INTRODUCTION

Financing Local Government

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Decentralisation is now taking place in most states, including Commonwealth member countries. This trend began in the 1980s and since then most countries have devolved some responsibilities to regional and local level. The move has been driven by the failure of the state to be sufficiently responsive to citizens' needs and regional differences and by the failure of centralised economic planning to deliver quality services to users at local level.

Irrespective of the reasons for decentralisation, reform initiatives have faced numerous challenges, especially in developing countries. These have involved the design of decentralised structures and the apportionment of resources and power between different tiers of sub-national government. Decentralisation has also placed increased responsibility for the delivery of public services and the achievement of the Millennium Development Goals on sub-national and local governments. This has especially been the case in federal systems, where regional and local governments have substantial responsibility for the provision of urban services and infrastructure. A critical determinant of the effective performance of sub-national and local governments is finance – their ability to mobilise financial resources and use them effectively. It follows that decentralisation requires the allocation of resources to sub-national and local governments so that they can finance their new role. This involves the assignment both of local government's own sources of revenue and of intergovernmental fiscal transfers.

The need for financial decentralisation

The decentralisation of administrative responsibilities and service delivery to lower tiers of governments without a corresponding reorganisation of finances is likely to be counter-productive. Fiscal decentralisation entails the assignment to sub-national or local governments of resources to finance the functions for which they are responsible. For there to be meaningful financial decentralisation, devolution of decision-making powers is also necessary. Own revenue sources include not only local taxes but revenues from charges, fees and other miscellaneous income sources. Intergovernmental fiscal transfers include the share of national tax revenues that is assigned to sub-national government and grants – both conditional and general.

In most countries, there are good reasons why the main sources of revenue accrue to central government; these include administrative practicality, economic efficiency and inter-regional equity. As a result, the own revenue sources assigned to local government are often quite limited, especially in rural areas. A system of intergovernmental transfers is therefore essential in order to ensure that local governments are able to carry out their responsibilities. A sound local financial system is critical to the integrity of the local public sector and for gaining the trust of citizens (Shah, 2007).

This book explores a variety of themes and topics relating to financial decentralisation. It starts by setting out the arguments for and against decentralisation and looking at its effects throughout the world. It asks what are the main sources of revenue for local governments and examines how local authorities administer their finances. It then moves on to explore more complex issues such as capital financing, municipal bonds and intergovernmental transfers. It discusses local government budgeting, accounting and auditing, as well as citizen participation and accountability at local level. Finally, the book highlights the experiences of particular countries, beginning with case studies of England and Ghana, and then looking briefly at other Commonwealth members.

In chapter 1, Nick Devas discusses how and why decentralisation is taking place in various parts of the world. He traces the trend towards centralisation in the period from the 1940s to the 1970s and towards decentralisation in the 1980s, and asks what were the drivers of reform. He makes it clear that there have been many different reasons for decentralisation and reviews the arguments for and against, backed by evidence taken from current literature.

Devas argues that fiscal decentralisation necessarily involves setting up systems to decide on the use of financial resources at sub-national level, and for monitoring and enforcement. This mechanism should contain the following important elements:

- Specification of local taxes
- The scope for local governments to levy fees and charges for locally provided services
- Regulations about the operations of local government-owned enterprises
- Regulations about borrowing by local governments
- Requirements regarding the execution of assigned functional responsibilities, including the level of discretion about the delivery of local services
- Specification of the use of intergovernmental transfers
- Systems of accounting and financial management
- External audit of the accounts of local government.

In chapter 2, Devas raises the fundamental issue of why local governments need resources in order to finance the services and activities for which they are responsible. Goods and services can be provided directly by local government or through contracting with or subsidising the private sector to provide them. Local government also has a variety of regulatory roles, such as building and development control and consumer protection, and these also have to be paid for.

Devas argues that local governments should be competent under law to levy a range of local taxes and charges, borne by residents of the jurisdiction, which will fund at least part of the cost of the services that benefit residents. This will also ensure that local decision-makers have a degree of discretion about the level of taxation. However, in reality most local governments only partially meet local expenditure needs from local sources. There are complex issues of equity and efficiency here, and these are discussed in the chapter. On the issue of taxation and equity, Caulfield (1997) argues that the real issue is whether improvements in local finances, including the taxation system, can strengthen local economies and reduce inequality, thereby reducing threats to social cohesion in urban areas.

