

Fiscal Decentralisation

Fiscal Decentralisation and Beyond: Norms, Linkages and Basic Reform Challenges

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Outline

- I. Fiscal Decentralisation Summary: Revisiting Fundamental Issues and Commonly Recommended Reforms
- II. Is the Traditional Fiscal Decentralisation Approach Fit for Purpose?
- III. Moving Beyond Fiscal Decentralisation: The Need for a Broader Integrated Approach
- IV. Empirical Evidence and the Larger Landscape of Decentralisation

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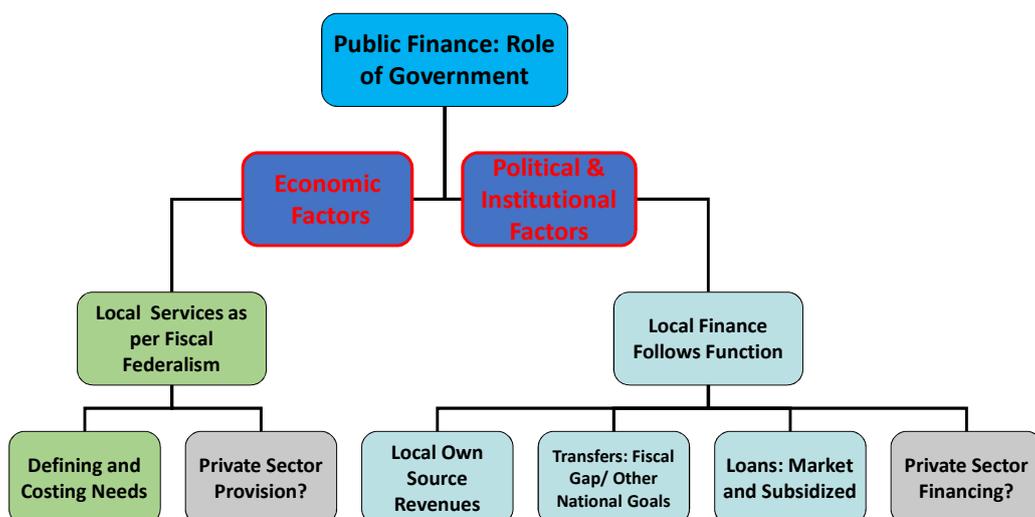
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I. Fiscal Decentralisation Summary: Revisiting Fundamental Issues and Recommended Reforms

- As discussed in previous sessions, for subnational governments to meet their responsibilities and deal with challenges they face, the elements of an **effective intergovernmental fiscal system** must be in place and functioning well:
 - Expenditure Assignment and Management
 - Local Revenue Generation and Autonomy
 - Intergovernmental Transfers
 - Local Government Borrowing and Investment Finance (where appropriate)

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Fiscal Decentralisation: Public Finance Design Perspective



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Subnational Government Finance: Progress and Challenges

- There have been **significant improvements** in subnational finance systems in many industrialized and developing countries in the past decades, including, for example:
 - Increased local expenditure functions/efficiency
 - Enhanced local revenue opportunities
 - Adoption of local governance innovations, such as participatory budgeting
- **Outstanding challenges** in subnational finance systems, however, remain pervasive globally, albeit in different forms and to different extents

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Expenditure Assignment and Management

- **Lack of clarity** in expenditure assignment
- Substantial **concurrency** in assignment
- **Inappropriate/insufficient/unenforced** expenditure assignment
- **Unfunded mandates**/offloading of expenditure mandates to subnational governments
- **Excessive control** by higher level authorities, e.g. budget approval
- **Lack of incentives** for local expenditure efficiency

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Local Revenue Generation and Autonomy

- Considerable vertical **fiscal imbalances**
- Problematically low revenue **autonomy**
- Inadequate **diversification** of the local tax base
- Challenges with what is often recommended as a **main local tax (property tax)**
- Neglect of potentially productive **fees and user charges**
- **Political constraints** on increasing local revenues
- **Balancing local and central roles** in revenue collection

