

**Project-number: 9912500300 (2008)**  
**„Harmonization, Decentralisation and Local Governance“**  
**(01.01.2007 - 31.12.2009)**  
**"Secretariat for the Development Partners Working Group**  
**on Local Governance and Decentralisation (DPWG-LGD)"**  
**InWEnt Department 2.04**

## **Terms of Reference**

Draft for a study on Fiscal Decentralisation  
for the "DPWG-LGD"

### **1. Presentation of the commissioning party**

InWEnt gGmbH – Capacity Building International, Germany (in the following referred to as "InWEnt") - stands for the development of human resources and organisations within the framework of international cooperation. InWEnt's range of services caters to skilled and managerial staff as well as decision makers from businesses, politics, administrations and civil societies worldwide. Each year, some 55,000 persons participate in our measures.

Programmes and measures at InWEnt aim at promoting change competencies on three levels: They strengthen the individual's executive competencies, increase the performance of companies, organisations and administrations, and at the political level improve decision-making skills and the capacity to act. The methodological tools comprise modules and can be adapted to meet changing requirements in order to provide solutions. Apart from face-to-face situations in measures offering training, exchange of experience and dialog, emphasis is on e-learning-assisted networking. InWEnt cooperates equally with partners from developing, transition and industrialised countries.

InWEnt's shareholders comprise the Federal Republic of Germany, represented by the Federal Ministry for Economic Cooperation and Development (BMZ), the Carl Duisberg Gesellschaft that represents the business community, and the German Foundation for International Development that represents the Länder (German federal states).

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### **2. Context**

Since the beginning of the 1990s, African countries have initiated a general process of decentralisation, the institutional framework of which, completed by the holding of regular local elections, currently allows the local communities to function. This decentralisation has been accompanied by transfers of relative competencies in the basic services to the populace, who confer on the local communities a vital role in the reduction of poverty and in implementing the Millennium Development Goals (MDG). The institutional reorganisation produces exchanges in an environment of liberalisation and the putting into place of Economic Partnership Agreements, which thereby provoke a lowering of tariffs on resources.

In this environment, the issue of financial means placed at the disposal of the local communities in order to ensure their objectives, constitutes a vital question.

Three principal sources of finance supply the local budgets: financial transfers from central government, loans and local taxes. The following is to be noted concerning these three sources:

- that the provisions from the state, even if they can progress significantly in certain countries, very often reveal shortfalls, irregularities and delayed payments,
- that for them the means of borrowing are still somewhat subject to availability,

Thus, in order to allow the local communities to rely on perennial and regular funds, granting them a real system of local taxation seems unavoidable.

### **3. OBJECTIVES**

The objective of the deliberations to take place aims at:

- analysing the fiscal contextual elements of countries in which our collaborations are active, relying essentially on the different studies that the members of the sub-group have been able to carry out in the field, and allowing a shared state of play with the local taxation system,
- proposing recommendations that allow the harmonisation of our co-operative politics in the field,
- formulating opinions, both in regulation and in fiscal administration with the aim of simplification, concerning optimisation of the systems for setting up, and of appointing of the means of local taxation.

### **4. POINTS COVERED BY THE REFLECTIONS**

The work will aim to address the following points, the list of which shall not be exclusive:

1) Proceed to a shared state of play:

- Appreciating the level of income of the local communities, according to the kind of funding, both in comparison with the GDP of the countries and with regard to all their public deductions.
- Evaluating and commenting on the fiscal potential in terms of the local taxation system.
- Reflecting on taking account of the characteristics and differences between rural and urban districts;
- Analysing the effective legislation and regulations by setting out to appreciate the relevance of output criteria, of effectiveness and of justice.
- Evaluating the ability to commission administrations, especially on the level of human resources (expenses/output effectiveness, role of the national government in the management of the local taxation, training of personnel ...);

- Taking stock of the situation regarding the organisation of the collection of taxes;

2) Identifying new angles likely to improve the raising of funds from local taxation:

- Identifying the elements of a legal and organisational sphere for decisive taxation to allow the local communities to lead politics of development of decentralised government effectively;
- Identifying the elements that allow the guarantee of coherence of the whole group and especially good communication of the proposed systems with the system of central taxation;
- What possible choices in the matter of systems of taxation should combine simplicity, justice and yield?
- What is the place for property tax and what recommendations are there for putting it into effect better the census of taxable assets, and the determination of the basis of assessment?
- How better to define a population liable to tax, with limited expenses;
- What is the administration of the local tax, and what are the advantages and disadvantages, between national and local levels, of the procedures for distributing the levy?
- Until the improvement, what is the role of the municipal administration in the management of the tax and its collection;
- How to reinforce consent to the tax;
- What account has been taken of the difference between rural and urban districts?

