Development Partners Working Group on Local Governance and Decentralisation

DPWG-LGD

Study on Fiscal Decentralisation

<u>Draft Report</u>

Berlin, May 2009

Nina Boschmann

Paulstr. 23
10557 Berlin
Tel: 0049-30-3933546
Email: Ninabosch1@aol.com

Index

List of Abbreviations

ARR	Annual Revenue Realized
BOT	Build-Operate-Transfer
CDF	Common Development Fund (Rwanda)
DPWG-LGD	Development Partners Working Group on Local Governance and Decentralisation
DIE	Deutsches Institut für Entwicklungspolitik
DILG	Department of Interior and Local Government (Philippines)
PFM	Public Financial Management
GDI	German Development Institute
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
IRA	Internal Revenue Allotment (Philippines)
IRS	Internal Revenue Service
LABSF	Local Authorities Budget Support Fund (Rwanda)
LGC	Local Government Code (Philippines)
LG(U)	Local Government(Unit)
LGUGC	Local Government Unit Guarantee Corporation (Philippines)
MFMA	Municipal Finance and Management Act (South Africa)
MINALOC	Ministry of Local Government (Rwanda)
MINECOFIN	Ministry of Economic Development and Finance (Rwanda)
MTEF	Medium Term Expenditure Framework
PDAP	Provincial Development Action Program
PEFA	Public Expenditure and Financial Accountability
PPP	Public-private partnership
PSP	Private sector providers
RPT(A)	Real Property Tax (Assessment)
RDA	Regional Development Account
SDC	Swiss Development Cooperation
SLA	Subsidiary Loan Agreement (Indonesia)
TNUDF	Tamil Nadu Urban Development Fund
ULB	Urban Local Government
US-AID	US-Agency for International Development
VAT	Value-Added Tax

Executive Summary

to be added

1 Introduction

Since the beginning of the 1990s, most developing countries have embarked in a process of subsequent decentralization, combining political, administrative and fiscal aspects. In this context, the Secretariat of the Development Partners Working Group on Local Governance and Decentralisation (DPWG-LGD) has commissioned a desk study in the area of Fiscal Decentralisation, to which DPWG-LGD members have contributed sources of information available to them.

The study shall analyse intergovernmental fiscal relations in a number of countries, where DPWG-LGD members are active and produce recommendations on two levels: (i) Simplification and optimisation of fiscal systems and (ii) harmonisation of development partners' interventions. The study shall focus on local taxation, rather than other means of municipal finance and take into account rural as well as urban settings (*See Terms of Reference in the Annex*). Parallel to this desk study, another field study on fiscal aspects in several countries of francophone Africa has been commissioned by the French cooperation, of which another report is available. The two sources are meant to further orient DPWG-LGD's work on donor harmonisation in the subject matter area.

The desk study has been conducted by an individual consultant from Germany and used sources of information provided by the working group members as well as other sources from her professional experience. *The corresponding draft report will be presented to a meeting of the Working Group in May 2009. The draft report is to summarise preliminary findings in order to seek further guidance which aspects shall be further developed in the final report.*

Methodological approach

There are different sources of finance available to sub-national governments, including conditional transfers, non-conditional transfers, own revenues and loan financing (including bonds). Local taxes are part of the local revenues, which shall constitute the focus of the study. On the other hand there are different approaches how to deal with the decentralisation or devolution of tasks to sub-national governments and these approaches relate to different modalities for intergovernmental fiscal relations.

The study therefore starts with a brief introduction on the theoretical background and concepts of fiscal decentralisation before referring so specific decentralisation frameworks *in different parts of the world,* including explicit references to highly decentralised countries such as RSA, Colombia, India and the Philippines. Some reference to related reforms in and Accounting as well as loan and bond financing will also be made in order to illustrate the place of local revenues.

At first, a brief introduction is given into the rationale of decentralisation and different ways of interpretation (Chapter 2). (Chapter 3) is dedicated to intergovernmental fiscal relations and in particular the issue of transfers and equalisation. Chapter 4 deals with the generation of own revenues at sub-national level with a particular emphasis on Real Property Tax and market fees. Subsequently, remaining issues for capacity building are highlighted (Chapter 5), with a focus on Public Financial Management and project management. Chapter 6 gives an overview on the implications of sub-national borrowing and options for innovative modalities of sub-national borrowing. Chapter 7 highlights the involvement of private providers in the provision of municipal services. Recommendations refer to the optimisation of fiscal systems and harmonisation of development partners interventions. Corresponding recommendations are added to each of the chapters, where relevant.

With regard to the regional focus, Sub-Saharan Africa is the focal area of development grant financing in the area of decentralisation and elsewhere and reflections on reforms should therefore refer to feasibility of implementation under the conditions given in this region. Some partner countries have launched promising initiatives to reform their municipal finance, including tax reform. Yet, many of those countries, which have further advanced in fiscal decentralisation and experienced innovative modalities, are usually not located in Sub-Saharan Africa. The same argument applies to the rural-urban link: Those countries, which have more reliable information, are usually the more decentralised and more urbanised.

For this reason, the desk study is referring to positive as well as negative experience with fiscal decentralisation from more as well as less advanced countries. The selection of examples was made according to the availability of comprehensive publications in this regard, focussing on the particular characteristics of each country and lessons to be learnt for others.

In order to avoid confusion about the variety of terms used to describe sub-national government layers, the study will generally use the term "local government" (LG), unless specific reference is made to provincial or regional governments. If dealing with specific francophone or other non-anglophone experiences, generic terms will be used (e.g. "municipalities", "districts").

2 Theoretical Background

2.1 Dimensions of Decentralisation Reform[1]

Decentralisation is a longer-term gradual process that involves, within an appropriate legal framework, various components, such as political decentralisation, administrative decentralisation and fiscal decentralisation:

- ***Political decentralisation*** relates to the transfer of functions or authority from central levels of government to local institutions that are governed by local *political representation*. It means that certain, well described decision-making powers, but also systems of accountability, are being transferred from central government to lower levels of government
- ***Administrative decentralisation*** refers to the de-linking of line ministry staff from their respective ministries and bringing them under the control of the local authority; which includes procedures for establishing a local pay-roll. It means that local authorities can hire and fire their own staff
- ***Fiscal decentralisation*** relates to the transfer of functions or authority from central levels of government to local institutions regarding local decision-making on the allocation of financial resources (i.e. financial discretionary

[1] Information in this chapter relies on Gallagher 1998 and van't Land 2009, who both refer to the School of Public Policy at Georgia State University; Further reference can be provided, if relevant.

powers) and the powers to levy local taxes. Full fiscal decentralisation requires political decentralisation and, at least to some extend, administrative decentralisation.

All three components need to be present. However, the mix of the components may vary and, consequently (eg. when administrative decentralisation is predominant) the prevailing situation may have a bias towards *de-concentration,* or, when all three components are present, the features of *devolution (See Annex X for terminology).*

Defining Fiscal Federalism

Fiscal federalism refers to the structure of financial and broader relationships between central and subordinate levels of government. The process of altering the structure of fiscal federalism by devolving powers to lower levels of government is generally known as fiscal decentralization. Essentially, fiscal federalism is a state of affairs, whereas fiscal decentralization is a specific process meant to alter that state of affairs.

In fact, each type of decentralisation represents a different way of organising the public sector service delivery, and therefore influences the way that public sector is organised. One form is not per se better or worse than the other, and the option chosen is a political decision. Yet, for technicians it is important to have a good understanding in which of the systems they are operating.

In the past, the term 'decentralisation' was normally equated with 'devolution', but of recent, delegation and de-concentration are equally recognised as forms of decentralisation, although not as far reaching, whereby each form will have its own ways and means to provide citizens with opportunities to be heard.

Decentralization essentially is a matter of the devolution of power from the center to the periphery. More precisely, fiscal decentralization generally refers to the ***devolution of taxing and spending powers*** from the control of central government authorities to government authorities either at sub-national levels (regional, provincial, municipal, etc). In a very decentralized system, local governments have considerable power to mobilize resources, through taxing authorities accompanied by strong tax bases.

Rwanda: Decentralization versus Deconcentration?

Over the period 2006 to 2008, the decentralised budget (defined as: the total budget in the Budget Law under the headings of districts *as budget agency)* rose sharply and more than doubled in absolute terms, while in relative terms it increased from 8.8% to 13% of the national budget.

Overall, some 41.3% of the decentralised budget is transferred into employee accounts, while 38.2% is transferred to the district account, which includes an amount that is to be passed on to health facilities. Some 20.5% of the decentralised budget is transferred directly to schools.

There are different modes of transferring the funds under the decentralised budgets. For education, the sector that takes 50.9% of the decentralised budget in 2008, most is transferred either directly into the employee accounts or to the schools in the form of capitation grant. For MINALOC, on the contrary, that only constitutes 15.2% of the decentralised budget, all is going to the district account, and therefore accounts to almost 40% of the cash resources under the decentralised budget that enter the district account.

Source: Van't Land 2009)

Conceptually – as well as operationally-, there is a difference between transfers made under the decentralised budget and transfers made by ministries or projects. Whereas the first is part of a parliament approved allocation for the districts in their capacity of budget agency –and for which funds they are fully accountable to the same parliament, as well as to their constituents-for the latter cases, the line ministry or the project remain the accounting officer. The first transfer is an 'entitlement' for the districts, but for the latter cases districts are dependent on decisions made by ministries and projects during the year.

As much as it is important that, for decentralisation to deliver the benefits as expected, districts should have a say on the allocation of their budget. It does, in principle, not matter whether or not the resources physically pass through their accounts, as long as districts are able to exercise some budget autonomy, and as long as roles and responsibilities –regarding autonomy and responsibility-are clearly defined. Given the limited human resources at the districts, including the accounts department, it makes sense, at least in the short-medium term, to use central government / the national Ministry of Finance as paying agent.

Generally, the devolution of functions and expenditure responsibilities to sub-national governments (in particular municipalities) goes along with (or is followed by) the deconcentration of public services. Reforms of the institutional framework are completed by the holding of regular local elections, which shall allow the local governments to function. Under the new mandate, local governments play a vital role in the reduction of poverty and the implementation of the Millennium Development Goals (MDG) and the availability of sufficient financial resources is a major concern.

At the same time, decentralisation is assumed to offer a way of ***sharing power*** more widely within a country, among regions and among various ethnic groups, thereby providing grounds for political consensus and stability. Overall, a stabilised political system offers a better foundation for the poor to improve their life. In a decentralised system much of the M&E with regard to actual implementation will be done at the local level, e.g. through the district council and other consultative mechanisms. Political (or democratic) decentralisation is expected to offer citizens, including the poor, normally through elected representatives, the possibility of increased participation in local decision-making processes, from which they have previously been excluded, and which is expected to provide them with better access to services.

2.2 Decentralisation and Good Governance

Fiscal decentralization has many proponents, in particular as a strategy to improve ***service delivery*** at local level. Commonly accepted objectives for fiscal decentralization include those of an efficient allocation of resources via a responsive and accountable government, an equitable provision of services to citizens in different jurisdictions, and preservation of macroeconomic stability and promotion of economic growth. Particularly during the last two decades, countries throughout the world have been decentralizing responsibilities for infrastructure delivery from the central state to lower spheres of government.

The reason why many developing countries opted for reforms aiming at greater decentralization, is the principle of ***subsidiarity***, according to which public authority should reside at the lowest level of political organization capable of using it effectively. At the same time, assigned expenditure responsibilities shall always be matched with adequate financing.

Decentralisation is believed having a potential to increase efficiency with regard to the use of public funds mainly through **improved governance** as a result of (i) increased ownership, (ii) better fine-tuning to local circumstances, and (iii) increased and more direct mechanisms of accountability. First, decentralization is associated with increased efficiency, as lower spheres of government are more likely to assess demand and to know peoples' priorities. Second, decentralization may lead to stronger democracy, as it makes local government more accountable for its actions (World Bank 2003; Ahmad et al. 2005, quoted via GDI 2007).

Arguments related to ***efficiency advantages*** through decentralization in particular refer to higher consumer efficiency, competition, lower transaction costs and more efficient revenue rising. Consumer efficiency relates to the assumption that consumers' preferences differ within a country; and, therefore uniform levels of services in all municipalities are inefficient. In this sense, decentralized service delivery increases efficiency, as services can be provided according to local preferences.

Second, vertical and horizontal ***competition between different government units*** can work as an incentive for cost-efficient service delivery, as competition restricts the possibility to endlessly increase taxes. Moreover, transaction costs may be significantly lower when services are provided locally, since local knowledge can be used and decisions can be implemented faster. Lastly, especially in developing countries a large portion of the economy falls outside the tax net. Since sub-national governments are more likely to have reliable information about the tax base, they might be able to capture more individuals for tax-paying.

Decentralization is also assumed to positively affect ***democratization***, as it "brings government closer to the people" (Wittenberg 2003: 4). This line of argument comprises several related strands of discussion, including accountability, participation, checks and balances and a greater variety of choices. First, local government is more likely to be accountable to its constituency, since information flows are better in a geographically confined area, and people can more easily control whether local authorities consider their needs (Wittenberg: 2003, 6).

Second, decentralization can increase ***participation*** of the local population When immediate beneficiaries (either directly or through representation) are involved in planning for allocation of public resources, it is assumed that interventions were likely to better suit ***local needs*** *and* priorities as compared to a situation where the Central Government plans and delivers on their behalf – hence increasing effectiveness. The presumed positive effects of dispersing responsibility to lower spheres of government may be foiled, however, if inappropriate forms of decentralization are implemented.

Within a democratic system, we generally extend this model to include devolution of power to "the people," which they can then exercise via ***locally elected government***[2]. In countries as varied as the republics of the former Soviet Union, the nations of Central and Eastern Europe, South Africa, Australia, and various developing countries (e.g., Argentina, Bolivia, and Colombia), many see decentralization as an important component of a strategy designed to increase the political power of people, as expressed through local governments. Decentralization may, at the least, be important for political reasons, and it may also improve the welfare of the populace.

Over the last two decades, many countries have opted (as did multinational companies and international organisations) for decentralisation of their operations. Countries throughout the world are increasingly recognizing the benefits of fiscal decentralization. In theory – if not always in fact – decentralization makes it possible for people to have greater influence on the decisions of government that affect their lives.

Two models for analytic reference

Gallagher (1998) has proposed the following categories to assessing depth and nature of fiscal decentralization: In a decentralized context (also called "***local choice model***", referring to the democratic content) local government is highly autonomous, its leadership is selected via local election, and it is accountable to the local electorate. In the local-choice model, most "normal" local public services are the responsibility of the local government, which has the legal ability to impose "normal" local taxation.

Local legislation or ordinances authorize these local taxes, which nevertheless must be consistent with the national constitution. Residents elect the governments. There is an adequate local economic base and an institutional capacity to enable local governments to both mobilize resources and to use them to provide public goods and services desired by local constituencies. Local governments mobilize their own resources and decide how they will be used. They prepare budgets that are voted on either by local councils or by the broader local electorate.

Contrary to this, in the "***principal-agent" model***, local government serves at the central government's behest or at its instruction. Local government may be elected, but it has so few powers or authorities as to make it incapable of providing services other than those mandated and funded by the central government. If these local governments prepare a budget, this is much the same as any central-government budget entity preparing its annual budget request. A local council or constituency need not review this request. Its approval or alteration is in the hands of a central government agency.

Quite obviously, the full local choice is not a condition given in many developing countries and even less in Sub-Saharan Africa. Some highly decentralized countries such as Germany have applied many of these components, although with very mixed results. The principal agent model may reassemble e.g. the Ethiopian model; however, Ethiopia as well as many other African countries claim to go through a process of decentralization.

---

[2] In non-democratic states, decentralization is not an option, but deconcentration may be (See Gallagher 1998).

The ***states of the world*** are structured in many different ways. The traditional federal republics often fall closer to the "local-choice" model of the state. The desires for governance are expressed at the local or regional level. A large share of resources is generally collected at the regional level, and a high proportion of spending is made at the regional or local levels. Size matters but cultural preferences and traditions also prevail. Not all large countries are federal republics and not all small countries centrally administered.

It is to be emphasized that in most countries of the north, the structure of fiscal federalism resulted from historical events rather than as a result of design. The same applies to developing countries. Their fiscal systems were mostly influenced by the one of the former colonial power and not consciously reflected by governments after independence. It is to be observed that Southern administrations' relationship with the former colonial power is quite ambivalent: While cultural and financial independence were important to achieve, it is not typical for governments to start from scratch thereafter and evaluate, which systems suits their needs[3]. Such an attitude is also not common among advisors.

While there is consensus among ***development partners from the north*** with regard to the democratic part of decentralization (local elections, citizen participation), the understanding of fiscal decentralization is quite varied (see Box). There is a logical temptation to transferring the respective models of decentralization to partner countries in the south, which makes donor harmonization in this area quite challenging.

Variety of fiscal decentralization among Northern countries

In France the central government is responsible for almost 90 percent of all government spending, compared to two-thirds in Germany and the United States and only one-third in Switzerland. Despite efforts to reform the state in 1982 and 1986, the central government in France is still quite dominant. The central government establishes the levels and rates of taxation for sub-national levels of government on an annual basis. The role of unconditional grants is rather small compared to Germany and the United States.

Source: Gallagher 1998

Under the ***former Soviet system***, all local-government officials were Communist Party members. This ensured that party decisions would be smoothly implemented. Not only were the local councils and executive committees subordinate, lower-level institutions of the state, indeed they were subordinate to the party. Since the dissolution of the USSR, the system of local governance is in flux in Russia as well as the former member states. The new system is based more on control by individuals beholden to the Federation president but in conflict with local councils that participate in multi-party elections. (to be updated)

A number of transition processes from the "principal agent" to the "local choice" model have also taken place, of which Colombia is an interesting example (See box)

Colombia: Successful fiscal transition without sustainable peace

[3] US-AID advisors found that Central American governments – if given a choice – were still most interested to learn from fiscal management in the United States, although the USA cannot be compared at all with the small countries in Central America.

Colombia had been a very centralized state. With political liberalization and the free election of mayors in the second half of the 1980s, the country has been moving headlong toward decentralization. Prior to the reform, the president named mayors, and local governments implemented central-government programs with central government funding[4]. Local government was part of the central-government budget system. The Colombians are moving toward the "local choice" model for municipal governments, while the regions and territories have also been decentralized, but toward the "principal-agent" model. Central government's budget is shared with local and regional governments, which receive transfers and shared revenues amounting to almost ***50 percent of the total budget***.

These revenues are transferred to local and regional governments for specific as well as non-specified uses according to a transparent formula. In part, these revenues are based upon the size of the population, the degree of poverty, and demand (e.g. with regard to schooling needs) but performance aspects have also been included (socalled sistema general de participaciones).

Limits were set to fiscal autonomy after a fiscal crisis around the year 2000. The fiscal state of sub-national governments is closely monitored by the national Ministry of Finance, which identifies the fiscal space for municipal borrowing and interferes in case of emergency, applying compulsory administrative measures.

The model is regarded as rather successful with regard to (i) the effectiveness of transfers and (ii) financial management at central government level. However, due to the amounts transferred, central government is now lacking funds to comply with its own functions. Further, it is to be mentioned that fiscal and political decentralization was not successful to solving the long-lasting security conflict at sub-national level. In various provinces, a significant number of municipalities are politically controlled by paramilitary groups, which do also benefit from the funds transferred.

2.3 Imbalances as childhood diseases of decentralization

The literature on fiscal decentralization is vast. Much of it has to do either with the economic returns from decentralization, although there seems to be little empirical evidence of a link between decentralization and economic growth, and decentralization as an important component in the process of democratization. There is still debate on the measurable advantages and disadvantages of decentralisation with regards to its impact on poverty alleviation.

In any case, for decentralisation to deliver up to its promises, a number of ***conditions and assumptions*** underpinning the above described impact chain need to be fulfilled. In fact, the link between decentralisation and improved service delivery, and thus the link to poverty alleviation, is only valid if certain conditions are met, including, amongst others (i) political commitment at the national level; (ii) availability of financial resources at the local level, (iii) human and administrative capacity; (iv) sufficient information flows, (v) effective participation and consultative mechanisms.

[4] It is to be mentioned that also centrally funded programmes can be highly effective in developmental terms and it is not assured that all spending is more effective when left to local authorities. In Colombia, one of the most innovative and effective social programmes of the 80s, the establishment of crèches for children in rural areas, was a central government programme

The ***matching principle*** of local finance emphasizes that the financial capacity of local governments should be aligned with the functional responsibilities delegated to them. Often, however, this principle is not met and local governments are assigned with increased responsibilities in providing services that are not accompanied with an accordant transfer of financing means or powers. Additionally, if local governments are too small, this might implicate efficiency losses due to decreasing economies-of-scale in service delivery.

It is a common problem that the financial resources and fiscal competencies assigned to local governments do not match their tasks and responsibilities and are inadequate to meet the rising demands in infrastructure and public service delivery.

At the same time, local governments often lack the necessary capacities to effectively make use of the available resources and competencies assigned. This refers to the capacities of effective revenue-collection as well as to financial management and accounting and the capacities to link budget with development planning and implementation in order to provide effective and efficient infrastructure and other public services at local level.

Finally, local governments must be held accountable on how they deal with public resources to ensure that funds are spent according to the actual needs and development priorities. In the absence of strong and effective internal and external control mechanisms local governments often struggle with low levels of transparency and accountability, which opens room for corruption and misspending of funds.

Thus inadequate financial resources, combined with poor management of those resources and a low level of capacities and accountability, prevent effective delivery of local services - particularly to the poor. Regarding the infrastructure backlog, especially the current underinvestment in basic infrastructure imposes a major constraint on sustainable development and poverty reduction/pro-poor-growth and thus on the achievement of the Millennium Development Goals.

If fiscal decentralization is to be a reality, subnational governments must control their "own" sources of revenue. However, in order to become effective, the different dimensions of decentralisation must be developed in a balanced manner, which means (i) if functions are assigned to local governments these need to be elected, (ii) if governments have been elected, they need financial resources to comply with their functions, (iii) if resources are assigned and transferred, these need to match the expenditure assignments. However, this does usually not occur. Decentralisation around the world is being accompanied by different kinds of imbalances, which can be regarded as "childhood diseases" in some cases and as political obstacles in others.

The most common imbalances in decentralisation processes are the following:

- Exaggerated focus on the revenue side: The decentralization movement in many countries of ***Latin America*** over the past decade made the mistake of designing a system of decentralized finances, revenue assignments and transfers, in the absence of a clear expenditure assignment, which is to put the car before the horse. Revenues were assigned to sub-national governments and transfers put into place before it was decided what functional competencies would be transferred from the central government to sub-national governments. These experiences led to weak decentralized systems and fiscally overburdened central governments, which in many cases continued to take on most expenditures responsibilities with fewer resources. The focus on the revenue side of decentralization and the neglect of a clearer assignment of expenditure responsibilities has also been a common theme of the decentralization process ***in countries in transition*** over the past five years.

