

Fiscal Decentralisation and Poverty Reduction

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I. Introduction

In an increasing number of countries, UNDP is requested to assist in the development of the policy framework for fiscal decentralisation through advice and piloting of mechanisms for the financing of services and infrastructure at the local level. Both the empowerment of communities by fiscally strengthening their local governments and the entire system of sub-national government finance are an integral part of the policies and strategies needed for achieving the MDGs.

This primer is intended to provide an introduction to the main principles of fiscal decentralisation, to examine linkages between poverty reduction and fiscal decentralisation, to briefly describe major comparative experiences, and to clarify UNDP's approaches and entry points. It should be read in conjunction with the UNDP Practice Notes on [Decentralization, Local Governance and Urban/Rural Development](#) and [Public Administration Reform](#), which provide an overview of the broader issues and UNDP's position on these.

The primer has been developed as a joint effort of the members of the global UNDP community of decentralised governance practitioners in the country offices, regional centres and headquarters. The primer has also benefited from the input provided by a range of UNDP practitionersⁱ in the drafting process and during an [e-discussion](#) on the global Democratic Governance, Decentralization and Local Governance, and Poverty Practice Networks. In addition, a number of external fiscal decentralisation expertsⁱⁱ have made valuable contributions. It covers the entire decentralisation and local governance practice of UNDP and includes the experiences of the United Nations Capital Development Fund (UNCDF) programmes. As an agency under the UNDP umbrella, UNCDF is involved in assistance to fiscal decentralisation in a range of LDCs through the provision of capital investment funding to local governments and through upstream policy support.

A separate primer is being developed on the linkages between central government reform and decentralisation. This primer will deal more comprehensively with the planning and budgeting processes, oversight and accountability, the legislative framework, and technical support from the centre to the periphery, issues which will not be covered in the present document.

Suggestions for further enriching this note are welcome. Please address them to Gita Welch, the Democratic Governance Practice Leader, and Henrik Fredborg Larsen, Policy Advisor on Decentralisation and Local Governance, and lead author of the fiscal decentralisation primer.

II. The Issue and its Dimensions

1. *Contextualising Fiscal Decentralisation*

The government sector of virtually every country consists of more than one level of government. Typically, a country has a central government that exercises jurisdiction over the entire national territory. In addition, virtually all countries have one or more levels of sub-national governments, which only exercise jurisdiction over a particular region, district or locality. Intergovernmental fiscal relations and fiscal decentralisation deal with how public expenditure is organised between these different levels of government and how it is financed. *Fiscal* decentralisation thus constitutes the public finance dimension to decentralisation *in general*, defining how and in what way expenditures and revenues are organised between and across different levels of government in the national polity. The precise nature of intergovernmental fiscal relations and fiscal decentralisation policy in any given country varies depending on how sub-national government and administration is organised.

Where decentralisation reforms lead to genuinely local government, as is increasingly the case in most countries, this implies that sub-national authorities enjoy considerable autonomy from central government but that they are accountable to local citizens for the public goods and services that they deliver. For such local governments to fully deliver the potential benefits of decentralisation (see section below on poverty reduction), however, they need to be fiscally empowered. Fiscal decentralisation, then, can be conceptualised as the empowerment of communities and citizens by fiscally empowering their local governments. In such a context, fiscal decentralisation is often more narrowly conceptualised as fiscal *devolution* – and this primer is predominantly concerned with this form of fiscal decentralisationⁱⁱⁱ. A major element of this is that local governments are given an important role and some discretionary authority in delivering services to their communities. The assignment of roles and responsibilities to local governments (the issue of defining ‘who will do what’ within the public sector), in turn, raises the key issue of how these expenditure responsibilities are to be financed. As such, the assignment of expenditure (or ‘functional’) responsibilities is considered the first “pillar” of fiscal decentralisation reform (see further in section 2 below).

Fiscal decentralisation, however, is not only a question of transferring resources to the different levels of local government. It is also about the extent to which local governments are empowered, about how much authority and control they exercise over the use and management of devolved financial resources, measured in terms of their control over (i) the provision of the basket of local services for which they are responsible; (ii) the level of local taxes and revenues (base, rates and collection); and (iii) the grant resources with which they finance the delivery of local public services.

It is important to note that fiscal decentralisation by itself is not enough to truly empower local communities and to achieve pro-poor outcomes. While local power over the purse is important, successful fiscal decentralisation goes hand in hand with political and administrative decentralisation. First, unless local governments are politically empowered by having democratically elected and representative local councils, local communities and citizens will not be able to hold their local governments accountable. Second, unless local governments have administrative control over the services they are supposed to deliver (for instance, by having effective control over the local government staff that deliver local services), local governments are not truly empowered to serve their communities. In addition, the creation of an enabling environment for local government (of which fiscal decentralisation is a core element) will often need to be complemented by support for capacity development, for the strengthening of inclusive systems for local public expenditure management, and for robust accountability mechanisms. Finally, successful fiscal decentralisation also requires a meaningful dialogue between local and central governments, an appropriate set of legal and institutional arrangements for local government management, and a system of incentives.

2. *Principles of Fiscal Decentralisation*

Although fiscal decentralisation covers a broad policy area, it can be looked at in terms of four basic building blocks or “pillars”, as follows:

1. The assignment of expenditure responsibilities to different government levels: what are the functions and expenditure responsibilities of each level of government?
2. The assignment of tax and revenue sources to different government levels: once sub-national governments are assigned certain expenditure responsibilities, which tax or non-tax revenue sources will be made available to sub-national governments in order to meet those responsibilities?
3. Intergovernmental fiscal transfers: in addition to assigning revenue sources, central governments may provide regional and local governments with additional resources through a system of intergovernmental fiscal transfers or grants.
4. Sub-national borrowing: local governments can borrow (in a variety of ways) to finance revenue shortfalls.

This section provides a brief summary of each of these four “pillars” of fiscal decentralisation. Each of these pillars is discussed in greater detail in background readings and in [online resource material](#) developed by UNDP/UNCDF together with the Andrew Young School of Policy Studies at Georgia State University.

Expenditure responsibilities

The assignment of functional or expenditure responsibilities is the first “pillar” of fiscal decentralisation simply because it defines who does what – which functions are assigned to different levels in the overall system of government in a given country.

There is no single “best” assignment of expenditure responsibilities among different government levels, and the expenditure assignment choices made in different countries depend, among other factors, on a range of historical and political circumstances. In addition, assigning expenditure responsibilities is often “multi-dimensional” in nature, in that different levels of government may need to be simultaneously involved in the same broad service delivery area (such as primary education), but in different ways (e.g. local government being responsible for the direct provision of primary education services, and central government in defining curricula and overseeing standards)^{iv}. However, the key principle in determining which level of government should do what in a fiscally decentralised system of government is known as the “subsidiarity principle”. This principle suggests that government functions should be assigned to the lowest level of government that is capable of efficiently undertaking this function (such as providing a good or service) – if a small local government can efficiently provide pre-school services, then it should – according to the subsidiarity principle – be assigned that responsibility. Generally, this principle results in a situation where, as far as possible, the area where the benefits of a government service are felt coincides with the government boundaries at each level of government. For instance, since national defence benefits people in the national territory of a country, this expenditure function should be a national affair funded by the central government. However, since the benefits from a local park are mostly felt by local residents, the responsibility for local parks should be placed with local governments.