#### 4. Project partners

Development Partners in the informal working group are:

<b>Germany</b>	German Federal Ministry for Economic Cooperation and Development (BMZ) German Development Bank (KfW) Gesellschaft für Technische Zusammenarbeit (GTZ) German Development Service (DED) InWEnt gGmbH, Capacity Building International
<b>Ireland</b>	Irish Aid
<b>Norway</b>	Norwegian Agency for Development Cooperation
<b>Spain</b>	Spanish Ministry of Foreign Affairs and Cooperation
<b>Great Britain</b>	United Kingdom Department for International Development
<b>Sweden</b>	Swedish International Development and Cooperation Agency

<b>The Netherlands</b>	Dutch Ministry of Foreign Affairs
<b>Switzerland</b>	Swiss Agency for Development and Cooperation
<b>Belgium</b>	Belgian Technical Cooperation
<b>Denmark</b>	Royal Danish Ministry of Foreign Affairs
<b>France</b>	French Ministry of Foreign Affairs French Development Agency
<b>Austria</b>	Austrian Development Agency
<b>Finland</b>	Ministry for Foreign Affairs of Finland
<b>Canada</b>	Canadian International Development Agency
<b>USA</b>	U.S. Agency for International Development (USAid)
<b>Multilateral organisations</b>	United Nations Development Programme UN Capital Development Fund UN-Habitat World Bank African Development Bank Inter American Development Bank Joint Africa Institute EuropeAid, European Commission

## 5. Programme Language

The programme language is English.

## 6. Requirements for the contractor

The works shall be carried out by a consultant with the following set of skills and experiences:

- Relevant background in development economics, law, political or administration studies with working experience in the areas of coordination and harmonization of DP support
- Relevant background in the field of fiscal decentralization
- Minimum five and preferably ten or more years of experience with decentralisation and local governance programmes in Africa, Asia and/or Latin America
- excellent writing skills in English and/or French and/or Spanish

The timeframe for the assignment will be 20 days for the review of existing material, the elaboration of the draft on fiscal decentralization which will be presented to the next meeting of the group in May 2009 in Bratislava as well as the finalization of the draft based on the comments provided afterwards.

## 7. Services by the contractor

The working process will cover the following phases for the consultancy input:

- Review of existing studies and documents and collection of complementary information (December 2008).
- Elaboration of a draft on fiscal decentralization (End December 2008).
- Presentation of the draft on fiscal decentralization to the next meeting of the group in May 2009. Finalization of a draft on fiscal decentralization on comments provided by the DP Working Group (June 2009)

Contact person at InWEnt is: Nina Helm; [nina.helm@inwent.org](mailto:nina.helm@inwent.org)

## **8. Services by InWEnt-Capacity Building International, Germany as the commissioning party**

InWEnt shall bear the overall responsibility for the development-policy approach of the project and its monitoring. Amendments to the original project planning require the explicit prior approval of InWEnt Capacity Building International, Germany.

InWEnt shall support the contractor in implementing the measures, in particular in relation to involving organisations in partner countries or other organisations / institutions of German or international development cooperation.

Specifically, InWEnt shall assume:

- the contractually agreed costs of the contractor in accordance with the bid

## **9. Recording data**

Personal and programme-related data necessary for organising, implementing and following up the seminar shall be saved by InWEnt.

## **10. Confidentiality**

The contractor is obliged to treat confidentially towards third parties all information obtained in connection with the implementation of the measures, especially all personal data of participants, even after the term of the contract.

## **11. Rights of ownership**

All documents drawn up in connection with the implementation of the service are or shall be the unrestricted property of InWEnt.

## **12. Subcontracting**

The Contractor is required to obtain InWEnt's prior written consent before entering into a subcontract, i.e. before entrusting the performance of the contract or parts of it to third parties.

When entering into subcontracts, the Contractor is obliged to name InWEnt as the principal. In cases of subcontracting, the Contractor may not impose less favourable conditions upon the subcontractor - especially in terms of payment modalities and securities - than those agreed between the Contractor and InWEnt.

With respect to the invitation to tender for subcontracts, the Contractor has to generally ensure an adequate involvement of small and medium-sized enterprises.

## **13. Audit, Inspection of the use of the remuneration**

InWEnt is entitled to request from the Contractor the presentation of the Contractor's accounts and supporting documents and to inspect them, or have them inspected by an agent, with regard to the use of the remuneration. The Contractor has to keep the relevant documents ready for such audits and give all necessary information.

## **14. Written Form**

Amendments and supplements to this agreement are valid only if made in writing in English.

**15. Offers not considered**

If an offer has not been accepted before **14 November 2008** expires, the offer has not been considered.

**16. Severability Clause**

Should any provision of this agreement prove to be invalid or incapable of fulfilment, this shall not affect the validity of the remaining provisions.

**17. Place of jurisdiction**

German law shall apply. The place of jurisdiction shall be Bonn.

**18. Contractual Elements**

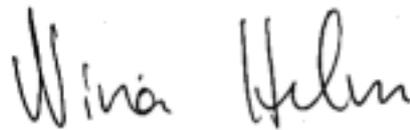
The General Terms of Contract of InWEnt gGmbH (Annex) form an integral part of the agreement. Moreover, the German Regulations Governing Services (VOL / B) are applicable. In case of contradictions of these contractual elements, they are deemed applicable in the sequence of priority as stated above.

