

Integrated Fiscal Decentralization

Concept, Determinants, Sequencing Strategies

Bratislava, May 25th 2009, Informal Development Partner Working Group on Local Governance & Decentralization

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Donors promote decentralization for two reasons:

Provision of Basic Services & Poverty Reduction

Strengthening democratic legitimacy & state structure

Decentralization processes encompass **three inter-related dimensions**: political decentralization, fiscal decentralization & administrative decentralization.

Decentralization processes are **endogenously political** in nature because these as deep institutional changes create winners and losers

➔ **Good thing to do, complex issue, hard to achieve**



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Donors increase their focus on **fiscal decentralization**

- a) Promoting overall transparency and accountability
- b) Strengthening the resource basis of local entities

Fiscal decentralization, apart from being linked with political & administrative decentralization, contains two crucial aspects:

1. **A vertical transfer system**
2. **Local revenue generation**

Fiscal decentralization often develops in a non-functional way because it is mainly driven by **political considerations** about resource distribution

→ **Good thing to do, complex issue, hard to achieve**



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Content: This study is on the concept of **Integrated Fiscal Decentralization (IFD)**, its political determinants & sequencing strategies for effective interventions

Motive: **Disappointment** about the lack of progress of ambitious donor attempts to create functional IDF

1. The study **illustrates** the concept of Integrated Fiscal Decentralization

2. The study provides **explanatory factors** for the fate of fiscal decentralization from a political economy perspective

3. The study formulates **recommendations** for more gradual approaches less likely to face political deadlocks



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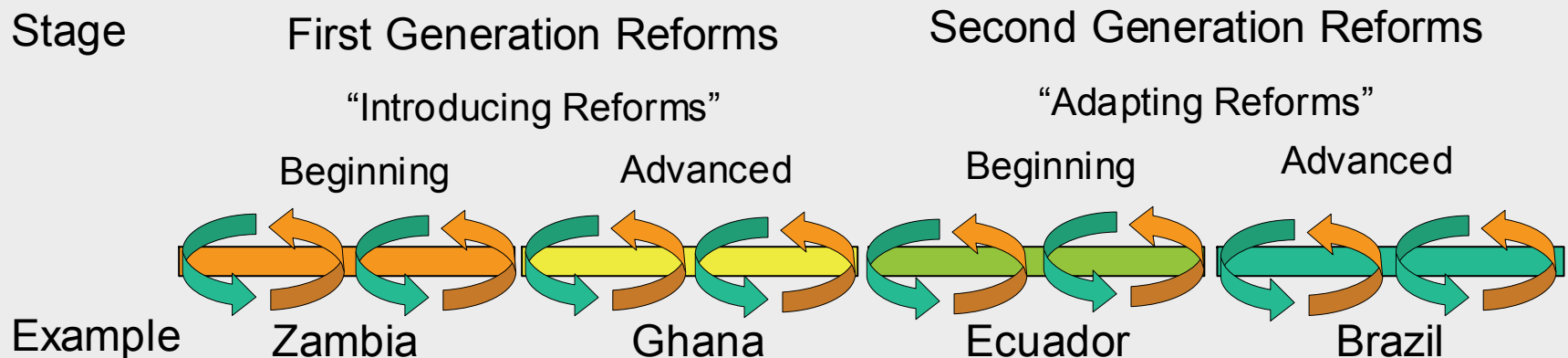
Cross Country Literature

Case study Literature & Case studies on Ghana & Zambia

Ghana & Zambia

- ✓ both countries still in first generation of decentralization
- ✓ slow advances (Ghana) or no progress (Zambia)
- ✓ donor interest in promoting IFD
- ✓ important presence of donors (donorship vs. ownership?)