- Focus on the political dimensions: In many African countries, expenditures have been assigned to local governments and elections held but the availability of financial resources is lagging behind, which puts in danger the democratic potential of the reforms
- Focus on the administrative dimension: In Ethiopia, expenditures have been assigned to municipalities but local elections are often delayed and transfers for municipal functions have not been designed at all, which leads to serious risks in public health and hygiene in urban areas

On the other hand, there are examples of comprehensive legal frameworks, among least developed countries as well as middle-income countries:

Rwanda: Low-income country with a convincing legal framework

Despite being one of the poorest countries in the world, since 2000 Rwanda has developed one of the more coherent policy and institutional frameworks in decentralisation in Sub-Saharan Africa.

In 2000, the Government launched a National Decentralisation Policy with the aim of strengthening the practice of good governance and promoting the mobilisation and participation of the people in determining their own well-being. Subsequently, Districts have been accorded a greater role for service delivery across all sectors. The four provinces remain arms of the central Government, whilst districts and cities exercise budgetary autonomy. Boundaries of local governments have been redrawn to consolidate and reduce the former number of districts, thereby strengthening their financial viability.

The current system of ***intergovernmental fiscal transfers*** is based largely on three flows of resources from the central Government to sub-national governments: (i) an un-earmarked block grant (the so-called Local Authorities Budget Support Fund, LABSF) from central Government to finance administrative costs (including salaries); (ii) grants earmarked for the delivery of specific public services at sub-national level; (iii) a development grant through the Common Development Fund (CDF) to fund capital projects.

Earmarked funds accounted for around 87% of central government transfers to districts in 2007[5]. The relative importance of these three main sources reflects the current status of the decentralisation process. Whilst the long-run objective is to devolve services, which are currently delegated to local government level (which implies a progressive decline in the use of earmarking), the requisite capacities of local governments and the associated

[5] Some of these funds are paid in ways, which encourage local providers to improve service delivery. For example, the Ministry of Education funds primary education through capitation (per capita) grants. So, if enrolment increases, so does the revenue of the school.

mechanisms for managing devolution have yet to be established for this in the majority of line ministries. [6]

The unconditional block grant has recently been increased from 3 to 5% of the previous year's (central Government) domestic revenue, which provides for little more than the operating costs of local governments. It is expected that this grant will increase in (relative and absolute) importance over time as devolution becomes more effective. It is already high when compared to comparable transfers in francophone African countries (See Chambas et al. 2009) The horizontal allocation of the block grant among local governments shall be governed by a formula, which is based on population, revenue per capita, area, 'percentage increase in revenue collection' (an incentive component with regard to local revenue generation) and 'financing gap of district' (with respect to operating cost – an equalisation component).

Earmarked sector grants are determined by and operated through the budget process of the line ministry with oversight responsibility for the function concerned (e.g. Ministry of Health, Education…). In the budget preparation process, line ministries indicate the level of earmarked resources (recurrent and development) to be transferred to each district under the various budget programmes. In most cases, allocation is already based on formulae, as required by the PEFA framework (add footnote). Disbursement is linked to certain formal requirements, such as (i) a specific set of services under the mandate of local governments (e.g. primary education), (ii) Output targets to be achieved by the local government over the budget period (e.g. classroom to pupil ratio, or number of people served with water), and (iii) Agreed quantity of activities, as proposed set out in the annual action plan (e.g. number of classrooms built).

Transfers through the CDF come from the Government budget as well as donors. GoR has committed itself to channel an amount equivalent to at least 10% of the previous year's domestic revenue collection to the fund. Further funding for the CDF is provided by the donor community. At the outset, the allocations from the CDF to districts were equally distributed among districts. This method of allocation was replaced in 2005 with a dedicated formula, based on population size, geographical area and indicators relating to household welfare and access to basic infrastructure within each district. Access to CDF funds, however, requires district governments to go through a project preparation process and to submit documents related to the progress of works before disbursements become effective.

This procedure has been classified as "conditional budget support": districts are autonomous with regard to the selection of investment projects but disbursement is regulated in order to limit fiduciary risks. At the same time, efforts are made to improve financial management at sub-national level. This is reflected in the Organic Budget Law of 2006, which foresees the decentralisation of most elements of public financial management from the Ministry of Finance and Economic Planning to the various budget entities, including Local Governments.

The Government of Rwanda has introduced in 2007 a new accounting system, along with a new chart of accounts. The format of the budget has been modified accordingly. The implication of this reform on the 2008 budget preparation is the change in the economic classification of the budget, and the integration of the recurrent and development budgets.

[6] Some observers have criticized that the system were rather deconcentrated than decentralised. However, according to the assessment of the author, this argument is not valid in view of the requirements for gradual reforms, starting from a very different system, and in view of frameworks in other African countries

The ***2007 PEFA Assessment*** (See Johnson et al. 2007) has recognized the GoR's efforts to improve Intergovernmental Fiscal Relations as well as PFM. It has considered the formulae for transfers to districts as sufficiently transparent and rule based and has also acknowledged that the budget process were designed to ensure that local governments receive timely and reliable information on their allocations from central Government. A positive Score A has been attributed to both dimensions. A more hesitant judgement is given on the districts' reporting on budget execution. The legislative and procedural requirements for reporting are considered as clear and appropriate. However, the environment for this function (skill and experience of staff) as well as the accounting function is regarded as weak and staff was found to have difficulties to handle the formats. ***An above average Score B was attributed to the PFM-topic "Transparency of Inter-Governmental Fiscal Relations"[7] as a whole.***

The Philippines: A decentralised lower-middle income country

The Philippines – besides Colombia – feature among the highly decentralised developing countries, where the reform process started early with a reasonable degree of comprehensiveness and continuity. Comprehensiveness refers to the difference between devolution and deconcentration, which is often discussed when criticizing the decentralisation framework in Sub-Saharan Africa.

The ***Local Government Code*** of 1991 (LGC) represents a major ***shift in local governance***[8]. It mandates the devolution of the Local Government Units (LGUs) of many functions previously carried out by the National Government with regard to investment planning and development as well as service delivery. Responsibilities are transferred to the corresponding sub-national levels (Provinces shall assume *area-wide* functions, roles and responsibilities, while cities and municipalities shall coordinate and deliver all *basic*, regular and direct services under their jurisdiction, with a minimum of shared responsibilities, which is a reasonable principle).

The devolved activities include the provision of municipal infrastructure such as public markets, bus terminals and roads, water supply and sanitation, solid waste management, school construction, basic health services, social welfare, environmental protection and agricultural extension. Accordingly, the budgets of line ministries such as the Departments of Agriculture, Health and Social Welfare were cut substantially, close to 50 % of their staff was devolved to subnational levels.

In order to cope with these responsibilities, LGUs were provided greater ***autonomy in mobilising resources*** and allocating these for service delivery. Transfers from national government were increased and fiscal management mechanisms improved in order to provide LGUs with a predictable amount of finance. LGUs receive a fixed share of the central government tax revenues (40 %), which is called "Internal Revenue Allotment" (IRA).

[7] The Term "Intergovernmental Fiscal Relations" describes the financial relationships between Districts and the central government. Such formal mechanisms must also apply to the financial relationships between the Districts and lower Administrative levels.

[8] Specifically, the LGC's policy declaration states: "…the State shall provide for a more responsive and accountable local government structure through a system of decentralisation whereby local government units shall be given more powers, authority, responsibility and resources", regulated by a Local Tax Code and the Real Property Tax Code..

Transfers to different vertical layers of LGUs are fix as well: provinces and cities receive 23 % of the total annual transfer, municipalities 34 %, and barangays[9] 20 %.

Within each category, individual LGU shares are based on population (relative weight of 50 %), land area (25 %) and equity considerations (25 %). It has been argued that the IRA formula is not perfect, as it does not dynamically compensate for changing fiscal conditions of LGUs from an equity point of view. Further, it does not include LGUs' different status with regard to uncovered infrastructure needs and may not provide sufficient incentives for LGUs' good performance. On the other hand, the perfect formula has not been defined yet: The General Allocation Fund in Indonesia is criticized for not being sufficiently equalizing as it is supposed to be, which has a negative impact on poorer municipalities.

Intergovernmental transfers grew very fast in the 90s and accordingly, the share of the IRA in total LGU revenues increased from 40 % in 1991 to over 60 % in the mid-90s. IRA growth rates approached 40 % p.a. in the early 90s, declined to 14 % between 1994 and 1998 and have been reduced to single digits since 1999. As for the future, revenue allotments are not expected to grow very fast, due to deficit problems of the Central Government, but may still be maintained in real terms, thus providing a considerable level of predictability. The IRA is automatically and directly released to the LGUs on a quarterly basis and minimal restriction is imposed on the use. Only 20 % of the IRA shall be earmarked for investment financing (the so-called Local Development Fund).

In this regard, the legal framework in ***Colombia*** is more specific, at a similar level of overall decentralisation: The "sistema general de participaciones" has established transfer quota to be invested in education, health and other purposes, in order to assure a balanced development, in line with national priorities (quota to be attached)

Capacity constraints are another cause of imbalanced local development, even if the policy framework is comprehensive. Local governments often lack the necessary capacities to effectively make use of the available resources and competencies assigned. This refers to the capacities of effective revenue-collection as well as to financial management and accounting and the capacities to link budget with development planning and implementation in order to provide effective and efficient infrastructure and other public services at local level.

Finally, local governments must be held accountable on how they deal with public resources to ensure that funds are spent according to the actual needs and development priorities. In the absence of strong and effective internal and external control mechanisms local governments often struggle with low levels of transparency and accountability, which opens room for corruption and misspending of funds.

Thus inadequate financial resources, combined with poor management of those resources and a low level of capacities and accountability, prevent effective delivery of local services - particularly to the poor. Regarding the infrastructure backlog, especially the current underinvestment in basic infrastructure imposes a major constraint on sustainable development and poverty reduction/pro-poor-growth and thus on the achievement of the Millennium Development Goals.

3 Intergovernmental Fiscal Relations

[9] Barangays are the lowest LG layer, comparable to comunidades, woredas or communes.

The first fundamental step in the design of a system of intergovernmental fiscal relations must be a clear ***assignment of functional responsibilities*** among different levels of government. A stable and meaningful decentralization requires an unambiguous and well defined institutional framework in the assignment of expenditure responsibilities among the different levels of government together with the sufficient budgetary autonomy to carry out the assigned responsibilities at each level of government.

With respect to resource allocation function. Decentralization of taxing and spending power allows subnational governments to tailor schemes that match the demand of their constituency which will increase efficiency ultimately because local governments have better information about their residents' needs than the central government.

Intergovernmental fiscal relations must be thought of as a fiscal *system,* and all the pieces of that system must fit together. It involves more than what is traditionally referred to as fiscal issues. In fact, the electoral system and other forms of accountability, civil service reform and a number of institutional arrangements are as important in assuring success as are the taxing and spending components.

Key elements in any plan for rolling out fiscal decentralisation are:

- Expenditure assignments and autonomy;
- Revenue assignment and autonomy;
- Design of the intergovernmental transfer system;
- Provision for fiscal discipline;
- Civil service rules; and
- Political accountability.

These different elements do mutually influence each other. As such, the way the system of intergovernmental transfers is shaped can influence the other components of the system. (See van't Land 2009) The following chapters will deal with the first three components mainly.

3.1 Expenditure Assignments – Who does what?

There are no hard and fast rules about which functions should be designed to which level of government. ***Expenditure assignment*** decisions should be based on a unbundling of each function into sub functions, and for concurrent functions the identification of attributes for regulation, financing and implementation, and then analysis of the viability for each as a central or local responsibility'. Bahl and Martinez-Vasquez (2006) note that 'policy analysts, international donors and central ministries, all find reasons to shy away from this difficult analytical task'.

For the various layers of government and their service delivery tasks, this normally means that a local government is best placed to deliver those services for which the 'delivery area' (or people that benefit from the service) falls entirely within the administrative boundaries of that government unit. *Feeder roads are normally a task of a district government, while district roads –that connect two districts-are normally the responsibility of the provincial or national level. Equally primary* *schools could be the responsability of a village government, while secondary schools could be managed at the sector or district level.* For instance, certain traditionally municipal services can usually be provided better at the ***local level***, including: garbage collection, Street lighting, Street paving (local streets), Traffic lighting and Municipal police. Other functions usually can be provided better at the ***central government*** level, such as: National defense, Border controls, International affairs, and Education standards.

Expenditures undertaken by government for ***equity or income equalization reasons***, such as social welfare or low income housing, is generally thought to be the domain of the ***central government***. Local or regional governments will not be able to sustain independent programs of this nature because they will attract the needy from other areas while they will have to tax their (potentially mobile) residents more heavily.

While funding for these expenditures should be a central government responsibility, implementation can very well be left to local governments which may have informational and other comparative advantages. Expenditures undertaken for the stabilization of the economy such as massive investment or unemployment compensation are by their scale naturally ascribed to the central government.

For conceptual reasons there is scope to distinguish between expenditure assignments for ***decentralised functions***, for which, in principle, districts have a certain degree of freedom (or discretion) to allocate the resources, and ***delegated functions***, whereby districts simply implement activities on behalf of central government which may lead to efficiency gains –as the managers and implementers are closer to the end-users-, but which may be less relevant to the local development agenda, and for which the core decentralisation principle of allocation gains (increased effectiveness) is not applicable. Both types of activities are equally relevant.

Though regional and local governments have autonomously elected legislative powers the heads of the executive powers often continue to be appointed by the center, an institution associated with centralized unitary states. This has led in many transition countries to an unwieldy ***mix of deconcentration and decentralization*** of government activities. One way to examine the adequacy of expenditure assignments is to analyze how well the actual assignment of responsibilities fits the fundamental rules for the ideal assignment of responsibilities in a decentralized system of government.

There is no absolute best way for deciding which level of government should be responsible for particular public services. The adequacy of any assignment has to be judged in terms of how well it achieves the goals or objectives set up by the government in its decentralization strategy. Further, the ***efficient provision of government services*** requires that government satisfy the needs and preferences of taxpayers as well as possible. This is best achieved by the "***subsidiary" principle***. Responsibility for the provision of services should be at the lowest level of government compatible with the size of the "benefit area" associated with those services.

Example: The benefit area for sanitation services is clearly the local community, but for air traffic control the benefit area is the entire national territory. Leaving the *supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient under-provision of services; e.g., a tertiary hospital providing regional services is solely financed by a single municipality.*

Expenditure assignment needs to be the first and fundamental step in the design of a decentralized system of intergovernmental finances. Only highly centralized systems are able to work without expenditure assignments. *For example, under the Soviet Union, because all government budgets were integrated with the federal budget, additional resources could be counted on when there was an unexpected shortfall for subnational governments.*

As unitary systems become more decentralized, (and clearly in the case of federal systems), the failure to establish by law a clear assignment of expenditure responsibilities for each government level can become a source of conflict between the central and subnational governments and can lead to an inefficient provision of public services. In situations where government budgets are tight, which is almost always, the lack of clear assignments may lead to the underprovision of key public services.

In the design of a decentralized system of intergovernmental finances, there is an obvious need for a policy decision on concrete assignment of expenditure responsibilities between the central government and the regions and between the regions and the local governments. The explicit and systematized assignment of functions and expenditures to the different levels of governments still needs to be a priority in transition countries' strategy for decentralization. A specific assignment protects sub-national government budgets by making the ad hoc transfer of responsibilities from the central government harder and by helping to guarantee the continued provision of services. A specific and concrete assignment of expenditure responsibilities, of course, should not detract from the flexibility needed to adapt government budgets to major changes in policy.

Common Problems with Expenditure Assignments and the Need for Reform

The lack of specific and clear assignments of expenditure responsibilities necessarily conditions the adequacy of any tax revenue assignment and fiscal equalization mechanism. Clearly, both systems can be inadequate for different expenditure assignments and can easily become obsolete as soon as expenditure assignments are significantly changed. The experience of many economies in transition shows that without a specific expenditure assignment, it is revenue availability that dictates the responsibilities of each government level. This leads to institutional instability and again to an inefficient provision of public services. Problems with expenditure assignments can be classified as follows:

- <u>Lack of Formal Assignment</u>: A common problem in countries in transition is the lack of a formal assignment of responsibilities. While a great deal of attention has been given to issues of revenue sharing and government transfers in the first years of the transition, much less attention has been given to the first logical first step in a system of intergovernmental finances: an efficient and stable assignment of expenditure responsibilities to particular levels of government. *The experiences of countries such as Kazakhstan, the Russian Federation, and Ukraine show how the lack of formal assignments may be a destabilizing factor in intergovernmental relations. In these* *countries, early in the transition, expenditure assignments had been continuously reworked by the central authorities simply for fiscal convenience as a tool of fiscal deficit containment*. From a fiscal management perspective, a formal expenditure assignment also introduces an important element of certainty for budget planning at all levels of government.

- Inefficient Assignments: A second common problem in the assignment of expenditure responsibilities is the inefficiency of the assignments. The problem in the early years of the transition, which has been slowly solved, but also common to other countries, has been the assignment of all capital expenditure responsibilities at the central level, independently of the level of government responsible for the provision of the services associated with the capital infrastructure. This assignment was guided either by the capacity to finance large projects or by the belief that only central government officials are qualified to make capital investment decisions. However, the full assignment of capital expenditure responsibilities to central government is not justified.
- A second important set of problems comes from the assignment of expenditure responsibilities for social protection and welfare to local governments. This is especially wrong when the responsibility for funding is assigned to regional and local governments out of general budgets. There is much less of a problem if social protection services are provided by the sub-national governments but financed by the central government. Local governments may have a comparative advantage for the efficient delivery of these services, given their proximity to local residents. But regional and local government financing responsibility for these services runs against the ultimate objective of helping the most needy because the need for social welfare and assistance is so much higher in poorer jurisdictions, which are at the same time the least able to provide the necessary funds to cover social protection needs.

Other areas where there have been problems with expenditure assignments include the responsibility for ***public utilities*** such as water and sewerage at the central level when these services should be assigned at the sub-national level. Ideally this type of service would be provided by ***corporate entities*** dependent upon or regulated by subnational authorities and with full-cost-recovery pricing.

Despite the ambiguity in assignments, remarkably few open conflicts or ***disputes*** have taken place between the central and subnational governments in terms of assignment of expenditure responsibilities. From the operational side, conflict and negotiations vary from country to country. For example, in the case of Kazakstan, only three types of services were recently the object of negotiations among the central and subnational governments: the maintenance of specialized education establishments, certain defense expenditures, and transfers to low-income families.

However, the ***actual assignment*** of functional responsibilities is often quite different from what it appears to be in the "formal" assignment established by law or practice. Even though, in terms of actual expenditures going through the budget, ***education*** would appear to be for the most part a local (or regional) activity, many key decisions in educational policies are carried out at the central level in many countries. More in particular the Ministry of Education may be responsible for the construction of school buildings, curriculum design, teacher training, and design and production of textbooks. Activities that are preserved at the local level may be the recruitment and hiring of teachers. At times, the local government may be given the authority for appointing principals, school inspectors and teaching specialists. However, even in these cases local authority is limited because of the dual subordination of school officials to both the Ministry of Education and to the subnational government. In many countries in transition as well as developing countries, even the head of the district administration is ultimately a central government appointee. Similar issues to those in the education sector arise in other sectors such as health.

The co-sharing or ***fragmentation*** of responsibilities within a particular public service has the disadvantage that it is likely to cause confusion leading to inefficiencies. In an ideal world, all inputs for the delivery of a particular service would be simultaneously decided by one single authority. With the fragmentation of duties within a service it is more likely that a relative disproportion of funds will be spent on salaries and much less on other operation expenditures; similarly, maintenance may be reduced to a minimum.

On the other hand, in reality the co-sharing of responsibilities for a single service may be inescapable. This may be the case for example for education where national governments may take on the responsibility for higher education while subnational governments take on the responsibility for primary and secondary education. Co-sharing of responsibilities may also take place within a particular function. Thus, for example, while subnational governments are responsible for primary and secondary education, curricula and textbook production may be carried out by the national government.

Co-sharing of responsibilities may not be a problem when particular functions and tasks in a common area are clearly assigned to different levels of government. However, it is a common practice to leave responsibilities unclear when they are assigned to more than one level of government. These are the so called common competencies or functions which often has led to conflicts in service approach and to less than adequate coverage. In difficult fiscal conditions, spending less or even withdrawing from common competencies is more defensible for both central and subnational governments.

Some country-specific assignments

There is a variety of expenditure assignment across countries. This variety reflects both different approaches to decentralization, as in federal and more decentralized countries, and unitary and more centralized countries.

In those transition countries that were a part of the ***Soviet Union*** (the CITs) there is a broad correspondence between the geographical dimension of benefits from a particular service and the level of government responsible for its provision. Most often, by and large, the functions allocated to the central government have a national dimension. These include defense and internal security, the justice system, foreign relations, and research.

Some of the expenditures with macroeconomic and redistribution implications such as pensions and unemployment compensation are also the responsibility of the central government. These are financed by extra-budgetary funds.

Correspondingly, most of the expenditure responsibilities of subnational governments involve services with regional or local "benefit areas" such as tertiary hospitals, primary education, fire protection, or sanitation. However, appearances are misleading and many of these countries have several important problems in expenditure assignments.

The ***shares of subnational governments*** in the consolidated budget have remained constant in some cases (e.g., Russia and the Baltic states) but have fluctuated significantly in other countries (for example Ukraine and Kazakhstan). These fluctuations reflect both the additional shifting of expenditure responsibilities to subnational governments and the relative budgetary priority given by the government to services provided at the central and subnational levels. In the least developed countries, during the first generation of PRSP the spending on the social sectors was a major concern but development partners did not follow up whether spending was done on national and sub-national levels.

Ethiopia: A unique case of assigning functions

The Ethiopian distinction between the so-called "***state" and "municipal" functions*** is a world-wide unique feature of expenditure assignments to sub-national governments. Besides police justice, trade, industry and finance, basic education and health care are regarded as state functions (which is unusual in a decentralized context). Waste management and local roads (as well as other economic infrastructure like markets and slaughterhouses) and city planning, construction, housing, land administration and development are under the city or municipal administration[10]. Responsibilities for water supply and sewerage are shared between the regions (capital investment) and the ULGs (recurrent expenditure). In some regions, zonal administrations do also have a share in this.

The city administration is subdivided into ***State and Municipal Functions***. State functions are. Municipal functions cover general administrative services, waste management, water and sewerage, municipals roads,. The State functions are directly under the responsibility of the Mayor or cabinet members who report to the Mayor, the Municipal functions are administered by a City Manager who reports to the Mayor.