Bonn, 29.10.2008



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**Glossary of Terms**

<b>Own taxes</b>	Base and rate under local control
<b>Overlapping taxes</b>	Nationwide tax base, but rates under local control
<b>Nontax revenues</b>	Fees and charges. Generally, the central government specifies where such charges can be levied and the provisions that govern their calculation.
<b>Shared taxes</b>	Nationwide base and rates, but within a fixed proportion of the tax revenue (on a tax-by-tax basis or on the basis of a "pool" of different tax sources) being allocated to the subcentral government in question, based on (1) the revenue accruing within each jurisdiction (also called the derivation principle) or (2) other criteria, typically population, expenditure needs, and/or tax capacity.
<b>General purpose grant = non-conditional grant</b>	Subcentral government share is fixed by central government (usually with a redistributive element), but the former is free to determine how the grant should be spent; the amounts received by individual authorities may depend on their efforts.
<b>Specific grants</b>	The absolute amount of the grant may be determined by central government or it may be "open-ended" (that is, depend on the expenditure levels decided by lower levels of government), but in either case central government specifies the expenditure programs for which the funds should be spent.

## Categories of Decentralisation

### Textbox 1.1: Decentralisation - Forms, definitions and meaning

Decentralisation reforms are currently ongoing in many developing countries, but the nature of these reforms varies greatly, as the term 'decentralisation' is often used as a concept without strict definitions. The World Bank normally uses the term "decentralisation" to describe a broad range of public sector (re-)organisations that involve the transfer of authority and responsibility for public functions from the central government to intermediate and local governments or quasi-independent government organisations. It adds that "decentralisation" is a complex multifaceted concept, whereby different types of decentralisation should be distinguished because they have different characteristics, policy implications, and conditions for success. Generally, a distinction is made between three main types of decentralisation:

**De-concentration** is often considered to be the weakest form of decentralisation; it redistributes decision-making authority, financial and management responsibilities among different levels of the central government. It can merely shift responsibilities from central government officials in the capital city to those working in regions, provinces or districts, or it can create strong field administration or local administrative capacity under the supervision of central government ministries.<sup>4</sup> De-concentrated functions are normally not entrenched in laws and can easily be withdrawn at any point of time.

**Delegation** is a more extensive form of decentralisation. Through delegation central governments transfer responsibility for decision-making and administration of public functions to semi-autonomous organisations not wholly controlled by the central government, but ultimately accountable to it. Governments delegate responsibilities when they create public enterprises or corporations, housing authorities, transportation authorities, special service districts, semi-autonomous school districts, regional development corporations, or special project implementation units. Usually these organisations have a great deal of discretion in decision-making. They may be exempt from constraints on regular civil service personnel and may be able to charge users directly for services. Delegation is often legally recognised.

**Devolution** is a third type of decentralisation. Devolution is legally entrenched, often in the Constitution. When governments devolve functions, they transfer authority for decision-making, finance, and management to quasi-autonomous units of local government with corporate status. Devolution usually transfers responsibilities for services to municipalities/district councils etc. that elect their own mayors and councils, raise their own revenues and have independent authority to make investment decisions. In a devolved system local governments have clear and legally recognised geographical boundaries over which they exercise authority and within which they perform defined public functions.

A fully devolved system combines elements of (i) political decentralisation, whereby locally elected leaders constitute the highest local government body, (ii) administrative decentralisation, whereby those local governments can 'hire and fire' their own staff, and (iii) fiscal decentralisation, whereby there are institutionalised arrangements in place for funding of local government operations, through normally a combination of local taxes and sharing of central government revenues through a system of intergovernmental fiscal transfers. In a devolved system, the aspects of political, administrative and fiscal decentralisation are closely linked. Based on the foundation of a decentralisation policy and an institutional framework to implement the policy, the aforementioned aspects, together with a legal framework are the pillars that jointly provide a democratic system at the sub-national level that is expected to improve service delivery.

When discussing and analysing systems of decentralisation, it is important to distinguish between models of **de-concentration**, whereby resources (such as civil service staff and budgetary funds) are merely delegated and reallocated from central government to a lower administrative unit (e.g. a district), but whereby the final decision-making authority remains with the central government (and local staff answer to their upstream superiors); and models of **devolution**, whereby **political functions** are transferred to lower levels and decisions are made locally, amongst others with regard to staffing and budgetary allocations

### **Principles for Expenditure Assignment**

There is no one best way for deciding which level of government should be responsible for the provision of particular government services. The adequacy of any assignment has to be judged in terms of how well it achieves the goals or objectives set up by the central government in its decentralization strategy. Commonly accepted objectives of fiscal decentralization include an efficient allocation of resources via a responsive and accountable government, an equitable provision of services to citizens in different jurisdictions, and macroeconomic stability and economic growth. These objectives are also incorporated in the European Charter of Self-Government.

An efficient provision of government services requires that government satisfy the needs and preferences of taxpayers as closely as possible. This is best achieved by keeping the provision of services at the lowest level of government compatible with the size of "benefit area" associated with those services. For example, the benefit area for sanitation services is clearly the local community, but for air traffic control the benefit area is the entire national territory. Assigning public services with wider benefit areas to smaller units of government is likely to result in the inefficient under provision of services; e.g., a tertiary hospital providing regional services is financed only by a single municipality, with other municipalities free-riding. Efficiency in the provision of public services is enhanced if consumption benefits are linked to costs of provision via fees, service charges, or local taxes.

