SOCIAL DEVELOPMENT NOTES

COMMUNITY DRIVEN DEVELOPMENT AND LOCAL GOVERNANCE

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HOW TO NOTE:

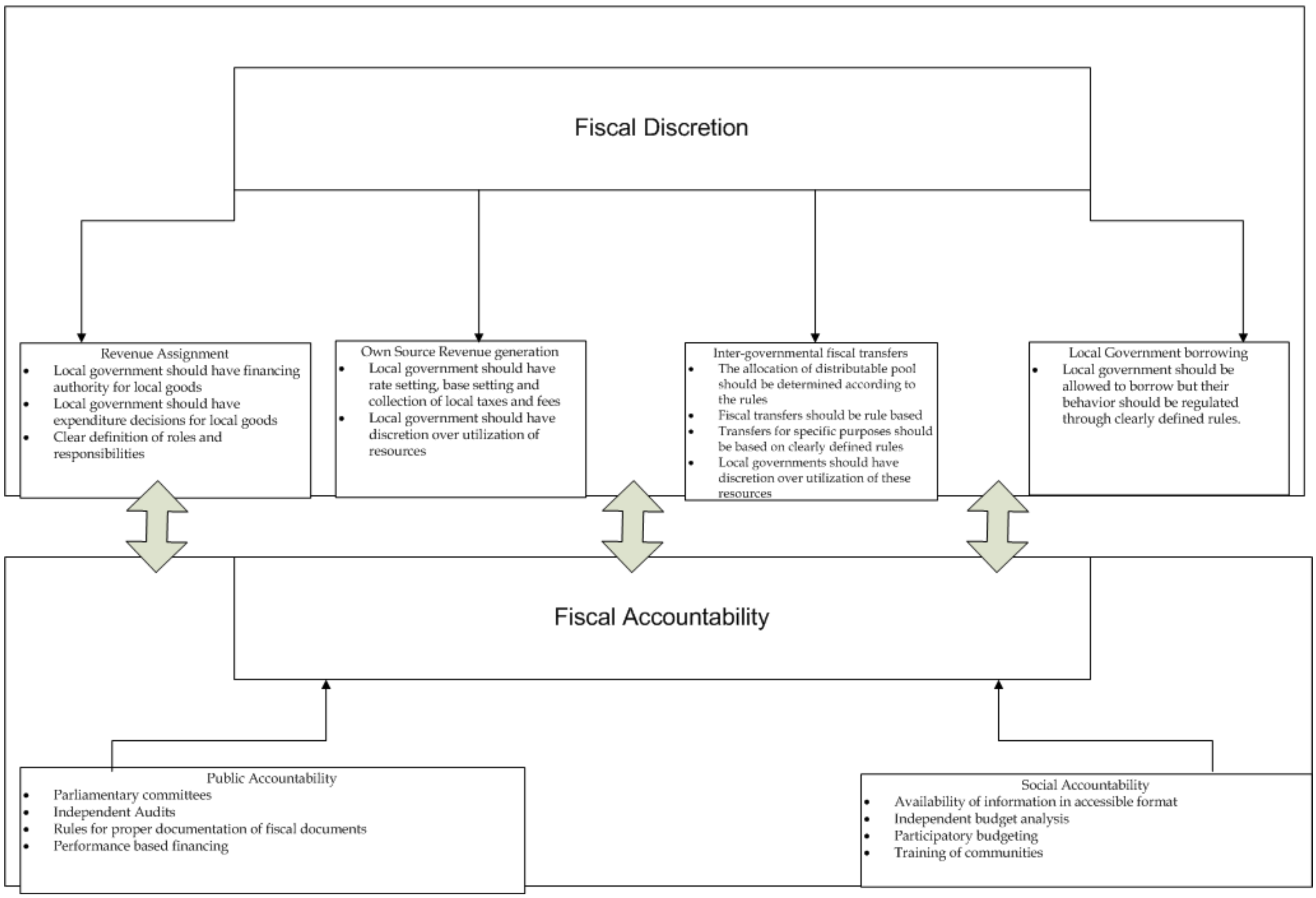
A Framework for the Assessment of Fiscal Decentralization System

Fiscal decentralization provides the link between incentives for better performance of the local government and the elected support from the citizens and is, therefore, essential for an effective system of decentralization. The purpose of this note is to elucidate components of a well-designed fiscal decentralized system and is aimed to assist task teams and stakeholders to evaluate fiscal decentralization effort in any given country. There are two main components of fiscal decentralization system: a) discretion of the local government to make decision on fiscal matters (including revenue assignment for local goods, revenue generation, transfer of funds through a well-designed transfer system, and utilization of funds) and b) accountability including mechanisms that hold local government officials to other elected and non-elected officials and social accountability that allows direct monitoring of the local government officials by the citizens.