Expenditures for the state as well as the municipal functions are administered by the ULGs but the ***state functions*** (unlike the municipal functions) are just *delegated* to the local authorities. Accordingly, regions do receive grants from the central government to comply with the state functions and ULGs receive some grants from the region for this purpose. Different from this modality, ***municipal functions*** are to be funded by own locally generated revenues, but capital investments may also be financed by special purpose grants received from the regional state as well as donors/NGOs. In all regions, except for Amhara, separate budgets, accounting records and administrations are maintained for the state functions and municipal functions, although there are intentions in some of the other states to merge the two separate administrations but still maintain separate accounting records.

As far as the revenue side of the budget is concerned, the Ethiopian Constitution stipulates the distribution of the different ***tax revenues*** between the federal government and the regions. Under this system, around 75 % of the total tax revenues belong exclusively to the

[10] As for the budgets, some ULBs have separated the municipal administration from the city administration, dwhile both are public administrations.

federal government, including the VAT as a major source. As a result, most regions do heavily depend on grants to comply with the state functions (80 % dependency rate on average).

Given the limited capacity of districts to raise own revenues, over the short to medium term, the majority of service delivery will be financed through a series of earmarked grants, whilst block transfers will fund administrative functions at the districts and provide discretionary funds to supplement earmarked allocations to service delivery.

3.2 Revenue Assignments to LGs

The question of the ***revenue assignment*** -who and which level of government are the resources for the public sector functions raised? In fact the question is broader, and should rather read "at which level do resources for the public sector become available?", Contributions for the development partners –that constitute a substantial part of the public sector budget in highly aid dependent countries (between 30 and 50 %), should be included as well, as those resources normally become available at the national level (through bilateral agreements) while part of this is meant to fund activities that fall within the expenditure assignments of local governments. In general, it is the question of vertical sharing of public resources and hence the question of what share of the total government budget should be decentralised.

General considerations

If fiscal decentralization is to be a reality, subnational governments must control their "own" sources of revenue. Subnational governments that lack independent sources of revenue can never truly enjoy fiscal autonomy; they may be – and probably are – under the financial thumb of the central government.

The question, then, is which revenue sources can and should be assigned to subnational levels of government and how these assignments are to be effected. This group of questions is commonly called "the tax assignment problem." They are closely related to "the expenditure problem," because of the importance of benefit taxation in the finance of subnational government and the need to assure that subnational governments have revenues that are adequate to finance the expenditures assigned to them.

The taxes commonly thought to have the most powerful stabilizing effects are the corporate income tax and the progressive individual income tax--the former because profits fluctuate more than general economic conditions and the latter because of the stabilizing effects of graduated rates (including tax-free amounts). This suggests that these two taxes should be assigned to the ***central government***.

The distribution function is also commonly assigned primarily to the central level of government. First, subnational attempts at redistribution may not be successful, and they are likely to distort the geographic allocation of economic resources. Progressive taxation intended to "soak the rich" may drive out capital and high-income individuals.

Even if subnational taxation achieves some redistribution within a given subnational jurisdiction, interpersonal inequalities may persist across jurisdictions. These can be addressed only by national policies. In some cases it may be better to use intergovernmental grants to address differences in average income levels in various subnational jurisdictions than to use taxes and transfers to individuals.

If ***subnational governments*** cannot much affect macroeconomic conditions nor easily adjust to wide swings in revenues, it is appropriate for them to rely relatively heavily on revenue sources that are relatively insensitive to macroeconomic conditions. These include taxes on consumption, such as general sales taxes, excises, and property taxes. Subnational governments should levy taxes but not generally rely on corporate income taxes – and that access to revenues from these taxes should be made available to subnational governments only subject to rigid controls.

Related to the local-government revenues or tax code is the issue of ***revenue sharing***. Revenue sharing has a number of advantages and disadvantages. One of the major concerns, however, is how a system of revenue sharing would fit in with the style of the desired system of intergovernmental relations. In some countries property taxes are imposed and collected by central government but are wholly or partly transferred to local government, which does not provide obvious advantages. Revenue sharing also takes place with regard to the value-added tax (VAT).

Each level of government should be assigned taxes that are related to the ***benefits of its spending***. Thus, the proper assignment of taxes that are related to benefits depends on the assignment of expenditure functions. In general terms, the central government should be responsible for expenditures having benefits that extend across sub-national boundaries or that are characterized by economies of scale not realized at the subnational level. The following ***taxes*** are usually reserved for the ***central government***:

- Import duties,
- Value-added taxes, and
- Corporate income taxes.

Certain ***taxes*** are usually, and for good reason, collected mainly by ***local governments***, including:

- Property taxes,
- Commercial or business licenses,
- Industrial cess, and
- Local retail sales tax.

To the extent possible, services provided by government should be financed by user charges and fees. This is both fair and efficient, in the sense of encouraging responsible use of the nation's economic resources. A fee-based approach allows beneficiaries to pay for identifiable public services that might otherwise not be provided. *Among the best examples of benefit-related taxes are those levied on motor vehicles and motor fuels and used for the construction and maintenance of roads and highways.*

Tax assignment should exhibit the following characteristics.

- Own revenues: First, subnational governments must have enough "own" revenues to finance the services they provide. If a subnational government legislates and collects its own taxes, protected by meaningful constitutional safeguards of its right to do so, it clearly has a source of own revenues.
- Marginal revenues: Even if subnational governments have own revenues, they may not be able to affect the amount of revenue they receive. This is true, for example, if the central government shares revenues from certain taxes with subnational governments. By comparison, if subnational governments legislate and implement their own taxes – or even if they are allowed to impose surcharges on the taxes levied by the central government at rates they choose, they can affect the amount of revenues they receive. This distinction is crucial, because subnational government must be assigned sources of marginal own revenues—own revenues whose level they can control--if they are to be truly autonomous.
- Subsidiarity in taxation: It is commonly accepted that expenditure responsibility should be assigned to the lowest level of government that simultaneously reflects the geographic scope of benefits of public services and achieves economies of scale; this is commonly called the principle of subsidiarity. A similar principle can be evoked in the area of tax assignment: a given tax should be assigned to the lowest level of government that can implement it (or for which it can be implemented) and for which it is not inappropriate. Compliance with this principle is important to minimize the tendency towards vertical imbalance, which exists because subnational governments have difficulty implementing many taxes, but higher levels of government can implement almost any tax that a lower level of government can implement

Alternative Methods of Revenue Assignment

A variety of methods of assigning revenues to subnational governments can be distinguished. These methods differ in the degree of fiscal autonomy they provide subnational governments, their ease of compliance and administration, the fairness and neutrality they are likely to produce, and the degree of interjurisdictional redistribution they can accommodate. In discussing these alternatives, it is convenient to distinguish four features: (a) which level of government chooses the taxes from which subnational governments receive revenues, (b) which defines the tax base(s), (c) which sets the tax rate(s), and (d) which administers the tax(es). From the viewpoint of subnational fiscal sovereignty, the capacity to set rates is clearly the most important of these; it is what allows subnational governments to choose the level of public services.

Independent sub-national legislation and administration provides subnational governments the most fiscal autonomy. Under this approach subnational governments choose the taxes they levy, define the tax base(s), set the tax rate(s), and administer the tax(es).56 This is the approach followed in the United States; subject only to very general constitutional limitations (e.g., due process and non-interference with interstate and international commerce) and almost no statutory limitations, the states can do virtually anything they want in these four areas.

Carried to the extreme, this approach is vulnerable to inconsistency, duplication of effort, and excessive complexity of compliance and administration. These problems can occur if different jurisdictions choose radically different taxes (e.g., if some levy retail sales taxes, but others levy value added taxes), define their tax bases in different ways or administer the same taxes in different ways. Inequities and economic distortions can also occur if the tax systems of various subnational governments do not mesh, resulting in gaps or overlaps in taxation.

Within limits, these problems – which differ in importance from tax to tax – may be tolerated in the interest of gaining the benefits of decentralized government. But serious complexities, inequities, and distortions can and should be avoided. This objective can be achieved, without greatly compromising the fiscal autonomy of subnational governments, through intergovernmental compacts among subnational governments or the imposition of uniform ground-rules by a higher level of government, for example, rules for the definition and division of the corporate income tax base. Alternatively, subnational surcharges on national taxes can be employed[11].

There is no reason, in principle, that the tax rate of the central government cannot be zero for a particular tax; in such a case the central government would simply administer the tax of subnational governments, thereby assuring uniformity and avoiding duplication of effort. There is, however, a problem of providing incentives for the central government to collect a tax that it does not keep – and, indeed, of trusting it not to keep the revenues it ostensibly collects for subnational governments. These problems exist in any system of surcharges.

Subnational surcharges appear to be the most appropriate means of providing subnational governments with own marginal revenues in many countries, especially LDCs and CITs, where administrative resources are scarce. While some Canadian provinces (the largest and wealthiest) implement their own individual and corporate income taxes, others rely on surcharges on the national taxes. In both cases tax bases and apportionment formulas are quite similar, if not identical.

Tax sharing is generally much less attractive than subnational surcharges. Under this approach subnational governments receive fixed fractions of revenues from particular national taxes originating within their boundaries; commonly the sharing rates are uniform across jurisdictions (though not across taxes), but this is not necessarily the case. As with surcharges, formulas may be needed to determine the deemed origin of tax revenues. In many less developed countries (LDCs) and countries in transition (CITs) the data needed to share revenues (e.g., data on consumption, by subnational jurisdiction, needed to divide revenues from the VAT) may not exist or may not be reliable.

This approach also avoids the problems that arise from extreme subnational independence in tax policy. But it does so in a way that severely restricts fiscal autonomy of subnational governments. Individual subnational governments have

[11] Under this approach a higher level of government defines the tax base and collects both its own tax and surcharges set by subnational governments. This approach ideally avoids the problems that occur when different subnational jurisdictions define the tax base in conflicting ways,

autonomy over how to spend a given amount of revenue, but not the power to alter the amount of revenue they receive from shared taxes; thus they cannot control the level of public spending. (While all subnational governments, acting as a group, can attempt to affect their share of revenues from these taxes, no subnational government, acting unilaterally, can hope to do so. The harmonized sales tax employed in several of the maritime provinces of Canada, which combines federal and provincial VATs, illustrates the problem. All of the provinces that participate in the scheme must implicitly adopt the same VAT rate. In Germany the central and subnational governments engage in an annual struggle over the split of revenues from certain taxes.)

Revenue sharing assigns revenues of higher levels of government to lower levels of government on the basis of formulas. Though the origin of revenues can be reflected in such formulas, it is more common for formulas to be based, inter alia, on population, tax capacity (inversely), or measures of need, such as per capita income. Since revenue sharing is not based on the origin of revenues, this approach offers an alternative that does not exist (or exists only in attenuated form) under the three methods of revenue assignment just discussed: redistribution of fiscal resources between jurisdictions.

Some governments (Ethiopia, Rwanda) ceded the income ***tax on rental income*** to the local authorities, at a time when capacities of their national revenue authorities was low and when local authorities needed a revenue stream. Regardless of the reasons, DFID advisors came to the conclusion that such an arrangement – apart from being unusual - is definitely sub-optimal[12]:

Firstly, it is not regarded efficient for the income tax to be split amongst different agencies (national Revenue Authorities and local authorities). Purchase of property is a common means of concealing funds that have been illegally siphoned off from a business. Involvement of different taxing authorities means that there is a 'disconnect' on the reporting of assets and income. A taxpayer siphoning income from his business and using that income to purchase housing for rent is not immediately obvious to either institution.

Secondly, there is the definition of what constitutes business income vis-a-vis rental income. Many taxpayers have more than one property let. Clearly with many properties rented, taxpayers are effectively engaged in business, rather than simply in receipt of casual rental income. As such they should be registered with the National Revenue Authority and obliged to return their rental income as business income. The confusion between business rental income and casual rental income is likely to lead to a significant overall revenue loss. Instead, rental income is recommended to be added to other income and emoluments and often pushes the taxpayer into a higher tax rate band with the consequence that more tax is paid.

Thirdly, the revenues from the retention of tax on rental income are insignificant and not viable when compared to the costs of collection and the lack of capacity to asses and collect at the local administrations. It is assumed that local authorities do not have the technical expertise to effectively assess this income, given that

[12] These arguments were collected from a policy dialogue between the Rwandan Government and DFID on new tax legislation and confirmed by the author's own experience from appraisal missions in the emerging regions in Ethiopia.

included in this category are all the rentals paid by embassies and international institutions, often in foreign currency and often to offshore bank accounts in respect of private housing (likely to be a very large sum).

3.3 The need for a legal framework to define fiscal relations

With regard to the required overall political commitment for fiscal decentralisation some advisors recommend consolidating decentralization by ***constitutional reform*** as a sign of broad consensus since it usually requires much more political support than does ordinary legal reform (constitutional reforms were e.g. applied in Nicaragua and Colombia to give more powers to sub-national governments). Whether there is constitutional reform or not, there is a need to clearly specify rules of governance. Laws specifying the composition of local government — which, how, and how often local officials and councils will be elected — are basic, and due attention must be paid to them.

Usually a general ***local-government code*** is developed, either by a central-government entity in unitary systems (e.g. Philippines, Burkina Faso) or by a state or regional entity in federal systems (e.g. India). The respective superior level of legislature then passes these codes into law.

Local government ***revenue legislation*** will be necessary to clearly define the limits to which local governments will be able to tax and collect other fees. In some countries, say, where there is less local choice, local revenue plans must be approved by the central government. In other countries a single local-revenue law specifies taxing and fee powers for all local government. In still other countries, enabling legislation provides broad parameters within which local governments may act. Related to the local-government revenues or tax code is the issue of ***revenue sharing***.

As part of the decentralization process, the central government will often need to amend the current ***budget law*** or even write a new one in order to appropriately regulate the budget process at the local level as well as interfaces between national and local level during the budget cycle.

The ***structure of the budget law*** needs to be consistent with the preferred structure of fiscal federalism in the country. Where local governments are to be given greater autonomy, greater ***accountability*** is often a prerequisite. Budget laws can prescribe transparent procedures for budget formulation and discussion at the local level. Posting budgets, voting on or public debate of budgets, and periodic budget reviews at the local level are usually important aspects of this type of law. Where the principal-agent model is dominant, the budget law may prescribe how, within central-government regulations, local budgets will be developed, presented to central-government authorities, and included in the central-government budget submitted to the legislative branch for approval.

In addition to the budget law, most countries have a ***treasury law***, which regulates how fiscal funds are to be managed, who will manage those funds, how public debt will issued, and how cash balances will be managed. In federal systems, or systems of extreme local choice, central-government treasury systems are irrelevant to local-government treasury operations, although these are usually regulated by regional (state or provincial) legislation. In some countries, even where local choice is strong or considered desirable, treasury operations for local governments are managed by the central government.

In any case it is very important that treasury regulations not discourage effective management by local officials. If local governments that are efficient in collecting and remitting tax receipts are made to subsidize less well-managed municipalities or even the central government without receiving adequate compensation, there will be undesired consequences.

3.4 Intergovernmental Transfers

Intergovernmental transfers

The question of the ***vertical (im)balance*** – How is any imbalance between income and expenditure at any level of government resolved ? Normally this is the point where intergovernmental transfers come in, which normally have -given that mostly the bulk of resources is generated at the national level-, the form of transfers from central government to lower levels of government, to ensure the latter have adequate resources to perform the

The question of the ***horizontal (im)balance*** -In other words, how should the total pool of resources destined for local governments be divided between them, and how and to what extent should adjustments be made for differences between government units at the same level of government in terms of (a) needs and (b) capacities to raise revenues.

Because of the imbalance of revenue-generating advantages at the central-government level and certain spending advantages at the local-government level, fiscal decentralization usually includes the ***transfer of financial resources*** from central to local government. These transfers can take many forms, with a varying degree of control and conditionality.

In general, transfer laws in countries where the preference is toward *local choice* will seek to impose few restrictions on municipalities regarding how they use these resources. In addition, transfer laws in these countries will usually be based on strict ***formulae***, including targeting transfers to specified criteria, such as population size, surface area, poverty levels, local fiscal effort. (Such criteria were specified e.g. in the distribution formulae in the Philippines, Rwanda and Colombia, to mention a few).

Textbox 2.4: Objectives and approaches to formula based grants

Normally, the formula should reflect the purpose of the grant, and in literature four strands of objectives are distinguished:

(i) The first objective is to reflect differences in expenditure needs. There are many different examples of indicators that reflect differences in expenditure needs such as (a) population; (b) physical factors that have a bearing on the cost of service delivery such as area, topography, levels of urbanisations, etc.; (c) indicators that reflect 'high costs populations' such as number of people below the poverty line; and (d) indicators that reflect different needs for both recurrent and/or investment costs for infrastructure such as length of the road network, percentage of people with access to water and or electricity, infrastructure needs related to economic potentials etc. Most earmarked sector grants, also in Rwanda, follow this objective.

(ii) A second objective could be to reach fiscal income equalisation, whereby the formula attempts to allocate more resources to districts that have a weaker tax raising potential, eg. because the area is poorer. The problem with this type of variables is the difficulty in establishing the 'actual tax potential', and not to confuse it with actual 'performance in tax collection'. Approaches normally used are to either include 'average income' as a proxy or to make estimates of the amount that Local governments could collect if all taxes were set at appropriate levels and a decent level of collection realised. Obviously, such exercises are quite cumbersome.

(iii) A third approach is to include a premium for good performance in respect of local tax collection directly in the formula, with the objective to provide incentives for local authorities to increase tax collection or rather the overall level of local revenue mobilisation. It can be done by including a variable that represents the tax effort, or by a minimum threshold that must be reached before becoming eligible to the grant.

(iv) Finally, a fourth objective, which is a combination of the first two objectives mentioned above is to make the formula fill the gap between the revenue potential and the expenditure needs. Although appealing, it also has all the difficulties of the above referred three previous objectives, although the level of difficulty depends on the objective of the grant i.e. what it is supposed to fund.

In other countries, where the revealed preference is toward the *principal-agent model*, transfers are designed with specific central-government objectives clearly stated. In such cases, local governments may be seen as having certain advantages in implementing specific programs, such as road construction, but the central government funds the program and "hires" local government as an implementing agent. An interesting but quite unique example of this is the Ethiopian separation of state and municipal functions (see Box).

Regardless of preferences, some transfer systems are just not transparent or not efficient. For instance, in francophone Africa the overall level of transfers is generally low, not known to local governments and in addition transfers are not predictable within the budget year.

Whatever idea about the volume of transfers and inbuilt control mechanisms may be, there is consensus among fiscal experts, that rules of transfer systems should be clear and transparent and should encourage behavior consistent with good management practices / give incentives for good fiscal performance and not encourage LGs to "remain poor" to receive more funds. The World Bank's PEFA assessments (Public Expenditure and Financial Accountability) do also favor formula based transfers.

In many countries, ***equalisation of grants*** is considered important. And surely it is, also in view of poverty alleviation objectives. However, the design of equalisation mechanisms is not easy. Firstly, the basic concepts involved in equalisation i.e. fiscal capacity, fiscal (or expenditure) need and fiscal effort, are not easy to understand. Secondly, the question needs to be asked : What is being equalised ?

Typically, to achieve an adequate level of equalisation, both fiscal capacity and expenditure needs, need to be equalised, which means the fiscal gap needs to be addressed. Quite often, however, the required hard data to operationalse the concepts are lacking.

Another question-apart from the degree of equalisation (should it always be 100%?) is whether considerations of equalisation for fiscal capacity need to be included in *each* grant, or whether they can be settled –provided data are available- through the unconditional grants.

Over the longer-term, the equalisation aspects of the unconditional grants becomes even more important, as it will need to cater for the residual differences not addressed by the 'expenditure needs estimates for the sector grants. It could even be argued that the sector grants only equalise partially, while the major chunk of it is assumed through the stronger pro-poor bias in the formula for the unconditional grant – and whereby poor districts can top-up the sector grants through contributions of the unconditional grant.

The manner in which resources are allocated by the central government among the various lower governments is the crux of a sound intergovernmental fiscal system, because in many, if not most countries the bulk of public resources is generated at the national level, while in a decentralised system of government the service delivery tasks are performed by lower levels of government.

There is wide consensus in literature that the potential benefits of both decentralisation in general, and fiscal decentralisation in particular, will only materialise if such an allocation system relies on a stable, equitable and efficient horizontal allocation mechanism, in order to provide stability, equity and efficiency. As such, ***formula-based grants*** can be an important component of intergovernmental fiscal relations.

Experts in the field of fiscal decentralization like to engage in controversial discussions, which country's reform process goes towards true decentralisation and which one may only reach deconcentration (See annex for definitions). The following box on the current practice in Rwanda indicates that there are many reasons for funds to pass through district budgets or not and it is not far too easy to claim that elements of deconcentration hint at lack of political will. Changes need to be gradual over time. It is not possible to decentralise the entire budget, and notably not the entire development budget immediately. Considering the limited capacities at the district and sub district levels, this would just not be realistic. Over the years, it is desirable that (i) Conditions of the sector grants will be increasingly relaxed and (ii) Un-conditional grants will increase at the expense of the conditional grants.

At the end of the day, it is likely that, in many countries, taxes reasonably assigned to subnational governments will not be adequate to finance the provision of services assigned to those governments or that they will result in horizontal fiscal disparities. If so, it may be desirable to use grants from higher level governments to compensate for vertical fiscalimbalance or to offset horizontal fiscal disparities.

While a complete discussion of the design of such grants is beyond the scope of this paper, one point deserves emphasis. Grants intended to offset vertical imbalance or horizontal disparities should provide infra-marginal funding for subnational governments, so as not affect the marginal decisions of those governments regarding the choice between public and private spending. It is especially important that subnational governments not be penalized for raising additional revenues, by reducing grants.

Formulae are mostly based on the idea that (i) districts with a higher population deserve a higher allocation; (ii) districts that are poorer deserve a higher allocation. In some countries, further aspects are added: (iii) that districts that improve their local revenue collection (as compared to the previous year) deserve a bonus; and finally (iv) that districts which have a larger gap between what they locally collect and what they need for staff expenditure deserve a large allocation.

The following guidelines are often given for defining appropriate ***allocation formula***:

- Keep it as simple as possible;
- Keep it transparent and objective (i.e. the outcome can not be manipulated by any of the involved parties by manipulating the data for the variables);
- Variables need to have an unequivocal relation with the purpose of the grant; and
- Variables themselves should not be related
- Avoid variables that create disincentive to enhance performance n either revenue or expenditure sides. It is important to keep in mind that allocation formulae are not meant to 'get it exactly right', but are to provide a fair overall allocation to all districts, whereby the districts, with flexibility to make decisions, can fine-tune the allocation to local circumstances.

However, experience of several countries has shown that the design of the perfect equalization formula is an impossible undertaking. Frequent changes are commendable as it shows willingness to improve, but on the other hand, there is the disadvantage that frequent changes undermine the credibility of any formula, while it also prevents the transfers becoming predictable (See box on Ethiopia). A simple formula cannot take all requirements into consideration, while complex formula are difficult to share with any audience beyond fiscal experts. In addition, efforts in least developed countries have shown that even simple formula may require updated data, which are difficult to generate.