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

While funding for these expenditures should be a central government responsibility, implementation can be left to local government, which may have informational and other comparative advantages. To the extent that mobility of households is limited, local governments may be effectively able to carry their own redistributive policies. Expenditures undertaken for the stabilization and growth of the economy, such as public investment projects or unemployment compensation, are by their scale naturally assigned to the central government.

The application of these rules largely facilitates the assignment of expenditure responsibilities to different levels of government. However, the rules are unlikely to yield a unique answer in every situation. Some public services, e.g., primary education and primary health services, may be of a local nature by the size of their benefit areas. But because of their relevance to welfare and income redistribution, they may also be considered a responsibility of the central government.

The objectives are not all attainable at the same time. The pursuit of greater efficiency and autonomy may be achieved at the cost of a sacrifice in the equality of

service levels. It is for this reason that we cannot speak of a "best expenditure assignment." The government's strategy and priorities would assign different weights to the objectives of efficiency, equity, and stability.

In addition, what is considered the best assignment is likely to change over time with changes in costs and technological constraints, as well as changes in preferences. However, there is a need at all times to have a concrete and clear assignment of expenditure responsibilities that could be considered preferable among the alternative assignments. Failure to have a concrete assignment may lead to instability in intergovernmental relations and to the inefficient provision of public services. Without an explicit assignment of expenditure responsibilities it will be much harder to reach consensus and stability in the assignment of tax revenues and to arrive at a workable system of equalization transfers.

**The following example illustrates the historically wide range of interpretation of local government functions:**

#### **Ethiopia: A unique case of assigning functions**

The Ethiopian distinction between the so-called "*state*" and "*municipal*" functions is a world-wide unique feature of expenditure assignments to sub-national governments. Besides police justice, trade, industry and finance, basic education and health care are regarded as state functions (which is unusual in a decentralized context). Waste management and local roads (as well as other economic infrastructure like markets and slaughterhouses) and city planning, construction, housing, land administration and development are under the city or municipal administration<sup>1</sup>. Responsibilities for water supply and sewerage are shared between the regions (capital investment) and the ULGs (recurrent expenditure). In some regions, zonal administrations do also have a share in this.

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

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

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<sup>1</sup> As for the budgets, some ULBs have separated the municipal administration from the city administration, while both are public administrations.

As far as the revenue side of the budget is concerned, the Ethiopian Constitution stipulates the distribution of the different **tax revenues** between the federal government and the regions. Under this system, around 75 % of the total tax revenues belong exclusively to the federal government, including the VAT as a major source. As a result, most regions do heavily depend on grants to comply with the state functions (80 % dependency rate on average).

It is to be mentioned that the system in Ethiopia is currently under discussion. There may be a move towards one common treasury system at the local level, integrating the state and the municipal functions. Recent World Bank funded programs consider the introduction of performance-based grants in the urban authorities.

## **Practical Approaches to improve Property Tax Collection**

### **A How to Establish an Integrated Reform**

The diverse experience in East Africa offers a unique opportunity to identify possible lessons for other Sub-Saharan African countries in the process of designing or implementing property tax reform efforts. (See Kelly 2009)

#### ***1. Strengthen political will and administration capacity***

The ultimate objective of property tax reform is the production of sustainable local level revenues. Although the private sector can be mobilized to expediently produce a valuation roll, it is essential to simultaneously develop institutionalized administrative capacity in the government to sustain the reform. Effective administration procedures, combined with a strong local capacity and political will, are the essential ingredients for a sustainable property tax reform.

#### ***2. Reform Must Link Property Information, Valuation, Assessment, Collection and Enforcement***

A property tax reform must follow a “holistic” approach—recognizing the linkages between policy and administration and between the various administrative components of property identification, valuation, assessment, collection, enforcement, and taxpayer service. Narrowly focusing on policy discussions—e.g., whether one should tax land only—is not necessarily useful when the primary problem is basic administration.

Focusing on only property valuation—e.g., solely creating up-to-date valuation rolls—is not necessarily useful when the primary problem is inadequate political will, collections and enforcement. Relying on the private sector for a one-time valuation roll creation exercise may be expedient but not necessarily useful unless local level institutional capacity is simultaneously developed to ensure quality control, systematic roll maintenance and ultimate use for tax purposes.

#### ***3. Managing Stakeholder Education Is Essential***

Successful property tax reform involves mobilizing widespread support from stakeholders from the central and local government and the private sector. Strong and sustained political and operational commitment is necessary to enact and implement property rates reform. Taxpayer education programs are essential to ensure that the rationale and procedures for the property tax are fully understood. It is also essential to provide customer service both in terms of more efficient and equitable tax administration as well—and perhaps more importantly—more effective and accountable delivery of local public services. Tax collection in the absence of service delivery is very difficult.

#### ***4. Mass Valuation Should Be Introduced***

As with the rest of Sub-Saharan Africa, East African countries rely on valuers to personally visit each property to determine an individual valuation for each property. Although this approach may produce very accurate valuations, it tends to be manpower and time intensive thus creating a backlog of out-of-date and incomplete valuation rolls. To overcome these problems, Uganda and Kenya are exploring the use of mass valuation

techniques to produce more equitable, up-to-date values in a transparent, cost effective, timely and sustainable manner. These mass valuation techniques will separate the field data collection activities from the valuation activities, allowing the scarce and more expensive valuation resources to focus on market data analysis, valuation models and specific property valuations rather than on collecting and maintaining property data in the field.