The subsidiarity principle suggests that three types of functions are best performed or funded by central (and not local) governments:

- (1) provision of public goods and services that benefit the entire nation (e.g. defence);
- (2) income redistribution or social policies: because firstly, sub-national governments – by their very nature – are simply not able to address income differentials between regions (which are often quite substantial) and, secondly, if local governments did engage in income redistribution, wealthy households and firms

would have an incentive to move away from sub-national jurisdictions that engaged in such income redistribution;

(3) government activities that involve spill-overs or “externalities” between local governments: sub-national governments would provide inefficient levels of certain public services if these activities involve spill-over benefits (or costs) in neighbouring jurisdictions. For instance, while residents of a locality would be the primary beneficiaries of local immunization programmes, surrounding local governments would also benefit from this immunization programme by reducing their risk of contagious diseases spilling over from the neighbouring jurisdiction. Thus, if local public health were to be left solely to the discretion of local governments, localities would likely under-fund these programmes because the local cost/benefit analysis would not take into account the benefits that accrue to the residents of neighbouring localities or to the nation as a whole.

Something that is perhaps worth noting with regard to the assignment of expenditure responsibilities (as well as revenue collecting powers) is that the process can be “asymmetrical” – thus, more responsibilities can be assigned to certain local governments (e.g. urban municipalities with relatively few “capacity” constraints) than to others (e.g. rural local governments, where “capacity” may be a serious issue). This type of asymmetry explicitly recognises that the absorptive capacity of local governments at the same level may be different.

→ See further materials in the detailed [primer on assignment of expenditure responsibilities](#) and resources in section IV

Revenue assignments

Once the assignment of expenditure responsibility has been determined, the second key question is: what revenue sources are assigned to sub-national governments^v ?

Obviously, an important determinant of the assignment of revenue sources to sub-national governments is the assignment of expenditure responsibilities, giving rise to the adage that finance should follow function. However, it should be stressed that in most countries, local governments cannot feasibly be assigned revenue sources matching their expenditure assignments. In addition, it is important to consider which revenues sources specifically make sound local government revenue sources, since some taxes are better suited for local governments while others are better left to national governments. For instance, local governments should be assigned stable sources of revenue. Local taxes should also be easy to administer and it should be easy to separate the tax base between different local jurisdictions. Also, it is preferable if local taxes broadly correspond to the benefits received by local residents from local government services. As a result, examples of appropriate local revenue sources include:

- real estate property taxes;
- retail sales taxes;
- business fees;
- regional personal income taxes;
- motor vehicle fees, and;
- user charges.

Revenue sources that are often bad local taxes – but good central government taxes – include the value-added tax (VAT), corporate income taxes, and trade (import/export) taxes.

One problem regarding the assignment of revenue sources in many countries is that while sub-national governments need to have at least some revenue discretion in order to fully benefit from fiscal

decentralisation reforms, central governments often seem unwilling to provide a significant degree of real revenue autonomy to sub-national governments – e.g. in setting tax rates or pursuing defaulters. In addition, revenue decentralisation often causes increased sub-national fiscal inequality – with wealthier regions being able to collect more revenues than poorer ones. In these cases, equalisation grants or other intergovernmental fiscal transfer schemes become necessary to ensure that sub-national governments have adequate revenues to fulfil their expenditure responsibilities.

→ See further materials in the detailed [primer on revenue assignments](#) and resources in section IV.

Intergovernmental fiscal transfers

Since the assignment of revenue sources rarely provides local governments with sufficient revenues to fund their expenditure functions, intergovernmental transfers are often necessary to assure revenue adequacy. Transfers are grants from one level of government to another (usually from higher to lower governments) for the purpose of funding public services. The term “transfer” is often used interchangeably with the term “grant.” In some countries, transfers may also be known under different names, such as “subventions” or “local government subsidies.”

Transfers can be used for a wide variety of purposes. They can be used to ensure:

- “vertical” fiscal balance (providing additional resources to the local level, so that there is a balance between the fiscal needs and resources available to different levels of government);
- “horizontal” fiscal balance (ensuring fiscal balance in resource allocations between government units at the same level of government);
- the funding of specific national priorities; or
- that the effects of inter-regional spill-overs or externalities are counter-acted.

Transfers can also be used to compensate sub-national governments for complying with central government mandates or implementing central government programmes that are delegated to the sub-national level. Unfortunately, and despite many good fiscal policy applications for intergovernmental transfers, in practice transfers are also often used simply to assure central government control over local government activities through grant conditions.

Intergovernmental transfers come in a wide variety of forms depending on the purpose for which they are used and can be classified or categorised in a number of ways. Common dimensions along which to consider different transfer mechanisms include:

- (i) the determination of the total size of the transfer pool (i.e. how and on what basis the intergovernmental transfer pool is defined);
- (ii) the determination of the distribution of the resources between qualifying local government jurisdictions (i.e. how and on what basis allocations to local governments are calculated); and
- (iii) the guidelines and conditionalities imposed for the use of funds that are transferred to the local level.

Although the manner in which an intergovernmental fiscal transfer system is structured and the method used to divide its funds among eligible sub-national governments can vary based on the policy objectives that the transfer seeks to achieve, international experience indicates a number of universal principles and practices that should be observed in designing appropriate transfer systems. These universally accepted principles of transfer design include:

- Providing revenue adequacy: A transfer formula should, as far as possible, provide a source of adequate resources to local governments.

- Preserving budget autonomy: A transfer system should preserve budget autonomy at the sub-national level within the constraints provided by national priorities. Within such constraints, local government authorities need to retain the power to determine their own budgets.
- Enhancing equity and fairness: The transfer mechanism should support a fair allocation of resources.
- Stability: Transfers should be provided in a predictable manner over time.
- Simplicity and transparency: Transfer formulas should be simple and transparent, and should pursue one objective at a time.
- Incentive compatibility: The transfer system should not create negative incentives for local revenue mobilization, and should not induce inefficient expenditure choices.
- Focus on service delivery: Transfer formulas should focus on the demand (clients or outputs) rather than the supply (inputs and infrastructure) of local government services.
- Avoid equal shares: Reliance on the “equal shares” principle (whereby all local governments at the same level, whatever their size or characteristics, receive the same size of transfer) as a major allocation factor should be avoided in the design of an allocation formula.
- Avoid sudden large changes: The transfer system should avoid sudden large changes in funding for local governments during the introduction of the new transfer mechanism.
- Grants should be announced in a timely manner corresponding to the local budget cycle.

→ See further materials in the detailed [primer on intergovernmental fiscal transfers](#) and resources in section IV.