Ethiopia: Controversial reforms of distribution formula

Vertical block grants are meant to contribute equalizing access to vital services between regions and / or local governments. Accordingly, the ***distribution formula*** is in Ethiopia a controversial issue and has been changed several times. Equalization efforts started as early as 1995, based on population, location, area and resource mobilization. Later, the level of development and own revenue generation were included. The formula in place until 2005/06, had a strong equalization impact towards large and under-populated regions, among them two of the four emerging regions (see graph below).

A ***new formula***, which was approved by the House of Federations, is currently being introduced. It intends to build on the Australian model and consider expenditure needs of regions (besides population and tax effort), which requires heavy data input. Up to Fiscal Year 2010/11, 100 % of block grants will be distributed according to the new formula. As the new formula builds on the "cost of service concept" instead of surface area and data availability is limited for peripheral regions, several of the emerging regions will be disadvantaged (Afar, Gambella). This does not directly affect the delivery of municipal services but limits the overall relative availability of funds at local level. It has been argued that such effects be outweighed by the increasing overall amount of block grants. However, the affected regions are concerned.

Rwanda: Simple formulae for Intergovernmental transfers but lack of data

Rwanda in common with every democratic state will continue to provide significant central fund allocations to LGs. The categorisation of these funds can be:

- Block grants
- Earmarked funds; or
- Limited discretionary funding.

At present, the allocation formula for the recurrent grant LASBF is based on four variables being population (20%), poverty index (20%), a bonus for revenue collection (20%) and the financing gap (40%). The allocation formula for the LABSF has been changed a few times over the years, but deserves to be revised again. This is mainly because, firstly the formula is too complicated to be widely shared and understood, and secondly because for several of the variables used, no accurate data are available, while proxy data as used at present provide a perverse incentive to revenue collection.

The allocation formula for CDF (which is the intermediary to finance district development projects) is, in principle, more straightforward and more simple (population 20%, area 10%, poverty index 40% and infrastructure index 30%). It is observed that that neither the data nor the calculations are widely shared (if at all).

Finding reliable data sets that can be used for allocation formulae is problematic. Even population data, for example, are (until data from the identity card project will become available otherwise until the next census) based on the Census of 2002, recalculated for the present district boundaries. As it is a first data set, population growth data are simply not available, apart from the fact that due to the genocide and the return of refugees, population dynamics are expected to be more unpredictable than one would expect in normal circumstances.

Latest figures show that the sources of revenues for Districts are :

- Own Revenues – 15%
- Block Grants – 11%
- Earmarked Transfers – 74%

DFID Technical note

Conditional versus Unconditional Grants

In view of the overall dimension of grants the LG finance, that nature of the grants is highly controversial. Controversy relates to the amount conditionality. In a centralised (and even in a de-concentrated) system, central governments typically treat local governments as agents in implementing national policies that use central government funding for narrowly defined activities. Such an attitude is not fully comprehensive with the theory of a decentralised system where local governments should be able to flexibly allocate resources in response to local needs and priorities, in which the local authorities are accountable to the local communities for the services they provide. The challenge is how conditionality can be relaxed or reformulated such that they provide local authorities, within the frame of national policies and set standards, some degree of freedom in the allocation of the resources

Thus as part of the decentralisation reform, government (together with the line agencies) has to decide in how far it wishes to rely on ***conditional transfers*** (the de-concentration model) or whether it wishes to go the route of increasingly ***unconditional transfers*** – whereby, as a long-term policy objective-in the end conditional transfers are only used for those activities that are considered important for the general good, but which would never be undertaken by local authorities on their own free choice (issue of *externalities).*

By adding ***grant conditionalities*** as a third dimension to be considered in the design of a system of intergovernmental transfers, in addition to the dimensions of the vertical and horizontal allocation, this yields three policy dimensions along which government have the opportunity to make policy choices (Boex and Martinez, 2003).

In developing as well as industrialized countries, the conditions (and level of earmarking) attached to transfers do vary widely. At the starting point of decentralization earmarking is generally tight and activity specific. In a decentralised model, the long-term vision of fiscal decentralisation is a system in which local authorities, through a combination of local revenue generation and transfers have enough resources to adequately deliver, in an autonomous or semi autonomous manner the services according to mandates given to them, while central government ministries set policies and standards local authorities have to go by.

Textbox 3.4 : Conditional and Un Conditional Transfers and the Theory of Decentralisation

Grants by the central government to local governments are often divided in unconditional transfers (also called block grants) that can be used entirely to the discretion of the recipient party (albeit, of course, only within the limits of the prevailing legal and policy frameworks guiding the functioning of local authorities), and conditional transfers, that can only be used for specific sectors or even specific activities within sectors. Generally, the more stringent the conditions, the less scope for decision-making by LGs, and, as a result, the more difficult to realise the objectives of decentralisation, which are based on the principle that local players can both better choose relevant activities (effectiveness) as well as choose the best way of implementation (efficiency).

3.4 LG Performance Measurement and Incentives to fiscal governance

One of the objectives of fiscal decentralization aims at providing better services to the local population. Though decentralization is proceeding in a considerable number of partner countries, reform processes are not always implemented in a comprehensive manner and the implications of some reforms may even contradict others.

Ambivalent Assessment of Reforms

The following observations have been made by SNV (see Tilburg 2008) with regard to Ghana, but are valid for many other partner countries to a certain extent. To summarise, it has been stated that contradictions in the policy set up are restricting the efficiency of local government’s performances in five different areas: decentralisation, planning, accountability, service delivery, and finances.

Decentralisation in Ghana (as well as many other countries) has taken the form of ***deconcentration***. Local governments are not fully autonomous but controlled by central government. Policy documents give an unrealistic number of responsibilities to the districts, without supplying them with an adequate amount of finances. It is not always clear where exactly the responsibilities of central government end and tasks of local governments begin.

The decentralised structure in Ghana goes along with two opposing ***planning processes***: top-down for dictating polities and bottom-up for proposing development plans. The combination of both processes results being counterproductive if policies are not in line with the felt needs in the districts and local development plans do rather reflect national than local priorities. Plans are sometimes covering a wide spectrum, budgets are not based on feasibility studies and are surpassing the potential income of districts, and priorities are not (or not comprehensively) identified.

In Ghana, a certain frustration is common among district officials with regard to planning, eventuating in developing plans, which do not require the undertaking of action. Documents and speeches seem to become increasingly characterised by a high intensity of wishful thinking.

In many partner countries there appears to be a contradiction between traditional governance (chieftaincy, caudillismo…) and modern forms of government, which are supposed to be ***accountable*** to their electorate. Traditional authority (including chieftaincy) is usually not rooted in democratic principles, but is popular; elected local governments may be democratic but not always popular. Assembly members are often internally divided, based on diverging urban/rural interest, the distribution between parties (in Latin America) or party and non-party members (in African countries with one party dominating).

The importance of the role of council members for the quality of local governance is often underestimated, and is restricted by inadequate resources. In countries, where elected local governments are new, community feeling is often absent (e.g. Ghana, Burkina, Ethiopia). In many countries, ***civil society organisations*** are poorly developed in the districts and are therefore not able to play a watchdog or advocacy role. There appears to be also no structural exchange of experiences between districts, Associations of Local Government Authorities often being weak and without well-defined functions[13].

Most local governments are presently delivering only a small part of the ***services*** of the total that they are supposed be responsible for. This is particularly valid for rural municipalities and emerging cities. This is sometimes due to incomplete devolution of responsibilities[14], and sometimes due to lack of capacity and capital to

[13] This is particularly alarming as many such associations have been supported by development partners for a long time. The French cooperation is active in francophone Africa in this regard and GTZ has a long history of supporting associations of districts and municipalities in Latin America and Anglophone Africa.

[14] As far as water delivery is concerned, e.g. in Ghana only rural wells are decentralised, but the income derived would never exceed the cost of maintenance. In Ethiopia, responsibility for water supply is shared between regions, cities and woredas (a layer similar to districts / municipalities), which is not favourable for promoting investment and sustainable service. In Nicaragua – to mention a good practice – the responsibility for promoting rural water was transferred to the Municipal Development Fund FISE some years ago, as FISE was better in a position to support municipalities in this function than the sector ministry.

invest in basis infrastructure. Therefore, very few revenues are generated from services such as water and electricity[15], which may potentially produce a surplus or at least be managed on a cost-recovery basis., etc.

While services delivered by local government are poor, and there is little inclination with the public to pay for them. On the other hand, when no payments are received for services delivered, local government is not in a position to improve these services, even if they are entitled to establish cost recovery charges. This is particularly true for services, which require a huge prior investment, like in drainage and waste management.

Notwithstanding the establishment of social investment and municipal development funds in many partner countries, as well as vertical transfers for various purposes, there is a structural ***shortage of funds for major capital investment at district level***. According to the observations of the authors, donors have shown a certain preference for investing in social sectors (such as basic education, health and rural water). Revenue generating infrastructure (markets, slaughterhouses, bus terminals) is now gaining ground but still, ***investment relevant to public hygiene and environment*** is included in comparatively few lines of financing. Small annual allotments of funds to LGs, which are common to many municipal development funds, have further favored smaller investments (such as schools), which can easily be financed from these allocations and allows to split funds into several smaller projects.

Despite efforts to increase intergovernmental transfers, in many if not most decentralized countries a continued (or even increased) ***Fiscal Dependency*** is being observed (See Box). This occurs when the amount of (conditional or unconditional) transfers is fast increasing while locally generated revenues are not.

Indonesia and Philippines:

Increasing Intergovernmental Transfers and continued fiscal dependency

With a new fiscal framework, which was introduced after decentralisation, and increasing transfers from the central government, the revenues of Indonesian local governments rose continuously in the past years. The transfers from the central government to the local governments (General Allocation Fund (DAU), Special Allocation Fund (DAK) and Revenue Sharing Fund (DBH) rose from 19 % of the total central government expenditures in 2000 to an estimated 34 % in 2007. Thus, the financial situation of the local governments has improved strongly facilitating increased expenditures.

However, in all ten cities (of the sample in question, NB) the revenue side of the local budgets is strongly dominated by transfers from the central government. In 2006 intergovernmental transfers reached from 53,1 % of total revenues in Surabaya to 90,1 % in Pare Pare. In all cities except Balikpapan the intergovernmental transfers are the strongest revenue source. In almost all cities the locally generated revenues are rather small, with an average value of 14,5 %. With 34,5 % Surabaya has the highest share of locally generated revenue (Source: German Development Institute 2007)

[15] Basic health and Primary education are sometimes also included in the category of revenue generating services. However, according to the author, this is (i) unrealistic and (ii) creates confusion with regard to local priorities and the overall priority to reach the MDGs.

In the Philippines, notwithstanding a flexible legal framework, progress with regard to increasing local revenue as well as sources of finance of LGUs has also been slow. LGUs contribute a mere 5 % to total tax revenues of the general government (compared to 4 % prior to decentralisation). From the LGUs' point of view, on average 70 % of all revenues for provinces and municipalities do still come from Central Government transfers. Revenues from own taxation are much smaller, although municipalities may have a large variety of revenue sources. On average, the position of cities is different with less than 50 % of IRA contribution to the budget.

Similar difficulties have been reported from ***Ghana***: "The District Assemblies still look up to the central government to provide grants for their development projects, which are often not forthcoming. Furthermore, the District Assemblies had only limited success in increasing revenues from rates and other forms of local taxation for a number of reasons. The long history of the failure of local government in Ghana and the misuse of locally mobilized resources has made taxpayers cynical about what the DAs may do with local contributions or tax revenues. They are therefore generally unwilling to pay taxes". (GTZ 2006)

On the positive side, a number of – mostly larger - municipalities have significantly reduced their levels of dependency.

South Africa: Lower fiscal dependency and higher revenues from service charges

On average, South African municipalities obtain 86 % of their income from their own resources (IDASA 2005, 1). However, it is important to keep in mind that the share of ownsource revenue varies significantly among the municipalities. While the six metropolitan municipalities generate about 97 % of their budget through own revenues, smaller municipalities with annual budgets of less than 300 million rand generate on average only 65 % through own revenues. Municipalities in poor, rural areas sometimes even generate less than 10 % of their income through own resources

Most of the own-source income of local and metropolitan municipalities comes from user charges and taxes. Thereby, user charges are the biggest source of revenue of the operating budget. The lion's share of the income can be generated through surplus-services like electricity and water, some through break-even services such as waste disposal or sewerage.

Source: GDI / DIE 2007

Approaches favoring incentive structures

After two decades of decentralization, it becomes apparent that tools are needed to measure the scope and quality of local service delivery as well as local governance in general, in order to be able to establish related ***incentive structures***. A number of donors and some governments have tried to partially link access to development funds to performance by e.g. including some performance criteria in the formula for intergovernmental fiscal transfers.

The most simple performance mechanism to be used in development programmes with a limited amount of funds is to reward ***fast project implementation***. Available funds are distributes into several "envelopes": Only those local governments, which have successfully implemented projects worth their first envelope, can access the next one with remaining funds being distributed among the best performers. Such a mechanism is easy to apply and acts as an incentive to speed up project implementation (+ related disbursement) at LG level. However, it does not contribute to improve service delivery and is opposed to equalization efforts as poor LGs would usually have most difficulties to efficiently manage projects.

Another criteria, which has been included in the distribution formulae for fiscal transfers of several countries (Colombia, Ethiopia) relates to ***growth of locally generated revenues***. This is another approach to reward efforts made by local governments themselves. Other governments (e.g. Rwanda) are trying to set uniform targets to LGs with regard to revenue generation and rank municipalities accordingly. However, the local tax potential per inhabitant is not equally distributed among LGUs and thus opportunities to make fair effort are either. Formulae, which refer to relative changes in revenues collected, run into problems if trends in revenue collection are not uniform. Should incentives be applied several times, if revenues go up and down?

The Bureau of Local Government Finance in the ***Philippines*** has ***categorised LGUs*** into six ***income groups***, which shall reflect their financial status in terms of revenues from different sources and is used as a proxi for local capacity also. Groups 1 and 2 are considered as well-off, groups 3 and 4 as regular and groups 5 and 6 as comparatively disadvantaged. The classification is reviewed every three years and can be influenced by the LGUs themselves through increased revenue generation. The Bureau of Local Government Finance has also encouraged LGUs to review and extend their own revenues, which – in some cases – have succeeded to improve their income classification by two ranks. Implications of ranking to be checked.

Based in these considerations, efforts have been made to develop more complex systems of performance measurement. Among the complex approaches, the most simple one is currently emerging in ***Rwanda***: the planning and budgeting process is linked through the signing of ***performance contracts*** between local (and other) government staff and the President. They are meant to describe what the districts plan to achieve over the year in terms of outputs and the inputs that are required for these. Logical links between inputs and results are not always defined to perfection and results do rather pass the output level (which means: do not give answers regarding the outcome of interventions). Nevertheless, it is a highly innovative approach for Sub-Saharan Africa and public servants feel tremendously pressured to comply with what has been agreed. Results are evaluated annually through the Ministry of Local Government and best performing districts receive a lot of publicity, which creates a certain competition between districts.

The Philippine Local Governance Performance Management System (LGPMS) is the most complex innovation aimed at continuing the efforts of advancing performance management (See box)[16]. It is more advanced than the Rwandan system in the sense that measurement goes beyond output and performance is also assessed.

Philippines: A complex system of Local Government Performance Measurement

[16] The World Bank Office in Jakarta has proposed a measurement framework for LG Financial Management in Indonesia in 2005, which is also complex and corresponds to the logframe approach. However, according to the opinion of the author, indicators are not as detailed as in the Philippine version (See World Bank 2005).

The LGPMS is a consolidation of the various performance standards and assessment mechanisms generated for LGUs in the past 20 years. It is developed and managed by DILG's Bureau of Local Government Supervision. Primarily, it serves as a self-assessment and management tool. The first national roll-out of LGPMS in 2005 featured the first complete voluntary capture of data from different LGUs based on a pre-defined set of 107 performance indicators categorized into five Performance Areas and 17 Service Areas. The results of the first national data entry of LGUs were published in 2006, based on the data input of 117 cities. It gave quite an optimistic picture and revealed that self-assessment may increase ownership but not necessarily realism.

In any case, the system is still under development and can provide a lot of "food for thought" for other countries interested. Performance Areas relate to Governance, Administration, Social Services, Economic Development, and Environmental Management. ***Performance*** indicators refer to:

(i) <u>Administrative Capacity</u>, which consist of the underlying capabilities of cities in terms of readiness of structure; effectiveness of policies, guidelines, and administrative systems; availability of managerial and technical competencies, and; accessibility of tools, facilities, equipment and financial resources;

<u>(ii) Productivity</u>, which refer to the availability and quality of basic services delivered by the cities to their respective constituents; and

(iii) <u>Development Condition</u>, which refer to the socio-economic and environmental information obtained from the cities during the assessment year.

Administrative capacity is strongly biased towards local revenue generation in the LGPMS: The presence of a (i) Comprehensive ***Revenue Generation Plan*** (CRGP) and (ii) The efficiency of the ***Real Property Tax Assessment*** and Collection (RPTAC) have been defined as main indicators. As there are important aspects for the strengthening of fiscal decentralization, the underlying logic and sub-indicators are presented.

The presence of Revenue Generation Plans and the efficiency of RPTAC system are used as determinants in measuring the ***administrative capacities*** of cities in generating sufficient local revenues for their development and delivery of services. The existence of a CRGP provides strategies for a city to achieve high revenue generation. The RPT has always been a major source of local income hence, the efficiency of the system for assessment and collection will help a great deal in generating enough resources for local development and service delivery.

In order to determine the ***productivity*** of the cities regarding revenue generation, the following LGPMS indicators are used, among others: (i) The percentage of annual revenue realized (ARR), (ii) Real Property Tax (RPT) collection efficiency rate, (iii) The percentage of IRA to total income.

The rates of attainment of the ***revenue targets*** of the cities determine not just their efficiencies in realizing their incomes but also their capabilities to come up with feasible targets[17]. The Real Property Tax (RPT) being the largest source of local revenues of LGUs,

[17] To determine the productivity levels of the cities, the following scheme for target accomplishment was used: (i) 81% and above target accomplishment rate - very high, (ii) 61% to 80% - high, (iii) 41% to 60% - medium/ benchmark, (iv) 21% to 40% - low, (v)20% and below – very low

the performances concerning RPT collections affects the levels of independence from National Government - both imaginary and real – in terms of their own revenue generation.

The presence of ordinances or resolutions in a city is the principal criterion of ***legislative productivity***. As of 2004, improvements in financial and economic development conditions resulted from the issuance of ***Revenue Codes*** (= collection of tax ordinances) in over 100 cities. The productivity of the cities concerning ***customer service*** is measured in terms of the readiness and promptness of the systems used in ***processing business permits and RPT documents***.

An efficient business permit processing procedure is boon to business and industry development. Businessmen and investors usually look for fast and well-organized procedures for permits processing. Another area where cities could excel was the processing time of RPT documents. About 38% of a total or 44 cities had established RPT processing in 30 minutes or less. Around 51% or 59 cities had established RPT processing time of 30 minutes to at most one day.

However, results in performance measurement are not yet reliable or are at best indicating trends. The Philippine survey indicates that the system of RPTAC seems to be highly efficient, at least in the cities. In 2004, a total of 25 cities claimed to have very high capacity levels while 51 cities had high capacity levels for RPTAC. Close to 90 % of the 116 assessed cities use updated RPT maps for property identification and over 90% claim to use indexing systems. Information dissemination is considered participatory in 90 % of the cities and revenue collection is generally enforced for current taxes as well as delinquencies, as well as penalties and sanctions imposed to delinquent taxpayers. It can be assumed that only the better organized cities may have participated in the first assessment of this kind.

3.5 Conclusions and Recommendations

Guiding questions for assessing depth and nature of fiscal decentralization

Gallagher (1998) has proposed the following approach to assessing depth and nature of fiscal decentralization and checking of assignments are matching.

<u>Expenditures</u>:

1. Which level of government decides the nature of public intervention and expenditure? Where is the legislative competence (e.g., national parliament or local ordinance)?

2. Which level of government is competent or has the power to administer a function? Does local government administer central government programs?

3. Which level of government will budget and maintain financial control over the expenditure in question?

<u>Revenues</u>:

1. Who has legislative competence with respect to certain revenue laws? For instance, is local taxation authorized by national legislation or by local ordinance?

2. Which level of government will actually collect the specific tax?

3. Which level of government will budget these revenues? For instance, does shared revenue get budgeted by the central government?

As long as central governments provide the funds, there is a trade-off between tight control and strict earmarking of funds, which will constrain the opportunity for the emergence of efficiency and effectiveness in resource allocation based on local priorities, and thereby achieving the overall objectives of decentralisation (notably devolution).

In the general passion for decentralization the matching principle has been neglected and imbalances created, which tend to overburden LGs (either with regard to the tasks devolved or with the money to spend). Given the capacities and human resources at LG level, it is generally unrealistic to expect that all possible activities, which fall under the mandate of districts, can be decentralised at short term. In view of limited administrative capacities, it may be considered to let districts focus on a selected set of activities for which they are mandated and bear direct responsibility i.e. to let them focus on the implementation of activities from own resource and the decentralised budget. Always a ***balance*** needs to be struck between ***national directives and local discretion***,

Technical Recommendations

On the process /modalities of decentralization

- Decentralisation implementation – though starting from deconcentration – shall proceed to the ***devolution*** of tasks, transforming local governments into autonomous institutions, clearly stating their exact responsibilities and sources of income.
- Decentralisation should lead to ***planning*** procedures that are based on perceived needs in the district and respect national policies (not vice versa). Responsibilities have to be made clear and a monitoring system implemented, corresponding to a performance-based approach. Having said that, development partners as well as governments need to understand that (i) understanding of national policies at local level requires a well-organised dialogue instead of the often practiced top-down approach and (ii) districts need a new type to advisory services to be able to balance respect to national policies, felt local needs and technical sector norms in a professional and cost-effective way and produce comprehensive planning documents accordingly.
- When introducing modern forms of representative democracy, traditional authorities / power structures and communication channels should be considered, in order to stimulate ***accountability***. Mechanisms for citizen consultation and management of complaints by elected authorities should be established in order to improve performance of and respect towards assembly members. Promotion of specific pressure groups and effective civil society associations should be stimulated[18].

[18] This is quite different from the often practiced promotion of non-governmental multi-purpose organisations, which claim to defend needs or rights of civil society (as a non-profit activity) but offer their services as (often not so professional) consultants and trainers as well.