Fiscal decentralization is a set of rules that defines roles and responsibilities among different levels of governments for fiscal functions including budget preparation, budget execution, revenue generation and public sector borrowing. Fiscal decentralization lies at the heart of any local government system as its rules define the generation and distribution of resources (both between and within different government levels) that are utilized to fulfil citizens' demands. The ability of the government to make fiscal decisions in the provision of local government services is a precondition for the voters to assess the performance of their elected representatives with respect to the amounts and qualities of services they are getting for the taxes that they are paying (Mueller, 2006). Therefore, if local governments are denied the fiscal instruments and funding to make real use of their political and administrative autonomy, decentralization is likely to be ineffective. In this respect, the ability of the task team leaders and other stakeholders to evaluate fiscal decentralization system is necessary for an effective system of local governance. To that end, this note provides a framework of evaluation by highlighting the important components that form a well-designed fiscal decentralization system.

According to this framework, there are two primary components of a fiscal decentralization system: *discretion* allowed to the local government to perform fundamental fiscal functions and mechanisms that hold the local government *accountable* for appropriate use of this discretion. Fiscal discretion can be divided into four elements, namely, the assignment of expenditure responsibilities, revenue generation, inter-governmental transfer systems, and local government borrowing. The framework emphasizes that an authority can be held accountable for performing a specific function only if it has the fiscal resources and the discretion to perform that function. Similarly, the framework argues that accountability is not an automatic outcome of increased discretion and that governments need to make a conscious effort to create structures that would hold local governments accountable. The two essential elements of accountability include public accountability, where responsible individuals are held accountable by other elected or non-elected officials, and social accountability, where public officials are answerable directly to the citizens. Figure 1 provides the graphical representation of these relationships.

The objective of this note is to explain the importance of each of these components of fiscal decentralization. It also explains how these components should be implemented. Challenges and good practices in implementations are illustrated through examples. A detailed checklist (Table A.1, A.2 and A.3 in the Annex) is prepared that can act as an expedient tool in evaluation of the decentralization reforms in any given country. Uganda, Philippines, Kerala and Rwanda are used as examples to elucidate the use of the checklist.[1] We also provide a blank questionnaire which the reader can complete for the country under review (Table A.4, A.5 and A.6 in the Annex).



1. Discretion

1.1. Expenditure assignment: Local government should have expenditure responsibilities of local goods

The ability of the local government to respond to the demands of the citizens depends on the functions assigned to the local level and the extent of discretion available to the local government to make their own budgetary decisions for local public goods. This discretion of the local government also encourages the citizens to participate in decision-making process. Although no single expenditure assignment approach fits all countries, Table 1 provides a worldwide standard of distribution of expenditure responsibility among different levels of government across different services. Among our study countries, Kerala and Philippines have the most decentralized expenditure assignments (See Table A.1). In Rwanda, on the other hand, central government participates in expenditure assignment of almost all local goods.

It is also important to ensure that roles and responsibilities among different levels of government and elected and non-elected branches of government are clearly delineated. In many countries, for example China, Vietnam, Indonesia and Pakistan there are ambiguities regarding roles and responsibility of each level of government. These confusions can prevent the local government from functioning effectively.

1.2. Own-source revenue generation: Local governments should have the discretion to raise their own revenue.

Local governments in developed countries rely on a number of own source revenues including taxes (for example property taxes), fees (for example, for licenses and permits), rent on local government property (for example, building and equipment) and user fees (for example, market fees or tolls on roads and bridges owned by the local government). Complete local revenue autonomy requires that local governments are able to assess and set the tax base, set the tax rate and collect revenue from respective sources. It is also crucial that local government has discretion over utilization of these funds. In our study countries, only the local governments in Rwanda have the discretion to set tax base (except for taxes on vehicles) while in Kerala and Philippines local governments have full autonomy only over rate setting, collection and utilization of taxes. On the other hand, local governments in Uganda only have full autonomy over collection of taxes and only partial authority over setting the tax rate and utilization of tax revenue (Table A.2).

