

Commonwealth Secretariat



Commonwealth
Finance Ministers Meeting

Georgetown, Guyana, 15-17 October 2007

FMM(07)(INF)2

FOR INFORMATION OF DELEGATES

**Financing Decentralisation and
Local Government to Meet the MDGs**

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Commonwealth Secretariat
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August 2007

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ABBREVIATIONS

CG	Central Government
CLGF	Commonwealth Local Government Forum
CHOGM	Commonwealth Heads of Government Meeting
EC	European Commission
GBS	General Budget Support
JNNURM	Jawaharalal Nehru National Urban Renewal Mission
LG	Local Government
MDG	Millennium Development Goals
MoLG	Ministry of Local Government
MoF	Ministry of Finance
OECD	Organisation for Economic Co-operation and Development
PBS	Provision of Basic Services
PFM	Public Financial Management
PRSP	Poverty Reduction Strategy Paper
SWAp	Sector Wide Approaches
UNCDF	United Nations Capital Development Fund
UNCHS	United Nations Centre for Human Settlements
UNFPA	United Nations Population Fund
UN-HABITAT	United Nations Centre for Human Settlements

A Paper for Commonwealth Finance Ministers

Commonwealth Finance Ministers are invited to consider the attached paper which has been prepared by ComHabitat as part of their work to support the implementation of the Habitat agenda in the Commonwealth¹.

Ministers are invited to:

- Endorse its conclusions
- Support the ComHabitat initiative in developing effective ways and means for financing decentralisation and local government to enable effective and accountable delivery of the services required to meet the Millennium Development Goals.

EXECUTIVE SUMMARY

This note is concerned with local government and new financing arrangements. The aid environment is rapidly changing. Three important trends can be identified:

- A emphasis on poverty reduction with the Millennium Development Goals;
- A shift in aid disbursement practices and instruments following the 2005 OECD Paris Declaration on Aid Effectiveness; and
- A general increase in policy support to local government and decentralisation as highlighted by the Aberdeen Agenda which was accepted by the Commonwealth Heads of Government in 2005.

2. Local government is critical in meeting the MDGs in particular in terms of primary health and education, water and sanitation, slum upgrading, public health and local economic development. In addition local government (LG) functions of the police and fire service, solid waste management, land use planning and the provision of roads play a very important supporting role in meeting the MDGs. LG also has an important role in working with central line ministries in other aspects of service delivery. LG is thus a critical partner of central government in successfully meeting the MDGs. Furthermore donor partners are increasingly eager to involve local government. Finally local government is also an important player in the introduction of both a) energy efficiency strategies (insulation and building by laws) and b) mitigation approaches to global climate change.

3. In order to fulfil these functions it is critical that local government be appropriately funded within the domestic funding framework. Unfortunately this is not always the case. However there are new opportunities - namely Sector Wide Approaches and General Budget Support (SWAps & GBS) - that the new disbursement mechanisms of aid are offering to

¹ The Commonwealth's principle mechanism for addressing human settlements concerns is a multi-stakeholder partnership known as ComHabitat. This consists of a Ministerial Group – the Commonwealth Consultative Group on Human Settlements (CCGHS) – and a collaborative partnership of agencies from government, local government and civil society. ComHabitat promotes implementation of the Habitat Agenda and is working towards the Commonwealth Goal of: “*Demonstrated progress towards adequate shelter for all with secure tenure and access to essential services in every community by 2015*”.

support. It is important that these new mechanisms strengthen local government and do not undermine it, and recent innovations have shown that this is possible. The key issue in achieving this is making local government visible and a key stakeholder in central policy making.

4. This paper argues that local government must be “hardwired” into the overall governmental system, and not be considered just as an adjunct to central government. To achieve this, the following action needs to be taken:

- Agree a local government component of the PRSP and PRSC process;
- Include local government in general Public Sector Reform Programmes and Processes;
- Integrate local government into overall Public Finance Management (PFM) discussions;
- Work towards making national statistics and financial accounting procedures compatible with local government systems;
- Ensure that all policies, as far as possible, spell out which spheres of government (CG and LG) are concerned with implementation. This is particularly important with Sector Plans Sector policies;
- Include local government in all SWAp and Sector Discussions which have a local service delivery component;
- Involve local government in the design of Performance Assessment Frameworks for the monitoring of SWAps and GBS programmes; and
- Consider the establishment of a separate budget head for MD7 (Slum Upgrading).

INTRODUCTION

The aim of this paper is to provide a short briefing note on issue of financing of local government in the developing countries of the Commonwealth, particularly in the context of human settlement development and strategies for achieving the MDGs. It is particularly concerned with this issue in the context of a changing aid environment (see below). The paper has three sections:

- an overview of the changing environment;
- a discussion of different financing options and modalities; and
- a brief discussion of future policy directions.

