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Integrated Fiscal Decentralisation: Taking New Aid Modalities to the Local Level

Summary

How to combine the implementation of the new aid agenda with the challenges of advancing subsidiarity-oriented decentralisation in many developing countries? This question has been neglected for some years, as most of the discussion on ownership, the use of partner-country systems, donor harmonisation and alignment has been focused on the central government level. However, that focus tends to ignore the fact that public finance reforms in developing countries often include elements of fiscal decentralisation. Decentralisation is especially justified in many least developed countries, where it is associated with higher levels of accountability and public service provision – if implemented in an integrated manner. This being the case, we discuss opportunities for and challenges to integrated fiscal decentralisation (IFD) from a domestic and a donor perspective, considering its potential in terms of alignment, coordination and the absorption of ODA funds.

- From a domestic perspective, the core of IFD is formed by a central government transfer mechanism that allocates resources to local government bodies in accordance with a single distribution formula. The aim of this approach is to create a unified fiscal framework for local development, integrating both sectoral and regional perspectives. A broader definition of IFD includes local fiscal governance and local revenue generation.
- From the perspective of international donors, IFD offers an interesting opportunity for improving harmonisation and alignment of ODA flows. Accordingly,

funds from different donors could be channelled into a nation-wide transfer (distribution) system, which would allocate resources in a transparent and accountable way.

Thus an integrated perspective on fiscal decentralisation might be suitable for both reform-oriented domestic actors and for donors interested in improving international assistance. Unfortunately, promoting IFD in least developed countries has often faced all kinds of political resistance. Integrating transfers into a single formula-based distribution mechanism usually meets with opposition from those who derive greater benefit from more fragmented and discretionary transfer mechanisms, such as powerful sector ministries and some privileged subnational government bodies. Moreover, focusing on central government transfers tends to result in the important issue of local revenues being neglected.

- Therefore donors should not expect immediate and encompassing ownership of IFD reforms, but rather prepare themselves for iterative and politicised reform processes. They should not press governments to develop overly ambitious IFD blueprints: the development of context-specific and realistic sequencing strategies for IFD appears more promising.
- Furthermore, donor agencies need to pay attention to the challenge of strengthening local revenue collection rather than concentrating entirely on the reform of transfer systems and the expenditure side of local budgets.

Introducing integrated fiscal decentralisation

Fiscal decentralisation can be defined as the transfer of fiscal resources and competences from central government to subnational government levels. Its aim is to provide local and regional (intermediate) authorities with the resources they need to fulfil their functions in public administration and service delivery. The supply of subnational governments with financial resources is generally organised in two ways:

- (i) fiscal transfers from central government and
- (ii) local collection of taxes and fees.

Other sources of subnational revenue, such as royalties from the extraction of non-renewable resources or access to financial markets, are significant in only a small number of cases in the developing world.

In many developing countries, goals and visions of decentralised government already form part of the political discourse. Mass media, societal actors, political parties and public authorities have taken up the issue, linking decentralisation to political participation, regional autonomy, better service delivery, improved administrative efficiency, etc. In a majority of countries, sub-national levels of government already exist. Many of them have elected authorities which already perform some functions.

However, decentralisation in practice hardly ever conforms to the ideal-type models and ambitious outlines devised by reform-oriented governments, donors and international organisations. To begin with, local revenue collection in most countries is not a significant source of income for subnational units. This is due to

- the small tax base in many poor districts, combined with extensive heterogeneity of subnational entities in terms of welfare and economic activity,
- a critical lack of tax administration capacities at local and intermediate levels,
- limited fiscal competences owing to high degrees of centralisation and
- economies of scale achieved by a more centralised tax collection.

Because of these factors, most subnational units in developing countries depend on fiscal transfers as their main source of revenue. In many cases, however, these transfer mechanisms are flawed.

- First, transfer mechanisms often include discretionary elements, the result of ad hoc decisions by central government authorities. Frequently, they are mandated by individual parliamentarians or high-ranking members of the executive branch, who use the funds to maintain clientelistic networks. In contrast, non-discretionary, formula-based mechanisms allocate funds in a transparent way, in accordance with such criteria as population size, poverty levels and the performance of subnational governments.
- Second, many local governments have little spending autonomy over transfers allocated to them. Funds are earmarked for specific budget categories (investment, salaries, etc.) or public services, often defined at the

central level without due consideration for local conditions. In contrast, non-earmarked funds allow local authorities to allocate resources according to their own priorities.

