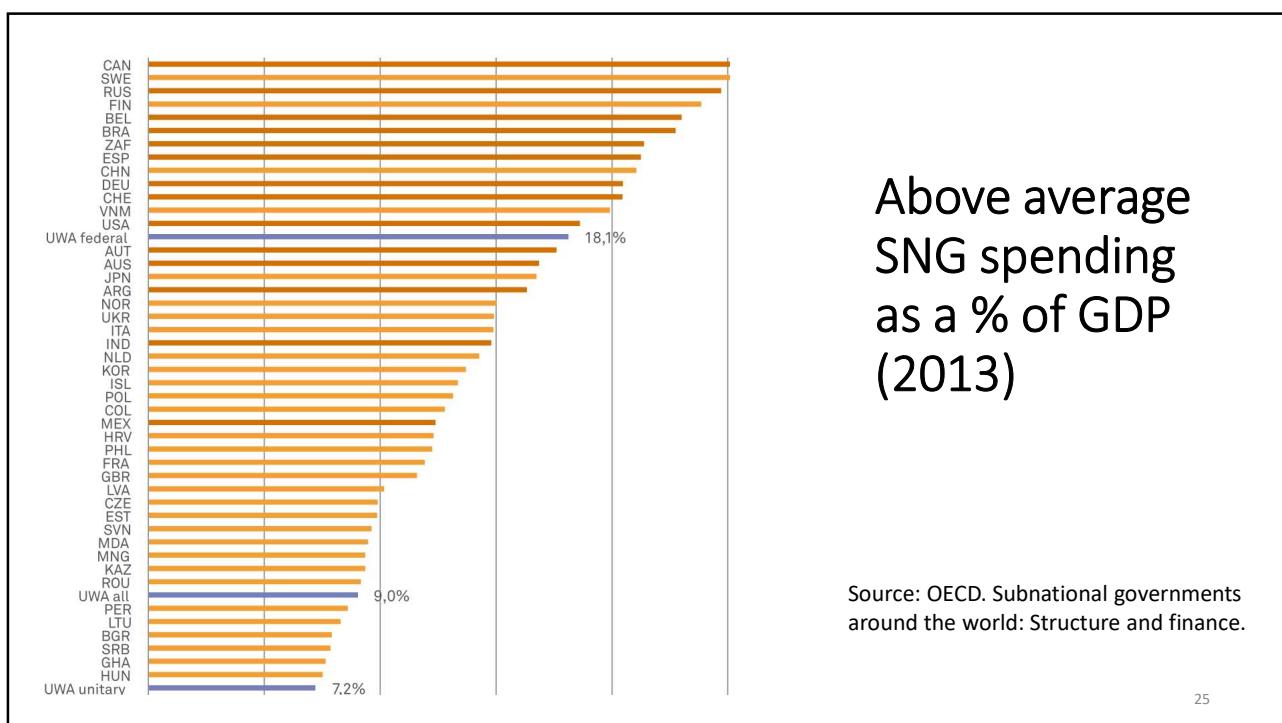
- **Own functions:** exclusive responsibility of one state level
 - ➔ e.g. municipal, cantonal or central state functions (with centralized or de-centralized implementation)
 - ➔ Financing by responsible state level only also in case of delegated functions when implementation is decentralized
 - **Shared functions:** vertical collaboration function
 - ➔ Higher and lower level work together
 - ➔ Typically higher level is responsible for strategic decision making; lower level for execution of the function
 - ➔ Joint financing of higher with lower state level
 - **Horizontal collaboration function:** collaboration at the same state level
 - ➔ Joint execution of a function (a) by a joint body or (b) through outsourcing to a utility or (c) when one local government provides a service also for other local governments based on a contract
 - ➔ Joint financing of the function
 - ➔ Mandatory or non mandatory horizontal collaboration
- ➔ Only “own functions” are fully disentangled. In the other cases, clarification of administrative competences of each involved state entity is highly important.