Decentralization as an ongoing, iterative process





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Fiscal Decentralization is defined as the transfer of fiscal resources and fiscal competences from the central government to subnational governments

Integrated Fiscal Decentralization 1

- ✓ across sectors (health, education, etc.)
- ✓ across regions
- ✓ in line with expenditure responsibilities
- ✓ performance-based (ex post incentive)
- ✓ transparent, formula based allocation



Concentration on
**integrated transfer
system**

- + *Local Fiscal Governance* (political decentralization / political autonomy, local accountability)
- + Own subnational resources from taxes and other revenues
- = **Integrated Fiscal Decentralization 2**



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Motivation & context for the promotion of IFD

Overall aim: Improve public service delivery & political participation

IFD 1 with a more narrow focus on transfer system:

- ✓ Increasing **transparency** of vertical allocations
- ✓ Constraining ***pork-barrel politics*** in parliament
- ✓ Strengthening of **finance ministry & local planning**
- ✓ Implementing the **Paris Agenda**

IFD 2 as an encompassing concept:

- ✓ Promoting **subsidiarity**
- ✓ Strengthening the principle of **fiscal equivalence**
- ✓ Strengthening **fiscal efficiency**
- ✓ Promoting local **democracy & participation**



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planning and implementation capacities at national & subnational level:

→ **Integration of budgeting and costing processes at the national level**, coordinated by finance or decentralization ministry

→ Strengthening of **local planning and implementation capacities** necessary to promote an independent organization of local-driven /needs-driven demand

→ **Integration of monitoring instruments at the local and the national level** required in order to promote high quality service delivery and to implement performance based incentive

→ **Locally generated revenues** support performance orientation and accountability at the local level → From transfer system to local revenues

→ **Strengthening political decentralization** tends to improve local legitimacy & representation of local preferences in public service delivery.

In the medium and long run, integrated fiscal transfer systems require strengthening the local level, eventually leading to a more **encompassing perspective of IFD**



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IFD requires

- ✓ Capacities at the **local level** for integrated (participatory) planning & implementation
- ✓ Capacity at the **national level** to integrate sector budget processes

- ✓ across sectors & regions
- ✓ in line with expenditure responsibilities
- ✓ performance based
- ✓ transparent, formula based allocation
- +
- ✓ Political autonomy of subnationals
- ✓ Own subnational resources

IFD confronts

- ✓ **Low capacities** for integrated planning at the **local level**
 - ✓ **Low political & technical capability** to integrate budgets across regions & sectors
-
- ✓ sector and regional discrepancies
 - ✓ incoherency between fiscal & administrative decentralization.
 - ✓ no ex post incentives
 - ✓ discretionary manoeuvring space & dysfunctional formula(s)
 - +
 - ✓ Political dependency
 - ✓ Low fiscal sustainability



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Question1: Scope

Is it effective to promote IDF with a focus on the vertical transfer system and not take into account aspects of a more **encompassing approach to IDF**?

Question2: Time

Can IDF be implemented at once in a full-fledged manner or is it more realistic to develop more gradual approaches by **context-specific sequencing**?

→ Potential Tensions

Interdependence of IFD vs. **shortage of political/admin. capabilities**

Promoting IFD in countries with limited levels of political, administrative & fiscal decentralization (as Ghana or Zambia) might be overly ambitious

→ Determinants of IFD inform us about viability of reform



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The viability of political & administrative reforms regarding IFD depends on the **underlying causal mechanisms**

“Crude indicator” of cross country research on fiscal decentralization
Subnational expenditures as a % of total government expenditures



Decision-making

Political system

Actor constellation & institutional framework

Political autonomy of subnational levels, democracy, electoral system, etc.



Structural factors

Geography / demography / society / economy

Size / frontiers / population / urbanization / ethnical & relig. fragmentation / world market integration / diversification of tax revenues, etc.