SECTION ONE: BACKGROUND AND CONTEXT

The changing environment

2. The aid environment has changed substantially since the mid 1990s. The following three factors may be considered.

3. In the late 1990s all the countries of the UN and the major donors signed up to the Millennium Development Goals (MDGs) as an approach and commitment to addressing global poverty. From a UN-Habitat perspective the most important MDG was Goal 7: to ensure environmental sustainability with specific targets to reduce by half the proportion of people without sustainable access to safe drinking water; and to achieve a significant improvement in the lives of at least 100 million slum dwellers by 2020.

4. Secondly, the OECD 2005 Paris Declaration on Aid Effectiveness committed all the relevant donors to disbursing their aid according to twelve broad principles emphasising the importance of ownership, alignment and harmonization. The most important of these were the statements that donors would seek to harmonize their assistance; seek to work with existing country systems and to shift their aid to a Programme Based approach.² This represented a shift in aid disbursement from a traditional project approach to Sector Wide Approaches (SWAs) and to General Budget Support (GBS). A main aim of this paper is to understand the implications of, and opportunities for, the financing of local government that arise from this shift.

5. The third change has been a commitment to a process of decentralisation, and to local government and governance. This was underscored by the 2005 Commonwealth Heads of Government commitment to the *Aberdeen Agenda: Commonwealth Principles on Good Practice for Local Democracy and Good Governance*. All countries of the Commonwealth have committed themselves to these three statements – the MDGs, the OECD Declaration and the Aberdeen Agenda - and they provide the broad framework for the rest of this paper.

² This was defined as having the following features (a) leadership by the host country or organisation; (b) a single comprehensive programme and budget framework; (c) a formalised process for donor co-operation and harmonisation of donor procedures for reporting, budgeting, financial management and reporting; (d) Efforts to increase the use of local systems for programme design and implementation, financial management, monitoring and evaluation.

The World is rapidly urbanizing and urban poverty is the coming issue

6. In 2007 humanity passed an invisible but important milestone: for the first time ever, more than half the world's population (3.3 billion) will live in urban areas. For the first time it is primarily an urban animal. By 2030 it is estimated that this figure will grow to 5 billion. The urban populations of Africa and Asia are expected to double by 2030. This population growth will primarily be of poor people (UNFPA, 2007). Urban Poor, defined as those who live in slums, are already a huge problem. In total 924 million people live in slums: Sub Saharan Africa has the highest proportion of its population living in slums in 2001 (72 per cent) while South Central Asia has figures of 58 per cent, Latin America and the Caribbean 32 per cent respectively. In absolute terms Asia with 554 million slum dwellers dominates but Africa with 187 million and Latin American and the Caribbean with 128 million are all well represented (UNCHS, 2003). There is no question that urbanization is inevitable. To some commentators this is a major problem (Davis, 2006).

7. Despite these figures it important to understand that historically the process of urbanization is a positive force and has been well correlated with increases in living standards and GDP per capita. While cities concentrate poverty they also represent one of the best hopes of escaping it. The challenge is to exploit the opportunities that urbanization affords (UNFPA, 2007).

The importance of local government in meeting the MDGs

8. In tackling the issue of urban poverty, local governments are the main agencies in terms of squatter upgrading and the provision of public health. In addition in the majority of local government systems primary health and education are LG functions, i.e. local government is responsible for planning and siting of clinics and schools, if not paying the teachers and medics. In most government systems water supply is also a LG function. This is not only a political reality but is also supported by economic theory as being the appropriate level for these functions (Shah and Shah, 2006: 10)

9. Crook and Sverrisson (2001), based on work in West Bengal in India, and the 2004 OECD report note that political decentralisation can potentially lead to pro-poor outcomes in the following four sectors:

- Pro-poor economic growth: changes in the level of economic activity;
- Pro-poor service delivery: better access to health, education, sanitation, water facilities etc. for the poorest sections of LGs inhabitants;
- Social equality: pro-poor redistribution of income within local governments; and
- Regional equality: redistribution of resources of growth between deprived and economically wealthy areas.

10. Recent research has clearly shown the importance of local accountability in the successful delivery of public services, and that it is much easier to make these systems work at the local level (World Bank, 2004).

11. Finally LG has potentially negative levers (police and "public order" agencies) for "bad governance". The evidence shows that these can be very effective in terms of destroying jobs, mainly in the informal sector. This is an important insight as in many circumstances it is much easier to destroy jobs than to create them (Amis, 2002). Thus it is important to ensure

that local government has the capacity to govern effectively. It may not on its own generate development, but where it is weak and unable to govern effectively, there is a strong chance that poor governance will inhibit growth. Removing it altogether is not an option that should be considered.