- Local government must be entitled to establish fees for ***services*** on a cost-recovery basis in order to be able to generate income from potentially profitable services (water, solid waste, liquid waste and drainage, which need to be dealt with in a combined way). As these services mostly require comparatively huge investments with long maturity periods and are highly relevant for health as well as environmental purposes, governments and donors should consider establishing adequate financing modalities (whether on a grant or on a loan basis).
- Central government should give more ***incentives*** to the local administration to make full use of their tax potential. A stronger link between revenue generation and transfers from the central government should be created. Districts need a clear sense of direction in order to generate revenues. There should be incentives and disincentives based on performance for revenue collectors as well as the management staff responsible for the revenue generation at the district. If local government staffs are well remunerated, the highly qualified personnel will chose to work there knowing the benefits that will accrue to them[19].(GTZ 2006)

On Expenditure Assignments

- Expenditure assignment needs to be the first and fundamental step in the design of a decentralized system of intergovernmental finances.
- To the extent possible avoid mixing decentralisation and deconcentration and shared responsibilities: Assign responsibilities to LGs, which fit their comparative advantages and fundamental rules for the ideal assignment of responsibilities in a decentralized system of government
- If fiscal decentralization is to be a reality, subnational governments must control their "own" sources of revenue. The question, then, is which revenue sources can and should be assigned to subnational levels of government and how these assignments are to be effected.
- Expenditure responsibilities should be specified in the law. Some countries do so in the Constitution but many others do so in particular laws such as the law on the budgetary system or the law on subnational budget and self-government. The latter is the preferred alternative because changing the Constitution is much harder, and it should be expected that as technology and conditions change in a country there will be a need to change expenditure assignments.
- *Targetted assignment of selected expenditure responsibilities according to subsidiarity:* The central government should assume 100 percent responsibility for expenditures in national defense, including the national guard, while sub-national governments should assume responsibility for public utilities.
- *Reassignment of Capital Investment Responsibilities*: Responsibilities for capital infrastructure should be placed at the level of government responsible

[19] As a better renumeration of public servants requires far-reaching reforms in public service, innovative modalities are also required in this regard. The Rwandan government has decided to pay a 30 % extra salary (taxable) to all public sector employees involved in financial administration and management.

for the delivery of the specific services including the operation and maintenance of those facilities. This will encourage a more efficient use of resources. Only those capital infrastructure facilities actually desired by sub-national governments will be built and sub-national governments will have an interest in maintaining and repairing the capital infrastructure.

- Central governments should consider introducing policies that guarantee desired minimum levels of provision for certain services at the local level. National standards can be enforced in several ways such as enticing local governments with a matching grant program. But national standards may also be enforced by denying full receipt of block grant money unless certain minimum expenditures and provisions established by the central government are met. Programs in which national standards may be required include not only social welfare but also education, health, sanitation, and the environment. But restrictions should be imposed sparingly to protect local autonomy which, in general, is very desirable.
- The priority for public expenditures in most countries should remain in investment in human resources through good levels of education and health, and strengthening the safety net. There are also significant changes that need to be made in these sectors to increase the efficiency of operations as well as public expenditures. These measures should be considered within the context of well defined sectoral policy objectives now lacking in many transition countries. Governments should proceed with comprehensive reviews of the housing, education, health, and social welfare sectors.
- Financial responsibility for social welfare expenditures is thoroughly to be discussed. For equity considerations, it is recommendable that central government takes the financial responsibility even if service delivery is performed via local governments on a reimbursement basis, a grant program, or another of several means.

<u>On decentralization of expenditures:</u>

- Integrate – as much as possible – all current direct transfers (including conditional transfers by line ministries to LGs) into the decentralised budgets.
- To review existing earmarking arrangements for transfers with the objective to provide a well-defined scope for districts to adjust investment to local circumstances and priorities, providing LGs with some general ceilings and menus as a reference for technical and budget planning.
- National Governments / Line ministries should consciously reflect, which degree of decentralization they are really ready to support; if the preference is towards de-concentration or delegation (rather than full devolution) adequate contractual modalities should be defined, in order to avoid overburdening LGs

<u>On equalization formula[20]</u>

- Use a transparent equalization formula, which may even be included in the constitutional arrangements; balance equalisation concern with regard to

[20] Most of these recommendations refer to van't Land 2009 but are viable on a larger scale

poorer local govenments and the need to maintain some incentives to improve local revenues (Chambas 2009)

- Introduce one horizontal allocation formula (for equalization between LGUs) and avoid having one for each activity/sector.
- Whichever mode of horizontal allocation is used, the access to the funds by districts could be made subject to meeting one or more particular conditions that are related to performance. This can be activity or sector specific performance or generic performance.
- A balance needs to be struck between local discretion and the need for the national government to set parameters to ensure minimum quality standards as well as adherence to national objectives.
- Typically, systems with more autonomy for local governments in resource utilisation, will usually be supported by stronger performance-measurement-based incentive systems. It means that in a situation, where decentralisation is gradually being put in place by the various line ministries, there is the challenge to *gradually* replace the strict earmarking by performance measures.
- Often, PB grants are criticised because they would not be '***pro-***poor'. Regarding this point, two remarks can be made. Firstly, in the long run, the poor are not well served by an underperforming local government. In one way or the other, even local governments in poor districts have to get their act together. Secondly, the relationship between poverty levels in a district and the performance of a particular district government may not be that straightforward. Quite often district administrations in poor districts do better than their counterparts in richer districts (provided the performance indicators are well chosen).
- A sustainable process of decentralization must balance local autonomy with accountability whereby local governments are gradually given more fiscal autonomy by relaxing transfer conditions while accountability mechanisms are being put in place.
- Such gradual relaxation could include replacing conditional grants with unconditional (or relatively unconditional) sector grants, provided local governments are able to assure and demonstrate adequate system for (participatory) planning, transparency in the budget process and compliance with financial rules and regulations.
- More long-term it could also mean a gradual increase of the unconditional grant(s) at the expense of the earmarked grants.

Recommendations to development partners

- Development partners should support joint comprehensive sector reviews of the housing, education, sanitation, health, and social welfare sectors, which are particularly relevant for service delivery at sub-national level to increase the efficiency of operations as well as public expenditures, ***before*** promoting joint modalities of financing

4 How to improve Local Revenue Generation

4.1 The Causes of poor Local Revenues

Local governments' own sources of revenue play an important role, especially in funding and maintenance of local public infrastructure. The capacity and ability of local governments to leverage own revenue sources is thus a core element of good financial governance on the local level. Appropriate mechanisms and procedures need to be in place in order to optimize the assessment and collection of local taxes, to set and collect appropriate levies, fees and tariffs for services and to minimize related administrative costs.

Available evidence allied to best practice for fiscal decentralisation suggests that the percentage of local revenues collected compared to overall expenditures remains low in many developing countries. Efforts to introduce fiscal decentralisation nationwide are not producing the desired policy outcomes.

A number of studies have dug into the causes of increasing fiscal dependency under decentralization. The above mentioned recent fiscal study in West Africa (See Chambas 2009) has identified four phenomena, which apply to all countries:

1. weak local revenue base in most African countries due to lack of tax authority and lack of administrative capacity
2. concentration of locally generated revenue in the larger urban areas
3. Transfes + grants which lead to erosion of incentives to locally generate revenues,
4. interfaces between weak local revenue base and other governance aspects

Evidence was found for unexploited local tax potentials with regard to Real Property Tax, professional taxes, market fees and taxes and vignette automobile. ***Revenue generation from services*** continues to be weak. Not all taxes due are assembled, fees and rates are very low and/or not all collected, and basic rates are insignificant. Concerning property tax, there appears to be a lack of insight in the exact number and sizes of the properties. Moreover, the setting of the fee levels is not based on the actual cost, but often on what government has dictated decades ago or the assembly considers as politically feasible.

In 2006, the ***Swiss Development Cooperation*** commissioned several case studies on the issue of Development and Taxation, gathering information from seven countries (Burkina Faso, Bosnia-Herzegovina, Macedonia, Mozambique, Nicaragua, Peru and Tanzania).(See SDC 2006)

Notwithstanding different administrative setups, it was observed that all partner countries had made important efforts to decentralize responsibilities related to the provision of public goods and services. This power shift reinforced the local and regional governments, especially in the area of infrastructure financing, local economic development and public service provision.

Most central governments are open to discuss political and administrative decentralization, especially in 'soft sectors' such as public utilities (e.g. water & sanitation) and education. However, there are exceptions to this trend[21].

Lack of delegation and lack of advocacy for fiscal autonomy

In a nutshell, the tax collection responsibilities devolved to LGs may not be appropriate and fiscal decentralisation objectives may be unrealistic

Unlike political and administrative decentralization, the majority of central governments does not support fiscal decentralization and the ***delegation of tax collection*** to local and regional governments. There are different reasons why central governments are not open for speeding up fiscal decentralization implementation.

Apart from the overall lack of human and financial capacities, in particular at the local level, some countries had difficulties to reform the centralized state structures from the ***colonial era***. An example is ***Burkina Faso***, which inherited extremely centralized colonial structures from the French system. Regarding fiscal decentralization, central governments additionally fear the loss of political power and the sovereignty over national revenues.

The widespread disinterest and ignorance of many other actors (political parties, CSOs and the private sector) on decentralization favors the status-quo. However, the position of central governments and administrations towards decentralization is rarely uniform. Often, there are differences in opinions between ministries, depending if they would gain or not from decentralization. In addition, there can be divergences in the views of central governments and central administrations.

Actors, which traditionally are favoring decentralization are local governments and bilateral and multilateral agencies. The position of the private sector and of NGOs is mixed. Unlike the matter of political decentralization, NGOs are often unaware of fiscal decentralization or not interested in the subject. Technical aspects may also contribute to indifference at local level: Local tax sovereignty has often been diminished in the efforts of simplifying of tax systems. As tax reforms often involve a limitation of the number of taxes, such a step can lead to a dry up of local revenues sources.

The ***record of revenue generation*** is mixed. Very generally speaking, recent performance of tax systems improved at the central but not at the local level. In all countries observed, the tax system at the central level evolved positively in terms of its ability to raise expected revenues. However, there is still space for significant improvement.

Undeniably, ***central governments*** have done efforts to reform their tax systems. In almost all countries observed, the central government is active in reforming the legal framework of the tax system in order to improve performance. Measures in this direction include adoption of a general fiscal code, establishment of (semi-) autonomous revenue authorities, introduction of flat tax rates, etc.. Further, revenue instruments have been diversified and some countries use tax-sharing

[21] The present Nicaraguan central government prefers to centralize power and is not open to support decentralization efforts. Bosnia-Herzegovina is a special case because of its complicated federal government structure (See SDC 2006)

arrangements. All central governments use sophisticated instruments, such as VAT and income taxes. However, policy frameworks are often not comprehensive with regard to LG revenues.

Ethiopia: Few incentives for local revenue generation

According to recently conducted studies, the existing policy framework for local revenue generation has some major conceptual gaps. One example of this is Ethiopia (See Nghuyen-Than 2007):

a) There are no in-built incentives for ULGs to attract the full tax potential, because no general tax sharing exists although local authorities collect taxes on behalf of the regions (and to a lesser extent on behalf of the central government).

b) The local authorities have no significant revenue autonomy, because the majority of the taxes and fees are restricted by the regions

c) Local administrations do not clearly distinguish between taxes, fees and licences, which can be observed for example in the common phrase "local service taxes".

d) Local authorities suffer from a high turnover of their staff and due to the lower salary level compared to the regions and the central government they have problems in attracting well qualified administration staff.

e) Further, Block grants do cover only part of the costs of the so. called state functions and none of the municipal functions.

As a consequence, the majority of the ULGs have to request the region to cover their deficit. If this is not possible, the budget is simply not executed as planned[22]. Recent studies in the central regions have revealed that in some ULBs even subsidise state functions that incur a deficit from revenues generated by the municipal functions. It is uncertain as to why this is occurring. As a matter of fact, actual capital expenditure spending in relation to that budgeted for municipal functions is low. (Source: Nguyen-Than 2007). Regional BOFEDs are generally busy with the woreda budgets and do not have a mandate to assist in consolidating city budgets or even municipal budgets.

Local governments are less active in the process of tax reform. Many tax issues are regulated by national legislation and therefore are perceived to fall in central government's responsibility. For instance, local governments normally do not have the authority to levy taxes on their own. In other cases, they don't have the necessary capacities or know-how. Some of the countries observed collect only marginal revenues at the local level and others presently do not know local tax collection at all. In some cases, the situation at the local level has worsened due to recent tax reforms, which centralized taxing power, lowered overall tax rates or abolished certain tax instruments.

Lack of specific know how may also be a reason for the relative inactivity of NGOs/CSOs. Tax reform is perceived to be very technical and does not represent a top priority for many NGOs[23]. Reference to the general principles for the establishment of local taxes is rarely made. (See Box)

[22] Borrowing is generally not accessible to ULGs for investment financing, in view of their delicate financial condition.

[23] However, there are exceptions such as private sector lobbies in Tanzania, the Union of local self-government units in Macedonia and a SECO supported association (CIFOEB) in Burkina Faso. Bilateral

Principles for a LG tax system:

1. Revenue autonomy, subsidiarity and connectivity (local accountability)

2. Transparency of the tax system and direct impact of the tax burden (tax-benefit link)

3. Reference to local conditions and neutrality of the taxes with regards to the private sector

4. Tax bases, which are not affected by economic fluctuation and are also viable

5. Simplicity of tax system

Source: Ngyuen-Than 2007

However, even tax experts admit, that these elements are not easy to apply and neither a federal nor a unitary country in the world has implemented a local public finance system that fulfils these five principles completely. Various countries have chosen different ways to reach these goals and thus the conception of financing the local services differs (See Ngyuen-Than 2007).

4.2 How much does fiscal autonomy matter?

There is consensus that LGs need a certain amount of fiscal autonomy in order to improve their revenues. However, the phasing of and interfaces between different reform dimensions (autonomy versus capacity building for accountability) are sometimes controversial. It has been argued that autonomy were a precondition to collect experience, which will finally improve governance over time, while other donors pinpoint at the fiduciary risk involved with increased local autonomy.

Tanzania is currently implementing a local government reform aimed at improving public service delivery. An important component of the reform is to increase the fiscal autonomy of local authorities. This policy is encouraged and partly initiated by the donor community. Odd-Helge Fjelstad from Chr. Michelsen Institute in Norway has conducted several studies to verify whether increased ***fiscal autonomy*** will improve the efficiency and responsiveness of the public sector.

The author concludes on various occasions (*see Fjelstad 2003 and 2004*) that it is unrealistic to expect that the present administration in many local authorities in Tanzania has adequate capacity and the required integrity to manage increased fiscal autonomy. In fact, there is a real danger that, in the absence of substantial restructuring of the current tax system combined with capacity building and improved integrity, increased autonomy will increase mismanagement and corruption.

The following key ***indicators*** are used as reference points: (i) the degree of fiscal autonomy; (ii) financial management, including budgeting, accounting and auditing; (iii) methods of revenue collection; (iv) transparency in fiscal and financial affairs; and (v) tax compliance and fiscal corruption in the case councils. With regard to fiscal autonomy, the rationalisation and abolishment of many local

and multilateral agencies are very active in the tax reform process and carry out activities of technical assistance, policy dialogue, General Budget Support (GBS), Sector-Wide Approach (SWAP) and capacity building for (central and local) governments and administrations.

revenue sources in June 2003 has most likely reduced the already limited fiscal autonomy of rural district councils even further; only urban districts are less dependent.

Transparency with respect to budgets and accounts is regarded the heart of local government accountability. However, in the case of Tanzania transparency in fiscal and financial affairs remains limited: All the case councils report that they disseminate information on financial and fiscal affairs to the public through meetings organised by the council, including full council meetings, ward and village meetings. Local authorities publish information on revenues collected and allocations of funds, as they are obliged to according to the Local Authority Financial Memorandum 1997.

However, at present much of this information does not reach or is not understood by the general public. Public notices gazetted in newspapers or posted on notice boards at the council headquarters are often presented in a relatively complicated and technical way, which is hard to understand by ordinary citizens. Few of the respondents in a recently conducted citizens' survey, covering 1260 respondents in the case councils, said they had seen some information about local government finances. As many as 86% of all the respondents said they had never received information on the amount of tax revenues and user charges collected in their area, while publicity on HIV-AIDs was wellknown.

Tanzania: No compliance to unfair taxes

In all the case councils in Tanzania, ***taxpayers' unwillingness*** to pay taxes and fees (tax compliance) was reported as a major obstacle to enhancing local government revenues. The citizens' survey provided some indications on factors that impact on taxpayers' compliance behaviour.

The most serious problem perceived by a majority of the respondents (58.4%) was that the money collected was not spent on public services. 48 % of the respondents found taxes to be too high and 46 % had doubts about the honesty of tax collectors. Dissatisfaction on poor linkages between taxes paid and service delivery showed no rural-urban divide.

In general, taxes were widely perceived to be unfair. Firstly, only 9% of the respondents agreed with the statement that 'most of the tax revenues collected in the area is used for reciprocal services'. Secondly, the majority of all respondents (51%) held the view that people should deny paying taxes until services improved. Thirdly, 73% of the respondents said they would be willing to pay more taxes in exchange for improved services.

Source: Fjelstad 2003 and 2004

Corruption was perceived to be a problem in all the six case councils. The most frequent reason given for this attitude was the view that 'all civil servants are corrupt and they protect each other'. This attitude reflects that much is left to be done to build trust-relations between the local authorities and citizens.

A recent analysis made by a GTZ-supported Revenue Mobilization Support Programme in ***Ghana*** hints to the fact that local tax systems may have design faults although sufficient tax authority and autonomy may have been given to districts (*See GTZ 2006*).

- Interpretation of the powers of LGs often rests with the central government, which makes local tax initiatives risky. Even beyond the coherence of the national framework, relations between politicians and administrators may be characterized by confusion, overlapping functions and ***interference*** in decisions.
- ***Tax bases*** of local governments are static because of weak databases for determining revenue potentials; areas within the districts where revenue could be generated are not well identified and therefore revenue collection is not optimized. There are no reliable tax registers and therefore tax potential is not known.
- ***Mechanisms for collecting*** internal revenues are ineffective. For instance, revenue collections from property rates are low because properties have not have been properly valued. As an Internal Revenue Service (IRS) report outlines this is mostly due to a lack of funding for revaluation, naming of streets and numbering of houses. However a lack of general experience in revenue administration relating to record-keeping, tax collection and debt enforcement also causes revenue losses from property rates.
- There are inadequate numbers of ***revenue collectors*** in most districts. This problem is further exacerbated by the poor logistics (means of transport) assigned to revenue collection. Inadequate resources and absence of trained and competent personnel limit the capacity for local initiatives and development. Key positions in finance departments are often vacant, and/or staff involved in local revenue collection exercise, have little formal education and lack appropriate skills for records maintenance, public relations and enforcement.
- Appropriate ***sanctions*** or punishment for tax defaulters are absent. Most residents, especially traders, do not feel obliged to pay taxes. There are no appropriate incentives both to the revenue mobilisers and taxpayers and the tax administration is not adequately supervised. Rewards and sanctions are often not based on performance, and not extended to financial management staff, who is responsible for overseeing revenue generation at LG level.
- The co-operation between the District Assemblies and other public institutions and state agencies seems not to function very well. In the case of Ghana, the district revenue department has only a ***limited data exchange*** with the Land Valuation Board and Internal Revenue Service. It is often the case that one building is valued several three times, due to bureaucratic "traditions"[24].

Lessons learned from Tanzania

A fundamental requirement when further redesigning the local tax system is greater emphasis on the ***cost-effectiveness of revenue collection***, taking into account not only the direct costs of tax administration, but also the overall costs to the economy, including the compliance costs to the taxpayers. In addition, losses through corruption and tax evasion need to be reduced.

[24] In Ghana, such habits lead to the general office of the Land Valuation Board makes a valuation for the determination of the value stamp tax, the District Land Valuation Board for the property tax, and the IRS for the capital gains tax.

To achieve these aims, there is a need for further ***simplification*** of the licence and fee structures by reducing the number of rates and coverage. Fees and licences that have regulatory functions, such as hunting and business licences, should be harmonised with central government taxes, to avoid ***double taxation***[25] and conflicts with national development policies such as employment creation and environmental protection. Furthermore, uniform rates on agricultural taxes (crop cess) are necessary to minimise distortions.

A main challenge is therefore to ***provide information*** on fiscal issues in ways which are understandable and which reach the general public. The successful dissemination of information on HIV/AIDS prevention may provide useful lessons for how to design and disseminate information on budgets and accounts to the communities. Written and oral methods of dissemination should be combined, including information submitted at service outlets such as schools and dispensaries, and at village and ward offices. Urban councils would in general require additional measures compared to rural councils, due to the often high mobility and turnover of residents that make it more difficult to reach citizens with such information.

Improved information to the public on budgets and accounts may improve the opportunities for citizens to exercise their voice and hold local authorities accountable. It is, however, important to stress that encouraging citizens and the civil society to engage in fiscal and financial monitoring at the local level does not imply that such measures should replace formal auditing and accounting mechanisms. On the contrary, it can strengthen the legitimacy and standing of local authorities in the communities by contributing with complementary measures to improved control of revenue collection and expenditure.

4.3 Property taxes – the untapped potential

A property tax, based on the assessed value of all properties located in a given area, is generally regarded an appropriate tax for local authorities[26].

The Anglo-Saxon countries like Canada, the USA and the United Kingdom provide their local authorities with a very extensive system of property taxation. A local property tax has the advantage that a direct link between benefit and cost of the public goods can be established. This direct link between the preference of the citizens in local public goods and the policy makers, who have to provide the local public goods, cannot be created by grants or transfers[27]. On the other hand, the concept is not easy to apply as many African countries don't know the concept of

---

[25] Double taxation is a sensitive issue as it is not supposed to exist. Recent field studies of the author in Ethiopia revealed similar practices, which were impossible to discuss with local nor national officials.

[26] This is valid for all regions, including countries under transformation: The property tax has been and still is the own source of revenues of municipalities in Macedonia. Although this tax has had a small participation in the total fiscal collection at the state level, it has been and can be a significant and stable source of revenues for the local self-government units (Stamatova 2002)

[27] Besides a local property tax, a group of European countries – namely Switzerland, Belgium, Croatia and the Scandinavian countries – give significant tax autonomy to their local authorities and therefore a local surcharge on the personal income tax is common. Furthermore, a third possibility to finance local authorities has been chosen by Austria, Germany and Poland, which developed a local tax system with its own revenues as well as tax-sharing. Nevertheless, vertical grants are also needed in the Anglo-Saxon model and the Scandinavian model and the German model.

property tax at all, which may be due to a different concept of land-ownership. *(See Box on Ethiopia)*

Ethiopia: Country without Real Property Tax

In Ethiopia no private land right exists as all land is owned by the state. Private households as well commercial and public companies can only lease the land from the ULG; a private person can lease the land for 99 years, while companies are able to lease for a maximum duration of 70 years. Furthermore, the ULGs are not completely independent in fixing the land lease. Regions determine a minimum fee per square meter for different zones, which does not provide incentives for city administrations to profoundly consider the issue. Further, fees are not linked to inflation.

In addition, no nation-wide cadastre exists and due to the fact that all properties are leased and not owned by private households or companies, the possibility of evaluating the property value by the selling prices of the property does not exist either. Therefore, the establishment of a property tax system for Ethiopian ULGs is a complex undertaking.