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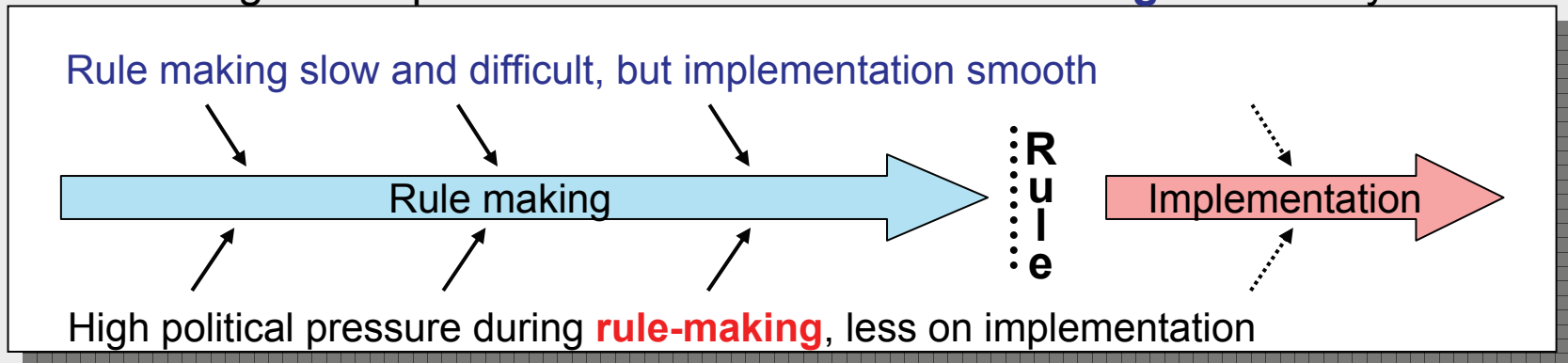
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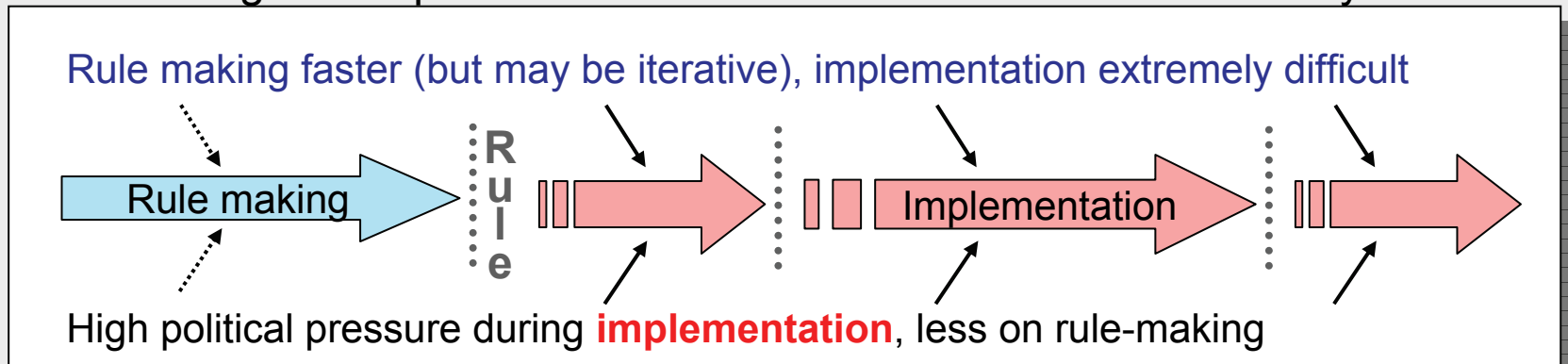
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Rule making and implementation in countries with **strong** national systems



Rule making and implementation in countries with **weak** national systems



Zambia: Encompassing plan but no implementation

Ghana: Slow progress

Ecuador: Many parallel decisions on transfer system



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National Actors

- National Government
- Subnational Governments
- Parliament

Donor Community

- Donors promoting decentralization
- Overall donor community

Institutional Environment: Guiding norms and rules

While we might identify crucial preferences of specific actors with regard to IFD, the concrete course of the process will also be shaped by the existing institutional environment, which reflects actor constellations and concrete distribution

Example: Institutional Environment in Zambia and Ghana work against active political demand for decentralization from below, while in many LA countries independence of mayors is much greater



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National Government and Subnational Politicians:

Explanatory models of decentralization often picture a uniform confrontation between national governments (NG) and subnational actors (SA) with regard to the distribution of political (PD), fiscal (FD) & administrative decentralization. (AD)

Preferences $NG = AD > FD > PD$ vs. preferences $SA = PD > FD > AD$

However, implementing IDF 1 requires differentiation.