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Intergovernmental Transfers

- Inadequate and unstable **pools of national resources** to share with local governments
- **Challenges with creating an appropriate mix** of unconditional and conditional transfers
- Lack of attention to **horizontal fiscal imbalances** across local jurisdictions
- **Information and design challenges**: equalisation transfers and conditional transfers
- Insufficient use of **innovative transfer mechanisms** (e.g. performance based grants)

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Subnational Government Borrowing and Investment Finance

- **Borrowing and fiscal responsibility frameworks** often poorly developed and implemented
- Subnational governments often have poor and unreliable **access to credit**
- **Special credit institutions** commonly set up to lend to local governments often underperform
- **Central government practices** such as bailouts and automatic intercepts have disrupted the normal development of subnational credit markets
- **Other aspects of the subnational finance system** sometimes not conducive to borrowing

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Possible Subnational Finance Reform Trajectories

- Different regions and countries are at **different levels of development** and refinement of their decentralized fiscal frameworks
- **General recommendations based on international analysis and consensus need to be properly adapted**--will apply to different extents in different countries:
 - Some need to start from a zero base
 - Some just require modest refinements
 - Most are in between these extremes, along a broad spectrum of system development

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Expenditure Assignment and Management

- **Central goal: Identify clear and exclusive responsibilities for each level of government**
- Consider use of **asymmetric assignments** where local capacity is limited
- **Clarify responsibilities for concurrent competencies**— regulation, financing, and implementation
- **Avoid unfunded mandates** that are unlikely to be met
- Develop better methods to **translate responsibilities into expenditure needs** and associated financing requirements
- **Reduce/eliminate funding/staffing of deconcentrated line ministry offices** where relevant
- **Reduce/eliminate higher level controls** on subnational expenditures, including *ex ante* control of local budgets

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Local Revenue Authority/Autonomy

- **Central goal: Increase own revenues and local discretion**
- **Diversify** the subnational tax base (as feasible and appropriate):
 - Avoid nuisance taxes/local distortions
 - Use vehicle taxes, business licenses, betterment levies, etc. (avoiding conflicts with higher level revenues)
 - Introduce local piggyback taxes (with a flat or limited rate)
 - Use 'green' taxes for waste management, pollution, energy production
- **Increase subnational discretion** to raise fees and user charges
- **Reform and modernize local (including property) tax administration** with improved collection incentives
- **More fully engage local officials** in mobilizing local revenues, linking them to service delivery, and using them more transparently so as to improve local governance and compliance

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Intergovernmental Transfers

- **Central goal: Assure predictable, regular and transparent transfer mechanisms**
- Secure an **appropriate balance** among types of transfers (using separate instruments for different goals as appropriate)
- Expand and improve the use of **equalisation transfers**
- Review and improve mechanisms for allocating resources under **conditional grants**
- **Consolidate grants** where large numbers of poorly coordinated programs exist
- Consider the use of **performance-based transfers** where appropriate

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Subnational Government Borrowing and Investment Finance

- **Central goal: Promote prudent, fiscally responsible local government borrowing**
- Develop and strengthen **legal and regulatory frameworks** for subnational government borrowing
- Expand borrowing **options and support**, including financial intermediaries/ municipal development funds
- Recognize **linkages**--how local investment and borrowing are affected by other aspects of the local fiscal system
- Adopt **other relevant finance mechanisms** (tax increment financing, betterment levies, public private partnerships, etc.)
- In developing countries make better use of **international financial institution funds** (likely to remain a major source)

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Framing Supportive Institutional Reforms

Local finance reforms will need to be supported and reinforced by institutional measures, such as:

- **Establishing a means for a regular and systematic dialogue** between subnational governments and the central government on intergovernmental and local financial policy
- **Avoiding unjustified creation of new subnational governments** and dealing with existing fragmentation issues
- **Identifying appropriate roles for and interactions** between deconcentrated and devolved government levels and entities
- **Rethinking the role of parallel institutions**, which are common in developing countries

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II. Is the Traditional Fiscal Decentralisation Approach Fit for Purpose?