## **Shortlist: What local governments can do to improve RPT collection**

*The following recommendations refer to a US-Aid supported project to increase RPT collection in the Philippines but are valid for other countries as well:*

### **Policy Issues**

- Recommend the amendment of exemption level, assessment levels and the frequency of general revision
- Recommend that Sangguniang Panlalawigan adjust "Fair Market Value" to true market values

### **Property Identification**

- Use all measures to identify property owners, including the involvement of barangay officials
- Coordinate with concerned local government offices and national agencies (e.g., Register of Deeds, DAR, and DENR) for maps, master lists, titles, etc.
- Conduct regular training for assessment and collection personnel Assessment and Appraisal
- Simplify assessment process and procedures
- Strict compliance with assessment laws, rules and regulations
- Establish uniform criteria for appraisal of properties

### **Records Management**

- Eliminate unnecessary forms or records
- Computerize assessment and collection procedures and record management
- Enhance coordination between treasury and assessment offices Collection and Enforcement Provide funds for tax information campaign Institute civil and administrative remedies for non-payment of taxes
- Conduct capability-building or training for assessment and treasury personnel
- Strictly enforce civil and administrative remedies

## **Possible Modalities for the involvement of private providers in the collection of market fees and taxes**

The following *proposal* has been elaborated as an advisory service of German Technical Cooperation (DED) to the Rwandan Institute of Administration and Management and the Association of Municipalities, to improve collection of market fees in Rwanda. (See RIAM, Ralga 2008). The concerns might be valid in other countries as well:

### **General procedure**

1. *Conduct privatization of market tax collection in 4 steps (i) Fiscal potential study; (ii) Tender process; (iii) Execution of a service contract; and (iv) Monitoring and Evaluation, with a number of defined tasks each*
2. *Give emphasis to a realistic potential study, including cost-benefit analysis before deciding on the privatization of tax collection. which must be repeated on a regular basis in order to produce realistic results,*
3. *Active contract management by the district, comparable to any other contract management (including controls, whether the tax rates as defined by the District Council are being respected by the enterprise and his private tax collectors, pursues merchants, who refuse or try to evade tax payment,*
4. *Monitoring of tax collections: site visits by districts, districts pay tax collector in time, tax collector transfers amounts collected onto the account of the district immediately*
5. *Create attractive conditions by maintaining the infrastructure of the market and improve hygiene; include funds for market maintenance in annual budget; the District Council should consider a revision of official market days for all of the markets based on the local need conduct and conduct intense awareness raising activities of planned changes amongst the population.*
6. *Creation of incentives and sanctions for collectors: Remuneration is increasing linearly with the collected tax revenues based on the agreed percentage; Payment based on a monthly reporting system, which clearly defines deadlines and penalties for both parties in case of disrespect of these deadlines ; payment of a monetary guarantee at the beginning of the contract by the contractor;*

**Specific procedures** for improving the collection of market fees through private providers:

- Review the tax system and the applied tariff structure and consider their simplification, Administer and establish statistics on tax revenues for each market;

if possible integrate reforms into an efficient fiscal administration, introduce a functional tax payers software / database..

- Choose the percentage of the collected amount demanded by the bidders as key criteria for the selection of the private provider (On the basis that all essential criteria are met, the bidder proposing the lowest percentage based on the fiscal potential of the market, as published in the tender documents, will win)
- It is not recommended to set a fixed ceiling for the collector's margin because according to the revenue potential of the market, the feasible margin will vary between districts and may be higher for rural districts with less commercial activity; a premium is not required either, if the potential study is updated on a regular basis
- Adopt a systematic monitoring system of the markets assuring proper performance of the enterprise and test privatization on a pilot basis