Sub-national borrowing

The final pillar of fiscal decentralisation is a logical corollary to the first three pillars. A local government’s fiscal balance can be defined as the difference between its expenditure responsibilities, on the one hand, and its own source revenues and transfers on the other hand. If any local government expenditure needs are not properly balanced with the resources available to it, this could result in sub-national deficits and the incurrence of debt. Local borrowing might be appropriate for certain types of local spending, such as responsible borrowing for long-term capital development projects, but generally not for recurrent spending. Local borrowing is also frequently constrained by the lack of local government creditworthiness in many developing countries, especially amongst rural local governments.

The presence of a well-defined local government framework for borrowing and issuing bonds is crucial in order to assure a hard budget constraint for local governments. Unless local borrowing is appropriately addressed and regulated, local governments might end up overextending themselves financially and end up in arrears. Since local governments are part of the public sector, it is often presumed (correctly or incorrectly) that the central government will fund local deficits or guarantee local government arrears. As long as the central government is presumed to financially bail out local governments, perverse incentives exist for local governments to run budget deficits.

In addition, because excessive sub-national borrowing or the risk of major defaults can have important ramifications for macroeconomic conditions (e.g. in driving up interest rates) and the ability of the central government to rely on fiscal policy as a tool to manage macro-economic conditions, central governments often require sub-national governments to balance their budgets or tightly regulate their ability to borrow.

→ See further resources in section IV

3. *Fiscal Decentralisation and Poverty Reduction: Links to the MDGs*

Before examining in more detail the linkages between *fiscal* decentralisation and poverty reduction, it is important to very briefly outline the broader relationship between decentralisation *in general* and poverty reduction. As mentioned earlier, it is generally assumed that by bringing decision-making about the provision of public goods and services closer to citizens, decentralisation allows poor people to voice themselves more clearly, facilitates communication and information flows between local policy-makers and their constituents, and fosters improved accountability. These assumptions need to hold true for decentralisation to “deliver the goods”, so to speak – and this may not always be the case, for a variety of reasons^{vi}. It would be safe to say that the jury is still out on whether and to what extent decentralisation in general contributes to poverty reduction (see Jutting et al. 2004 and Jutting et al. 2005). A number of important studies and think-pieces (among others, see Moore and Putzel 1999; Crook and Sverrisson 1999) have underlined that decentralisation, in and of itself, is not synonymous with poverty reduction – and that a wide range of “external” factors (e.g. central government’s political commitment to poverty reduction, overall literacy rates, the strength and effectiveness of central government institutions and functions, gender sensitivity in public expenditure management, etc.) determine whether the outcomes of decentralisation are pro-poor or not.

However, if the assumptions do hold, an appropriately crafted set of intergovernmental fiscal relations constitutes an essential pre-requisite for translating the promise of decentralisation into the reality of poverty reduction. Simply stated, what local government offers – better opportunities for public participation, improved transparency, and greater accountability – will only lead to pro-poor services and outcomes if: (i) local government does what it is best suited to doing (and not what it is ill-equipped to manage or deliver); (ii) it has access to the fiscal resources with which to finance local public service delivery; and (iii) the financial resources needed by local government are made available in equitable and non-regressive ways.

As such, fiscal decentralisation is an important cross-cutting thematic area with major implications for poverty reduction^{vii} and the achievement of the Millennium Development Goals (MDGs). Fiscal decentralisation enters into countries’ poverty alleviation strategies in a number of ways. On the basis of the “subsidiarity” principle (discussed above), sub-national governments are often given the responsibility for managing many “pro-poor” priority sectors, including primary and secondary education, primary health care, agricultural extension, water and sanitation services, and local roads and public infrastructure. In many countries, responsibilities for reducing income poverty and improving food security are also assigned to the local government level, since it is assumed that the proximity of local government officials to the target groups reduces the information and transaction costs associated with identifying the poor and thus puts them in a better position to deliver pro-poor services. Local governments, then, are generally in a good position to provide many of the key pro-poor public services that can contribute directly to attaining MDGs 1-7.

Proponents of decentralisation believe that sub-national governments are generally in a better position than the central government to identify local needs (including those of the poor) and to deliver public services accordingly. However, when exploring the relationship between fiscal decentralisation and poverty reduction it needs to be remembered that there are certain things that local governments are badly placed to do as part of a poverty alleviation strategy. As noted in the previous section, the “subsidiarity” principle strongly suggests that income redistribution policies aimed at alleviating poverty should not be the responsibility of local governments, as they are poorly placed to carry out this function effectively. Furthermore, any initiative at the local government level – whether it is rural development policy, urban development policy, or local poverty alleviation more generally - will be unsustainable and fail unless local government activities are properly monitored and coordinated by the central government in the context of its national priorities. In short, to ensure sound coordination as well as equitable development across regional

and local governments, a strong and effective central government and well-developed institutional framework for intergovernmental fiscal relations are needed.

That said, local governments have a significant role to play in the delivery of pro-poor public services. As already noted, many – if not most – public services that are closely associated with poverty alleviation are generally believed to be best delivered by local governments. Incidence studies (which examine who benefits from public services), for example, show that local sectors, such as education and certain public health services, are indeed among the most pro-poor areas of public spending (Martinez-Vazquez, 2001). However, the link between local resource availability and service delivery outcomes is not necessarily uniform across regions and local governments (Hofman and Guerra, 2004). This is because some local governments use the resources at their disposal more efficiently than others, thereby highlighting the importance of local participation and accountability in assuring pro-poor outcomes.

Local governments, then, can be assigned functional responsibilities for a wide range of pro-poor public services, which they are well-placed to provide in an efficient and responsive manner. That said, the issue then becomes one of understanding how local governments can best finance such service delivery functions in ways that positively foster pro-poor outcomes (and avoid regressive ones). The following sections of this primer therefore look at the second and third pillars (revenues and transfers) of fiscal decentralisation to see how they relate to poverty reduction issues.

The revenue dimension of fiscal decentralisation has a strong bearing on the ability of and incentives faced by local government to address basic service delivery needs^{viii}. A high degree of revenue decentralisation or revenue autonomy, for example, is generally not associated with improvements in the equitable distribution of public resources. This is particularly true in LDCs, where rural (as opposed to urban) local governments often have an extremely limited tax base, as well as a weak tax administration capacity. In such circumstances, requiring local governments to rely on own-source revenues would substantially increase inequalities between local jurisdictions, although this can be off set through the design of appropriate grant or transfer schemes (e.g. by introducing equalisation grants to poor jurisdictions^x). In addition to addressing inter-regional revenue disparities, there is also a need to critically analyse the impact of revenue collection on poverty at the local level. Incidence studies (which look at who pays revenues financing public services) conducted in a number of countries have found that the collection of taxes and, in particular, of user fees is often regressive^x. However, the impact of revenue assignments on income redistribution should not be overstated. Martinez-Vazquez (2001), for example, concludes that pro-poor outcomes are achieved predominantly through spending policies, rather than through revenue assignments.