Countries in ***East Africa*** share a common British heritage yet have distinct property tax policy structures. Yet, the tax base, assessment basis and the tax rates vary considerably. (See Kelly 2000). Tanzania taxes only buildings, Uganda taxes both land and buildings, while Kenya taxes only land. Despite these differences, each faces similar problems of weak administration. Tax base coverage is incomplete, valuation rolls are out of date, collection rates are low, enforcement is virtually non-existent, and taxpayer service is poor.

The East African experience suggests that the primary obstacle to effective property taxation is not policy but ***administration***. Property must be identified, with the information systematically collected and maintained. Properties must be valued. The tax must be assessed and billed. The bills must be delivered. The tax must be collected and properly accounted for and enforcement must be timely and effective. Simultaneously the government must work with stakeholders to ensure that necessary information and services are provided. Successfully combining these administrative components is critical for an effective property tax system.

The experience in East Africa shows that these administrative components are not effectively managed, leading to low revenue yields and inequity. Improved property valuations alone are not sufficient to generate the necessary revenues. Rather there is a need for a comprehensive improvement of all administrative aspects. Strong political will and improved administration efficiency are prerequisites to improved revenues and equity.

Property tax systems in East Africa exhibit distinct policy differences, yet all face administrative constraints limiting their ability to generate significant revenues for local governments. To overcome these constraints, these countries have embarked on property ***tax reform efforts***. Tanzania and Uganda in the early 1990s adopted the classic "valuation-pushed" strategy—focusing solely on the creation of valuation rolls in their capital cities. Tanzania was fortunate that the new valuation rolls were introduced in 1996 simultaneously with the new City Commission which combined the new revenue potential with strong political will and improved collection efficiency. Uganda, on the other hand, brought in their new valuation rolls for

Kampala in the mid-1990s only to see their total property tax revenue fall by over 30 percent.

This drastic result forced Kampala in 1999 to shift their reform implementation strategy to a more "***collection-led*" *approach***. Kenya is the last to undertake reform, just now embarking on a "collection-led" property rates reform implementation strategy linked to the broader Kenya Local Government Reform Programme.

Countries in Asia have made significant effort to improve RPT administration but also produced limited results while general fiscal management was not improved. (*See Box on the Philippines).*

A lessons learned from Tanzania is that ***more realism*** is required when it comes to the implementation of a well functioning property tax system (See Fjälstad 2004)[28]. It is, therefore, a need to reassess the basis of the property tax in urban councils and to implement a more ***simple and coherent approach*** to the valuation provision, which takes into consideration administrative capacity and capability constraints facing the councils. Moreover, the experiences from urban councils advocate cautiousness when extending property tax to rural district councils.

Having said that, the adequacy of the approach chosen depends on conditions of the partner country. In the ***Philippines*** for example, the legal framework is comprehensive in this regard: In order to create own sources of revenue, LGUs have been given more responsibility for operation of the Real Property Tax. Furthermore, they can levy taxes, fees and charges such as business and amusement taxes, fines and penalties, garbage and water fees, permit and licence fees and fees for selling on public markets. The LGC has expanded the potential tax base of LGUs and increased the maximum allowable rates of most local taxes. Further, the establishment of a Property Tax Collection has been promoted for decades.

Accordingly, the above-mentioned Local Government Performance Measurement System has identified comparatively ambitious ***indicators*** as determinants of an efficient system of RPTAC (see box).

Philippines: Advanced Performance Indicators for Real Property Tax Administration

1. Use of an updated Local Revenue Code as a guide, which should not be more than three years old
2. Utilizes the latest RP Tax maps for property identification;
3. Employs an indexing system that facilitates, at the very least time possible, access to records of real property owners per barangay according to name, location, status of property, and other relevant information;
4. Provides on-line computer-based information to taxpayers;
5. Operates in a network that is interlinked with the computers in the offices of the city assessor and the treasurer;

[28] "The municipalities' capacity and capability to administer the property tax have, in general, proved to be inadequate. Hence, it has been difficult for many councils both to maintain the current property valuation registers and to continue the property valuation exercises".

6. Involves the participation of local officials and other key sectors in the information dissemination to ensure that the people are properly consulted prior to the imposition of the RPT, and that they are updated with the schedule of market values used for the assessment of their properties;

7. Offers an incentive program for local officials or personnel involved, and for the taxpayers (e.g. giving of cash and other forms of rewards and publication of names) to promote efficiency of RPTAC;

8. Enforces revenue collection program both for current taxes and delinquencies; and. Imposes penalties or sanctions to delinquent taxpayers.

Notwithstanding the vanguard function of this approach, development partners complain that their support succeeded only in shifting the point of evasion from assessment to collection. Other interventions, particularly in the computerization of real property tax administration (RPTA), increased collections but there was also a corresponding increase in expenditures. The schedules of market values are usually not updated (as required by the law) and thus the potential of this source was not fully exploited. (See Final report of a US-Aid supported project to improve RPTA)

The productivity of the real property tax system is not encouraging. "Collection efficiency"–defined as the ratio of actual current collections to potential collectibles based on total assessed value of all taxable properties—of municipalities in sample provinces ranged from a low of 6.7% to a high of 74.8%.

Further, the Property Tax on plots and buildings is collected jointly with the (equally compulsory) contributions to a "Special Education Fund" (SEF), which is used for the equipment and routine maintenance of local schools. This may be practical in terms of collection but does not contribute to the transparency of local budgets and may not raise the motivation of landowners to accept increases of the RPT.

4.4 Privatisation of collection - The case of market fees

Following previous experiments in other countries of the EAC, Rwanda in 2006 has declared privatization of market tax collection an official policy. ***Objectives*** of a privatization of market tax collection can be summarized as follows:

- Improvement of efficiency & efficacy of the local fiscal administration;
- Mobilization of fiscal revenues;
- Strengthening of private sector; and
- Increase in transparency.

The advantages of the Private Agent versus previous practices are attributed to (i) the supposed reduction of collection costs; (ii) the promotion of competition for the market; and (iii) increase in transparency.

This policy has been implemented on a pilot basis in several Rwandan districts since then. Tax collection was tendered and subsequently awarded to a private collector for a monthly lump sum. To date, the following modality has been applied***:*** The district is contracting out the market tax collection service to a private enterprise, with whom the duration of the service contract is normally 1 calendar year. The entrepreneur is obliged to first transfer the total amount collected before he is being remunerated for services rendered. The remuneration of the entrepreneur is defined as a percentage of the total amount collected; and the percentage is the key criteria for the selection of the bid. The following advantages are attributed to private tax collection: The district saves labor cost and receives a predictable amount of internal revenue, while new jobs may be created in the private sector and the risk is transferred to the collector.

Basic Modalities for privatisated collection of market fees

a) The tax collection is delegated to a private enterprise in the form of a service contract.

b) The enterprise is obliged to first transfer the total amount collected onto the account of the district before being remunerated.

c) The enterprise is paid on the basis of an agreed percentage of the total amount collected and transferred onto the account of the district.

d) The LG Finance Department remains responsible for monitoring the tax collection and for the administration of fiscal revenues. It equally remains responsible for the pursuit of any form of tax evasion and fraudulent actions.

e) The district remains responsible for the management and the maintenance of the markets.

f) The enterprise is obliged to respect the tax rates defined by the District Council.

g) The district is obliged to conduct a fiscal potential study before the privatization of the tax collection.

In contradiction to this optimistic forecast a recent analysis done by German technical advisors to the Rwandan Institute of Administration and Management and the Association of Local Government Authorites found the issue of privatization to be much rather complex and successful implementation goes far beyond routine implementation of a cabinet decision. (See Ralga/Riam 2008)

First, external factors determining the ***general conditions*** the districts have an impact on the revenue potential: Though having a privileged geographical location and a significant economic growth, which was favorable for broadening the tax base, the current tax base in the two districts in question is narrow and volatile due to a certain vulnerability of main commercial activities and agricultural production to force majeure, which is a typical condition for many rural districts in Africa. Despite the favorable economic situation of the districts, management of public markets is not particularly effective: Markets are unattractive, due to insufficient electricity and water supply, creating difficult hygienic situation. Official market days are limited in number and not well chosen, leading to suboptimal exploitation of fiscal potential.

A general tendency for tax evasion and corruption is also there, which corresponds to a shortage in human resources. Relevant tax information is partly not accessible or incoherent. Tax payers database are not fully functional. Tax collection on market is caracterised by ***specific weaknesses***: Tariff structures are complicated and complex, particularly with regard to the variety of taxable units; in addition, tariffs are not always applied in a correct manner caused by insufficient knowledge or fraudulence of tax collectors, which always attend to the same market. To summarise, there is a lack of transparency on market taxes and unequal treatment of tax payers. Insufficient fencing of market area eases tax evasion.

Under these circumstances, it was found that privatization of tax collection would bear considerable risks and probably not produce the expected results. Based on unrealistic fiscal potential analysis lump sum agreements might lead to an either inappropriate profit of the private tax collector and a high loss for the district or vice versa.

Experiences from ***other African countries*** (Uganda, Ghana, Mozambique) have raised similar doubts: Profit margins for private collector s were found to be mostly inadequate, resulting in no significant increase, but occasional decrease in public revenues. Monitoring for districts is apparently difficult.

Uganda: Concerns on privatization of market tax collection

Present initiatives for local revenue enhancement in Uganda advocate a larger role of the private sector in tax collection. Norwegian researchers question the narrow remit of this policy debate, and the absence of careful analysis of how local government systems for private tax collection actually work.

Under present routines for assessing markets and procedures for tendering rights to collect taxes, the prospects for local bureaucrats to extract bribes are positively correlated with the value (i.e. the profit or rent) generated by a contract. The rent or contract value, in turn, is inversely related to the tender price, that is the local council's share of the total revenue from a particular tax item such as a market. This is the core of the incentive problem. At present, private tax collection involves redistributive transfers from rural and often poor taxpayers and into the pockets of the local elite.

The six rural markets surveyed by the Norwegian study are all fairly well-organised. Officially, a large number of tax rates are usually imposed on the various tax bases, For market dues, the rates are specified by commodity and quantity and essentially designed as taxes on transactions (i.e. sales taxes). The nature of rural markets, usually weekly events rather than permanent institutions, makes this large number of official rates hard to implement in practice. Operating a similar system in a weekly rural market would be very costly since a vendor would have to pay on entry and be reimbursed for unsold quantities after finalising the day of trading. In the typical rural market a complex official tax system has therefore been replaced by a pragmatic and less administratively costly solution.

Nevertheless, The discrepancy between agreed bids and the estimated revenue potentials of the six rural markets covered by the study is striking, and comparison of the agreed bids and market revenue yields illustrates the poor performance of the private tax collection system in Uganda.

The gap between total revenue collected and agreed tender can be divided between two categories: (i) the 20% margin private tenderers are permitted to realise on their collections in some districts, and (ii) an amount representing the 'lost revenue' to councils, that is the additional revenue the councils would have obtained if the revenue potential of each market had been correctly assessed.

In the six markets in question, the 'lost revenue' amounted to between 25% and 74% of total revenue collected in each market. Moreover, the actual gross margins realised by private tenderers caused by this undervaluation of market yields varied between 71% and 970%. On average, 53% of all revenue collected from vendors in the markets could be interpreted as pure redistributive transfers to members of the local elite.

The distributional effects of the system of private tax collection, as it currently operates, are therefore highly questionable. These observations provide stern warnings to donors and others who often see problems with privatisation as symptoms of low administrative capacity or as reflecting absence of sensitivity that can be repaired by programmes of sensitisation.

A more effective solution could be to move the responsibility for market assessment out of district administrations by establishing an independent body responsible for such assessments. As clean bidding processes are unlikely in the short-to medium-term, a properly assessed reserve price provides an important check in the presence of expected bid rigging. It is also possible to consider more fine-tuned incentive mechanisms that link remuneration of local bureaucrats to revenue enhancement goals.

Source: **Fjelstad 200x**

4.5 Conclusions and Recommendations

If fiscal decentralization is to be a reality, sub-national governments must control their "own" sources of revenue. One major administrative problem today for many LG councils is their inability to collect fully the revenue due to them. Fundamental issues to be addressed in this context are to (i) redesign the current local revenue structure and to (ii) strengthen financial management. Moreover, measures are required to enhance (iii) taxpayers' compliance and to (iv) improve the accountability of tax collectors and councillors.

National Governments who want to increase local revenues in a sustainable and efficient way, must first establish a clear policy framework. If this is given, LGs are to focus on those sources of revenue, which provide a significant potential and a reasonable cost-benefit ratio. There is consensus to focus on (i) real property tax, (ii) market fees and taxes, possibly via involvement of private providers and (iii) other fees for services (water and sanitation, electricity)

Privatizing parts of local revenue collection could be a viable response to corrupt and inefficient public structures, but can't replace a weak administration. Private tax collection still requires a strong and transparent administration to minimize the loss from the contributions of the population. A "sufficient remuneration" of collectors, private or public, to avoid corruption appears unachievable.

Technical recommendations[29]

[29] Many of the below-mentioned recommendations have been developed in a recent policy dialogue between development partners and the Government of Rwanda, which is being facilitated by a DFID policy advisor in the Ministry of LG. Recommendations have been exchanged by Emails and informal papers. Many of the recommendations are supported by the above-mentioned fiscal study financed by the French cooperation (see Chambas 2009). Note to DFID: If there is a particular policy paper, which you would like to be mentioned in this regard, pls let me know

On the tax policy framework

- Prepare a detailed local government ***tax policy paper***, defining sources of revenue of local governments as well as proper sharing arrangements[30] so that their revenue needs are addressed
- As a general recommendation, laws concerning local revenues should contain only those provisions/articles that establish the policy principles and provide a clear enabling framework for implementation.
- Implementing modalities should be consigned to secondary or tertiary ***regulations*** that do not require full adoption procedures every time a change is made. Mention of fees, charges, penalties or other matters that are likely to be subject to frequent change should be excluded from primary legislation. These items can be set annually by the competent authorities and published as secondary or tertiary rules/order/regulations etc.
- Scale back ***policy objectives*** for fiscal decentralisation to realistic aspirations. Adjust fiscal decentralisation policies so that is congruent with the real situation in many communities with limited tax bases and limited revenue raising potential. Introduce changes to the legal framework to increase (i) the tax base, (ii) tax yields and (iii) collection capacity at the local and central levels and as a result assist in achieving the fiscal policy objective of increasing the levels of local resources to meet local responsibilities.
- Legal frameworks should not provide high levels of ***tax relief*** / exemptions at national level, which may limit overall tax income as well as sharing arrangements to benefit Local Governments.
- As Real Property Tax has the largest untapped revenue potential for local governments in developing countries, a modern ***property tax law*** should be developed as an appropriate income stream for local authority financing
- The Legal framework should have a separate and stand alone organic law setting out the ***types of licences and fees*** that can be levied and collected by local administrations.
- It should be guaranteed (institutionally or otherwise) that local governments receive their part of the locally generated revenues in a timely manner without delays and without diversion.

On tax priorities (See Chambas 2009)

- In order to ensure proper planning, forecasting and collection of revenues, there is the need to improve databases used to construct the nominal roll. District assemblies should be assisted to undertake a survey of businesses and economic activities as well as the social and demographic situation in their respective areas of jurisdiction. This will aid in the establishment of a central tax register, which would be of mutual benefit to both the district administration and other revenue authorities, especially on taxpayer location. A unique Taxpayer Identification Number (TIN) could be issued (GTZ 2006)

[30] "Sharing arrangements" refer to transferring part of the centrally collected taxes to local authorities (such as VAT, rental income tax), not vice versa, as currently practised in several countries

- Collection efforts should be concentrated on taxes with high productivity. Tax items should be ranked considering cost of collection and share of total revenues. Inefficient fees and rates should be abolished: the practice of districts collecting taxes that have cost of collection rates over 100 percent should cease. Realized savings should be directed to collection efforts for more productive revenue sources (GTZ 2006).
- If assessment of real properties is not possible / surpasses capacities of the administrations, a small per-capita residential tax or development tax may serve the same purpose and broaden the tax base (See Chambas 2009)
- Local tax systems should consider the investment needs of fast growing urban areas ; in this regard, efforts should focus on direct taxes and arrangements on RPT and urban transit (vignette automobile ou une vignette sur les vélomoteurs) should be flexible to allow adjusting to changing conditions. (See Chambas 2009)
- Double taxation of the same purpose should be avoided (e.g. parallel existence of RPT and a residential tax)
- User charges on water and electricity should also be flexible

On property tax collection[31]

- Collection of basic rates, and the costs incurred with solid waste collection and treatment, as well as drainage maintenance, should be collected by means of the property tax.
- Co-operation between the Districts and national agencies could help to overcome district assemblies' difficulties to levying and adjusting unpopular taxes; e.g. property evaluation may be carried out by the central tax administration or by a separate valuation agency (GTZ 2006); it is highly recommended that one authority be assigned the responsibility of property valuation.
- Poverty concerns in this regard should be addressed by (i) establishing a very low or zero property tax for informal dwellings but proceed with registration and collection of basic service fees, (ii) promoting / maintaining low-cost solutions in water and sanitation (e.g. public standpipes, public toilets, public showers) for those groups of the population who cannot afford to connect to urban networks, (iii) offer payment by installment for connection fees.Empower the local authorities to effectively collect the property tax through capacity building and introducing appropriate IT solutions[32]
- If local tax assessment and collection capacities are to be strengthened through training then these initiatives should be targeted at improving the rate of collection of Property Tax solely as this source of revenue is under exploited throughout many countries.

[31] See also checklists on RPT collection in Annex XX
[32] Several IT solutions for local government tax administration are being promoted by private providers as well as German Technical Cooperation (e.g. GTZ-product ITAX, Philippines).

- Establish complete records of properties and then assessing and collecting tax on these would provide a significant and sustainable source of revenue for many local communities. A comprehensive data base of all (private and commercial properties is a pre-requisite to an efficient Property Tax system.
- Apply differential rates of property tax on private and commercial properties. This is a common concept as commercial and private residences typically have different market and use values.
- Build financial ***incentives*** for LGs to improve RPT collection (*See Box on Tamil Nadu in Chapter 6)* and promote good transparency practices (e.g.Giving publicity to the "Top Ten Defaulters")

On private collection of market fees and taxes (See Fjelstad 2003 and 2004)

The privatization approach has to respond to the following general challenges in order to avoid failure:

- be embedded in other initiatives to improve administrative capacities and monitoring
- Create incentives for tax collectors
- Sensitize for tax payers compliance and understanding

Despite all reservations, privatization could help to overcome shortages in district administration and help increase revenues, given

- a comprehensive planning of the process, incl. a viable tax potential analysis
- strong monitoring procedures
- a transparent and complete fiscal reporting system

Recommendations to development partners

- Develop a common position with regard to tax sharing and fiscal autonomy in each partner country, based on the experience of donors and specific framework conditions given
- Support including the capacity to generate local taxes in general LG capacity assessments in order to specify administrative versus political weaknesses
- Conduct an independent evaluation of different IT solutions for sub-national finance and tax collection on the market, in order to avoid biased financing

Ghana: Requirements to increase locally generated revenues

"The implementation of recommendations (to increase locally generated revenues) requires certain minimum standards of competence and skills in public financial management. Logistical support in the form of computers and software for the development of financial management information systems is also crucial. A pilot project to undertake a comprehensive capacity assessment of selected districts could be done to ascertain their capacity to implement the recommendations. The result of the capacity assessment could constitute the basis for technical support to the District Assemblies. Clearly, the main challenges facing decentralisation in Ghana are the issues of political will and commitment; the resistance by bureaucrats and technocrats; divided loyalties; overlapping role of key players; …" (GTZ 2006)

5 Challenges for capacity building

The institutional capacity of local government in many cases is very limited. The World Bank points out that local capacities are often not immediately up to the tasks that would be imposed by fiscal decentralization. In great part this is because local government has had little authority or capability to mobilize resources as well as few specific responsibilities to provide services. Weak institutional capacity is often cited by central-government stakeholders in their arguments against fiscal decentralization. At any rate, where fiscal decentralization does take place, it almost always is accompanied by efforts, often funded by international donors, to strengthen institutional capacity at local levels.

Capacity development for local governments has often suffered from unclear institutional responsibilities. In most countries, the Ministry of Finance is in charge of PFM reforms, which are an essential requirement for fiscal decentralisation with limited fiduciary risk. On the other hand, the political advocacy for decentralisation as a whole is generally with another Ministry (***Ministry of Local Government or similar).*** This implies to make sure that (i) A democratic and accountable system of local government is in place with an effective administrative structure, (ii) Planning is comprehensive and services to communities are delivered in a sustainable manner, (iii) Social and economic development at a local level is sustainable and based on felt needs of the local communities. Service delivery concerns the line ministries, while the establishment of an effective administration often requires a reform of public service, which may concern again another Ministry (Ministry of Labour or Fonction Publique).

In this regard, the Ministry in charge of decentralisation needs to have a strong coordinating mandate in order to comply with its crosscutting function. This is not generally given. Often, the Minister of Local Government is among the weaker members of the cabinet and certainly not as influential as the Minister of Finance.

An ongoing study on Ethiopia found: "An obstacle for the decentralisation is the fact that at federal or regional level no agency has the overall responsibility for driving the decentralisation and capacity building process and ensuring compliance with agreed visions and policies. Four ministries (MCB, MWUD, MoFED and MoFA) play roles in this regard, which favours overlaps. Regional disparities have posed practical problems in the decentralisation process in particular within those regions labelled as "emerging".

Overlaps affect the organisation of the badly needed capacity building for districts and other layers of local government. An effective national capacity building programme with a related basket-financing supported by several donors does not yet exist.

In those low-income countries, which are recipients of general budget support, the area of PFM reforms does generally receive a lot of attention and some of the related training under the leadership of the Finance Ministry trickles down to sub-national levels, following uniform guidelines. This is not the case with capacity building needs in other areas. National training needs assessments or action plans

– if in place – are too general to promote reforms and best practices[33]. In most countries, planning, citizen participation and service delivery are mainly supported by bilateral development projects or at best sector programmes but not comprehensive programme based approaches.

5.1 Public Financial Management as a key area for CB

Improving Public Financial Management at sub-national is a precondition to fiscal decentralization, in order to reduce fiduciary risks. Despite the fact, that the Ministry of Finance is mostly one of the more capable partner agencies there is a lot of room for capacity building efforts to support PFM reform at LG level.

First, reforms of the budget cycle as well as the budgeting process are required, which affect national as well as sub-national fiscal governance. These reforms refer to (i) the predictability of transfers, (ii) timely preparation of budgets at all relevant levels, (iii) inclusiveness and transparency of the budget and (iv) accounting, (v) reporting and the flow of information.