Preferences: discretionary allocation (**D+**) vs. formula-based allocation (**D-**)
conditional transfers (**C+**) vs. non-conditional transfers (**C-**)

	D +	D -
C +	Sector ministries	Finance ministry
C -	"Subnational" winners of status quo	"Subnational rest"



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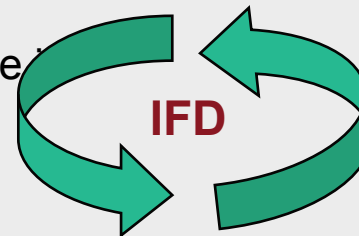
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Parliaments:

- ✓ Parliamentarians seek resources & re-election:
- ✓ They will tend to **oppose** IFD if IFD threatens their discretionary powers to allocate resources according to their political preferences (pork-barrel-politics). Bazaar-style negotiation “culture” lead to deadlock (Zambia) or proliferation of “individual” laws (Ecuador).
- ✓ They will tend to **support** IFD if their political careers depend on the respective subnational executive (Brazil)
- ✓ They will tend to act in accordance with the national party leaders if there nomination depends on the national leadership of political parties.

Impact of parties and electoral rules on Parliament
(open list in Brazil, majority rule in Ghana, etc.)

Relative strength of sector ministries
Strong in Zambia



Relative autonomy of subnational government
(weak in Zambia, strong in Brazil)

Relative strength of Finance Ministry
(weak in Zambia, strong in Peru)



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Donor organizations: mixed incentives?

In general, donor organizations tend to promote IFD

Moreover, the Paris Agenda promotes instruments conducive to IFD (pooling resources for fiscal transfers, budget support for promoting structural decentralization reforms, strengthening of finance ministries, etc.)

- ✓ However, donors cooperate with crucial line ministries such as health and education, because of their capacity to absorb funds
- ✓ Also, donors cooperate with specific regions or municipalities, selecting “promising subnational entities” instead of pursuing cross-regional IFD

Donors involved in decentralization

Promoters of IFD

- ✓ IFD strengthens their counterparts (local entities & finance ministries)
- ✓ IFD has structural impacts on state structure
- ✓ IFD allows to develop pooled financing mechanisms in accordance with Paris Agenda

Donors involved in sectors

Not necessarily promoters of IFD

- ✓ Closely related with line (sector) ministries → most capable actors
- ✓ Sector Wide Approaches vs. IFD

→ Donors, too, have to integrate decentralization and sector approaches!
But who is responsible for such coordinated planning?

IMPORTANCE UP IN AID DEPENDENT COUNTRIES (Ghana; Zambia) mostly irrelevant in many anchor countries



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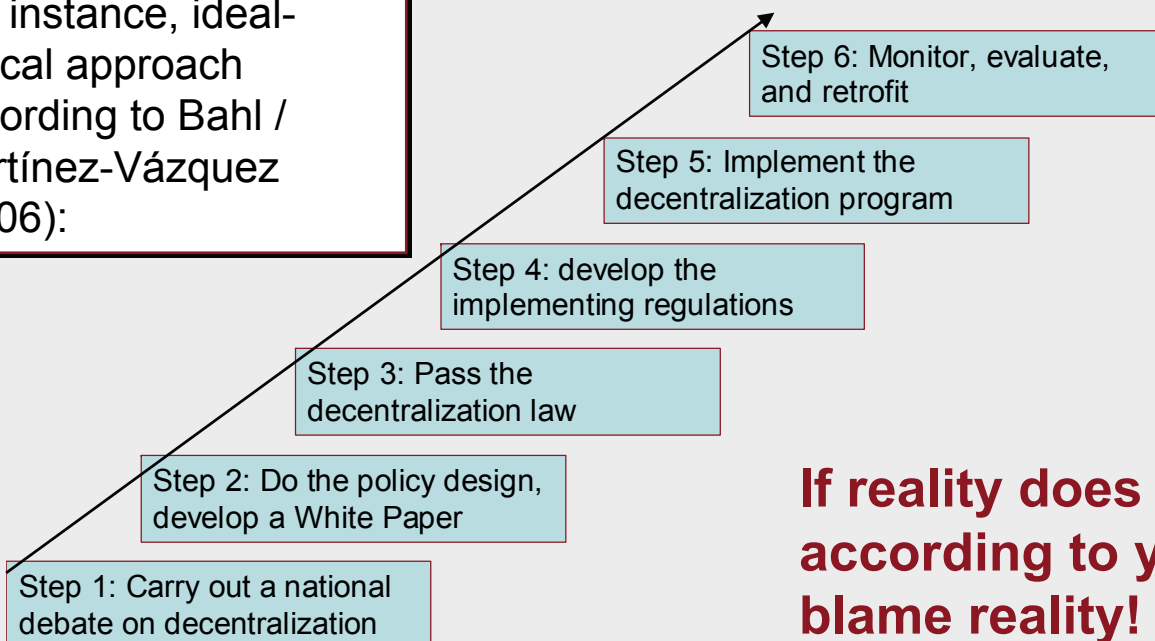
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There is a **standard approach** to sequencing:

1. Define an ideal-typical process from a technical perspective
2. Ascertain that any individual case necessarily deviates to some degree from the ideal type you just described
3. Then formulate 10 (or 11 or 12) “golden rules” that reflect the above-mentioned technical perspective anyway

For instance, ideal-typical approach according to Bahl / Martínez-Vázquez (2006):



If reality does not behave according to your approach – blame reality!



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For instance, 12 golden rules according to Bahl (2006):

1. Intergovernmental Fiscal Relations (Fiscal Decentralization) is a system, and all of the pieces must fit together.
2. First, fix the assignment of expenditures, then assign revenues in amount that will correspond to the expenditure needs.
3. Begin fiscal decentralization with a strong central ability to monitor and evaluate.
4. One system will not fit the urban and rural sectors.
5. Accountability of local government officials requires significant local fiscal autonomy. Urban local governments must have some taxing powers.
6. The central government must honor its commitment to decentralization by following the rules it makes.
7. Keep it simple. Precision in tax administration and grant distribution is probably not possible in most cases.
8. Grants and shared taxes must play an important role in almost any decentralized fiscal system in a developing or transition country. Transfers may be designed as more centralized or more decentralized.
9. There is an intra-province (intrastate) dimension to intergovernmental fiscal relations and this should be taken into account in planning the system.
10. Impose a hard budget constraint.
11. Recognize that intergovernmental systems are always in transition, and plan for this.
12. There must be a champion.



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- With regard to complex systemic reforms, such as (fiscal) decentralization, there are **no universal procedural rules!**
- Thus, golden rule approaches give some principle guidance but aren't flexible to meet real, iterative, open-ended political processes:

- There are, however, **meta rules useful for sequencing:**
 - Decentralization is not a purely technical process. Try to **understand the political character** of reforms.
 - **Know the relative strengths of supporters and the opponents** of reform (stakeholder mapping). Networking and the building of alliances are crucial features of decentralization reform.
 - Political reforms may strengthen a **winner-loser perception**. Attempt to **demonstrate win-win situations**
- What reform step brings an acceptable
- To build support for reform (and to reach a point of no return), focus on **initial actions that yield immediate results**.
 - Don't lose sight of **political (electoral) cycles**.