- The fiscal federalism and related fiscal decentralization literature provides **well-defined normative principles** for sharing fiscal functions
- Despite considerable reform momentum over a lengthy period, a clear analytical framework and considerable consensus on solutions to common challenges, fiscal decentralisation reform has **too often failed to adequately meet needs or expectations, even where normative policy advice has (or seems to have) been followed**
- There is an increasing number of instances of **stalled decentralisation reforms or even some degree of recentralisation**

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The Puzzle: Some Consequential Basic Challenges Well Recognized

- **Why this stubbornly persistent divide** between theory/intent and practice?
- **Technical aspects** of intergovernmental fiscal system design not entirely straightforward—tradeoffs complicate their use
- **Common fragmentation of fiscal reforms and institutional responsibilities** weaken the overall system, for example:
 - **Subnational government incentives to generate own source revenues and to borrow for developing infrastructure** can be undermined by intergovernmental transfers
 - **Borrowing depends on the ability of subnational governments to generate sufficient revenue from their own sources** in order to repay loans (and local revenues also finance operation and maintenance of infrastructure financed by loans)

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Other Well-Recognized Challenges

- **Economic realities** (limited/narrow economic bases, pervasive poverty, etc.) can constrain subnational fiscal performance (perhaps less in urban areas)
- **Lack of good information and empirical evidence (and poor use of what exists)** creates significant challenges for decentralisation policy and implementation
- **Capacity constraints** are often cited as key in limiting subnational government fiscal performance
- **Political challenges** are often highlighted as a binding constraint, but often in the relatively simplistic argument that there is insufficient “political will”

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Need to Look Beyond Traditional Fiscal Decentralisation also Generally Recognized

- Over time increasing recognition of the **need to think beyond traditional functional and revenue assignment concerns** of fiscal federalism (more later)
- General agreement on the need for **a broader multi-dimensional constitutional/legal/administrative framework, e.g., property rights** affect property tax policy/administration, **legal provisions for local governance (elections/other) and civil society rights** create space for citizen discipline of SNGs, etc.
- Such factors can strongly **affect performance and the accountability of SNGs** to their constituents in raising and spending resources

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But Fundamental Weaknesses in the Fiscal Decentralisation Approach Remain

- FDG design remains **dominated by a fairly normative, narrow technical analytical framework** infused with assumptions (explicit and implicit)
- Need for **context specific analysis is recognized, but what is context?** The typical notion is too narrow and mechanical, lacks nuance, and inadequately accounts for the integrated and complex nature of reforms
- Often limited analysis of **why certain behaviors do or do not happen on the ground**—explanations typically simplified and proposed solutions technocratic and ineffective—e.g. adopt state of the art PFM or independent revenue authority reforms—“the budget as theatre”
- On balance the approach **lacks a clear sense of pragmatic strategy** and is often **overwhelmed in practice by factors it fails to or only weakly considers** (more on this in the next session)

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III. Beyond Fiscal Decentralisation: The Need for an Integrated Approach

- As discussed on the first day, **fiscal decentralisation must be complemented by** administrative and political decentralisation (often subject to separate policies and managerial structures)
 - **Fiscal decentralisation without administrative and political:** means providing resources without institutional and governance capacity
 - **Administrative without fiscal and political:** means devolving local functions/autonomy without adequate financial resources and governance structures
 - **Political without administrative and fiscal:** means devolving decision making without institutional and fiscal structures

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Elements ("Prerequisites") of Decentralisation: A Broad Based Mainstream View

- Enabling framework
- "Political will"
- Adequate local political system
- **Adequate fiscal system**
- Adequate organisational and managerial system
- Implementation capacity

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Enabling Framework

- Established subnational government **rights, responsibilities and revenues** (legal and/or constitutional)
- Appropriate **oversight roles** for higher levels of government
- **Fiscal discipline framework** and a hard budget constraint
- **Borrowing framework** (where relevant)
- **Capacity building** mechanisms and institutions

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“Political Will”

- **Committed, reform-minded national and local leaders** support and promote decentralisation and local governance reform
- **Process for defining decentralisation** (building consensus through the “national debate”) is well established and functioning
- **Effective coordination** of the numerous agencies typically involved within and across levels of government is well provided for

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Adequate Local Political System