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FRHW5 Diese Folie als Alternative zum Entscheidungsbaum

Fischer Roland HSLU W; 04.09.2018



4.2 Allocation of revenues

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Revenue sources

- **Own revenue**
 - Taxes
 - Fees
 - Fines
- **Transfers**
 - Shared taxes
 - Unconditional, non-earmarked grants
 - Conditional, earmarked transfers

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Fiscal autonomy

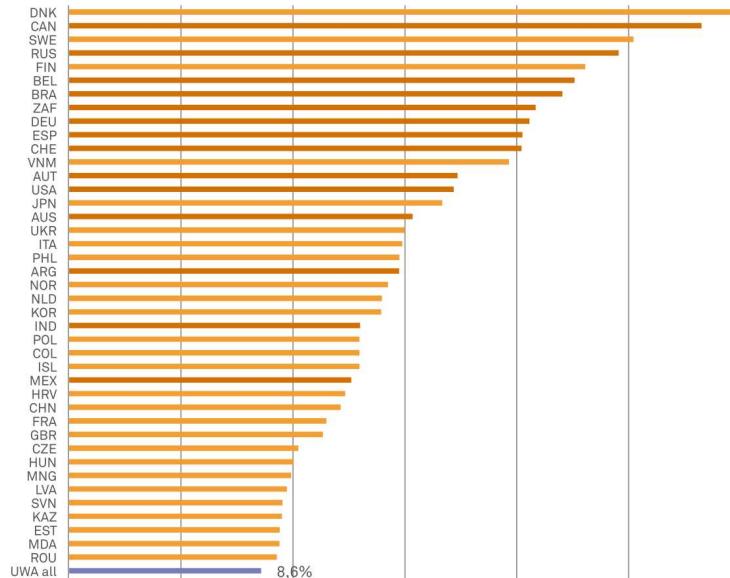
- Adequacy of revenue to finance the assigned functions (avoiding unfunded mandates)
- Yielding own taxes with good economic growth elasticity, right to adjust tax rates
- Predictable, formula-based transfers

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Above average subnational revenue as % of GDP

Source: OECD. Subnational governments around the world: Structure and finance.

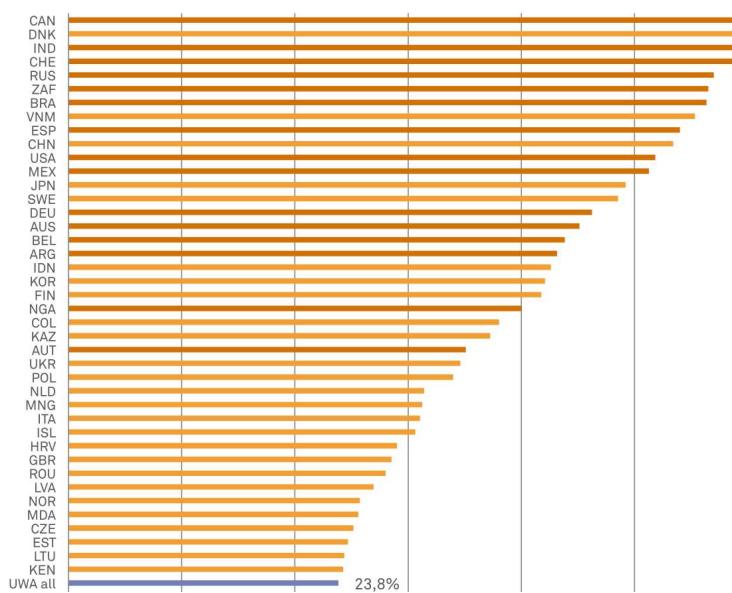


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Above average SNG revenue as a % of public revenue (2013)

Source: OECD. Subnational governments around the world: Structure and finance.