In light of the fact that in most countries local governments are chronically short of resources, there is a need to examine options on how to fill this gap. Devas suggests various ways of doing this, including control of expenditure, exploiting the tax base and improving revenue collection, charging for services, increasing the transfer of funds from central government and borrowing. The chapter throws light on several related issues which no local government can afford to ignore in its efforts to increase local revenue, such as the cost of collection, equity and enforcement. It also deals with various forms of local taxation. Devas argues that the most suitable local taxes are those where the tax base is wholly confined within a jurisdiction, is immobile and is similar to that in other jurisdictions. This is why property taxes are the commonest form of local taxation around the world. In the OECD countries, there are two main sources of local revenue – income tax and property tax. English-speaking countries tend to depend on the latter (Caulfield, 1997); the chapter also discusses their relative merits.

Chapter 3 deals with local revenue administration. Devas argues that improving tax administration is as important as the reform of tax policy. The chapter deals with all stages of local revenue administration, including tariff setting, taxpayer identification, tax collection, enforcement, accounting for taxes collected, and reporting on and monitoring results. It goes on to discuss performance indicators for revenue administration, for example tax effort, effectiveness and efficiency.

Devas suggests some effective revenue administration practices, such as taxpayer identification, better records management and giving minimum discretion to assessors. He also argues for compartmentalisation of the functions of assessment and collection, and the rotation of staff on a regular basis. Where possible, local taxes and charges should be designed to ensure that payment is made in full at the earliest date – for example, for water and electricity charges. The whole system will be thwarted if there are not adequate checks and controls. In particular, the system of recording assessments and payment should be straightforward and amenable to checking.

Raising the public's consciousness of the importance of taxation is vital to the sustainability of the system. There is an important educational task to be done in making the public aware of the need to pay their taxes promptly. This can best be done by providing proper information on how revenues are used. Soliciting the help of community leaders in presenting the information and exhorting the community to pay its taxes may have some positive results, particularly if community leaders feel they have an input about how the resources are to be used, and if they are seen to directly benefit the local community.

Chapter 4 deals with financing capital investment. Large-scale local governments require big investments in municipal infrastructure to create or improve local services. There are several ways of financing capital expenditure, such as borrowing from central government, raising loans from international agencies, for example the World Bank, borrowing from a central credit institution or facility for local authorities, as well as direct borrowing from the public or the money market, for example by issuing local authority bonds. Devas makes a lucid assessment of the pros and cons of local government borrowing. Borrowing by sub-national entities is a complex issue which can sometimes have serious impact on macroeconomic management. While presenting the arguments for and against borrowing, the author considers complex economic issues such as inflation and economic growth, and argues for more stringent technical and financial scrutiny of projects that are to be financed from loans as compared with those financed from the recurrent budget. The chapter also deals with alternative ways in which capital investments by local governments can be financed, including public-private partnerships.

Typically, cities in emerging market countries have growing urban populations, and service capabilities that are unable to keep pace with rising demand. Further, the increasing devolution of functions to municipal level is often incommensurate with the fiscal capabilities granted to the city. In the face of these constraints, most national and local governments are seeking alternative forms of market-based financing to supplement their revenue sources, and are trying to attract private sector participation in the delivery of services. While some municipalities have the institutional and financial strength to access market-based financing directly, others are establishing special purpose funds or facilities to attract private financing for infrastructure services.

In this context, chapter 5 sets out international experiences of accessing credit and capital markets to finance infrastructure and presents a case study of the Tamil Nadu Urban Development Fund (TNUDF) in South India. Pritha Venkatachalam argues that while the TNUDF pioneered several innovative approaches to urban infrastructure financing through the issue of bonds, there has been limited thrust on developing the demand-side capabilities of local government in preparing bankable projects. In order to develop long-term sustainable access to capital markets as a source of finance for municipal infrastructure, projects need to be commercially viable and close to operational readiness in order to pay back the borrowed funds. A successful innovation in Tamil Nadu was 'pooled financing'. Thirteen small municipalities aggregated their water and sanitation requirements and raised about Rs 300 million through a pooled bond issue. The layered structure of credit enhancements and the principle of credit aggregation boosted investor confidence in subscribing to these bonds and enabled local bodies to access market finance at competitive interest rates.

The chapter concludes that financial market innovations and reforms should be accompanied by stronger project preparation and development capability of local governments. This is essential to increase creditworthy investment opportunities for market-based financing and develop commercial financing as a long-term alternative to the traditional revenue sources of local governments.

Chapter 6 discusses the crucial issue of intergovernmental fiscal transfers. It covers the full range of transfers from central government to sub-national and local governments, including:

- Tax/revenue sharing
- General (block) grants
- Specific grants
- Deficit grants
- Capitalisation grants
- Subsidised loans.