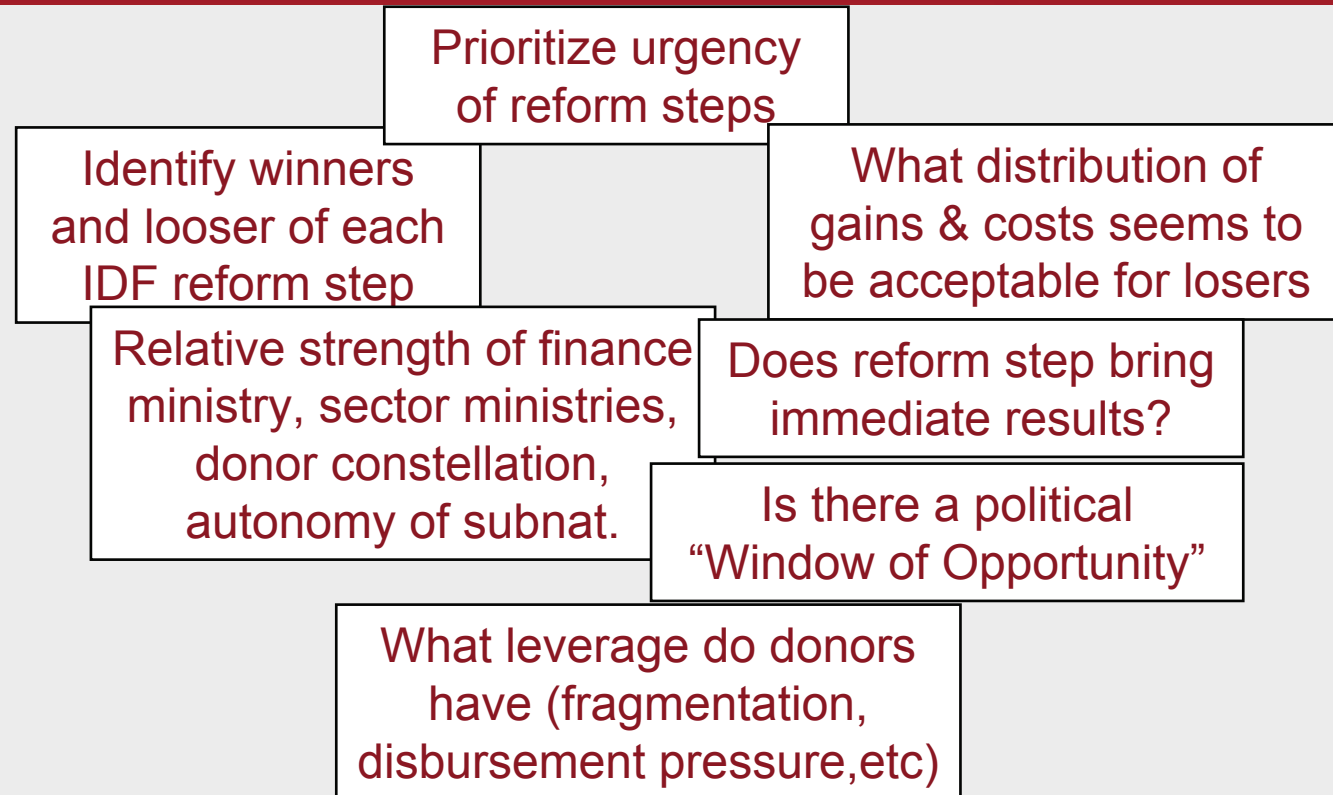
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Improved approach to sequencing: context-oriented Scenario-Analysis allows for openness and flexibility

→ Success probability of a reform step in specific context

Traditional Approach to sequencing: Linear Process according to blueprint



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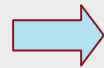
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Overarching objective: Systemic reform towards fiscal sustainability, public service delivery and accountability



In cases of countries with weak national systems, a **comprehensive reform** towards fiscal decentralization (including local revenue collection and local accountability) may be too ambitious!

Zambia: Ambitious Plan, no implementation



Individual **pilot projects** are a risky approach to trigger reforms, because they often have little impact on overall public sector capability (no benchmarking, no scaling up, no realistic time-frame).

Selected attempts of strengthening local governance in some districts will be absorbed by contrasting incentive structure of political system. Examples from the 1990s all over Latin American and Africa ...



A feasible solution may lie in the **territorial or sectoral sequencing** of reforms, following an **incremental approach**

Attempt to craft a “limited” transfer system in Zambia: Too big to be simply absorbed and too little to overstretch the “capabilities” of the system