## Regulatory Framework for Municipal Borrowing (Examples)

Country	Regulation of Borrowers
South Africa	<p><b>The Local Government Transition Act, No. 209 of 1993:</b></p> <ul style="list-style-type: none"> <li>• Municipal budget submitted to MOF: particular attention paid to maximum expenditure limits;</li> <li>• Provincial Executive Committee can demand full disclosure to itself or certain other bodies within a certain time period</li> </ul> <p><b>Project Viability</b> approved on 19 September 1996:</p> <ul style="list-style-type: none"> <li>• Ongoing monitoring of municipalities</li> <li>• Management audits of municipalities in financial difficulty</li> <li>• Introduction of a management support program if a municipality is unable to respond to instructions issued by provincial MEC</li> <li>• Capacity building and training of councilors and officials</li> <li>• Introduction of a reporting framework on key financial indicators</li> </ul> <p><b>1995 Framework Document (FFC)</b></p>
Brazil	<p><b>Law 9696 law of 1997:</b></p> <ul style="list-style-type: none"> <li>• Targets for declines in debt and deficit ratios</li> <li>• Ceilings for personnel spending and investment</li> <li>• Growth in own revenues</li> <li>• Privatization of state enterprises</li> <li>• Stricter ex post consequences: <ul style="list-style-type: none"> <li>○ No fed. government guarantees for state debt</li> <li>○ Interest rate penalties on existing state debt held by federal government</li> <li>○ Increases in debt service ceilings</li> <li>○ Deduction of all debt service directly out of the revenue-sharing participations from the federal government</li> </ul> </li> </ul> <p><b>FRL (May 2000)</b> covering state and federal levels:</p> <ul style="list-style-type: none"> <li>• Systematizes and reinforces restrictions in previous measures</li> <li>• Min. standards for state budgeting, personnel management, and debt management.</li> <li>• Annual budget of each SNG must be consistent with its multiyear budget plan and with federal fiscal and monetary program; SNG prohibited from contracting new debt if in default on old debt.</li> <li>• Prohibits officials from contracting debt within the last 6 months of their terms</li> <li>• SNG loan applications must go first through MOF to prove compliance with law</li> </ul> <p><b>Central Bank Resolution 2461</b></p> <ul style="list-style-type: none"> <li>• Limits debt between the financial system and public entities</li> </ul>
Columbia	<p><b>Traffic Light Law (Law 358-1997):</b></p> <ul style="list-style-type: none"> <li>• Introduction of a rating system for territorial governments: <ul style="list-style-type: none"> <li>○ “Red”-highly indebted SNGs (debt interest to operational savings ratio &gt;60% or debt to revenue ratio &gt;80%) ; prohibited from borrowing and 2-yr adjustment plan required</li> <li>○ “Yellow”-intermediate cases (ratio between 40 and 60%); require MOF permission for borrowing; fiscal adjustment plan required</li> </ul> </li> </ul> <p><b>Law 617 (2000)</b> covering state and municipalities:</p> <ul style="list-style-type: none"> <li>• Primary current expenditure may not exceed non earmarked current revenues and should not exceed a fixed percentage depending on SNG category</li> <li>• Requires across the board cuts whenever effective non earmarked current revenues are lower than budgeted</li> <li>• Limits on state legislature expenditures</li> <li>• SNG cannot make transfers to their public entities</li> <li>• Strict limits to municipality creation; non-viable municipalities must merge</li> <li>• If non compliant, SNG must adopt fiscal-rescue program to regain viability within next 2 years</li> </ul>

	<ul style="list-style-type: none"> <li>• Extensive list of characteristics and requirements for the election of governors, majors, legislators, and their relatives</li> </ul> <p><b>FRL (June 2003)</b> covering national and state levels:</p> <ul style="list-style-type: none"> <li>• Sets out a process for setting budget targets and linking them to target ranges for debts and deficits.</li> <li>• Publishing quarterly fiscal results; defining deficits on the basis of cash revenue and accrual of spending obligations; defining debt to include floating debt</li> <li>• National government cannot lend to an SNG or guarantee its debt if it is in violation of Law 617 or 357 or in default to any creditor</li> <li>• Prohibits any government from committing future spending or increasing personnel spending in an election year</li> </ul>
<b>Peru</b>	<p><b>Law of Fiscal Prudence and Transparency (1999)</b> national level:</p> <ul style="list-style-type: none"> <li>• Annual fiscal deficit of the non-financial public sector would not exceed the limit of MMM and not exceed 1% of GDP</li> </ul> <p><b>Amendments to LFPT (2003):</b> National level:</p> <ul style="list-style-type: none"> <li>• Prohibits any admin. or legal norm that interferes with the correct execution of the MMM</li> <li>• In election years, the government can spend up to 60% of the annual spending allocation in the first 7 months and may only use 40% of the annual limit on the deficit in the first semester</li> <li>• Quarterly monitoring of fiscal performance; adequate remedies to revenues/expenditure must start in next quarter</li> <li>• Specifies a transition to return to the regular rules on fiscal deficit limits, if they are relaxed</li> </ul> <p><u>SNG levels:</u></p> <ul style="list-style-type: none"> <li>• Each regional government must prepare an annual development plan consistent with the national MMM</li> <li>• All SNGs must keep a non-negative primary balance on avg. in the last 3 years in office</li> <li>• Overall public sector deficit limit applies to all SNGs</li> <li>• SNGs can only borrow internationally with the guarantee of the national government; a guarantee requires compliance with the Annual Debt Law and demonstration of capacity to pay</li> <li>• National government can withhold some transfers to make required payments of debt</li> </ul>
<b>Argentina</b>	<p><b>Fiscal Solvency Law (1999)</b> national level:</p> <ul style="list-style-type: none"> <li>• Numeric limits for fiscal deficits</li> <li>• Limited growth on expenditure</li> <li>• Adoption of pluri-annual budgeting</li> <li>• Created a Countercyclical Fiscal Fund</li> <li>• Various favored transparency measures in public finances</li> <li>• No enforcement measures</li> </ul> <p><b>Provincial FRLs</b> (voluntary adoption; no buy-in from largest provinces):</p> <ul style="list-style-type: none"> <li>• Limits on deficits and/or debt</li> <li>• No enforcement measures</li> </ul>
<b>Mexico</b>	<p><b>Secretariat of Finance</b></p> <ul style="list-style-type: none"> <li>• designed a fiscal adjustment program to which all SNGs must agree</li> </ul> <p><b>Non-FRL debt control (2000):</b></p> <ul style="list-style-type: none"> <li>• Requires that capital risk weighting reflect riskiness, based on international credit ratings</li> <li>• Strong incentives for borrowers to disclose fiscal and financial information</li> <li>• Eliminated executive discretionary transfers from the federal government</li> <li>• Ended SHCP's role as <i>fideicomiso</i> for collateralizing debt (to reduce likelihood of bailouts)</li> </ul>
	<b>Regulation of Lenders</b>
<b>Brazil</b>	<p><b>National Monetary Council Policy</b> (through Central Bank):</p> <ul style="list-style-type: none"> <li>• Limits each bank's total lending to the public sector</li> </ul>