Nonetheless, some degree of revenue autonomy on the part of local governments may positively contribute to pro-poor outcomes. Firstly, own-source revenues are usually important sources of discretionary expenditure for local governments – and this may allow them to respond effectively to very local needs and problems, thus accruing the “allocative efficiencies” that decentralisation is supposed to encourage. Transfers, on the other hand, are often tied or conditional, and thus do not provide for a great deal of local government discretion in deciding how they are to be used – this reduces the likelihood of “allocative efficiencies” being achieved. Secondly, a degree of revenue autonomy can provide local governments with incentives to attract private sector investment (and thus stimulate economic growth), because they will benefit from any revenue increases associated with a growing economy. Insofar as economic growth is pro-poor, then, local government revenue autonomy may be seen as leading to poverty reduction. However, there are clearly potential trade-offs here for the reasons suggested in the preceding paragraph.

In contrast, the design of intergovernmental fiscal transfer systems can have a significant impact on the ability of local governments to contribute to strategic MDG policies, as local governments in developing economies typically receive as much as 80-90% of their resources from transfers:

- First, the size of the overall transfer pool is a significant determinant of the ability of local governments to engage in pro-poor spending. If local governments are assigned expenditure responsibilities that have an important equity dimension (such as primary education or basic health care), an under-funded transfer pool will clearly limit the ability of local governments to engage in pro-poor spending.
- Second, the “horizontal” allocation mechanism is crucial in reducing resource inequalities between sub-national governments. Despite having explicit poverty reduction policies, the actual redistributive impact of the fiscal transfer system in some countries may in fact be counter-equalizing (see for instance, Boex 2003). A recent review of international practices shows that the outcomes of fiscal transfer systems vary from equalising (as intended) to politically motivated and *counter*-equalising (Boex and Martinez-Vazquez, 2004). Thus, the relationship between decentralisation and poverty may not depend on the degree of decentralisation, but rather on whether decentralisation is pursued in an equalising manner.
- The third dimension of designing a transfer scheme is how local governments spend the transfer resources. Even when the horizontal allocation mechanism (such as the transfer formula) is equalising, this does not necessarily mean that resources are spent in a pro-poor manner at the local level; transfer resources may be captured by local elites (Crook, 2003). Central governments often try to regulate the local use of transfer funds through conditionalities, budget guidelines and minimum service standards^{xi}, but this may also limit the ability of local governments to address poverty issues. There is clearly a need for open local budget processes, participatory and inclusive planning procedures, and so forth in order to foster pro-poor local government spending (see Practice Note on [Decentralization, Local Governance and Urban/Rural Development](#)). Furthermore, systems of performance-based allocations may help improve the accountability, transparency, inclusiveness and pro-poor nature of local government public expenditure management^{xii}.

III. UNDP's Approach and Possible Entry Points

1. *UNDP's approach for support to fiscal decentralisation*

Since 1998, UNDP has advocated for integrating human rights with development through the use of a Human Rights Based Approach (HRBA) to its development programmes^{xiii}. In essence, HRBA applies the international human rights framework (the universal declaration on human rights, the international covenants and other international tools) to development programmes. Focusing on human rights attains two main goals: (i) it provides a normative framework for policies and programmes^{xiv} and (ii) it defines a basis for minimum legitimate demands by “claim-holders” and obligations on the part of “duty-bearers”. HRBA also ensures accountability of the state, its organs and individuals (“duty bearers”) that are obliged – under the international legal framework – to guarantee protection of and respect for basic rights. Finally, HRBA develops the capacity of the claim holders (including the most vulnerable and poorest segments of the population) to have their entitlements recognised and fulfilled, as well as the capacity of duty-bearers to meet their obligations.

UNDP applies a human rights based methodology to decentralisation and local governance^{xv}. In the specific case of fiscal decentralisation, this translates into the following main points, which together define the key entry points for UNDP:

- Clear assignment of functional (expenditure) responsibilities across different levels of central and local government is fundamental to the identification of duty bearers and their respective obligations.
- Assignment of responsibilities to local governments without the corresponding provision of adequate financial resources should be avoided since this would limit the capacity of local governments to meet their obligations.
- Special consideration should be given to the human rights implications of fiscal decentralisation reforms, in terms of analysing whether public services are improved and rights better protected.
- Any assessment of a reform of intergovernmental fiscal relations should include an analysis of its likely impact on the poorest and most vulnerable groups, as well as on inter-regional disparities (see section II on the linkages between fiscal decentralisation and poverty reduction). Any UNDP programme should ensure that government decision-making bodies are aware of the likely impact of their policy choices on basic human rights and are sensitized with regard to their role as duty bearers. UNDP should ensure that the participation of local communities and citizens in decisions on fiscal decentralisation reforms is fostered and that, as claim-holders, they have access to information on the impact of the decisions.

A first issue that needs to be considered is whether fiscal decentralisation merits direct support – as pointed out in earlier sections of this primer, there are many factors at play which determine whether decentralisation (in general) and fiscal decentralisation (in particular) will result in pro-poor outcomes. Depending upon a thorough analysis and assessment of context and the role of devolved service delivery in national strategies for achieving the MDGs, then, it may be more sensible for UNDP not to support fiscal decentralisation as a pro-poor instrument and, instead, to support policies and processes that would establish the conditions under which decentralisation stands a better chance of leading to poverty reduction.

Where appropriate, UNDP support is structured around two complementary broad sets of instruments for effecting change in the policy framework for fiscal decentralisation and pro-poor service delivery:

- The strategic use of UNDP downstream activities to pilot mechanisms for the financing of services and infrastructure at the local level with trialling and support for the development of operational procedures (e.g. guidelines, regulations, etc.). Such pilot projects aim at (i) addressing explicit ‘policy

issues' by testing improved and innovative procedures and practices at the local level; (ii) working through local government institutions so as to improve these "from within", rather than creating parallel systems or resource flows; and (iii) being "owned" by national policy making bodies, thereby allowing "policy-relevant" lessons to be monitored, documented and disseminated within and by these bodies.

- Pilot projects at the local level are complemented by **upstream advisory and advocacy activities**. These activities are aimed more directly at those institutions involved in policy making and oversight, or in formulating recommendations for change. As such, these activities generate (or respond to) opportunities to reform policies by: (i) informing the policy debate, through documenting the implications of current policy or practice, drawing the lessons learned from the pilot portfolio, and/or identifying policy options; (ii) building the capacities of key national stakeholders for policy analysis, formulation and oversight; and (iii) promoting strategic dialogue and collaboration between development partners.

Within this broad framework, entry points for UNDP assistance and emerging challenges are outlined below. The capital development funding provided by UNCDF programmes offers an entry point for piloting financing mechanisms and for delivering related upstream support, and the examples below include UNCDF programme support in LDCs.