Sequencing: Between Pilot and Comprehensiveness



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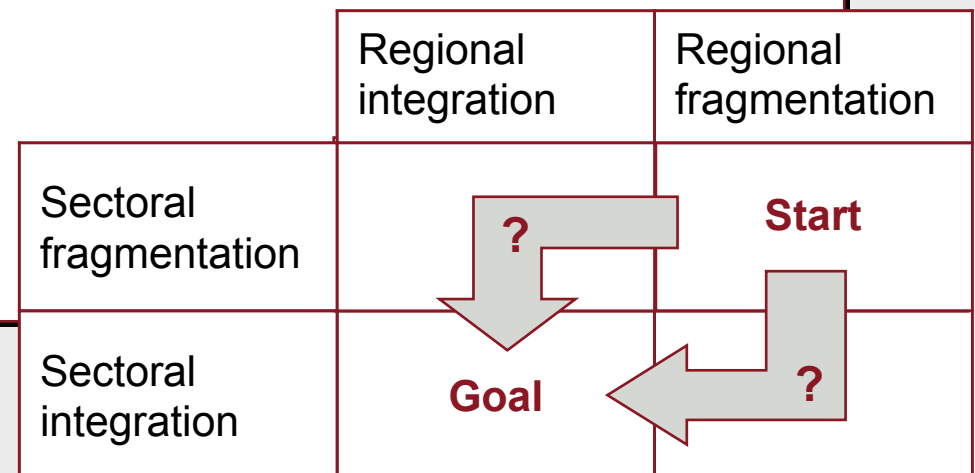
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Typically, current reforms do not start from zero:

Where is the country / reform process located? Where are Potential Entry Points

- The goal and vision of decentralized government is part of the political discourse (limited in Zambia, strong in Ecuador)
- Sub-national levels of government exist, and they already fulfill some functions (Zambia, Ecuador, Brazil, Ghana, etc.)
- Donors already engage in some forms of decentralization promotion (most Latin American and African and some Asian countries)
- Some regions experiment with decentralization (less in Zambia, more advanced in Ecuador, established in Brazil)
- In some sectors, some kind of decentralized service delivery is already taking place





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First issue: Getting the transfer system right

Regional and sectoral integration

- **Territorial or functional (sectoral) sequencing** may be necessary in order to get decentralization started, but it should be taken as an intermediate step → Prepare **scenarios** for next steps.

- **Territorial sequencing** (Phasing in, for instance Indonesia, Peru)

decentralization of functions and funds starts with some categories of municipalities/regions. This approach accounts for the heterogeneity of local situations in most developing countries, but it may contribute to consolidating this heterogeneity, instead of overcoming it.

Be aware of danger of political selection ! (Are there cleavages, which might be chosen as selection criteria but at the same time represent political patterns of representation (Party x has stronghold in region y))

- **Functional (sectoral) sequencing** (*optional dec. in Peru, Ecuador, etc.*)

decentralization starts with the transfer of a few functions (and funds). This approach is more equitable with respect to local governments. It can be combined with a system of applications and certifications.

However, it may enable sectoral ministries to undermine decentralization.



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First issue: Getting the transfer system right

Transparency

- Often, a significant first step consists in promoting transparency: Access to information about who gets what under which mechanism may lead to public debate and, eventually, reform of skewed transfer systems

Introducing performance-based approaches

- In cases where multi-donor budget support (MDBS) has already led to a strengthening of performance-based systems at the national level, it may be sensible to adapt these systems at the local level
- In cases where performance-orientation is still weak, starting from “outside the system” may be preferable. It is important, however, to keep an eye on the incentive structure embodied in the transfer system at a whole – not only on individual funds or mechanisms.

For instance, municipal development funds could be managed by special units or agencies, using specific performance criteria and assessment tools.

Remember: MDFs are attractive for disbursement and are relatively easy to implement – integrating them into a broader transfer system is the real challenge (Bolivia)



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Second issue: From transfers to full-fledged fiscal decentralization

Strengthening local revenue collection

- This aspect is key to the effective promotion of (fiscal) decentralization. Often, important incentives operate against the local generation of revenues. **Transfer systems should therefore encourage co-financing of projects** - as for example in many MDFs Performance criteria should include local revenue generation.