- **Subnational elections** (adequately competitive and fair) are regularly conducted
- Inclusion of **marginalized groups** is assured
- **Transparency** in local government processes and decisions is sufficient
- Variety of additional **accountability mechanisms** beyond elections are in place
- **Autonomy** to facilitate responsiveness to citizens is adequate and protected

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Adequate Fiscal System (focus of this course)

- Local **own sources** of revenue are well defined and operating effectively (at a minimum some degree of autonomy over local tax rates)
- Appropriately structured **shared taxes and intergovernmental transfers** are in place and regularized
- **Borrowing mechanisms** (where relevant) with limited government involvement (to the extent possible) are established and effective

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Adequate Organisational/ Managerial System

- Institutional structure is in place with **clearly defined intergovernmental responsibilities**
- **Planning, budgeting and financial management procedures** (on-budget vs. extra-budgetary) are in place and operating
- **Civil service system** with local control consistent with functional assignment is in place
- **Framework for partnering** with private and community based entities is defined

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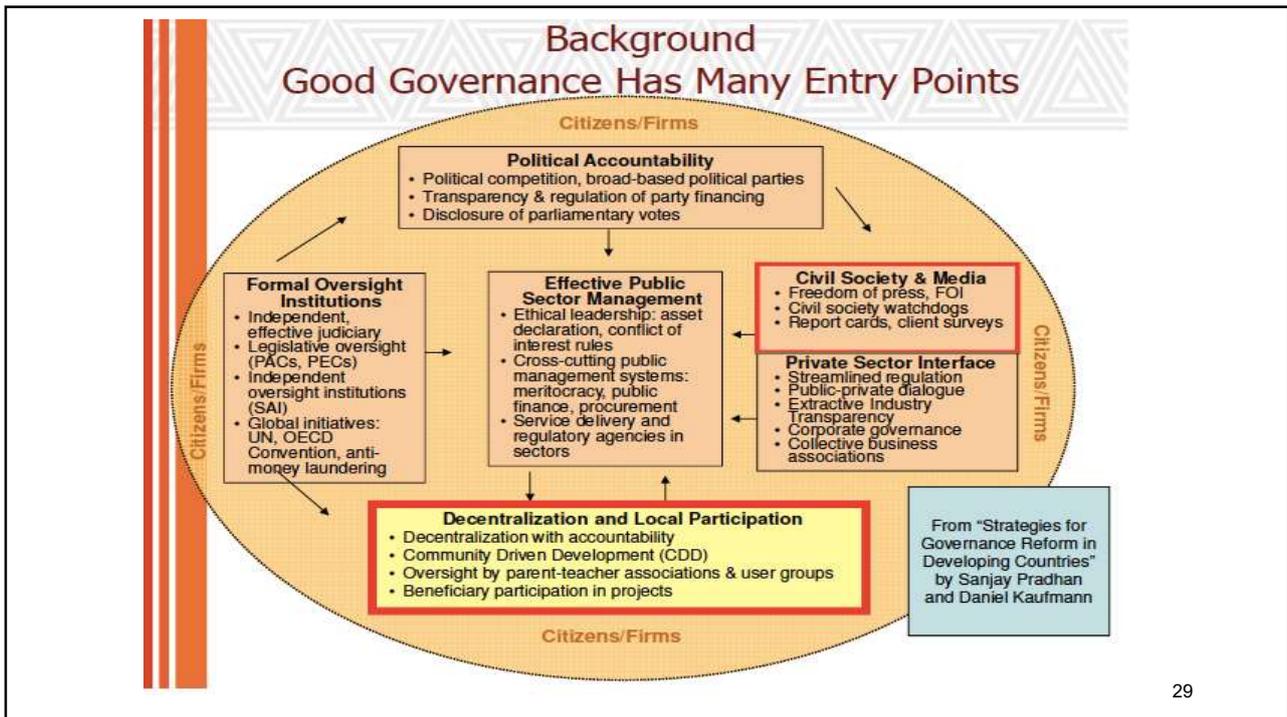
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Implementation Capacity