In addition to the discretion of local governments to collect own source revenues, it is necessary to assess local governments' capacity to perform this function. It has been observed in some cases that even when local governments are given own revenue raising powers, they are not able to use it effectively. A number of reasons have been suggested for this inability, including, unwillingness of the local officials to enforce the tax laws, the limited capacity of the local government officials to effectively administer a

Table 1. Expenditure assignment – Worldwide Standards

Social Services		Transportation		Utility and other services	
Social Welfare	C	Urban Transportation	C,P,L	Electricity	C,P,L
Hospitals	C,P,L	Railroads	C,P	Waste Collection	L
Public Health	C,P,L	Airports	C,P	Water and Sewerage	L
Universities	C,P,L	Ports and Navigable Waterways	C	Fire Protection	L
Secondary Education	C,P,L	Urban Highways	C,P,L	Irrigation	L
Primary Education	C,P,L	Interurban Highways	C,P	Police	C,P,L
Housing	C,P,L				

C: Central Government **P:** Provincial/Regional Government **L:** Local Government **N/A:** Not applicable
Source: World Bank (2009)

revenue system, and weak administration procedures such as poor maintenance of tax rolls (World Bank 2004).

The disadvantage of the low discretion of the local government to raise own-revenues (or the inability of the local government to collect revenues when they have the discretion) is the excessive reliance of the local government on transfers from central government authorities. Excessive reliance on central government transfers may discourage local governments from exploiting their own resources. It also creates incentives for the local government to respond to the demands of the central authorities rather than their own constituencies, since by responding to the preferences of the centre, the local government officials have access to resources that otherwise could be denied to them (See Box 1).

1.3. Inter-governmental transfer system: The mechanisms that determine the amount of distributable pool and allocation among local governments should be rule-based and local governments should have discretion to utilize the transfers.

Four elements of the intergovernmental transfer system have important local government discretion and accountability implications (Yilmaz and Bindebir, 2003):

1) Rules that determine the total amount of transfer—the distributable pool.
2) The rules that govern the allocation of distributable pool among local governments.
3) The purpose of the transfer system—an unconditional general purpose grant versus a conditional specific transfer.
4) Management of the intergovernmental transfer system including participation in devising rules for the transfer system

A rule-based transfer system brings greater stability and predictability, and thereby promotes good planning and efficient service delivery effort. On the other hand, if the distributable pool is determined by the central government in an *ad hoc* and opaque manner, it creates allocative inefficiency[2] and gives rise to uncertainty at the local level regarding the receipt of the transfer revenues. This uncertainty leads to poor budgeting practices and weaken the accountability linkage between local governments and citizens. Similarly, restrictions on the use of funds transferred to the local government also diminish the ability of the local governments to respond to the preferences of the citizens. The conditional grants also allow the departmental ministries or departments to maintain control over the local governments.

In many developing countries, however, inter-governmental transfer systems are weak and possess undesirable characteristics. For example, in Uganda, Pakistan and Philippines, significant portions of the transfers from central to local governments are

Box 1. An example of arbitrary inter-governmental transfer system and its implications

The case of province Punjab in Pakistan illustrates how arbitrariness can increase avenues for elite capture and politics of patronage. The primary transfer to the local government from the provincial government is formula-based through the Provincial Finance Commission (PFC). However, revenues are also distributed directly from federal to the local government, for example through Khushal Pakistan Program, the federal Education Sector Reform and the President's Program for improvement of Watercourses. The province also makes direct transfer from the provincial retained funds most of which are tied to local or are conditional grants for education health under the provincial Education Sector Reform Program and Health Sector Reform Program. Additional funds for the social infrastructure improvement are also transferred to local governments on an ad hoc basis under the Chief Ministers Accelerated Program for Social Development. In addition to all the transfers listed above, funds are transferred arbitrarily amongst different levels of government through development/special grants, executive's discretionary funds, and parliamentarian funds. For example, in 2006-07 the non-PFC development transfers to local government in Punjab totaled to Rs. 14.5 billion which is larger than the local government's allocation through PFC (which was Rs. 11.8 billion). There is also some evidence that discretionary transfers are linked to the degree of embeddedness of the mayor of the local government unit in formal and informal political network of the province indicating that the elements of discretionary transfers encourage patronage politics. Moreover, most of these funds are ear-marked for specific purposes, thereby, diminishing the ability of the government to allocate expenditure according to the preferences of the local constituency.