2. *UNDP entry points in support of fiscal decentralisation*

Integrating fiscal decentralisation in strategies for achieving the MDGs

Any planning for achieving the MDGs (e.g. in the context of PRSPs) needs to address the role of local governments in these strategic interventions. Should specific interventions (e.g. the delivery of certain services or public infrastructure) be delivered by local governments, by deconcentrated structures of central government ministries or by semi-autonomous agencies that form a parallel mechanism? As such, the entire system of sub-national government finance (the assignment of expenditure responsibilities, the assignment of revenue sources, the definition of intergovernmental fiscal transfers and the sub-national borrowing framework) should be considered as an integral part of the policies and strategies for achieving the MDGs.

The choice of overall strategy involves at least two major decisions. Firstly, a strategy for the choice and combination of approaches to local development is needed. Here, a distinction can be made between (i) decentralised sectoral approaches, (ii) direct community support approaches and (iii) local government approaches^{xvii} and financing should be provided accordingly within the national framework for fiscal decentralisation. Secondly, having decided on the mix of approaches and, hence, expenditure assignments to local government, the type of funding/grants (government and donor) would have to be decided. Many of the 'targeted' programmes identified in poverty reduction strategies tend to suffer from a number of the weaknesses highlighted in the previous section, notably in defining the framework for horizontal allocation, by limiting the discretionary decision-making powers of local governments and by relying on funding mechanisms for the sub-national level that are based on ad hoc decisions and/or reimbursement of approved expenditures.

As mentioned in Section II, financing redistributive policies should be mainly the responsibility of central (rather than local) government because of the national nature of income redistribution issues. Despite this general policy prescription, sub-national governments in many developing and transitional countries undertake significant redistributive activities. Hence, strategic decisions are also concerned with specifying which poverty alleviation activities local governments should not engage in.

Comparative examples on integrating fiscal decentralisation into strategies for achieving the MDGs include the following countries:

- In Nepal, UNDP supported the efforts to strengthen the linkages between the MDGs and the PRSP/National Development Plan by applying the Millennium Project's needs-based approach [\[link\]](#). In a separate exercise, UNDP/UNCDF supported the Local Bodies' Fiscal Commission to further devolve and clarify expenditure responsibilities of local governments [\[link\]](#).
- In Uganda, UNDP/UNCDF has pioneered the establishment and development of efficient systems of intergovernmental fiscal transfers and local government own source revenues in line with poverty reduction strategies, which have since been adopted as national policy. See the website of the [Local Government Finance Commission](#) and the [Ministry of Local Government](#).

Improving information bases and flows

One possible – and very general – entry point is to simply support the development of better information about issues linked to fiscal decentralisation and poverty reduction. Although this is perhaps self-evident, without robust information, policy-makers will be unable (i) to know whether fiscal decentralisation is pro-poor and contributing to the attainment of MDGs, (ii) to determine the spatial distribution of poverty (and thus design appropriate equalisation measures), or (iii) to measure progress. UNDP can, then, contribute to strengthening the linkages between fiscal decentralisation and poverty reduction by improving the quality and quantity of information that is available to policy makers and other stakeholders.

An example of this kind of support includes:

- In China, UNDP is supporting reforms to the local government budget classification system, making it more transparent and easier to track pro-poor expenditures.

Analysing the impact on the Poor and Disadvantaged Groups: Incidence Studies, Public Expenditure Tracking Surveys (PETS) and Public Expenditure Reviews (PERs)

In the analysis of options for fiscal decentralisation, UNDP can play a key role by supporting a pro-poor policy perspective. Whereas a set of principles and policy considerations forms the basis for defining expenditure assignments and the means for financing them (revenues, grants and borrowing), there remains a need for specific analysis of the outcomes with respect to poverty. UNDP has a proven track record in addressing poverty issues in decentralised governance, as well as in the analysis and assessment of the pro-poor dimensions to fiscal decentralisation policy and practice.

Fiscal Incidence Studies and Public Expenditure Tracking Surveys (PETS) are powerful tools for analysing the pro-poor outcomes of fiscal decentralisation. Expenditure incidence studies are used to quantify the actual benefits received by the poor from different (central and local government) expenditure programmes. Incidence studies thus help guide the decision on which public programmes – and which levels of government – are best positioned to provide pro-poor services. PETS, applied specifically within a context of fiscal decentralisation, are used to track the share of grants (and other resources) reaching schools, health clinics and other services with a high impact on poverty. The methodology is also used to analyse the actual allocations made by local governments with discretionary decision-making powers as compared to previous allocations made by central government and/or non-devolved service providers (such as line ministries). Examples of influential PETS and Incidence Studies include:

- PETS conducted in [Uganda](#) which encouraged central and local government to make changes in the utilisation of grants and the flow of information. See also Ritva and Svensson (2001).
- Alderman (1998) showed that local governments in [Albania](#) – through a conditional transfer scheme – were in a position to provide social assistance in a more effective and more pro-poor manner than the central government.

- An incidence study of intergovernmental transfers in Tanzania (Boex, 2003) demonstrated that the central government – through its system of discretionary grants – was allocating local government resources in a dis-equalising manner (with wealthier local governments receiving greater transfers). This study helped justify the introduction of a more equitable system of formula-based block grants.
- In [Nigeria](#), PETS was one of the tools used to develop a Benchmarking Exercise that examines and analyses the capacity of States in four areas (policy, communications and transparency, fiscal and budget management, and service delivery), all of which have a significant bearing on local poverty reduction efforts.

Supporting sub-national Public Expenditure Reviews (PERs) is another way of highlighting the pro-poor outcomes of fiscal decentralisation policies and for informing pro-poor policy reforms. Sub-national PERs allow stakeholders to see how and on what local governments spend and how they finance such expenditure.

- In [China](#), UNDP's "Capacity Building to Support Pro-Poor Fiscal Reform" Project undertakes sub-national PERs that try to analyse whether and how county-level expenditures and revenues are pro-poor or not, with a view to informing fiscal decentralisation policy reforms in China as a whole. These PERs aim to better understand whether county administrative expenditures are disproportionately high, how expenditures are financed, and whether counties are able to access sufficient resources to meet their wide range of expenditure assignments.

Capacity for revenue mobilisation and analysis of the impact of local revenues on poverty

Improving local government revenue collection is part of UNDP's capacity development efforts in many countries. Although a core element of this has traditionally been to strengthen the local administrative capacity for revenue collection (in order to finance local government service delivery), more attention is currently being paid to the impact of local revenue collection on poverty and the distribution of income. Recent studies, for example, have shown that poor people often spend a disproportionately larger share of their income (than the less poor) in paying local taxes and user fees. This may indicate that local user fees need to be made more progressive^{xvii}. However, care should be taken not to throw out the proverbial baby (the benefits of local revenue autonomy) with the bathwater (inequitable outcomes). Instead, and whenever possible, equity concerns should be addressed through improvements in the local revenue system (for instance, through local property tax exemptions for poor households) or other creative local revenue solutions (such as the introduction of differential user fee structures, such that poorer households pay lower user fees). A special case of inequitable local resource mobilisation lies in the conventional practice of requiring 'community contributions' to match outside investment funding – here too there is some evidence that the outcomes may often be regressive (see Vietnam study cited below).