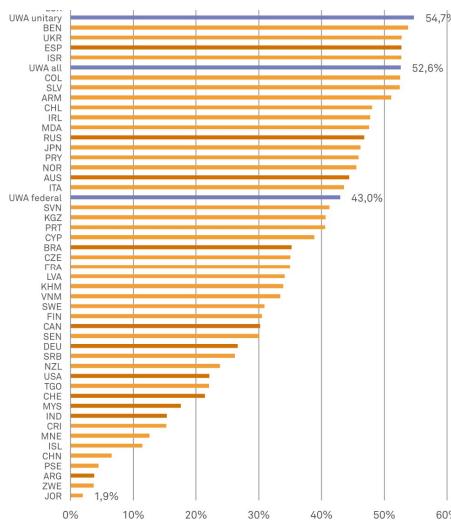


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Below average transfer share as part of SNG revenue (2013)

Source: OECD. Subnational governments around the world: Structure and finance.



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4.2 Fiscal Equalisation

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Rationale for fiscal equalisation: Horizontal equity

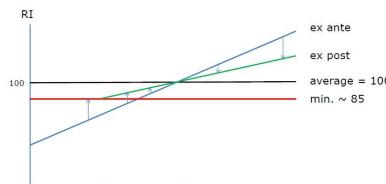
- Building-up the capacity of sub-national governments to provide comparable levels of public services at comparable levels of taxation.
- Without equalization, less ability to respond to local needs in economically poor LGUs.
- Two aspects:
 1. Reduction of revenue disparities
 2. Compensation of higher cost per capita

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Resource equalisation and cost compensation

- Resource equalization



- Non-earmarked transfers
- Empiric research needed on the revenue potential and on simulations on the redistributive effect of alternative indicators

- Cost compensation

- Information needed on fixed and variable running cost and on capital investment spending
- Research needed for identifying cost drivers pushing cost above average and assessing their true weight
- Situation of cost situation of capital city / larger cities
- Construction of a simple compensation model with non-earmarked cost compensation transfers

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“Good governance” issues of fiscal equalisation

- Formula driven equalization regimes are preferable to ad hoc funding arrangements.
- Major features of an equalization mechanism should be exogenous. SNGs should not have the power to influence the relevant parameters for the allocation of funds
- Clear measurement of disparities, transparency of pool, criteria, formula, relevant statistical data, allocation of funds. Jealousy of SNG make sure that allocation takes place in a correct way.
- Advantage of having an independent body outside SNG deciding on the measurement of disparities and the allocation rule. However, this body (agency) is only as good as it remains un-corrupt.

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4. Risks and Risk Prevention

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Risk overview

- Project risks
 - Length of project
 - Incompletely designed reform
 - Not tangible
 - Resistance from line ministries and their deconcentrated entities
 - ...
- Decentralisation policy risks
 - Regional divide
 - Unprepared local governments
 - State capturing
 - Fiscal unsustainability
 - ...

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Project risks

Risks	Measures
Length of project	<ul style="list-style-type: none"> - Decentralisation strategy approved by government and based on broad consensus - Strong political leadership with effective and participative project organisation - Well sequenced and communicated project plan
Incompletely designed reform	<ul style="list-style-type: none"> - Improve reform design
Not tangible	<ul style="list-style-type: none"> - Communication measures - Indicator-based monitoring system - Visibility of local and national faces of reform champions
Resistance from line ministries and deconcentrated entities	<ul style="list-style-type: none"> - Political economy analysis - Involvement of ministries and of strong figures from local level in project organisation - Strong political leadership
...	

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Decentralisation policy risks

Risks	Measures
Regional divide	<ul style="list-style-type: none"> - Allocation of adequate financial resource at local level - Fiscal equalisation - Regional economic development
Unprepared local governments	<ul style="list-style-type: none"> - Capacity building especially with regard to local PFM - Deployment of former line-ministry specialists to the local level - Possibly merger of local governments or horizontal collaboration
State capturing	<ul style="list-style-type: none"> - Empowerment of disadvantaged groups at local level - Open budgeting processes, strong downward accountability - Internal control, internal and external audit, supervision by central state - Free media
Fiscal unsustainability	<ul style="list-style-type: none"> - Adequacy of local finances; no unfunded mandates - Vertical and horizontal fiscal equalisation - Strengthening of local PFM - Hard budget constraint, no bail out
...	...

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