highly discretionary; funds are also sometimes ear-marked for specific services or reserved for recurrent expenditure (personnel salary for staff recruited and hired by the central government) (World Bank, 2009). This haphazardness undermines the stability and predictability in the local policy making and also makes the system more prone to political pressures. Kerala, on the other hand, presents an example of rule-based intergovernmental fiscal transfer system where not only transfers are largely rule based but the local governments also have full control over the management of transfer systems.

1.4. *Local government borrowing: Local governments should be allowed to borrow with restrictions and strict accountability*

Local borrowing can act as a significant source of revenue for local governments, especially in countries where own source revenues and intergovernmental transfers fall short of responding to local investment needs. However, irresponsive borrowing practices or excessive reliance on subnational borrowing can put macroeconomic stabilization at risk. The option of local defaults and bail-outs by the central government creates a moral hazard problem for the local governments and results in inefficiency and over-spending at the local level. Therefore, local government borrowing, if allowed, should be adequately overseen by the central government by devising precise rules and procedures of borrowing. Consequently, in developing countries, many central governments limit, control, or prohibit the issuance of debt by local governments. Local governments in our example countries also only have partial discretion over borrowing.

2. Accountability

Accountability is not an automatic outcome of increased discretion of the local governments. Specific mechanisms should be designed to ensure that citizens and higher officials are able and willing to hold local governments accountable for their discretion. The notion of fiscal accountability can be divided into public accountability and social accountability.

2.1 Public Accountability

Public accountability: An effective, efficient, transparent, and rules-based public financial management system includes setting standards for control on intergovernmental transfer revenues, monitoring transfer figures, observing clear rules for responsible local borrowing, providing public access to borrowing information; and setting clearly defined rules for hard budget constraints on local governments.

Maintenance of documentation that adheres to generally accepted standards of accounting: Since information is the basis of monitoring maintenance of proper documentation is necessary. However, many developing countries do not adhere to proper documentation purposes. Among our study countries also, only Rwanda keeps proper documentation of budgetary documents even when Kerala and Philippines have de jure requirement for doing so. The most crucial cause of this absence of documentation is the lack of capacity and training at the local level. This incapacity is highlighted when the budget process becomes complex and requires multiple bank accounts to manage funds coming from a number of different sources. This situation is particularly seen in Ethiopia and Tanzania.

Parliamentary Committee: A parliamentary committee comprising elected council members can act as an effective monitor of fiscal functions of the local government. They should report their findings to the local council regarding performance of the local government along with their recommendations. The local council should then follow up with required corrective actions or sanctions. In our study countries, only Philippines and Uganda have such parliamentary committees

Audit committees: Audit committees that oversee the fiscal functions of the local government including budget and expenditure statements can be very effective in ensuring fiscal accountability of the local government. In addition to identifying discrepancies in budget and expenditure documents, the audit committees should also have the authority to make recommendations to the local council (See Box 2 for more detail on audit procedures).

Box 2. Different approaches to audit- Kerala and Rwanda

In Rwanda, internal auditors are placed at the district level. These agents belong to the Government Chief Internal Auditor's staff, who was appointed in 2004. Monthly internal audit reports are required for each of the local government districts. The quality of internal audit is likely to have improved with the appointment of the Government Chief Internal Auditor. The internal audit regulations are reinforced by external oversight mechanism through the Office of the Auditor General (OAG) which is an independent institution that is answerable to the parliament and is constitutionally required to audit state, local governments, public enterprises and parastatal organizations to ensure that they conform to the law and demonstrate sound management. Institutions and public officials at the receiving end of the audit are obliged to implement its recommendations by taking appropriate measures in respect of the irregularities and other shortcomings which are disclosed.