UNDP's focus on improving local revenue mobilisation is shifting towards a more sophisticated analysis and understanding of local revenue issues, rather than simply concentrating on revenue administration. For instance, it is becoming increasingly clear that the poor quality of local government services is often a key contributing factor to persistent local tax evasion, and that improving service delivery may therefore be a pre-condition for successfully strengthening local government revenues. Increasing attention is also being paid to the nature of the relationship between taxpayers and local government, and to ways of establishing better dialogue and greater trust between them. Another constraint to adequate local revenue mobilisation (which has received more attention in recent years) is the fragmented nature and structure of sub-national taxes, licenses and user fees, which often limits local government revenues to minor, low-yielding sources that are relatively costly to administer. Relevant country examples in the areas mentioned above include:

- Study of taxpayers' decisions on whether to pay or evade local taxes in [Tanzania](#).
- Facilitating dialogue between local taxpayers and municipal authorities with support from UNV in [Ghana](#).

- Overview of new utility policies introduced in the Municipality of Budapest ([Hungary](#)) during the 1990s, including social subsidies for utility charges through a self-funded, need-based Compensation Fund.
- Studies of revenue (and expenditure) assignments in [Serbia, Macedonia, Croatia, Georgia and Armenia](#).
- Study of the impact of user fees in [Vietnam](#).
- Support for improving revenue mobilisation in [Malawi](#).
- Support for rationalising and reforming property tax regimes in [China](#).
- Various studies in [Uganda](#).
- See also *Lessons Learned on Donor Support to Decentralisation and Local Governance* (OECD 2004) for findings in [various countries](#).

Linking local planning to decentralized financing

As noted earlier, the potential pro-poor benefits of decentralisation are unlikely to be reaped unless the system of local government finance is systematically tied to a sound system of community participation and citizen involvement in local planning and budgeting. Conversely, if they are to be effective and efficient, participatory local planning processes should be budget-based and firmly embedded in the framework of local government finance. In many of the 100-odd countries where it provides support for decentralisation and local governance, UNDP has established a strong track record in supporting participatory planning with assistance provided for policy development, for developing mechanisms for meaningful popular participation at the sub-regional level, and for ensuring civil society/community group involvement and consultations in local government public expenditure management. Indeed, this focus on participation and inclusion is consistent with the HRBA that underpins UNDP's work in the area of decentralisation and local governance – citizens, as claim-holders, have the right to participate in and to be informed of local planning. UNDP supports efforts to improve linkages between needs assessments at the grass-roots level and planning at higher levels of local government, and increasingly to link planning to finance in order to ensure implementation and the sustainable management of services in support of the MDGs. This entails support to develop the national framework for fiscal decentralisation as well as to strengthen local government capacity for budgeting and the management of devolved resources, including specific measures for pro-poor budgeting. UNCDF's Local Development Programmes, which provide local governments with access to "real-time" development funds, offer an entry point for working on these processes. Select country examples and hyperlinks to documentation on them include:

- [Bangladesh](#)
- [Bhutan](#)
- [Nepal](#)
- [Vietnam](#)
- [Uganda](#)
- [Mali](#)
- [Senegal](#)
- [Niger](#)
- [Ethiopia](#)

Improving the system of intergovernmental fiscal transfers

As mentioned earlier, one objective of many transfer systems is to accelerate growth and ensure service delivery in poorer regions by offsetting the 'fiscal disabilities' of sub-national governments that can only rely on very limited local revenues or face high unit costs in providing public services, or a combination of both^{xviii}. UNDP facilitates the participatory processes and provides technical input for reviewing

intergovernmental fiscal transfer systems with the aim of making them as pro-poor and equitable as possible. Country examples include:

- The intergovernmental fiscal transfers study conducted for the Government of [Malawi](#).
- Support for the development of an allocation formula for district grants in [Nepal](#).
- Support for the development and implementation of a formula-based system of intergovernmental grants in [Tanzania](#).
- Support for the development of a new fiscal transfer system in [Uganda](#).
- Support for an overall analysis of fiscal decentralisation issues (including intergovernmental fiscal transfers) in several central and eastern European countries.

Developing fiscal incentives to improve the performance of local governments

While central governments generally expect local governments to contribute to achieving certain national policy objectives, the system of local government finance is not always aligned with these policy objectives. In fact, poorly designed financing systems can provide local governments with incentives to behave inefficiently^{xix}. The development of systems for performance-based allocations of intergovernmental fiscal transfers has proven to be a key instrument for encouraging sound financial behaviour by local governments and for improving the service delivery outcomes of devolved functions, including making these increasingly pro-poor. In a number of countries, UNDP/UNCDF have assisted central and local partners in developing performance-based approaches to fiscal transfers. This approach usually combines two instruments:

- *minimum conditions*, which typically link local governments' compliance with basic requirements (as defined by laws and official regulations) to their access to grants; and
- *performance measures*, which are applied to provide additional 'top up' grant allocations to the extent that local governments have met broader policy goals (such as poverty reduction).

[Steffensen and Larsen \(2005\)](#) provide a useful overview and comparative analysis of these performance-based funding instruments.

The capital development grants and technical support provided by UNCDF programmes have, in many cases, provided an entry point for developing such performance-based approaches to fiscal transfers, and country examples include:

- In [Mali](#), minimum conditions were tested for access to annual block grants from the Local Development Fund, and performance assessments take place within two broad categories, with the possibility of obtaining an additional block grant allocation (French only).
- The Anseba Local Development Fund in [Eritrea](#) contained a set of minimum conditions introduced and applied progressively in years 1 and 2 of the pilot programme. Performance criteria are applied to reward good technical performance and pro-poor outcomes (see the programme document and operations manual).
- Local government access to the District Development Fund in [Uganda](#) was conditional upon compliance with a set of minimum conditions and the country now has one of the most sophisticated systems for performance-based allocations, allowing annual grants to vary +/- 20 percent.
- In [Ethiopia](#), the access of the *woredas* to capital funding is based on satisfactory compliance with a number of minimum conditions.
- In [Nepal](#), and based on experience in Uganda and elsewhere, the Government and UNDP/UNCDF are currently piloting a model of minimum conditions and performance criteria through the Decentralised Financing and Development Programme.

- In Bangladesh, the Government and UNDP/UNCDF have been piloting a mechanism whereby *union parishads* receive block grants for the first time, subject to their meeting basic standards of management and governance. This approach is now being replicated by on a wider scale by the Government.