The predictability of transfers goes along with well planned expenditures and usually, Medium Term Expenditure Frameworks are introduced to local governments at this stage and local governments must be enabled to develop an MTEF process that is similar to and integrates with that for central Government. In order to facilitate PRSP monitoring, capital (investment) expenditures must be clearly separated from recurrent (ordinary) expenditure. LGs must follow the same programme and sub-programme structure. Programmatic budgets and related standard charts of account are required, which are usually new to national as well as local governments.

The ***district MTEF process*** requires district governments to prepare a District Budget Framework Paper and proposed MTEF allocations for the coming budget year and the following years. District governments prepare revenue projections for the MTEF based on figures for grant ceilings provided by central Government and on their own estimates of local revenues and donor funding.

Budget reforms are usually accompanied by changes in accounting practice (shift from simple cash based to modified cash-based or accrual-based accounting. LGs usually practice cash based accounting, the double entry concept is not generally known and depreciation of fixed assets is not common (in fact, before decentralisation in rural areas there were not too many fixed assets to be depreciated). This constitutes a mayor change for LGs as most accounting staff were trained under a different system (if staff at local level is trained at all)[34] ***There is a huge need for retraining in order to meet requirements for transparent and complete budgets at LG level***.

During budget execution, Districts have to provide regular reporting on budget execution and performance achieved. This is a challenge in term of quantity and

[33] A typical example for this is the Plan Triennal du CSMOD 2008-2010 in Burkina Faso, the implementation plan for the governments decentralisation strategy. It talks a lot about “renforcement des capacities” without defining whose capacity shall be developed to do what.
[34] In francophone countries there are generally vocational schools for administrative staff in place, which follow the French model (e.g. ENAM and ENAREF in Burkina Faso). However, district staff is not usually graduated from these schools.

quality of reports. First, before fiscal decentralisation there were not many expenditures to report on and second, different formats were in place. Based on budgeting reforms, financial statements should use the same classification and format as the approved budgets, and show comparisons/variances between actual performance and budgets.

As a tool to support PFM reforms, many countries introduce ***Integrated Financial Management Systems***, which are offered by several IT companies and intended for use throughout the general government. The system is centrally controlled at the headquarters of the Ministry of Finance and Economic Planning, and is accessible to the Budget agencies (including LGs), via the "world wide web". System modules are the equivalent of the books of accounts previously kept in a manual accounting system.

Challenges for local governments in partner countries with regard to such systems are multi-fold: First, there is a "generation gap" to switch form manual to electronic systems, second, power supply and internet connectivity are not that reliable, particularly in rural districts. Thirdly, local governments are usually not trained in filing and have difficulties to provide the required information in a timely manner. Last but not least, the lack of anti-virus protection is one of the most neglected risks for successful introduction of PFM reform at LG level, according to field visits of the author.

Generally, Ministries of finance issue a ***Budget Call Circular (fr.: Circulaire)*** to all budget entities, including local governments, in which requirements are explained. However, as many reforms are new and so are local administrations, correct application requires additional support to local governments.

First, m***anuals and guidelines*** need to be updated and validated at national level. The impression of the author is that to date there is not much exchange of information between Anglophone and francophone reform supporters. It might be worthwhile to systematically check and compare tools and training content used to support PFM reform in different countries and give more attention to less strategic aspects such as filing and antivirus protection. The implementation of decentralised financial management is a gradual process, which will require additional efforts in capacity building at local level for a longer time. The experience of South Africa, which is quite advanced in several aspects of fiscal administration, may be a realistic indication for that (See box)

South Africa: Capacity constraints in an advanced middle income country

Even in more advanced African countries capacity constraints at municipal level are endemic: According to a recent study there is a severe scarcity of well-educated financial managers and engineers, leading to high vacancies in municipalities' administrations and a lack of qualification of decision makers. Some municipalities in a given sample did not have a chief financial officer for months, and suffered from vacancy rates of up to 50 %. Additionally, high fluctuations among the staff and a weak succession planning further disable a consistent policy.

Other figures indicate that of the 231 local municipalities 42 had only one technical professional (i.e. civil and transport engineer or technician) on staff and 79 municipalities had none. The lack of financial management capacity directly impacts the ability to borrow as it leads to an inability to understand and deal with debt instruments. Many municipalities do not have the expertise to write the necessary reports, which lenders require

See DIE / GDI 2007

5.2 Project Management Skills as a Strategic CB area

While support to (participatory and other) LG development planning has received a lot of attention (mainly through support to municipal and regional development plans), project management skills of LGs have not been upgraded accordingly. This area was not essential, while most LGs had no funds to implement major investment projects on their own and donor-sponsored projects were mostly implemented by the respective donors.

During the high season of Social Investments Funds and AGETIPs (Agence…traveaux d'intérêt public), municipalities were initially not systematically involved (Latin America) or were non-existent (West Africa). According to the status of local governments, tasks related to the management of sub-projects were either done by the funds themselves or partly delegated to local communities.

With the subsequent devolution of responsibilities as well as funds to local governments, this has changed fundamentally. Municipal development funds (= third generation social funds, e.g. in Central America) as well as the emerging national LG financing systems (such as ANICT in Mali, Fonds Permanent in Burkina Faso, CDF in Rwanda) regard cities and municipalities as owners of their investment projects, whose costs should also appear in LG budgets.

However, most local governments of most developing countries (except for the major cities and urban LGs of middle income countries) are not in a condition to fully manage project cycles without support, due to lack of skilled staff, lack of experience or high turnover. Weaknesses relate to linking plans to budgets, conducting feasibility studies for investments, procurement and tender evaluation, contract management, supervison of works, internal audit, operation and maintenance of related services. If weaknesses are evident from the beginning, funds may just accumulate on district accounts; if they become evident midway, contractors may abandon construction sites before completing works; if operation is not dealt with at an early stage, works may be ok, but still no satisfactory service resulting. The issue for CB is how to guide and capacitate local governments to gradually learn taking over these tasks without wasting public funds.

In different countries, different approaches have been tried but it seems that interventions are rather guided by governments and development partners preferences and traditions in their countries of origin rather than empirical assessments of results:

- In francophone Africa, municipalities can delegate part of the project management to a consultant, who is paid by the fund/financing system (maîtrise d'ouvrage délégué; the modality has proven to be efficient with regard to the completion of works but does not cover subsequent phases of operation and maintenance; further, according to the experience of the author, the difference between maîtrise d'ouvrage and the delegation mode is not always clear to LGs. This means, that transfer of knowledge may not be effective.

- In Central America, municipalities have been assisted to establish multidisciplinary technical teams to manage investment projects, supported by a regressive financing of salaries; this approach was successful in a period of growing transfers to municipalities, which facilitated the take-over of staff by LGs; secondly, trainings to local communities were conducted to participate in the maintenance of structures, with limited success.

5.3 Conclusions and Recommendations

In general terms, development partners who favour general and sector budget support, have not given much attention to the need for CB in project management and rather argue in favour of increasing discretionary non-conditional transfers to districts, allowing them to learn from experience. According to this philosophy, some funds have been set up as financing mechanisms, without caring for technical departments and support staff to guide districts (which proved to be an expensive learning process). On the other hand, francophone governments and donors from this administrative context may give effective technical support to LGs but do really hesitate to hand over funds.

Technical Recommendations

Capacity building for effective decentralization requires interventions at all government levels. It is a helpful tool to classify the need for support according to the levels of intervention, in order to define target groups and viable approaches, e.g. :

<u>Macro Level</u>: Support to establishing a regulatory and administrative framework, including roles and responsibilities of different stakeholders, support to coordination, negotiation and decision making in the overall reform process, support to establishing revenue and expenditure responsibilities need to be assigned.

<u>Intermediate level</u>: Support to establishing financial and technical support mechanisms for fiscal decentralization, such a Municipal Development Funds or financing Systems

<u>Local level</u>: Support to establishing effective and participatory planning and control mechanism.

Recommendations to development partners

- Acknowledge that fiscal decentralisation is a long term process, which depends on political will as well as technical expertise at different levels
- Acknowledge that CB in (fiscal) decentralisation requires involvement in CB and advisory services on the ground
- Define realistic phases for support and realistic transition periods in line with the national reform process

- Acknowledge that CB requires results monitoring on the ground as any other area of support
- Support governments in defining CB topics in a precise manner (contents, target groups, training and other service providers, pedagogical approach, follow up, monitoring)
- Agree on best practices to be promoted in each of these areas (exchange these practices among the donors)
- Support governments in establishing long-term support services for local governments, which are adequate to complement their administrative setup
- Go for basket financing in capacity building (instead of dividing partner countries in areas of CB influence)
- Encourage governments to establish specific CB grants (as part of the intergovernmental transfers or in addition)

Good Practice from South Africa: Transfer payments for capacity building

The transfers to municipalities in RSA can be separated into three basic types of grants: Besides the usual unconditional transfers (the "equitable share"), which are determined by a poverty-based formula and conditional infrastructure transfers, conditional capacity transfers have been introduced as a third category. They are intended to assist municipalities improve their capacity or restructure their operations, such as the Restructuring Grant, the Financial Management Grant, and the Municipal Systems Improvement Grant. These capacity related transfers accounted for only 4 % of total transfers

6 Sub-national Borrowing as an Option for the Fittest

6.1 Rationale for Sub-national Borrowing and risks involved

As a result of decentralization policies, sub-national spheres of governments face increasing responsibilities for infrastructure service delivery. In this context, a controversial international debate has emerged, whether to allow sub-national governments to borrow in order to finance part of their infrastructure and to what extent. Skeptics argue that sub-national borrowing bears a high risk of over-borrowing, while proponents argue that access of sub-national governments to capital markets were a logical further step to meet financing demand.

Through the often externally funded preferential loans, access of municipalities to ***financial markets*** is improved and investment in infrastructure speeded up, which in most cases is environmentally relevant and essential for improving living conditions. Infrastructure is crucial for economic growth and spurs the achievement of the Millennium Development Goals (MDGs). Infrastructure services like electricity, roads, water, and sanitation are main drivers of economic activity. Social infrastructure, such as health and education, but also access to clean water and sanitation, lead to direct positive impacts on the quality of life and reduce mortality and morbidity.

The ***rationale*** of a positive impact of all kinds of loans (including commercial ones) is that the exposure of local governments to capital markets can significantly speed up infrastructure development and in addition requires municipalities to be transparent and leads to lenders exerting a certain control function on local government finances. This link is established through four processes: External assessments such as ratings, the tender process, reporting and monitoring.

However, in many countries, particularly in parts of Asia and Latin America, the first generation of municipal loans – often backed by state guarantees or financed by government financial institutions, have not been sustainable (see Box). Municipalities became so used to avoiding repayment of loans that in Latina America the paradox term "prestamo no reembolsable" (a non repayable loan) was created.

The Philippines:

A changeable history of municipal borrowing with effective incentives

In the 1980s, prior to the passage of the Local Government Code, the delivery of basic services and other activities of the LGUs were financed from resources provided by the National Government. LGUs turned to the Government Financial Institutions for their support to intermediate credit finance requirements and this lending served the LGUs well until many LGUs began to default on their obligations (due to a severe economic recession resulting from the political uncertainty in the country). Unpaid obligations rose to Ps 2.1 billion in 1985, which led to the cessation of lending to LGUs. The national government had to carry out a debt relief programme for the LGUs.

After a more comprehensive approach to decentralisation in the early 90s, the legal framework for LGU's access to loan financing was liberalised again. Local governments may access any form of loan with any government, bank or lending institution (bonds and other investment schemes included). As a lesson learned from the debt crisis of the 80s and in order to assure fiscal viability of the loans, the amount of appropriation for debt servicing "shall not exceed 20 % of the regular income of the LGU concerned".

In order to encourage the use of loans and lending to LGUs, up to 20 % of Central Government Transfers to an LGU may be used as a collateral for loans. This mechanism (called IRA intercept) has started in the early 90s and is growing since then, as internal revenue allotments have also increased substantially. It has met the expectation as lending has been fast increasing and default rates are under control.

6.2 Strict Regulatory Framework to avoid overborrowing

As a result, most middle income countries have strictly regulated municipal access to loans and introduced indicators to assess the debt potential (see Annex XX on loan regulations). Based on these grounds, at least 25 developing countries started to (re-) engage with sub-national borrowing. Those are mainly (Lower) Middle Income Countries (MICs), such as South Africa, India, the Philippines, to mention a few, which have reached a certain degree of political and administrative decentralization, along with a level of economic development.

In many countries, local governments are only allowed to borrow from the central government. In other countries, local governments are not specifically allowed to borrow at all. In still others, local governments, states, regions, and municipalities all have the authority to borrow from private lenders. In some countries, state or regional governments impose borrowing restrictions on local governments, restricting them only to borrowing for "revenue anticipation" needs or to specific capital infrastructure needs.

It was learned that municipal loans require a regulatory framework, which encourages actors to borrow or lend for infrastructure, by imposing rules that give municipalities clear guidance and provide lenders with predictability, clarity and confidence. In this context national state guarantees for sub-national debt are generally abolished, increasing municipalities' responsibility and self-reliance. South African lawmakers have e.g. successfully diminished some of the previously perceived uncertainties by introducing a set of regulations of which the centerpiece is the Municipal Finance and Management Act (MFMA), which was implemented in 2004.

It must be assured that long-term loan capital is actually used for infrastructure investments debt can only be raised to finance capital expenditure and not to finance current expenses. Additionally, regulations on budgeting, accounting, reporting, and supply chain management impose discipline on municipalities. Inevitably, the workload of municipalities' administrations will increase while financial reforms are implemented but improved transparency may also increase credibility of the administration.

The concept of creditworthiness

The market potential for municipal loans depends (i) on the general creditworthiness of LGUs and (ii) on the unused debt capacity***.*** Creditworthiness of sub-national entities is a demand-side requirement for sub-national borrowing. Generally speaking, creditworthiness refers to the ability and willingness of a borrower to repay the debt. Creditworthiness leads to a good credit rating, which enables sub-national entities to attract lenders and borrow at reasonable prices. Phelps (1997, include source), among others, considers information about creditworthiness to be a key factor for a working sub-national borrowing market.

This refers to ***key financial indicators*** like

- total debt burden,
- the ratio of debt to revenue,
- debt per capita and the financial deficit.

Municipal loan applications (as well as any other loan) can be positively assessed, if debt service can be financed from the overall (municipal) cash flow balance and sufficient funds be left for recurrent expenditures. These are logical restrictions. Calculations on the financial viability of ***revenue generating projects*** (= projects related to services where user charges are applicable) in a wider sense (including water and sanitation) should rather be based on assumptions about the connected population, user charges and collection efficiency***,*** for cost recovery to be achieved in the medium or long term***.***

In poorer and more ***rural municipalities*** in developing countries, there are no historical records about the capacity and willingness to connect and pay, as services are established for the first time. This makes calculations more risky for both the lender and the borrower. Further, loans for water and sewerage projects are restricted to the ULB's willingness to review user fees and often cost-recovering charges are considerably higher than the existing water ones. Deposit payments for water and sewage house connections are an additional burden for low-income households, which has to be considered.

Determinants of the general local economic performance also influence the creditworthiness of sub-national entities. Important in this context are, for example, demographic factors, growth prospects, key industries, poverty, employment levels, and the diversification of the local economy. Local institutional-political factors comprise the quality of governance, and financial management capacities like accounting, planning, reporting, public disclosure, and marketing skills.

Why South African LGs can access loans while others cannot

South African municipalities are advanced in terms of fiscal decentralization since they have significant and stable income sources. They receive many transfers from national government and some have their own income sources, making them less dependent on the national government. Fourth, with the DBSA, South Africa has a strong public development bank. Such a public lender is valuable to play a lead role in developing a municipal market, leading municipalities to the capital markets, and in addition, one can observe strong private banks that increase competition. There are diverse financing instruments employed by public and private lending institutions.

South Africa does not only have unusually many actors on the financing side but also an unusually high level of liquidity in the financial sector. Moreover, the good national government budgetary situation has allowed South Africa to increase intergovernmental transfers for infrastructure service delivery. Such a strong financial sector with a long history of long-term investment lending in the local currency is nonexistent in many developing countries.

Source: GDI / DIE 2007

Thirdly, ***Efficient lenders*** and innovative financing instruments are necessary for a functioning sub-national capital market. Notwithstanding an increasing number of countries, whose municipalities are actually borrowing without defaulting, recent studies indicate that access to capital markets is a ***slow process***, on the supply-side as well as on the demand side.

A recent study on South Africa (GDI 2008) found that debt capital is not evenly distributed across municipalities, but concentrates on the metros (six biggest cities of South Africa) and some secondary cities. Generally, there are ***few competitors*** on the LGU loan market. For example, in the Philippines, approximately 40% of LGUs have taken up loans, which refer to only three Financial Institutions. GFI lending is focused on short and medium term ventures such as public markets, heavy equipment, terminals and small water supply systems, while financing of large infrastructure projects is limited through the medium-term duration of most loans.

According to recent studies in Indonesia, the motivation for long-term ***borrowing at market rates*** is very limited. Sources of previous loans have been the Subsidiary Loan Agreement (SLA) and the Regional Development Account (RDA). Only few cities have received loans from commercial banks. These loans were mainly short-term and they were used to manage volatility in the cash-flow of the local budgets.

Several Indonesian cities could be regarded as creditworthy, provided their arrears will be settled and they comply to the legal requirements such as reporting and auditing procedures. This means most cities must settle old debts before taking a new loan. Several larger cities have a debt-service-ratio below 5 %. However, the majority of cities prefer other funding sources for financing local infrastructure. Loans will only be considered as option for financing infrastructure needs if the conditions for loans are easy to fulfil, which includes low interest rates and fast and easy access.

On the ***positive side***, municipal borrowing in South Africa was found to impact positively on local governance in terms of transparency, accountability and financial management. This, in turn, was assumed to result in a more efficient and needs-oriented use of resources and therefore in improved infrastructure service delivery.

The development of ***intermediate financing institutions*** and mechanisms is often an important step towards sub-sovereign lending. So called 'credit enhancements' shall diminish potential credit risks, prepare local governments for future lending and contribute to the development of local financial markets. Municipal Development Funds, financial intermediaries established in a considerable number of countries, usually integrate different credit enhancement instruments and provide a platform for joint and coherent financing interventions of partner countries and donor institutions.

6.3 Municipal Loans and Poverty Considerations

In view of the need of general coverage of basic services and the limited creditworthiness of LGUs it is worthwhile asking, whether loan financing can be used to improve the situation of poor municipalities or if it rather discriminates against the poor.

The selection of particularly ***poor municipalities*** for loan financing is obviously not a viable option for a loan programme as all loans must be financially viable. In the case of preferential loans, specific covenants regarding the quality and poverty orientation of Local Development Plans as well as the establishment of common facilities might be viable but are not common and not easy to assess.

As a result, municipal loans can complement but not replace or reduce intergovernmental fiscal transfers, which are required to introduce those reforms, which may lead to accessing capital markets. Access to capital markets (without state guarantees) requires a sound condition of municipal finance, in order to be able to repay the loan. Further, in order to avoid disturbances of the capital market, ***conditions and interest rates*** of development loans should generally be set in consideration of the prevailing national interest rate level taking into account the specifications of the urban infrastructure sector (long repayment period plus a certain grace period of up to five years).

Space for poverty oriented manoeuvring is therefore quite limited and it may be argued that loan financing will not be a viable option for most municipalities in Sub-Saharan Africa or even Latin America in the medium term, except for some larger metropolitan areas. However, it is worthwhile to look at the experience of the Indian State of Tamil Nadu, which is applying a clever mix of moderate government subsidies with financial market tools to provide reform incentives for revenue generation and create a ***soft equalization bonus*** for poorer municipalities (*see Boxes*).

Tamil Nadu I: How to combine moderate subsidies and loans at market conditions

Under the World Bank-financed TNUDP, a special financial tool (the so-called ***Grant Fund***) was created to facilitate the participation of poorer Urban Local Bodies (ULBs) in a loan scheme[35]. A certain part of the *loan* to the Government of India is transferred to beneficiary ULBs as a *grant*, which means that financing costs are covered by the national government in order to promote municipal loans. ULBs with an above-average share of poor population are eligible for a certain amount of co-financing from the Grant Fund[36].

In order to enhance local revenue generation, financial assistance under the Grand Fund is subject to the condition that (i) 80% of property tax should have been collected in the past three years prior to the project investment year and (ii) the local body should have repaid all loan dues for two years prior to the project investment year. Urban Development Plans are financed under a similar facility.

As a starting point, the chance of all ULBs has been improved through state government reforms in urban governance, in particular reforms of the ***Property Tax*** (comprehensive assessment of plots and buildings). The Grant Fund is like a subsidy from the GoI, facilitated by the German and IDA funds, which has boosted local tax collection through the in-build conditionality[37].

The Grant Fund Mechanism leads to a reduction of debt service for poorer ULBs and thus increases the fiscal space for this range of local governments. A positive impact on access to service is probable, if additional funds were reasonably used. It is an adequate response to facilitate loan access to poorer ULBs but does not contribute to better poverty-targeting of sub-projects.

Tamil Nadu II: Do infrastructure loans discriminate the poor?

According to findings in Tamil Nadu, deposit payments for new sewerage connections may exceed the monthly income of households below the poverty line (socalled BPL population). The Tamil Nadu Urban Development Fund (TNUDF) is aware of this challenge. Calculations on the financial viability of municipal loans for such projects are based on conservative assumptions. TNUDF does not take into account any deposit or charges from BPL population, which means that feasibility is assured, even if none of the BPL population (e.g. 30 % of households) will go for house connections. This procedure is regarded sufficient to protect BPL population from undue pressure to find funds for deposits. ULBs' announcement to offering payment of the deposit by instalments as an incentive to the low income population is also promising. Further savings of expenditures will occur after the closure of the existing septic tanks. The risk of BPL populations not getting connected could be further mitigated if the

[35] The same mechanism applies to a new operation of the German Development Bank KfW in Tamil Nadu (See Boschmann 2008).

[36] For basic services, grant assistance is made available if more than 20% of project beneficiaries are people living below the poverty line. The total quantum spent shall not exceed 30% of the cost of the sub-project subject to a maximum of Rs.10 crores per project. Grant towards Viability Gap funding shall not exceed Rs.10 crores.

[37] For example, in 2003-04, the total demand for property tax in Salem, a city of 0.8 million inhabitants, stood at Rs. 3131 Lakhs (both arrears and current). Only Rs 1516 Lakhs had been collected. The overall collection performance was 48 %. Following the establishment of the Grant Fund, Salem city administration was able to collect about 25 % of the arrears demand during the period 2003-04 and over 80 % of the current debt was collected (See City Corporate Plan 2004).

coverage of common facilities were assessed and possibly further improved, while not the whole population can access house connections.

6.4 Municipal bonds for diversifying the Debt Portfolio

Bank credits and bonds both have strengths and weaknesses. Since bond issuance goes along with many disclosure requirements, bonds contribute to more ***transparency*** in local government, from which the public would profit as much as lending institutions. Thereby, the monitoring function of the public may contribute to strengthening accountability. However, other LGs might rather avoid the modality for that particular reason.