- **Central agencies** are ready to transform their role from a focus on control to a focus on facilitation
- **Subnational governments** are ready to deliver on their new responsibilities
- **Various dimensions of capacity**—technical, fiscal, managerial, governance—are provided for
- **Capacity is needed for all actors involved**, not just subnational governments

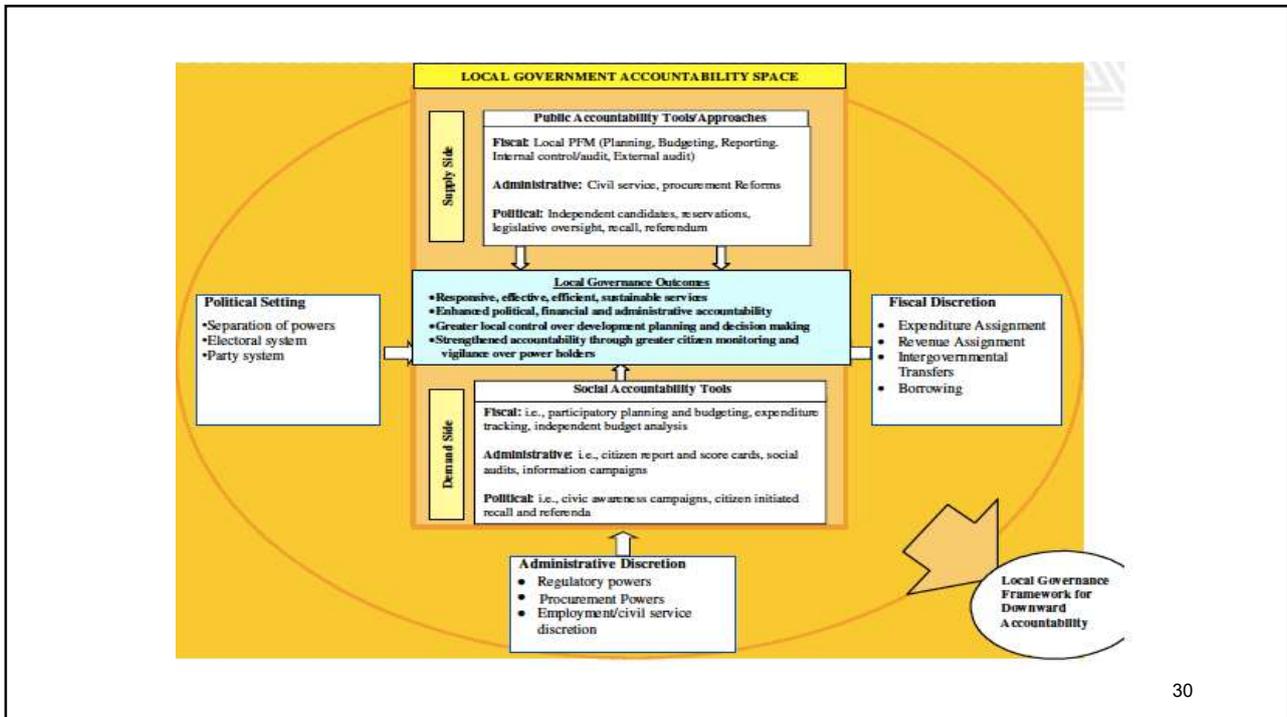
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Assessment of the Mainstream Approach

- **By definition, many countries do not have these “prerequisites” in place**—if they did, they would already be decentralized and would not need to adopt and pursue a decentralisation policy!
- **Although some basics would need to be in place to make progress, these “prerequisites” are in fact the elements of a decentralisation reform**—they will need to be built in some appropriate combination with pragmatic sequencing
- **Developing decentralisation is, of course, a demanding process**—given both nontrivial analytical and practical challenges to building an effective intergovernmental system

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Key Analytical Challenges

- **Institutional diversity** and often complex and unevenly applied intergovernmental relations
- **Official and unofficial objectives**: the underlying **political economy** may mean that official objectives are not the primary objectives
- **Relationships with other public sector reforms** (and external support)—ringfencing and fragmentation are common
- **Decentralisation as a process** of behavioral modification & learning in a specific context—everything cannot happen at once
- **Measuring and interpreting** variables and results—common data and attribution limitations