Support for Fiscal Decentralisation Reform Processes and Consultations

Cutting across the above-mentioned support for various elements of the fiscal decentralisation framework, UNDP also facilitates the work of fora of national stakeholders on fiscal decentralisation issues. In a number of countries, specific assistance is provided for fiscal commissions as the main institutions for facilitating a dialogue on fiscal decentralisation, strengthening national ownership of fiscal decentralisation reforms and developing an appropriate national framework for local government finance. In accordance with HRBA, a finance commission which is constitutionally mandated to determine the allocation of central revenues to provinces, and from provinces to local bodies, on the basis of transparent norms, helps ensure that universalism is not compromised, and that there is no inequality and discrimination based on e.g. ethnic, religious or political party considerations.

As a core part of this support, UNDP advocates for, and helps facilitate, broad-based national and local consultations on issues related to fiscal decentralisation. Such consultations not only reinforce the ownership and transparency of any policy process, but also increase the likelihood of poverty being seen as an issue and of pro-poor considerations being factored into fiscal decentralisation policy. UNDP also assists governments in ensuring that information about fiscal decentralisation policy-making and policies is made available to the public. Support is provided for decentralisation reviews and for facilitating discussions between governments and donors on policy options, including in the area of fiscal decentralisation. UNDP assistance can take a variety of forms: support for the policy process, help in formulating and drafting implementation plans and road maps, and – in many cases – support for reviewing various concrete options. Country examples include:

- Support for developing the institutional capacity of the fiscal commission in [Sri Lanka](#).
- Support to the Local Bodies' Fiscal Commission in [Nepal](#) to formulate a fiscal decentralisation road map and implement the individual components.

Facilitating dialogue among bilateral donors and international financial institutions

International agencies and bilateral donors are currently engaged in promoting political and economic stability in many countries, some of which have been beset by, or even born out of ethnic and civil strife. There are inevitable tensions between the political and economic reforms which the various bilateral donors and international financial institutions promote. Depending on the government's own ability to coordinate international agencies, UNDP can play an important role by facilitating dialogue between the government, bilateral donors, and international financial institutions to break down the barriers to effective fiscal decentralisation.

Most development partners (including UNDP) are typically concerned with issues of pro-poor development, governance and political stability. A high priority is often accorded to decentralisation as a way of diluting the concentration of political power, providing some degree of local autonomy for disaffected minorities, and improving the accountability of local public services. This implies some devolution of taxing and spending power.

In contrast, other agencies are chiefly concerned with achieving macro-economic stability, involving – *inter alia* – the reduction of fiscal deficits and associated public sector debt, and the rationalisation of tax systems to remove disincentives for enterprise development and job creation. These objectives are typically pursued through a tight centralisation of taxing and spending powers, overseen by ministries of finance.

At first sight, these economic and political objectives are seemingly incompatible, leading to conflicting pressures on governments from the international community. As such, ensuring a constructive dialogue between development partners and international agencies (to see whether and how far different political and economic agendas can be reconciled) is extremely important to the success of any decentralisation policy.

3. Links to other Practices

How does UNDP's work on fiscal decentralisation within the Democratic Governance Practice (the second of UNDP's five practices) relate to the four other Practice areas? In addition to the links between fiscal decentralisation and the efforts to achieve the MDGs and reduce human poverty (the first of UNDP's five practices), which have been discussed in detail in this primer, there are a number of issues that relate to the remaining three practices.

Energy and Environment for Sustainable Development

The impact of fiscal decentralisation on the environment is a key issue to include in any analysis. The sharing of revenues from the taxation of natural resource exploitation and use is closely related to environmental issues. This has an impact on the capacity to finance services and, hence, on poverty as well as on the exploitation of the natural resources. There is no easy or correct answer to the 'right' way of sharing natural resource taxes, but some policy directions seem clear. Firstly, the central government is in the best position to tax natural resources, since it has the major appropriate instruments of taxation and the tax administration advantage. Secondly, there should be some sharing with federal and local governments, if only because of the need to compensate them for the costs associated with natural resource use/exploitation in their jurisdictions. The key issues to be addressed include:

- (i) what is an appropriate division of revenues between central and local government (vertical sharing) ?
- (ii) how should revenues related to natural resource use/exploitation be distributed among local governments (horizontal sharing) ?
- (iii) should local governments be allowed to tax extractive industries (see further in Bahl and Tumennasan 2002) ?

Crisis Prevention and Recovery

Fiscal autonomy and the more specific issue of sharing of local revenues are at the heart of many conflicts of a regional or local nature and are often an integral part of many peace and regional autonomy agreements. In cases where the solution to the conflict is agreed to be more devolution, fiscal decentralisation usually forms a major part of this. Special autonomy agreements (such as those drawn up for Aceh and Papua in Indonesia) often include provisions for larger shares of natural resource revenues being devolved to sub-national governments. Such arrangements are illustrations of how revenue assignments within a decentralised system of governance can be "asymmetric" in their structure.

Responding to HIV/AIDS

Major opportunities for addressing the global HIV/AIDS epidemic exist at the local level with a need for community intervention as well as a role for local governments. Hence, any planning for achieving the MDG target on HIV/AIDS involves the same concerns with respect to fiscal decentralisation as outlined above (see further www.worldbank.org/urban/hivaids/handbook/handbook.pdf).

IV. Partners and Resources

1. Key Global and Regional Partners

Key Partners – Global

Andrew Young School of Policy Studies, Georgia State University
<http://isp-aysps.gsu.edu/>

Duke Center for International Development, Duke University
<http://www.pubpol.duke.edu/centers/dcid/>

Key Partners – Asia and the Pacific

Institute for Social and Economic Change, Bangalore, India
<http://www.isec.ac.in>

National Institute of Public Finance and Policy, New Delhi, India
<http://www.nipfp.org.in>

Key Partners – Europe and CIS

Local Governance and Public Service Reform Initiative (LGI/OSI), Budapest, Hungary
<http://lgi.osi.hu>

Strengthening Fiscal Frameworks for Local Government Reform in the Caucasus, Fiscal Decentralization Initiative
http://rbec.undp.org/index.cfm?menu=p_search/p_result/p_projects&ProjectID=603

Key Partners – Latin America and the Caribbean

Observatory of Public Policies (OPERA) - Externado de Colombia University (Strategic Alliance with UNDP)
<http://www.uexternado.edu.co>

Economic and Social Planning Institute for Latin-America and the Caribbean (ILPES)
<http://www.eclac.org/ilpes/>

Key Partners – Arab States

Lebanese Centre for Policy Studies (LCPS)
www.lcps-lebanon.org

Arab Towns Organization (ATO)
www.ato.net

Key Partners – Africa

Municipal Development Partnership - Partenariat pour le Development Municipal - MDP/PDM

PDM, a non profit organization founded in 1991, has two autonomous sub-regional bureaux in West/Central Africa (Benin) and in East/South Africa (Zimbabwe). It operates with (i) a programme for support to projects and services and (ii) a reference centre for institutional support and development. Its members are the National Associations of Local Powers, and its partners are international organizations and donors.