To have a more ***diversified debt portfolio*** is another advantage of bonds. This was one reason for the emission of the first Johannesburg bond in RSA (See box). The main motive for bonds, in addition to publicity reasons, is the need to diversify funding sources. Other benefits of bonds are their greater ***flexibility*** since a city can eventually buy back debt at a lower rate on the bond market, and their ability to catalyze further investment.

In the long run bonds may be ***cost effective***, if they are launched with a good rating. However, this advantage depends on the current situation of both, bonds and loan markets. Bonds may also be more expensive to service than loans, which is the case since 2008. Further, bonds have higher fixed costs (for road shows and administration as well as for listing fees) and many municipalities felt that they were too small for issuing a bond. It does not make sense to issue a bond smaller than a certain amount due to the fixed costs that arise. In addition, it is necessary to get an expensive rating from an international rating agency such as Fitch, Standard & Poor's, or Moody's.

The ***market for municipal bonds*** is still nascent with several constraints to growth to be overcome: On the demand side, most local governments have no or only rudimentary understanding of this financing mechanism and there is no secondary market for bonds. Accordingly, municipal experience with bonds is even more limited than experience related to municipal borrowing.

Even middle income countries are hesitant in this regard: While bank credits are a common municipal financing instrument in South Africa today, municipalities in RSA are reluctant to issue bonds. Issuing bonds had been a common instrument of municipal financing in RSA prior to 1994. One reason is that South African pension funds were required to invest in municipal bonds. However, the municipal bond market has virtually disappeared. This is due to the uncertainties of the transition phase and also because the pension funds are no longer required investing in bonds.

A recent study on ***Indonesia*** (GDI 2007) is also hesitant to predict a fast take off of municipal bonds although there is a large potential market: The regulations on issuing municipal bonds were found to be too restrictive as bonds cannot be secured by intergovernmental transfers or similar funds. ***Corporate bonds*** of municipal enterprises as a special case of municipal bonds are solely backed by corporate assets and revenues without further explicit public guarantees. Consequently, municipal bonds cannot be used as a general financing instrument for municipalities, but are restricted to the financing of projects. Projects that cover their full operating cost and generate a surplus covering the interest payments of the bond such as toll roads, toll bridges or investment projects of the very few municipal water enterprises which cover their operating costs.

Yet with this restriction, those Indonesian cities, which were assessed in the sample, did not take the issuing of municipal bonds for infrastructure investments into consideration. The main and most stated reasons were "unclear regulations", "too much bureaucracy" and the awareness, that there were no investment projects readily available that fulfil the conditions for bond issuance. Several cities indicated that asset evaluation were a major problem (which relates to capacity to implement PFM reforms).

An exception from this trend is the launching of bonds by the metropolitan administration of Johannesburg, which is considered a success story (*See Box*).

Johannesburg: A metropolitan experience with municipal bonds

In April 2004, Johannesburg was the first (and so far only) municipality to launch a bond after the breakdown of the municipal bond market in 1994 due to the transition process. The issue was widely praised both nationally and internationally, animating a vivid debate on municipal bonds as a means to finance development in emerging economies. The issue in the amount of 1 billion rand even scooped the Bond of the Year-Award from the Bond Exchange of South Africa (Besa). Being 1.5 times oversubscribed, the bond certainly can be seen as a success, especially considering the cities pioneering in this respect.

Only 40 % of the proceeds of the first two bonds are used to finance the city's capital expenditure program. The rest is used to refinance existing, more expensive debt that Johannesburg had accrued in the late 1990s, when it was experiencing financial distress. As banks were overexposed to Johannesburg, the City had reached its credit limits with almost all banks and basically had to go the bond route to obtain more funds. The refinancing of the onerous debt arrangements through the bonds will save the city interest payments of about 20 million rand annually over the next 6 years. However, with 230 basis points over the government benchmark bond, Johannesburg paid a high price for that success, as it certainly pays a higher interest compared to bank lending rates at that time.

Only two months later, the City issued a second bond, again worth 1 billion rand. COJ02 was an innovative issue, as it was accompanied by a 40 % guarantee from the International Finance Corporation (IFC) and the DBSA (20 % each). The enhancement was necessary to guarantee investors confidence for the longer maturity of 12 years and led to an 3-notch rating uplift (from A- to AA-), thereby allowing for a better pricing than the first bond in spite of the longer maturity. Although it was a success to reduce basis points, the bond remained expensive compared to loans.

Source: GDI / DIE 2007

Innovative initiatives: Guarantees for municipal bonds

Several countries have launched initiatives to make the launching of bonds more attractive to both municipalities and investors. Two mechanisms shall be mentioned in this regard:

- The Local Government Unit Guarantee Corporation (LGUGC) in the Philippines
- The Pooling of Bonds in the South Indian State of Tamil Nadu

The ***Local Government Unit Guarantee Corporation*** (LGUGC) in the Philippines was established in 1998 to develop the primary and secondary markets for local government debts through guarantees for municipal bonds. It operates as a private sector corporation. Equity shares are owned by one of the major development banks of the Philippines (DBP) and 21 financial institutions. With a total equity capital of Ps 216 million, 12 LGU bonds of more than Ps 2 billion have been floated and guaranteed up to 2004 (Figure to be updated).

Financing is limited to revenue-generating projects in a wider sense such as a slaughterhouse, a jetty port and terminal, two housing projects, several markets, an academic centre and a hospital. Prior to making a decision to insure a proposed LGU bond, LGUGC performs its own client analysis. 500 LGUs have been screened and around 20 rated. ***Screening*** is done to broadly assess the political as well as the developmental risk of lending. ***Rating categories*** range from "triple A" (highest credit standing) to "C" (poor standing). Among the 20 LGUs rated, only five got a "good credit standing", while nine were classified as "below average", which indicates a limited market even in a large country such as the Philippines.

The ***project cycle*** consists of a preparatory process and the proper bond issuance process The preparatory process resembles the one for loans. LGUs approach the guarantee corporation with an approved feasibility study and a financing plan at hand, which are evaluated in-house and then referred. LGUGC will contact private banks, which might be interested to buy the bonds to be floated. As for collaterals, bonds are secured by the projected revenues, project assets and the IRA transfers (See box on page xx).

Debt service is to be paid from the project's revenues. Interest rates are based on the Treasury Bill Rate plus a spread of up to 3 %. However, the effective costs of bond flotation involve additional upfront fees. The LGU bonds floated to date have maturities of up to seven years, which is realistic for convincing investors but is still very limited for complex projects.

Results may appear quite moderate when compared to the overall capital needs of local governments. On the other hand, LGUGC has supported some ***economic success stories***, which would otherwise not have been implemented. The most well-known is the bond launched by a small visayan municipality to finance the jetty pier on the tourist island of Boracay. The improved infrastructure has significantly contributed to attracting 4- and 5 star resorts, which has increased revenues by dimensions. (Whether or not this kind of development is socially desirable, surpasses the scope of the study).

A pilot ***securitization initiative*** for infrastructure financing in ***water supply*** have been supported by donors in Indonesia. USAID has developed a concept for financing the investment requirements of water utilities that involves a strategic partnership between donors (USAID, JBIC), the Ministry of Finance and an investment bank (PT Danareksa). The IWF (Indonesian Water Fund) provides long-term loans in local currency, backed by partial credit guarantees. The debt service of the water enterprises is to be made affordable by mixed financing from donors on favourable conditions and domestic medium-term funds at market rates. However, the water utilities would have to agree to cost-covering water tariffs, which hints to the restriction to economically viable projects. Another obstacle is the prevalent double taxation on Asset Backed Securities which increases the cost to the borrower.

Innovative initiatives: Pooled bonds in Tamil Nadu

Beyond the launching of municipal bonds by individual municipalities, further innovative procedures are under development to broaden the range of beneficiary LGUs. An interesting example is the promotion of ***pooled bonds*** in the ***state of Tamil Nadu*** (India).

Pooled bonds are to achieve a three fold impact of (i) funding / refinancing municipal infrastructure, (ii) at an affordable cost of funding and (iii) establish a non-guarantee mode of raising resources for urban infrastructure. Bonds can save a sizable amount in the debt servicing of the ULBs, thereby freeing up the resources of ULBs for further augmentation. The concept of catering to a wide range of smaller ULBs through pooled bonds is meant to generate substantial multiplier effects (as a long-term vision).

Pilot experiences of the financial intermediary, the Tamil Nadu Urban Development Fund (TNUDF) have shown that this is not an easy market[38]. Only one out of two pooled bonds has been fully subscribed, while the other is meeting a number of systemic constraints, related inter alia to an unfavorable overall market situation, political interference and investors expectations. The lesson to be learned is that TNUDF would not push the issuing of bonds unless overall conditions were improved.

The guarantee of such pooled bonds, which is promoted by the German Financial Cooperation, is regarded only as a marginal element, compared to market forces. Further, according to TNUDF officials, pooled bonds are not prime tool to enhance good governance. The performance of the bonds may reward responsive local policies and project management to a lesser extent and may mainly relate to conditions on the bond markets in general.

This argument was confirmed by a recent studies on loan financing in South Africa and Indonesia (GDI / DIE 2007 and 2008). Interviewees in RSA believed that bonds are no longer preferred because low-interest loans were available. Interviews in Indonesia revealed that past experiences with regional bonds[39] will not be repeated for the time being, due to lack of demand for long-term funds at market interest rates.

6.5 Conclusions and Recommendations

The central government, as the unit of government most responsible for developing and enforcing macroeconomic stabilization policy, has considerable concern about the extent to which borrowing by subordinate levels of government takes place. Regardless of the degree of local fiscal autonomy in a country, central governments will always need to carefully monitor and project local-government finances. Legislation with regard to the borrowing powers of local government must also be reviewed. Direct access to capital markets by sub-national governments will take

[38] See Nina Boschmann 2008 on Tamil Nadu in India

[39] Bonds issued between 1991 and 1997 by BPD with maturities of up to five years were backed by general revenues of regional governments and issued to refinance loans to local governments for small-scale infrastructure projects. Six bonds were issued.

time to develop. Loan and bond financing are viable options for a considerable number but not all local governments. Access to capital markets requires a sound condition of municipal finance, in order to be able to repay the loan. It is rather a second step, following reforms in municipal financial management. Municipal bond financing can be cost-effective for larger and resource rich municipalities but is rather complex as it requires a certain scale of experience and operations and success also depends on conditions of general markets for bonds.

Technical recommendations

- All types of sub-national borrowing should be closely regulated by the central authorities. Besides enforcing the debt limits established by the law, there should be a certification process of the conditions for any bond issues.
- Before promoting municipal loans, start comprehensive support for reforms in PFM
- Establish a system for fiscal screening and rating of municipalities
- Loan financing requires specific expertise; don't institutionally mix grant and loan financing for infrastructure, establish clear rules which source of finance is accessible to which category of LG
- In order to avoid disturbances of the capital market, set conditions and interest rates of development loans in consideration of the prevailing national market conditions
- If softer conditions are offered to poorer municipalities, make it conditional t implementing FM reforms and improvement of own revenues
- The central government *as a general policy* should not act as guarantor of regional and local government debt issues. Special circumstances such as the borrowing in foreign currency from international lending institutions, which may require central government guarantees should be handled directly by the Ministry of Finance. In these cases, the central government should institute mechanisms to ensure repayment by the local government.
- Local governments should be allowed to issue non-guaranteed or limited liability debt for investment in public utilities. These "revenue bonds" will be repaid from revenue proceeds associated with tariffs set at full cost-recovery levels. Bonds should not be encouraged, unless proper conditions are given
- Given the limited interest of the private sector to engage in municipal borrowing, there is considerable merit to the establishment of a subnational development fund to promote lending to subnational governments for long-term capital investment. This may be the only effective way to allow small local governments to fulfill their capital investment responsibilities. The desirable structure for such a subnational development fund is that of an autonomous institution that takes direct and final responsibility for borrowing and investment projects. The bulk of funds for this institution should come from direct bond issues in the capital market. The central and local governments could contribute initial capital shares. The institution should be managed by independent professionals who answer to a managing board composed of central and local government representatives.

-

Recommendations to development partners

- Don’t mix loan and grant financing for infrastructure;
- If grant funds are provided in the area of municipal loans, use them for specific purposed, e.g. (i) financing or awarding of reforms, which will facilitate access to capital markets, (ii) as guarantee capital to establish lending institutions with suitable modalities

7 Involvement of Private Providers as a way forward

7.1 Rationale for PPP

As many infrastructure services possess the characteristics of public goods, the private sector alone will feel motivated to sufficiently provide them. Some responsibility remains in the hands of the state. Even after deconcentration or devolution of responsibilities and powers to sub-national government, fiscal imbalances are common and governments not effective as service providers. Higher current own-source revenues and municipal borrowing could be complemented by public-private partnerships to rebalance responsibilities and financial resources at the sub-national level.

From a local governments’ point of view, the major advantage of PSP lies in its nature as an off-budget mechanism for mobilising funds that are not available in the public budgets and as an additional income source for the local budget in the short run.

7.2 Risks involved in PPP

However, the overall attitude of local governments towards private participation in infrastructure as well as experience is varied between countries. A recent study from GDI (2007) reports largely positive attitudes from ***Indonesian local governments***, due to positive experiences with recent and ongoing PSP projects which constitute a promising “win-win-situation” for both the local government and the private investor. It was emphasized that due to their superior financial strength, foreign investors were particularly welcome.

Contrary to this, in several ***Latin American*** countries, the topic of private sector participation in water supply is highly politicized (e.g. Bolivia, Nicaragua); after complete failure of a poorly negotiated PPP in El Alto, the Bolivian Government has even decided to terminate an international contract by force; Nicaragua’s Sandinista government has strongly rejected any kind of management contract for a long time. Driven by promises of positive cash flow, local administrations overestimate the willingness of private investors to engage in long-term projects with higher operational risks and underestimate the complexity of contracts and risk-sharing arrangements for PSP in infrastructure projects with uncertain revenue streams[40].

Usually, systems in Latin America have a high share of unaccounted for water and efforts to increase water charges are highly unpopular. The understanding of popular movements is, that water is a public good, which should not be used to generate a profit. In order to ensure reliable revenue streams, some investors have negotiated a predefined rate of return, which could later not be achieved, as systems required more investment and consumers more protection than anticipated. An "ideological argument" is also there as private electric companies and related user charges are generally accepted without arguments. Interestingly, in West African countries, which are all low-income, water charges seem to raise less fundamental public concerns when compared to parts of LA.

The experience of a higher middle-income country (***Colombia***) in the water and sanitation sector indicates that municipal water utilities as well as private ones can provide satisfactory service at reasonable cost, if a strong state run oversight agency is in place.

In order to avoid the inherent risk of taking over the management of an existing network the most popular model of PPP is **"Build-Operate-Transfer" (BOT) with land provision to the investors as public contribution.** Local governments prefer the BOT-model as it is simple in structure, mode of operation and control of results. The structure is similar and simple: government provides public land, the private investor constructs, finances and operates the project and receives regular revenues during the operating period which lasts up to 30 years. Contracts may even be negotiated without a tender and investors provided unsolicited proposals without much effort in terms of project development for the municipalities.

The benefits for the local governments can be fourfold: an annual rent, income from taxes (building tax, market tax etc.), parking fees in the case of the frequently built markets and shopping malls, and a negotiable part of the investors' returns. The BOT-model incorporates zero-risk from the local government's point of view and ensures constant revenue streams over a long period. With the provision of public land, the local government eliminates the most severe constraint that keeps away investors: the question of property rights and land use. Obviously, this relatively simple BOT-model can be used for commercial projects only and not for basic infrastructure projects with uncertain revenue streams.

Indonesian: Small space for Public-Private partnership in infrastructure financing

In Indonesia, BOT-projects are mostly used for markets, shopping malls and public buildings. **PSP-projects in Indonesia are relatively small, limited to a few sectors and are rarely used for the provision of basic infrastructure.** PSP in traditional markets is the most prevalent form of private involvement. Besides this, often cited examples for PSP were housing, hotels, bus terminals, public buildings, city street lights,

[40] With regard to the complexity of PPP contracts and the know-how required, German local governments have recently learned a bitter lesson: Those who went for the sale and lease back-modality for their municipal assets in order to generate a positive cash flow, have now been confronted with high financial risks, unknown before the international financial crisis.

and a few private hospitals and schools. The study team was not able to find out details about the volume of the private-public profit-sharing.

There are a number of sponsorship models for sanitation, social infrastructure and education. In Yogyakarta, private enterprises have built parks and invested in sanitation facilities, getting the permission to advertise in these facilities or carry out promotion activities. The maximum volume of this kind of projects is still small (around Rp. 2 billion) but the demand seems to be huge. In Pontianak, every company which wins a public tender has to sponsor a school or a hospital but there are no minimum requirements on how much to "invest". It appears that local officials have a rather wide definition of public goods and see the provision of hotels, water parks and entertainment facilities as a public responsibility. However, there are practically no PSP activities in basic infrastructure. PSP projects in basic infrastructure with long capital amortization periods have not been realized yet.

Source: GDI 2007

Further, a recent study on Indonesia found that the PSP-approval process is particularly prone to ***corruption practices*.** As a result, the expected gains for the public by involving the private sector in the provision of infrastructure may not materialise. Quite obviously, the relevance of this point depends on the overall quality of local financial governance, which goes much beyond the specific cooperation modality.

7.3 Gradual approaches to improve service and revenues

As indicated above experiences with PPP have been mixed and municipalities do not have a common position towards innovative management concepts.

There are several micro-level success stories for the application of ***gradual approaches**,* which relate to (i) doing the easiest things first and (ii) going for gradual involvement of private providers, even If comprehensive privatisation or management contracts are not. Doing "the easiest things first" relates to the avoidance of politically sensitive issues and focus on other feasible improvement. The administration of the water utility in the capital ***Quito*** had substantially been improved over the years, using a gradual approach of first implementing less controversial reforms (such as improved leak detection and reduction of the unaccounted for water) before touching the sensitive structure of water charges. Some medium-sized municipalities in Nicaragua have applied the same strategy and thus managed to avoid local "wars on water".

This is in line with a recent study of the French cooperation on the improvement of local revenues in West Africa (….2009), which highly recommends focussing on revenues, which are easy to assess and to collect.

The following examples relate to gradual involvement:

- Feasibility Studies conducted on behalf of the German Development Bank KfW in the water and sanitation sector of rural municipalities of ***Ecuador*** in 2000 revealed that many of these local water markets may not be profitable for private sector involvement in the form of BOT or even management contracts. Still, there was room for improvement with regard to revenue generation through the outsourcing of specific tasks, e.g. collection of user charges.

- A similar policy is now followed by the ***Rwandan Government***, which is promoting the privatisation of market tax collection. The process has been supported by German Technical cooperation but It is too early to know the results. A lesson learned was that the analysis of the market revenue potentials itself was sometimes quite controversial and met stiff resistance from local officials, which again indicates the links between local revenue generation, fiscal transparency and good governance at a whole.
- Generally, ULBs are in charge of ***operation and maintenance***. In rural municipalities of ***Burkina Faso*** and ***Nicaragua***, the fee-based involvement of local private craftsmen in the maintenance of public water supply systems is successfully being promoted. The privatisation of O+M of new public facilities and services is also foreseen in Tamil Nadu. However, concepts for this are still under development and it is too early to assess impacts.
- In the Indian State of ***Tamil Nadu***, a Grant Fund has been established as a part an IBRD line of credit for providing Technical Assistance to Urban Local Bodies and Statutory Boards, It will be used to explicitly assist ULBs in the preparation and / or supervision of more complex and innovative projects such as PPPs and BOTs, for such project and technologies which can reduce the cost of services.

Ghana's new Local Government Finance Bill intends to establish a comprehensive financing and TA mechanism for local governments, which shall overcome the constraints of existing services: *The Bill provides a comprehensive Law on how private capital and other resources can be channeled to District Assemblies in order for them to undertake infrastructural development and provide other services more efficiently. The proposed Local Government (Finance) Bill seeks to provide a comprehensive law to guide MMDAs in raising private capital, enter into partnership ventures and mobilize other financial resources. It empowers MMDAs to systematically move away from over-reliance on central government transfers to undertake productive infrastructural development and provide other appropriate services more efficiently.* (see draft from July 2008).

The Government of Ghana intends to establish a multi-purpose Local Government (Finance) Authority as a vehicle for accessing funds for investment projects and pool, manage and minimise the risk of local government borrowing. At the same time technical and financial advisory services shall be provided to District Assemblies.

The new Authority is expected to borrow from domestic and international sources and on-lend to a District Assembly for the developmental needs of the District Assembly; facilitate direct and indirect access to wider sources of funds including the use of innovative financial instruments; assist a District Assembly to establish innovative partnership ***arrangements with the private sector*** and other public institutions; support the capacity of a District Assembly to initiate and manage investment projects, among others.

Question to those who know Ghana: Has this draft been further developed? How to summarize the value added of this modality?

7.4 Conclusions and Recommendations

Privatisation of pubic services may be a viable option for improving the fiscal space of municipalities with (i) a strong oversight capacity, (ii) a strong negotiation capacity for fair and transparent contracts, (iii) local markets, which are profitable enough to generate a constant stream of revenue. Quite obviously, this is not a typical situation for many municipalities in developing countries (and even not for industrialised countries); PPP should thus be regarded as a complex modality, which requires a thorough assessment of the local market, feasible revenue potential and financial interests involved before taking decisions

Technical Recommendations

- If the above-mentioned conditions are not met or privatisation of a politically sensitive issue, it is recommended to promote gradual approaches, including e.g. the following elements:
    - Before investing energy in how much to charge, get people used to contribute financially at all
    - Involve private providers for specific tasks on a pilot basis, which can easily be controlled (e.g. maintenance works, collection of fees); in this case, financing or technical assistance agencies may e.g. develop standard contracts for delegation of maintenance to private providers
    - focus on fees and charges, which are easy to collect (avoid that collection cost exceeds the amount collected)
- User charges are generally a sensitive issue and may also contradict efforts for poverty reduction. It is therefore recommended to
    - first improve service and afterwards adjust charges (not vice versa)
    - define and publicly discuss a transparent structure of user charges, which does not favour or discriminate against part of users
    - assess the ability to pay of low income groups / informal business and define low minimum contributions, which can be met by these groups; cross subsidization and transitory supply of low cost services may be viable optiosn
    - avoid huge increases of user charges within a short period

Recommendations to development partners

- Avoid a confrontation between the PPP concept and the rights based approaches, but deal with PPP as a technical issue, which requires thorough assessment before taking decisions or making recommendations
- Discuss evaluation criteria in a transparent manner (What shall be achieved for whom? What are the costs and benefits? Who shall pay?)

- Assist partner countries in developing and assessing contractual arrangements with private providers, which they are able to follow up
- Analyse experience with privatisation in your own country before making recommendations to Africa!