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IV. Empirical Evidence and the Landscape of Decentralisation

- There have been relatively **few attempts to comprehensively and critically assess** the literature on the impact of decentralisation initiatives on local development
- There are **considerable challenges to conducting such an analysis**: the literature is vast and diverse in terms of issues, methods, levels of analysis, time frames, measurement of variables, countries, etc.; *this makes meaningful comparison of results extremely challenging*

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Empirical Literature: Methods

- The empirical literature can be broadly classified into **quantitative and qualitative**
- **Quantitative** studies use **statistical methods to estimate effect of decentralisation on outcomes**
- **But often do not deeply explore factors underlying their results**: context, design, processes, and political dynamics, etc.
- **Qualitative** studies often **focus on processes and dynamics** shaping the relationship between decentralisation and outcomes (interdisciplinary)
- But are typically **context specific** and their results cannot be generalised

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Empirical Literature: Level of Analysis

- Empirical research can be categorized into **macro-, meso- and micro-level studies**
- **Macro refers to cross-country analysis** (mostly quantitative); best for comparability, but usually at a high level of abstraction that limits specificity to policymakers
- **Meso refers to analysis of specific countries**; largest share of studies (quantitative and some qualitative); generalisability limited, but may offer insights into useful approaches and lessons for other countries
- **Micro refers to in-depth (mostly qualitative) case studies** of one or few local governments, communities, service providers or other subjects; often offer rich insight but very context specific

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Empirical Literature: Overview

LOCAL DEVELOPMENT OUTCOMES

- **Service Delivery**: Effectiveness, Efficiency, Equity
- **Human Conditions and Livelihood**: Average Improvements, Distribution of Improvements
- **Governance**: Participation and Inclusion, Transparency and Accountability, Resource Allocation, Conflict Reduction

UNDERLYING FACTORS

- **Context**: Social, Political, Economic
- **Institutional Design**: General, Financial Resources, Mechanisms for Transparency and Accountability
- **Political Economy**: Central-Local Relationships, Local Dynamics
- **Capacity**: Local/Central Governments and Citizen

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Summary: Local Development Outcomes

Category of Outcome	Volume of Studies	Level of Analysis	Method	Results
Service delivery	Large, dominant	All levels—macro, meso, micro	Both qualitative and quantitative	Overall results are mixed
• <i>Effectiveness</i>	High	All levels	Both quantitative and qualitative	Macro-level results inconclusive; trend positive for quantitative and negative for qualitative at other levels.
• <i>Efficiency</i>	Small	Most macro and meso, a few at micro	Mainly quantitative studies	Most results are mixed with a few studies finding negative outcomes
• <i>Equity</i>	Moderate, often studied with effectiveness	All levels	Both quantitative and qualitative with a modest tendency to the former	Most studies report mixed or negative results except for a few meso-level quantitative studies
Human conditions and livelihoods	Moderate	All, more macro and meso	Both quantitative and qualitative studies with more of the former	Results tend to be mixed, with some of them more positive
• <i>Average improvements</i>	Dominates (often on specific services)	All, more macro and meso	Majority of studies are quantitative, with a few qualitative	Often positive results, especially quantitative; some mixed or negative results especially in qualitative studies
• <i>Distribution of improvements</i>	Small	Mainly meso	Both quantitative and qualitative, with former focused on the meso level	Results are mixed and inconclusive
Governance	Large	Majority meso and micro level	Majority of studies are qualitative	Mixed results with a tendency towards negative
• <i>Participation and inclusion</i>	Large	Majority of studies at meso and micro level	Most studies are qualitative	Findings tend to be largely mixed or negative
• <i>Transparency & accountability</i>	Small	All	Mainly qualitative, very few quantitative	Findings are inconclusive
• <i>Resource allocation</i>	Small	More meso and micro	Almost exclusively quantitative studies	Results are mixed with a few clear positive or negative findings
• <i>Conflict reduction</i>	Very small	All	Studies mainly qualitative	Findings tend to be mixed or negative