- Finally, the source of transfers varies. In a completely integrated system all transfers from central government would be merged into one account and allocated on the basis of a single formula. As a rule, however, transfer systems are much more fragmented. Funding for subnational units originates from multiple central government bodies and is based on a variety of laws and regulations. Moreover, many donor funds are still channelled directly to their local addressees, without passing through the general budget, thereby adding to the fragmentation of the transfer system.

Hence *integrated fiscal decentralisation* (IFD) has a sectoral as well as a territorial dimension: instead of transferring funds only within specific sectors or to specific types of local government, IFD is meant to cover all sectors involved in local service delivery and the whole range of subnational units. Ideally, there would be no parallel allocation mechanisms for urban and rural areas or specific instruments for politically relevant regions and municipalities. Instead, structural differences between subnational units would be taken into account within one non-discretionary allocation formula.

In addition, donors could also integrate their funds into a transfer mechanism of this kind. This would increase not only the harmonisation of aid interventions but also alignment with partner systems since aid agencies would support a country-owned mechanism and reduce off-budget financing of local projects.

Theoretically speaking, an integrated transfer system therefore offers not only important advantages in terms of efficiency, transparency, oversight and civic monitoring, but also complies closely with the principles of the new aid agenda defined by the Paris and Accra Declarations.

In practice, however, such a scheme is quite difficult to establish, since key political interests are usually linked to existing systems with higher levels of fragmentation. Establishing an integrated fiscal transfer system may provoke the opposition of powerful sector ministries that would lose some of their freedom to allocate resources to the local level. IFD may also be harmful to central government's local allies, who, under the old system, can count on discretionary transfer mechanisms to provide them with additional resources. In some cases, parliamentarians will also oppose these reforms because they will limit their chances of using political transfers for their individual constituencies. Finally, some donors may also be reluctant to support IFD because it will shift resources away from off-budget projects to government-owned mechanisms. Given this constellation of possible opponents, it is not surprising that hardly any country in the world has a fiscal transfer system which fully complies with all the elements of IFD, even though the benefits of the concept appear to be obvious from a collective perspective.

The adoption of a **broader notion of fiscal decentralisation** that includes the dimension of local fiscal governance,

embracing political decentralisation, local accountability and the local generation of revenues, makes matters even more complicated. In particular, local revenue collection is key to the effective promotion of (fiscal) decentralisation. Not only does it contribute to the mobilisation of resources and the financing of public investments and services: perhaps even more importantly, the collection of taxes and user fees has a significant impact on the relationship between citizens (as taxpayers) and local governments. Taxpayers are far more willing to hold governments accountable for public service delivery and the use of funds, since it is their money that is being spent. Yet in many cases there are few incentives for the local generation of revenues. If local governments can rely on discretionary funds and on the central government to bail them out of fiscal distress, they will probably turn to moral hazard behaviour rather than engaging in the difficult task of raising local revenues.

The danger of implementation deadlocks

For the political reasons given above, it may be overly ambitious to embark on comprehensive fiscal decentralisation reforms straightaway. This is especially true of countries with weak national public policy and administration systems and limited capacities at subnational levels of government. In general terms, promoters of IFD should bear in mind that many stakeholders will perceive reforms from a winner-loser perspective. Donor agencies in least developed countries in particular should therefore be aware that political decision-making and policy implementation work differently in countries with strong public management systems from countries with weak systems (see Figure 1).

- In countries with strong systems, decision-making is often a slow and difficult process, since stakeholders concentrate much of their political energy at this stage. In contrast, policy implementation is more straightforward, since administrative capacity and compliance with rules are stronger, making political pressure at this stage less rewarding.
- In countries with weak systems, political actors know that passing a law or decree is one thing, but actually implementing it is quite another. Political pressure stays high during implementation, often leading to subsequent modifications of regulative or allocative decisions. Weak public administrations are also more exposed to political pressure, since procedural consistency and managerial capacity are weaker.

Consequently, applauding an ambitious bill on IFD reforms that has passed through the cabinet or the parliament can easily be followed by disap-

pointment, once it becomes clear that the implementation of reforms is obstructed by political or capacity problems at the central and local levels.

The sequencing of reforms

The alternative to ambitious comprehensive blueprints that will be hard to implement is the functional or territorial sequencing of reforms. Thus the introduction of IFD in developing countries should be a more incremental process that adequately responds to capacity shortages and makes use of political windows of opportunity for gradual reforms. To gain support for IFD reforms (and reach a point of no return), there should be some initial actions that yield immediate results. In principle, two broad avenues for sequencing are possible, each with specific advantages and disadvantages.