The design of the intergovernmental transfer system is extremely important, as is the General Budgetary Support (GBS) mechanism. This is absolutely critical in determining the extent to which local government can benefit from new approaches to aid. Amis (2007) recommends that ministries of local government and local governments should be considered as a key stakeholders in the GBS and other central policy-making activities.

The chapter deals with the criteria for evaluating intergovernmental transfer systems: adequacy, elasticity and stability, inter-regional equity, economic efficiency and simplicity. As there is always tension between central and local government, central-local transfers raise complex issues. Another facet of this relationship is that financial flows from central government do not necessarily imply the political subjugation of the sub-national entity. There are examples of local governments that receive a large proportion of their revenues from the centre without any diminution of their local discretion (for example in the Netherlands); in other countries, local governments are tightly controlled by the centre, even where they do not receive significant funds (for example in Kenya). Devas gives a comprehensive account of these issues and argues that the impact of the transfer system on local governments should be regularly monitored, so that undesirable results can be corrected. However, the system also requires stability – frequent changes to the formula destabilise decentralised service provision.

Chapter 7 deals with budgeting and expenditure management. It begins with the key roles played by financial planning and budgeting and recurrent and capital budgets, and then discusses the sub-national government budget preparation process. The chapter stresses that it is important that the estimates prepared by local government departments are based on adequate guidance from the municipal finance department on resource limits, policy priorities, etc. This enables services managers to plan realistically within the available resources. In the absence of such guidance, spending departments are likely to bid high ('pad their bids') in the expectation of cuts, obliging the central finance department to make arbitrary decisions about cuts in budget proposals later in the process. There are also strategic choices which need to be made by elected representatives through a proper policy process based on agreed objectives and strategies.

Debate about the extent and level of state involvement in the economy and its impact on corruption continues in the literature (Becker, 1994). Galtung (1998) has argued that there is a correlation and puts forward the thesis that the distribution of power is more important than the extent of government activity. Decentralised financial management requires the manager to deliver specified service levels and performance and potentially puts more public resources at risk, in the sense that more resources are handled at locations remote from direct central control, with more people having an influence on how the resources are used. Therefore, decentralisation may disperse corruption more widely, although it may not increase the overall level – indeed, it may help to curb corruption through greater accountability. This chapter also draws attention to the reforms to financial management employed in many countries, such as simplifying accounting systems, computerisation of revenue collection and paying grants directly from the Ministry of Finance to the bank account of the sub-national government. Devas argues that decentralisation involves a shift from a direct role played by central government in service delivery to one of enabling and monitoring the work of local governments. Decentralisation requires that central government pays agreed grants and revenue shares on time, and that it seeks to reinforce good practice at local level.

The cost of services provided by local governments is measured in terms of money, because governments have to buy from the same markets as other businesses; but the effect of financing governments by taxation is that beneficiaries do not express their satisfaction in money terms (Jones, 2007). In chapter 8, Simon Delay argues that effective systems of accounting are essential, not only to provide managers in local government with the financial information they need to manage their services, but also to account to citizens and taxpayers for the use of public resources. However, Delay maintains that conventional accounting is good at identifying costs, but poor at identifying performance. Therefore, accounting as a tool needs to be combined with other approaches in order to assess the performance of a public body such as a local government.

Delay also argues that monitoring budgets is essential not only to avoid overspending, but also to avoid underspending that might threaten performance in service delivery. However, budget monitoring provides only a limited insight into overall performance. Delay also notes how government spending is monitored in the UK, where there are two principal governmental external audit bodies: the National Audit Office, which is responsible for auditing central government; and the Audit Commission, which audits local government.

Delay points out that there is a fine line between over-regulation and local autonomy. He argues that perhaps a natural consequence of increased devolution and local autonomy is the lack of trust (much of which may be justified) on the part of central government towards local government. There is therefore often a danger of over-regulation. Moreover, we should not ignore the fact that audit and inspection have heavy compliance costs, putting a strain on limited capacity and possibly encouraging rent-seeking behaviour by inspectors and auditors. Over-regulation and excessive inspection and audit can discourage local initiative and risk-taking.

Competition between audit and inspection agencies may be healthy, but it may also lead to turf wars. Efforts at scrutiny need to be co-ordinated to ensure greatest benefit. There are also important issues relating to who scrutinises the scrutineers and who guards the guardians.