	<ul style="list-style-type: none"> <li>Prohibit lending to any SNG that is in violation of the debt and deficit ceilings of the SRs or in default to the fed. government or any other bank</li> <li>Penalties for any bank in violation of the rules</li> </ul> <p><b>Rescheduling agreements:</b></p> <ul style="list-style-type: none"> <li>Privatizations required in agreements include the state owned banks</li> </ul> <p><b>FRL (May 2000):</b></p> <ul style="list-style-type: none"> <li>Debt and labor contracts in violation of this law are not legally valid; therefore, the SNG is not obligated to repay the loan.</li> <li>Loans made above threshold ceilings is required to be repaid in full, not including interest</li> </ul> <p><b>Senate Resolution 78</b></p> <ul style="list-style-type: none"> <li>Moratorium on bond issuance until 2010</li> <li>Strict and clear limits of local debt issuance</li> </ul>
<b>Colombia</b>	<p><b>Superintendency of Banks:</b></p> <ul style="list-style-type: none"> <li>Required that any SNG loan with over a year maturity to be classified as risky and to have some provisioning</li> </ul> <p><b>Traffic Light Law (1999):</b></p> <ul style="list-style-type: none"> <li>Requires banks to provision fully for the debt of any territory with a red rating, increasing the cost of those loans for banks</li> </ul>

## Debt Limits on Sub-National Governments

Country	Indicators for Debt Limits
<b>Hungary</b>	Municipal debt services must not exceed 70% of own-source revenues in any given year
<b>Czech Republic, Lithuania, Poland</b>	Municipal debt services must not exceed 15% of own revenues in any given year
<b>Bulgaria</b>	Limits debt service to 100% of own-source revenues
<b>Brazil</b>	Limits total debt service to the state operating surplus during the past year or 15% of its revenues, whichever is less
<b>Honduras</b>	No more than 20% of the municipality's annual revenue can be used for the service of debts for projects "where investment is non-recoverable"
<b>Lithuania</b>	Limits <i>debt stock</i> to 30% of own revenues
<b>USA</b>	Uses per capita debt limits or limits on debt as a percentage of local property values
<b>Argentina</b>	The Convertibility Plan (1991) prevented provinces from rolling over existing borrowings from local banks; also, provinces' access to provincial banks was limited; debt service limited to less than 20-25% revenues
<b>Columbia</b>	Law 358 (1997) established debt control procedures based on the ratio of interest payments to operational savings (debt service limit is 30% of recurring revenue as long as debt service is also less than 40 percent of operating surplus)
<b>Mexico</b>	Some states limit debt service of municipalities to 35% of revenues
<b>Ecuador</b>	Debt service less than 20% of revenues
<b>Costa Rica</b>	Debt service less than 40% current revenues; debt/current revenues less than 80%

## **Technical recommendations for the design of Performance-based Grants**

The following conditions should have to be reviewed prior to the launch of any new PG system (see Steffenson 2005):

- Weaknesses in the existing LG system and areas to be addressed by the PG system.
- Possibilities to strengthen the LG accountability and incentives;
- Possibilities for LGs to respond to the requirements in the performance assessment system;
- Possibilities to carry out the actual assessment and the related costs; and

The definition of the universe concerns the issues on the number of LGs to be covered by the PG grant schemes and the kinds (categories) of LGs eligible for the grants. These issues will in turn be determined by:

- i) the available resources from the existing grant schemes and own source LG revenues and the prospects over time to attract additional funds from donors and other existing sources;
- ii) the investment needs of the various types of LGs; and
- iii) a classification of the LGs in terms of level of poverty and the possibilities for LGs to attract funding from alternative sources.

It may be considered to target the funds towards certain types of LGs and only the poorer areas. However, whatever method is used to identify these areas, it should not discourage the LGs from improving their situation, or provide disincentives to focus own source revenue mobilisation efforts.

### ***The size of the grants***

The considerations on the size of the grants differ for capital and recurrent grant schemes. Particularly for capital grants schemes, the overall per capita size of the will depend on a number of factors of which some of the important ones are the:

- i) size of the available funds from the existing grants to be enrolled in the new transfer scheme (similar to the considerations on the size of the universe under section one);
- ii) prospects for additional funding from donor sources;
- iii) standard costs of typical LG small scale infrastructure and service delivery investments (the minimum size required for meaningful investments);
- iv) general absorption capacity of the LGs;
- v) long-term sustainability of such a grant scheme; and
- vi) minimum required size of the grant to provide sufficient incentives for LGs to improve performance.

The latter will also depend on the relative size of other types of funding sources available for the LGs. The size of the capital grants is easier to adjust, whereas the recurrent costs are typically more fixed to the existing obligations and division of mandatory functions (e.g. teacher salaries and maintenance of the existing stock of infrastructure). However, it is important to stress that there is a relationship between the two types of grants, which should be carefully considered, especially as investment have implications on the recurrent costs on maintenance and operations.