Strengthening local accountability

- Transfer systems tend to emphasize upward accountability more than downward accountability
- Effective local accountability depends on the powers local constituencies have to influence public policies according to their own preference orders
- One of the strongest factors operating in favour of local accountability is local revenue collection



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Promoting IFD is a multi-dimensional task aiming at **fundamentally altering the distribution incentives** of the political system

Beyond developmental goals, **the new aid regime** makes IFD attractive for donors as IFDs promotes an **integrated transfer system**

At least in the medium & long run, **successful implementation of IFD** must go beyond fiscal aspects and promote political decentralization

Because IDF requires **integrated planning & monitoring at national and subnational level**, resulting **conflict will mirror** this process

Especially in early stages of decentralization reforms, attempting to **implement full-fledged IFD** might prove a **recipe for political deadlock**

Modest sequencing strategies are more apt to overcome shortage of technical/political capabilities but traditional sequencing strategies have a linear bias and do not respond to open political processes

Advanced sequencing strategies are guided by **some meta rules** transformed in **open context questions** which deduce **scenarios**

Successful sequencing has to walk the thin line between **overly ambitious structural reforms** and **overly insulated pilot projects**



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There is a country with a broad consensus (existent since several decades) about the need of deeply reforming the fiscal transfer system ...

... where the one thing, which was not missing were encompassing blue prints ...

... where several high level constitutional reform committees have been elaborating broad & small reform steps ...

... which nevertheless were constantly embedded in a struggle of competing political actors ...

... which just seemed to be too clever to get convinced by technical considerations ...

...despite of being part of a well-established democracy – Germany.

Thank you for your attention!



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Ghana is considered a **forerunner of democractization and decentralization** in Sub-Saharan Africa.

- Local elections since 1988
- Establishment of a formula-based transfer system in 1993

However, a closer look reveals **important shortcomings**:

- The President appoints the District Chief Executive and 30% of District Assembly members. This interferes with local government accountability towards their local constituency.
- Lacking integration of sector policies makes integrated and sustainable local development and budget planning an impossible task.
- Transfers are unreliable and intransparent, local spending autonomy is limited.
- Local governments have no autonomy with respect to staffing.
- There are only weak incentives for the generation of revenues and the improvement of local tax administration.



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Sequencing of fiscal decentralization

- A **formula-based** transfer mechanism has been established (District Assemblies' Common Fund, 5% of the public budget), but transfers are irregular and intransparent for local authorities. Also, over 40% of funds are kept and distributed at the national level.
- Before the elections in 2008, a new, **performance-based** transfer mechanism was introduced (District Development Facility, DDF), but a first assessment produced the result that only 36% of districts were eligible, and no payments have been made as yet.
- Next steps in fiscal decentralization:
 - Making DDF work (strong albeit hidden political resistance against the picking-the-winner principle)
 - Improving regularity and transparency of other transfers
 - Strengthening local revenue collection
 - Integrating budgets at the local level (“composite budgeting”)



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Zambia is considered as country with a **rather disappointing track record** with regard to decentralization reforms in the two last decades

- Local elections since the 1990s
- Local Governance Act of 1993 delegates many responsibilities to municipalities (administrative decentralization)

However, a closer look reveals **important shortcomings**:

- During the 1990s, the sources for municipalities own revenues have been systematically cut in order to constrain the fiscal manoeuvring room of subnational entities.
- There is no established transfer system, which allocates resources from the central government to subnationals by using transparent, formula based mechanisms.
- The political independence of decentralized local entities is severely constrained: no direct election of mayor, mayor has only representative functions, ministers & parliamentarians as strongmen in local councils. → weak political decentralization
- Ambitious requirements for IFD with regard to planning & monitoring processes meet only very weak capabilities at national & local level.



1. Introduction

Since several years, a group of donor countries/agencies has been actively promoting decentralization reforms in Zambia.

2. Concept

Already in 2002, the government of Zambia declared an encompassing **decentralization reform** (“launched” in 2004), which was followed by a **Decentralization Implementation Plan (DIP)** in 2004. Content:

3. Determinants

- reducing power, resources, competences of the central government across all sectors
- To build an integrated transfer system based on transparent formula and to strengthen own sources of local revenues
- Capacity-building in order to be able meet the ambitious requirements of integrated planning and monitoring at the national & local level

4. Sequencing

However, since then, **not much has happened**, the DIP has not been ratified by the cabinet, not even a “small” transfer system has been established: Why

5. Conclusions

- Weak local entities are not able to articulate substantial political demand
- Central government fears to strengthen local opposition strongholds
- Opposition of sector ministries, struggle between ministry of local governance & finance ministry
- Parliamentarians fear to lose their political weight in local councils