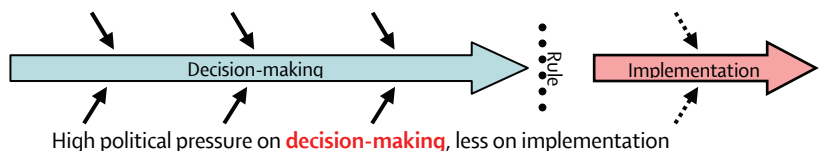
In **functional (sectoral) sequencing** decentralisation begins with the transfer of a few functions and the corresponding financial resources. This approach can be combined with a system of applications and certifications in which subnational units gradually assume additional competences on a case-by-case basis. Functional sequencing may be useful in dealing with resistance to decentralisation from powerful central government actors (especially sector ministries). Yet this functional approach can also enable sector ministries effectively to undermine decentralisation if they can impose their own sectoral conditions on the process. Moreover, as it makes it difficult for local governments to integrate their budgeting and planning processes, it is important to consider functional sequencing as an intermediate step in countries with low levels of decentralisation rather than as an end in itself.

In **territorial sequencing** the decentralisation of functions and funds begins with certain categories of municipalities or certain regions. It takes account of the heterogeneity of local situations and capacities. Accordingly, distribution mechanisms may be restricted to some categories of municipalities (e.g. rural ones) or regions in a given country. This sequencing strategy also poses risks, however, since it

Figure 1: Policy processes in countries with strong and weak national systems

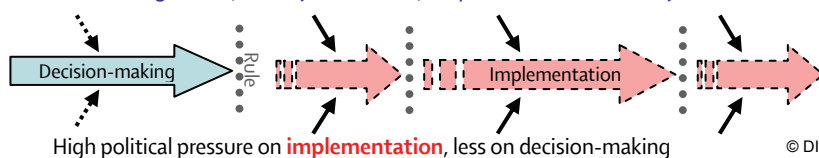
Countries with **strong** national systems

Decision-making slow and difficult, but implementation smooth



Countries with **weak** national systems

Decision-making faster (but may be iterative), implementation extremely difficult



may contribute to the atomisation of public administration and to the consolidation of local heterogeneity rather than to its elimination. Thus, as a first step towards decentralisation, territorial sequencing should be handled with care. Nevertheless, territorial sequencing based on categories of local government appears to be highly recommendable, if not necessary, in subsequent phases: once local revenue generation and local accountability come into play, it is essential for population size, civil society organisations and economic capacity to be taken into account. Preferably, territorial sequencing should be planned, with the final distribution of functions, funds and responsibilities clear from the outset.

Conclusion: How to reconcile theory and practice

Building an integrated transfer system would make it easier for donors and partner countries to follow the principles of alignment and harmonisation. The existence of such a mechanism would reflect the partner country's spending priorities, and it would allow donor agencies to finance such an account jointly. IFD could also help to reduce disbursement pressures experienced by individual donors while at the same time improving the predictability of ODA.

Unfortunately, decentralisation in practice tends to differ considerably from this picture. As a result, reformers should strive above all to get the incentive structure right. For instance, the poorer regions and rural areas usually expect decentralisation to lead to a more equitable allocation of funds. In this context, decentralisation is perceived

from a **needs-based perspective**. In contrast, more advanced regions and the larger cities expect decentralisation to broaden their range of autonomy and to leave them a larger share of the wealth they produce. In this context, decentralisation is perceived from a **development potential perspective**. These divergent perspectives may also be reflected at the national level (e. g. finance ministry vs sector ministries) and among donors (e. g. technical cooperation approaches vs financial cooperation schemes).

Pursuing both objectives simultaneously poses the risk of a mutual distortion of incentive structures, possibly leading to moral hazard behaviour at the local level. If transfer mechanisms based on performance and development potential exist side by side with transfers based on needs criteria, local authorities will try to compensate for lower transfers due to poor performance by pressing for higher transfers because of unsatisfied needs.

Many donors are already promoting decentralisation. From their point of view, it is attractive because it is usually quite popular with the public and it can be linked to developmental objectives such as poverty alleviation, public service efficiency, civil society empowerment and transparency. In most countries, however, donors need to do more to harmonise their approaches and agree on a division of labour. Nonetheless, in those cases where multi-donor budget support (MDBS) has already led to a strengthening of performance-based systems at the national level and to increased levels of donor harmonisation, it may be sensible to engage in integrated fiscal decentralisation.

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