International experience indicates that efficient and accountable local governments are those where the people who make the spending decisions, those who enjoy the benefits and those who pay the taxes are the same (Slack, 2006). In chapter 9, Devas broadly deals with citizens' participation and local government accountability. In most contemporary societies, citizens elect councillors who make decisions about local services and levy local taxes to pay for those services. The citizen's only role is to vote in elections every four years or so and pay their local taxes. This is the traditional view of local government, which is being increasingly challenged. Citizens now expect to have a greater say in the running of the services that affect them. They are dissatisfied by the lack of accountability of those they have elected for the taxes they have levied and other resources they have used. In many countries, they are concerned about the level of corruption in local government. Devas argues that councillors are able to make decisions without any democratic participation or accountability to citizens from one election to the next. Local political processes are often dominated by local elites, who may rely on patronage networks to ensure their re-election. Little information is available on which to judge the performance of those who have been elected. In view of these constraints, Devas suggests that for decisions on more specific issues, other mechanisms of participation are needed. He cites some participatory mechanisms, but hints that it is important to be realistic about what can be achieved within any particular situation.

Devas also indicates that participatory processes do not necessarily help the poor, who lack the time, resources and education to participate effectively. What matters is the attitude and commitment of the politicians and officials involved in the process.

In the context of accountability at local level, civil society is significant. However, one should not be oblivious of the fact that civil society is also riddled with divisions along racial, ethnic, religious and political lines and reflects various conflicts of interest.

Chapters 10 to 12 present country case studies. Chapter 10 discusses an example from a developed Commonwealth country – local government in England. This is followed in chapter 11 by a detailed case study of a developing country, Ghana. Finally, chapter 12 reviews current practices in selected Commonwealth countries which are at different stages of development and looks at some common denominators.

Chapter 10 focuses on local government and local government finance in England. (Scotland, Wales and Northern Ireland have slightly different systems.) It summarises the evolution of English local government and describes its current structure. The chapter also covers the functions of local government and their division between two tiers. In some places, unitary authorities are responsible for all aspects of local government. However in London, the Greater London Authority has powers in relation to strategic planning and transportation, with the remaining functions being carried out by the London boroughs. Some important functions commonly assigned to local government are not local government functions in England: for example, health (a central government function devolved through the National Health Service), social welfare payments (handled by the central government's Benefits Agency) and utilities such as water, sewerage, electricity, gas and telecommunications (all now run by privatised companies). The police service, which was formerly a local government function (except in London), is now the responsibility of regional police authorities which consist of representatives of both central and local government. The chapter also gives a full picture of local government finance in England, including the council tax, transfers from central government, capital financing, financial management and auditing.

In chapter 11, Dr Oppong Koranteng presents a case study of Ghana. He analyses how politics have facilitated or constrained fiscal decentralisation by examining the response to the country's fiscal decentralisation policies. The chapter also looks at how politics within the various policy networks affects fiscal decentralisation, and shows how the various stakeholders have different interests and resources, which influence the implementation of fiscal decentralisation policies.

The analysis suggests that resistance to the implementation of fiscal decentralisation has come from the central government's Ministry of Finance. The implementation of centralisation is technically and administratively complex in situations where there is low public participation and visibility. It is apparent from the case study that reactions to fiscal decentralisation have been generated in the bureaucratic arena, which has a low political stake in reform.

The Commonwealth is extremely diverse – and so is the way in which local governance is conducted in member countries. Though decentralisation is taking place in many Commonwealth countries, there are wide variations in the pace of reform. The reasons behind decentralisation and local government reform also differ from country to country. The final chapter presents contrasting perspectives on systems of local government finance in the many Commonwealth countries that have participated in the Secretariat's flagship programme over the last three years. In order to cover the main areas and current practices, the chapter focuses on the following issues:

- External control of local finances by the central or state/provincial government ministry, e.g. approval of the budget, taxes and loans;
- Current annual taxation capacity;
- Potential for improvement of revenue mobilisation;
- Ratio of taxes collected to taxes due;
- Generation of revenue from service charges;
- Central-local financial relations – the kind and extent of intergovernmental transfers;
- Ability to access capital markets;
- Local government bonds as a mechanism for raising capital;
- Audit of local government accounts;
- E-governance processes, e.g. for payment of taxes, dues and licence fees, and for making complaints;
- How budgeting can be made more open to public influence.

The chapter includes short case studies of Malaysia, Jamaica, Sierra Leone, Malta, Mauritius, Nigeria and Sri Lanka.

The issue of finance cannot be considered independently of the purposes that local government is intended to serve. In order to meet the challenges of the twenty-first century, local governments need to be given power and resources that are commensurate with their changing responsibilities. The need for reform is clear. However, financial decentralisation raises complex issues, and it is these that are the theme of this book.

References and further reading

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