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Summary: Underlying Factors

Type of Factor	Volume of Studies	Level of Analysis	Method	Results
Social/political/economic context	Moderate	Mainly at meso level, with a few macro and micro	Both quantitative and qualitative	Strongly suggest context matters, but limited hard evidence and sometimes inconclusive
Institutional design issues	Significant and diverse	Majority on the meso and micro levels	Majority qualitative, limited quantitative	Findings tend to confirm relevance of various institutional design issues
• <i>General institutional design</i>	Fairly large	Focus on meso and micro levels with few macro level	Qualitative dominates, few quantitative	Results indicate importance of institutional design but generally context specific
• <i>Local financial resources</i>	Somewhat smaller	All levels, more at meso level	Both quantitative and qualitative	Results suggest lack of resources and high dependence on transfers as major impediments to achieving outcomes
• <i>Mechanisms for transparency and accountability</i>	Moderate	Mostly meso and micro levels	Majority qualitative, few quantitative	Findings support the importance of effective mechanisms for transparency and accountability
Political economy issues	Small	All levels, in particular meso	Mainly qualitative	Results illustrate critical but diverse/ ambivalent role of political economy forces
• <i>Central-local relationships</i>	Small	Mostly meso level with a few at the macro level	Mostly qualitative, fewer quantitative	Findings indicate that intergovernmental political economy dynamics can strongly influence development outcomes
• <i>Local dynamics</i>	Small	Majority at meso and micro levels with a few macro	Mostly qualitative, fewer quantitative	Results suggest that within-community dynamics can hinder or support performance
Capacity issues	Moderate	All levels with a focus on meso and micro	Mostly qualitative, fewer quantitative	Studies identify capacity as major constraint on achieving outcomes

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Empirical Literature: Conclusions

Given the many constraints, **detailed universal prescriptions for improving decentralisation outcomes (beyond the obvious) are not feasible**

Empirical work validates many expected **relationships, but to varying degrees (as per conditions that vary across countries)**

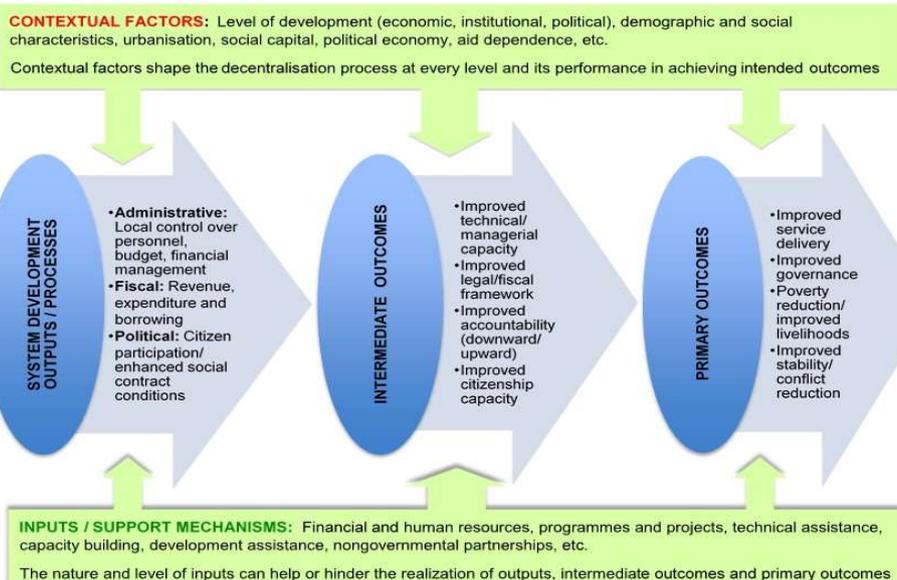
Since countries operate in diverse contexts with different initial objectives outcomes must be assessed in relative terms

Quantitative and qualitative analysis have different advantages; the two are rarely used together, but this could often contribute to better policy analysis

The key to improving outcomes is to learn from experience **how to analyse decentralisation (prospects and performance) in a specific case more effectively**

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The Landscape of Decentralisation



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