On the other hand, Kerala has devised a more encompassing audit system which is called performance audit. According to this new system, performance audit authority at the state and the regional level is responsible for carrying out comprehensive audits which cover not only scrutiny of the financial statements of the local bodies but also function of the panchayat including works undertaken, issues related to tax collection, resource mobilization, debt position and timeliness of various reports including annual reports. Detailed procedure for performance audit has also been developed. However, experience does not vindicate the efforts made in developing exhaustive procedures for audit; accountability could not be ensured as envisaged, basically because performance of local bodies has remained lackadaisical.

Performance-based transfers: Central government can also make the provision of some components of inter-governmental transfers conditional on pre-defined performance measures. This aligns the incentives of the local government with that of the central government. For example, in Uganda under the Local Development Grant program, only the local governments that meet certain minimum governance criteria (for example adequate financial management capacity) can access funds for capital investments in development projects. The top twenty percent of the districts receive twenty percent increase in funds for the subsequent year while bottom performers are penalized by twenty percent for the next year's budget. There are indications that Local Development Grant mechanism has met with significant success since its inception and has improved planning, financial management, accountability and transparency in development projects, including greater communication of decision to stakeholders of the system.

2.2 *Social Accountability*

Social Accountability: A crucial requirement for any social accountability mechanism to operate is to make information accessible to the public (including budgets and end-of-year financial statements); allowing strong public involvement in the budgetary process through participatory budgeting practices and initiating independent budget analysis and participatory public expenditure tracking programs that monitor budget execution and leakage of funds.

Information sharing and dissemination: Information sharing and dissemination in formats that are understandable to general public is an essential component of any social accountability mechanism. Different ways can be employed to achieve this objective. Public meetings where local government explains its budgeting and expenditure activities can be useful. Disseminating information through radio and other regularly used medium of communication in a locality can also prove effective.

Citizens monitoring committees to perform independent budget analysis and public expenditure tracking programs: Effective accountability can be instituted when different groups of citizens come together to monitor various aspects of the budget and expenditure process.

Participatory budgeting: Participatory budgeting allows the citizens to present their demands in terms of allocation of budget through discussions and negotiations with the local government officials. This practice does not only ensure that citizens' preferences are included in decision making but also

Box 3. Social fiscal accountability - participatory budgeting in Rwanda

A promising instrument for social accountability in the financial domain can be found in the *Ubudehe* process. The primary purpose of this innovation is to promote participatory planning and budgeting at the village level. *Ubudehe* has its roots in traditional collective working in the fields, but has been adapted to modern ways of planning and budgeting. It builds on the concept of poverty reducing strategies (PRS) and participatory poverty assessment (PPA). The *ubudehe* for poverty reduction has taken several forms. In some areas, it has been used to create a benefice like access to water, a transport service, and a few credit programmes. In other areas it has been used for livestock rearing. The various forms reflect different priorities in different villages. All forms have a common denominator of collective community planning and budgeting. The success of the *ubudehe* is to a large extent dependent on the Government's program of training of trainers – local NGOs have trained one or two members from communities, these in turn are training other community members to plan, budget, and prioritize in a collective way. *Ubudehe* projects generally include a decentralized financing mechanism that operates more quickly than comparable disbursements from line agencies. Furthermore, the services delivered are cost-effective compared with the delivery of small-scale works by public agencies. It is a unique policy of nurturing citizens' collective action in partnership with a government committed to decentralization.

allows the citizens to become active participants in community problem-solving (Rocamora, 2004). After its start in Porto Alegre, Brazil, in 1988, participatory budgeting has been taken up voluntarily by more than 140 municipalities in Brazil. In Kerela, participatory budgeting is made mandatory and is regulated by legislation. Similarly in Uganda, local government is required by the constitution to make the budget process democratic and participatory. In the Philippines, also, NGO network Barangay-Bayan Governance Consortium (BBGC) has initiated participatory budget process in 2500 villages. See Box 3 for details of participatory budgeting mechanism in Rwanda.