- Bureau régional pour l'Afrique de l'Ouest et du Centre (PDM-Ouest)
Partenariat Pour le Développement Municipal
<http://www.pdm-net.org/>
- Eastern and Southern Africa Regional Office (PDM-Est)
Municipal Development Partnership for Eastern and Southern Africa
<http://www.mdpafrica.org.zw/>

United Cities and Local Governments of Africa (UCLGA)

<http://www.uclga.co.za/>

See also <http://www.cities-localgovernments.org/uclg/>

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3. Additional Online Resources

GRC-Exchange:

http://www.grc-exchange.org/g_themes/cc_decentralisation.html#fiscal

World Bank:

<http://wbi0018.worldbank.org/prem/ps/iaamarketplace.nsf/075c69a32615405f8525689c0051fb88/4cdd74a05fd3506b8525689c005333bc?OpenDocument>

ADB Governance Brief no. 8: Challenges in designing and implementing intergovernmental fiscal transfers in Asia:

<http://adb.org/Documents/Periodicals/GB/default.asp?p=govpub>

Credit Ratings and Bond Issuing at the Subnational Level

http://www1.worldbank.org/wbiep/decentralization/Module11/cmd_english.pdf

Intergovernmental Relations Institutional Review (World Bank/ADB):

<http://www1.worldbank.org/publicsector/decentralization/toolkit9.pdf>

Devas, C.N. (2002): *Issues in Fiscal Decentralisation: Ensuring Resources Reach the Poor at the Point of Service Delivery*, http://www.grc-exchange.org/info_data/record.cfm?id=432

Rao, G: *Poverty Alleviation under Fiscal Decentralization*

<http://www.worldbank.org/wbi/publicfinance/documents/module%2012/Poverty.pdf>

Fiscal Decentralization in South-Eastern Europe, 2004

http://lgi.osi.hu/cimg/0/0/1/7/4/LGI_report_on_fiscal_decentralization_in_SEE.doc

Local Government Borrowing: Risks and Rewards, 2004

http://lgi.osi.hu/publications_datasheet.php?id=256

Dilemmas and Compromises: Fiscal Equalization in Transition Countries, 2003

http://lgi.osi.hu/publications_datasheet.php?id=249

ESCAP study of 15 Asian countries (see finance section in chapter II of the individual studies)

http://www.unescap.org/huset/lqstudy/comparison1.htm#_Toc450984088

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ⁱⁱ The contributions of Jamie Boex, Jesper Steffensen and Mike Winter are gratefully acknowledged.

ⁱⁱⁱ A broader definition of fiscal decentralisation could also incorporate fiscal deconcentration and delegation. *Deconcentration* means a transfer of responsibilities, powers and resources from the central government (ministries and agencies) to field offices at the local and regional level, thereby becoming closer to the citizens while remaining a part of the central government system. The staff is fully accountable to the centre, and the regional/local administrations typically have no or very limited discretion on how the services are provided and there are no independent local revenue sources, i.e. the regional/local bodies are seen as service delivery arms of the centre. *Delegation* is an intermediate form, where the centre retains more control over service delivery, the financing of these services and staffing matters. The centre can withdraw and overrule the local governments within areas of delegation and the local governments, although they may be led by locally elected politicians, are fully or partially accountable to the centre.

^{iv} The assignment of expenditure responsibility has a multi-dimensional nature: the assignment of an expenditure responsibility can be broken down into four attributes, including the responsibility to (i) produce, (ii) provide, (iii) finance, and (iv) set policy standards and regulate a certain government function. For example, while local governments are often deemed to be in the best position to provide primary education, primary schooling can be produced either by local governments themselves, or by private schools in their jurisdiction. Likewise, higher-level governments often share the responsibility of financing and regulating local primary education. Central governments often regulate and (co-)finance primary education since there are significant equity issues involved in access to education, and because many of the benefits from primary education accrue to the nation as a whole. When the responsibilities to produce, provide, finance and set policy standards/regulate a certain government function do not all fall within the jurisdiction of a single level of government, institutions and processes need to be set up in order to assure that different levels of government work together effectively.

^v Like expenditure assignments, revenue assignments are multi-dimensional. A comprehensive definition of a revenue assignment considers which government level: (1) legislates a tax; (2) defines the tax base (and exemptions); (3) determines the tax rate; (4) collects/administers the tax; and (5) receives the revenues from the tax? Economists do not define the assignment of revenues based on which level of government legislates the tax, or based on which government level collects the revenue source. Instead, an own source tax revenue is defined as a tax for which the local government has a certain control over the revenue yield received, e.g. either by controlling the marginal tax or the tax base. Alternatively, the revenue sharing is actually considered to be an intergovernmental transfer.

^{vi} See Jutting et al (2004; 2005) for an overall (and sobering) survey of the relationship between decentralisation and poverty reduction.

^{vii} Poverty is usually measured in either money-metric, or non-money metric terms. Poverty reduction as analysed in this guidance note refers to non-money-metric measures of poverty. As indicated in this section, local authorities can intervene in generating incomes. However, in most countries local authorities are mainly responsible for delivering basic social services (basic education, health services, water/sanitation services etc). So in a majority of countries local bodies can play an important role in reducing the non-money metric dimensions of poverty.

^{viii} See e.g. J. Steffensen and P. Tidemand: Synthesis Report: *A Comparative Analysis of Decentralisation in Kenya, Tanzania and Uganda*, 2004.

^{ix} To the extent that national revenues are typically collected in only a few wealthy regions and then distributed across the entire national territory (either through central government spending or through intergovernmental transfers), revenue centralisation can improve fiscal redistribution.

^x See e.g. *Fiscal Decentralisation Strategy – The Way Forward*, on Uganda, <http://www.molg.go.ug> and further in the next section on UNDP entry points).

^{xi} In order to assure a sound transfer mechanism, it is important to balance grant conditionalities with local flexibility. It is further important to assure that the service standards imposed on local governments are realistic and affordable given the available resources to the local level. (Martinez-Vazquez and Boex, 2001).

^{xii} See e.g. UNCDF (1999) *Taking Risks: Background Papers*, UNDP www.uncdf.org; www.molg.ug; and Steffensen and Tidemand (2004).

^{xiii} See [Integrating Human Rights with Sustainable Human Development: A UNDP Policy Document](#), 1998.

^{xiv} See [The Human Rights Based Approach to Development Cooperation: Towards a Common Understanding Among UN Agencies](#), 2003.

^{xv} See [Decentralization and Human Rights: A Systemic Approach](#), UNDP 2003.

^{xvi} See e.g. <http://www1.worldbank.org/sp/ldconference/index.asp>).

^{xvii} However, as noted in section II, it is important to consider the incidence of the entire system of public finances as a whole and not overestimate the impact of revenue assignments on income redistribution.

^{xviii} See Govinda Rao, *Poverty Alleviation and Fiscal Decentralization*, p. 13.

^{xix} For instance, if local governments receive a deficit grant at the end of the budget year to cover the local budget deficit, this provides local governments with an incentive to run deficits. Likewise an equalization transfer that is based on sub-national revenue collections provides a perverse incentive to reduce sub-national revenues.