Contribution from LGs It should be considered to require a contribution from the LGs to the capital/development investments in order to: i) promote a stronger sense of ownership; ii) strengthen the local priorities; iii) promote own source revenue generation; iv) improve the focus on investments vis-à-vis other types of expenses (e.g. administrative costs); and v) to provide better longer-term sustainability. The size and the type of co-funding will have to be decided in the light of the available LG resources.

### **The horizontal allocation of grants**

Allocation of the capital/development grant The distribution of grants across the LGs should be consistent with the overall purpose of the grant. Ideally, it should depend on basic factors like expenditure needs and fiscal capacity, adjusted by the results on the performance-based indicators (up and downwards). Examples of these basic criteria may be: the number of inhabitants in each LG, number of people living below the poverty line, other indicators of poverty (like illiteracy rates, child mortality etc.), the size of the LG territory, and other costs factors and the LG revenue mobilisation capacity, e.g. the LG tax base or other proxies for LG revenue raising potential.

Considerations of the possibilities for the LGs to utilise the funds properly (maximum absorption capacity) may also play a role in the final decision. However, due to limited data on these issues, a pragmatic and simple approach is generally recommended. A clear, simple and 'fair' basic allocation formula will have to be defined. Formula-based allocations, supported by principles of strong transparency, predictability, stability and objectivity, have shown their benefits in many other countries. However, the exact formula will have to be based on the overall objectives of the new grant scheme and the country specific context. The figures in the basic formula will then in turn be adjusted at the margin (rewards or sanctions) against the LG performance to provide strong institutional incentives. The size of this adjustment should be sufficiently significant to constitute a real LG incentive.

### **The performance indicators and assessment procedures**

The assessment process comprises a number of important design issues.

Indicators for performance -the capital/development grant A performance based grant allocation system will have to be based on certain benchmarks/indicators for performance. Below is listed some of the key decisions to be made as well as a brief discussion of each of these.

- Generic versus sector specific performance measures;
- Minimum conditions versus performance measures;
- Quantitative versus qualitative indicators ;

- Legal requirement (mandatory legal compliance) versus other objectives like good governance;
- Scoring: Equal weighting of all indicators versus specific evaluation of critical areas with greater importance;
- Scoring: Absolute improvements versus relative improvement in performance.

PMs are typically more qualitative indicators for the LGs performance. These allow a more gradual measurement/"scoring" of the LGs performance and adjustment of the grants against this performance. The main objective of the PMs is to ensure strong incentives for the LGs for continuous performance improvements. Most systems operate with approximately **30-60 indicators** reflecting key areas of generic performance.

1) Percentage of revenue collected (in the previous finance year) against the planned; 2) Increase in collected revenues (last finance year compared to the year prior to this) 3) Share of development budget applied on national priority areas (e.g. water, health, education etc.) 4) Development plans capture operational and recurrent costs implications of investments; 5) Posting of annual budgets, accounts and audit reports on public notice boards and LG offices; 6) Procurement thresholds for goods and services through out the previous finance year were observed (according to regulations).

Related to these issues is the question of the relative **weighting of the various performance measures** – are some areas of more critical importance than others and should they lead to a higher scoring? Identification of the specific indicators to be measured to reflect the most critical aspects of the LGs performance and the specific scoring attached to these are key design issues.

Finally, a decision needs to be taken as to the extent to which the system should review the performance of a LG against pre-determined **benchmarks**, compared with other LGs, or against its own performance over the time, rewarding **relative improvements**. The latter requires a much more detailed and sophisticated evaluation framework and raises relevant fairness and equity concerns.

The manner in which these indicators are shaped, the way the scoring is structured, etc. have an important bearing on the acceptance and credibility of the entire system when applied at the local level. The main guiding principle for the final selection should be the practicality and simplicity of the various options. In any case it is important that the indicators are clear, transparent, non-repetitive, and exhaust the key performance areas consistent with the overall objectives of each transfer scheme.

Issues pertaining to the **quality control/audit** of the assessments, possibilities for LG appeal and 'grace periods' (should LG be allowed to have some extra time to comply with the MCs in case they only miss one or two of the conditions?) need to be resolved, and cannot be handled informally. The institution/body to be in overall charge of the final endorsement of the results from the assessment and of the management of the new grants will have to be defined - is it going to be managed by a specific Department or by a specific dedicated Committee and who should be represented in this? A clear division of tasks and responsibilities from the on-set of the process is very important.

There is a critical link between the complexity of the performance assessment system, especially the type and number of indicators, the existing capacity available to perform

the tasks and the ***costs of the assessment system***. More sophisticated systems with numerous qualitative indicators divided into many performance areas will require more capacity and will impact on the overall costs of the assessment. There needs to be a reasonable relationship between the size of the grants, the expected benefits in terms of improved LG performance and the systems and procedures put in place to manage the assessment system.

Finally the links to other on-going M&E systems should be explored to review options for synergies and cost savings. In some respects the indicators, which are examined by a performance based grant allocation system, may co-exist with the indicators and benchmarks from other M&E systems and may be of benefit for these systems. The same is the case for systems elaborated to evaluate the creditworthiness of the LGs.