Training communities for participation in budget monitoring: Public financial management processes are generally technical; therefore, citizens, especially at the local levels and public require a particular skill set to scrutinize these processes. Therefore, training communities is an important initiative that can significantly strengthen social accountability processes in fiscal domain. Philippines has taken such an initiative. Rocamora (2004) reports that this initiative generated new perspectives in citizen participation and local politicians are able to devise active propositions for solving commonly-perceived problems in engagements within state institutions.

3. Conclusion

A well-designed fiscally decentralized system should provide adequate discretion to the local government in terms of expenditure assignments for local goods, collection and utilization of own revenue, and utilization of inter-governmental grants. A well-designed fiscal system also requires that inter-governmental transfers are rule-based and discretion of the central government is kept to a minimum. These responsibilities, however, should be adequately matched by establishing strong accountability structures. Proper documentation of budgetary and other fiscal documents is a necessary condition for operation of any mechanism of public accountability. Parliamentary committees and audit committees can also provide effective monitoring of the fiscal function of the local government. Similarly, mechanisms to share information with the citizens in an easy-to-comprehend format, citizens monitoring groups, participatory budgeting practices and training of communities to enable them to perform accountability function are indispensible elements of a well-designed fiscal system.

Table 2: Some challenges and recommendations

Challenges	Recommendations
Capacity of the local government to carry out their responsibility, for example own-revenue generation and effective information dissemination, is generally lacking.	There should be a clear and precise strategy of building capacity at the local level through trainings and other methods. Lack of capacity at the local level should not act as an excuse for inadequate discretion.
Capacity of the citizens to monitor fiscal processes due to their inherent technical nature of the fiscal processes.	Special initiatives should be taken to train communities and to provide them with the skill set that is essential for scrutinizing the fiscal performance of the local government. Strong social accountability capability of the local government does not only improve the performance of the local government but also reinforces the citizen involvement.
Unclear expenditure assignments and division of responsibilities result in confusion within the local government and adversely affect accountability.	Other than the expenditure assignments, public finance management laws should be clear and precise so that there is no room left for manipulation. A distinct effort should be made to ensure that fiscal decentralization laws conform to the other laws in the country.
Capture of the local government by the center through flow of funds distorts the allocative efficiency.	There should be clear rules to determine distributable pool. Moreover, the major portion of the transfer should be rule based. Increasing the capacity of the local governments to generate their own revenue and decreasing their dependence on inter-governmental transfer can make the system more efficient and would allow the local government to respond more effectively to the demands of the citizens.

Appendix:
Checklists to assess Fiscal Decentralization Framework Country Examples and Questionnaire

Table A1. Expenditure assignment-Country examples

Function	Kerala	Philippines	Rwanda	Uganda
Social Services				
Social Welfare	L	L	C,L	C
Hospitals	R	C,L	C,L	C
Public Health	L	C,L	C,L	C,L
Universities	C,R,L	C	L	C
Secondary Education	L	C	C,L	C
Primary Education	L	L	C,L	C,L
Housing	L	C,L	C,L	N/A
Transportation				
Urban Transportation	C,R,L	C,L	C,L	C,L
Railroads	C,R	C	C	N/A
Airports	C,R	C	C	C
Ports and Navigable Waterways	C,R	C	C	C
Urban Highways	C,R,L	C, L	C,L	C,L
Interurban Highways	C,R,L	C, L	C	C,L
Utility Services				
Electricity	L	C,L	C,L	C
Waste Collection	L	L	L	L
Water and Sewerage	L	L	C, L	L
Other Services				
Fire Protection	L	L	C,L	L
Heating	N/A	N/A	N/A	N/A
Irrigation	L	L	C,L	L
Police	R	C,L	C,R,L	L

C: Central Government **R:** Regional Government **L:** Local Government **N/A:** Not applicable

Table A2. Own-source revenue generation, intergovernmental transfer systems and ability to borrow- Country examples

Function	Kerela			Philippines			Rwanda			Uganda		
Own-source Revenue Generation												
How much control do local governments have over	Rate setting	Base setting	Collection	Rate setting	Base setting	Collection	Rate setting	Base setting	Collection	Rate setting	Base setting	Collection
• Property tax	Full	None	Full	Partial	None	Full	Full	Full	Full	Partial	None	Full
• Taxes on vehicles	Full	None	Full	None	None	None	None	None	None	None	None	None
• Fees (for example on sale of animals, market fees, fees for license and permits)	Full	None	Full	Partial	None	Full	Full	Full	Full	Partial	None	Full
• Rents (for example on land, buildings, equipment, machinery owned by the local government)	Full	None	Full	Partial	None	Full	Full	Full	Full	Partial	None	Full
• User fees (for example toll on roads and bridges owned by the local government)	Full	None	Full	Partial	None	Full	Full	Full	Full	Partial	None	Full
How much control do local governments have on budget utilization from own source revenue?	Full			Full			Full			Partial		
What is the percentage of own revenues of total local government revenue?				31.5% (2002)			10% (2008)					
Intergovernmental Transfers												
How are the following decided?												
Distributable pool	Formula based			Formula based			Formula based			Formula based, *ad hoc*		
Distribution across local governments	Formula based			Formula based, *ad hoc*			Formula based			Formula based, *ad hoc*		
Purpose of transfers	Unconditional block grant			Unconditional block grant, Conditional earmarked grant			Conditional earmarked grant, Unconditional block grant			Conditional earmarked grant, Unconditional block grant		
Does the local government have control over management of transfer system	Full			Partial			Partial			Partial		
Ability to Borrow												
Do local governments have discretion to borrow?	Partial			Partial			Partial			Partial		

Table A3. Public Financial Accountability

Do the following exist?	Kerela	Philippines	Rwanda	Uganda
De jure requirement for the publicity of budget documents	Yes	Yes	Yes	No
Proper documentation of budgetary documents	No	No	Yes	No
Legislation (rules) prescribed for the budget preparation process	Yes	Yes	Yes	Yes
Parliamentary Committee to oversee the budgetary process	No	Yes	No	Yes

Table A.4. Expenditure Assignment

Function	Country
Social Services	
Social Welfare	
Hospitals	
Public Health	
Universities	
Secondary Education	
Primary Education	
Housing	
Transportation	
Urban Transportation	
Railroads	
Airports	
Ports and Navigable Waterways	
Urban Highways	
Interurban Highways	
Utility Services	
Electricity	
Waste Collection	
Water and Sewerage	
Other Services	
Fire Protection	
Heating	
Irrigation	
Police	

Table A.5. Own-source revenue generation, intergovernmental transfer systems and ability to borrow

Function	**Country**		
Own Source revenue generation			
How much control do local governments have over *Options: Full, None, Partial*	Rate setting	Base setting	Collection
• Property tax			
• Taxes on vehicles			
• Fees (for example on sale of animals, market fees, fees for license and permits)			
• Rents (for example on land, buildings, equipment, machinery owned by the local government)			
• User fees (for example toll on roads and bridges owned by the local government)			
How much control do local governments have on budget utilization from own source revenue? *Options: Full, None, Partial*			
What is the percentage of own revenues of total local government revenue?			
Intergovernmental Transfers			
How are the following decided?			
Distributable pool *Options: Formula based, ad-hoc*			
Distribution across local governments *Options: Formula based, ad-hoc*			
Purpose of transfers *Options: Unconditional block grant, conditional earmarked grant*			
Does the local government have control over management of transfer system *Options: Full, None, Partial*			
Ability to borrow			
Do local governments have discretion to borrow? *Options: Full, None, Partial*			

Table A.6. Public Financial Accountability

Do the following exist? *Options: Yes, No*	**Country**
De jure requirement for the publicity of budget documents	
Proper documentation of budgetary documents	
Legislation (rules) prescribed for the budget preparation process	
Parliamentary Committee to oversee the budgetary process	

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[1] The choice of countries is based on the variety of decentralization structures found in these countries.

[2] Ad-hoc transfers from central (or provincial) to the local government create allocative inefficiency by providing an incentive to the local government to respond to the preferences of the centre in order to get access to funds, rather than to their constituency. Central governments may also purposefully discriminate among different local governments to the extent that transfers may become a political decision. Moreover, in situations where discretionary transfers are a possibility, and central governments cannot make a credible commitment to a hard budget constraint, central government may act as a ready "bail-out" for the local governments. These options provide virtually irresistible incentives for decentralized governments to extend public programs beyond efficient levels (Oates, 2005; Faguet, 2008).