12. The chart in Annex 1 illustrates linkages and relationships between the MDGs and local government functions. While LG is involved in providing direct provision to most MDGs it is also worth noting the extent to which it has an indirect supporting role and/or some relationship with most MDGs. The provision of basic infrastructure including roads, police and fire service, solid waste management and land use planning are all very important in such capacities. MDG 8 on global partnerships for development is the only MDG that LG is not seriously engaged with, but it can clearly be much more involved as programmes such as CLGF's Local Government Good Practice Scheme, funded by the UK, Australia and New Zealand, and the Federation of Canadian Municipalities' "Partnerships Programme" has demonstrated impressively.

The implementation of energy efficiency and mitigation approaches to climate change is usually a LG responsibility

13. One of the most promising approaches to climate change is to improve the efficiency of energy use, particularly in relation to buildings (IPCC, 2007: 19). The enforcement and implementation of such building regulations and introduction of insulation to increase energy efficiency is a LG responsibility in most countries. Clearly given the current concerns with climate change this is both important and an easy win. It has the advantage that such an approach is a win-win in that it reduces expenditure and is thus self-financing. In addition the evidence suggests that environmental regulation requires administrative capacity at the local level.

14. Local government also has a very important function in providing and supporting adaptation and mitigation strategies for climate change. This is important as one of the consistent predictions for climate change is of an increase in extreme weather events. The provision of water facilities and storm drainage are LG responsibilities.

In most countries local government is under resourced to fulfil its mandates; furthermore it is becoming less dependent upon its own revenue sources

15. The evidence from a range of countries is that in most cases LG simply does not have the resources to either fulfil their mandates and/or to seriously tackle the MDGs³ although it is central government that has committed local government to delivering them (Kiyaga-Nsunbuga, 2006). This was also a very important argument in CLGF's submission to the Commission for Africa. Furthermore it has also been noted that there is a long running tendency for local government to become less dependent upon own revenue sources thus:

“Most countries experienced a decline in LG revenue sources as a share of LG funding of services (i.e. increased dependency and risk of decline in the sustainability of investments and LG autonomy). This is a trend that has proven difficult to reverse through existing support mechanisms” (OECD, 2004: 34).

³ This point was forcefully made by Professor Jeffrey Sachs at the recent CLGF conference in Auckland March 2007

16. This trend has often been noted in Commonwealth countries; for example the experience of urban bodies in India – despite the 74th Amendment to the Constitution of India - are still unable to fulfil their mandates. (Om Prakash Mathur, 2006: 201). On average the under funding in relation to the Zakaria Committee⁴ norms is 130 percent.

17. Finally it is worth discussing the crude politics around national governments and taxation policy. Despite economists' arguments about the appropriate levels for the incidence of different tax in almost all systems, with the exception of Scandinavia and Switzerland, CG holds onto the best taxes. The result in many cases is that LG must depend upon CG transfers; thus in most cases the emphasis has shifted from LG's own revenue sources to the robustness and efficiency of intergovernmental transfers.

LG is often invisible to CG policy makers

18. In many circumstances one of LG's most persistent problems is that it is often simply invisible to many CG policy makers and is not considered an appropriate stakeholder in general policy and governmental reform discussions. There is no clear reason nor is there a "conspiracy theory" in this but the following seem relevant:

- Economics – which tends to dominate policy making especially at the MoF- is fundamentally an aspatial discipline;
- this is reinforced as central policy making and donor interactions are often very capital city focused. Furthermore there are some elements of the new Aid Architecture (especially the emphasis on GBS) that are basically centralising and seek to strengthen the role of MoF as the key agency in resource management and allocation;
- in many countries the MoLG is often a relatively weak ministry in terms of personnel and capacity; and
- in many countries LG finance figures and data are very poorly integrated into national accounts.

19. For all these reasons there is a tendency for CG policy makers to simply ignore the role of LG and their concerns. This is potentially being exacerbated as many new interventions seek to strengthen a "vertical" logic while LG and decentralisation aims to promote a more "horizontal" logic.

20. Nevertheless it is worth noting that LG not being recognised might reflect the relatively recent moves towards support for LG and decentralisation in many countries; as such it could be interpreted as a transitional problem until LG systems are more fully embedded. A central aim of this note is to facilitate and encourage such a process.

Some myths on why LG should not be supported

21. There are many reasons often given by policy makers to resist demands to support LG and channel more funds through a LG system. Firstly it is often argued – often with some justification- that LG is weak in terms of capacity. While this may be true, it seems a particularly pessimistic approach to development. *Surely* the response to weak capacity is to

⁴ The Zakaria expenditure norms for municipal services were established in 1963. They have lost their relevance but are still used as a reference point to illustrate the weakness of LG in India.

strengthen it rather than to seek to by pass or ignore it. Furthermore there is good evidence that channelling funds through a system is a very good way of strengthening the system – especially in terms of PFM. This was precisely one of the benefits of GBS that was identified in the recent GBS Evaluation (IDD, 2006).

22. Secondly it is often claimed that decentralisation programmes are likely to lead to “elite capture”.⁵ There is no evidence that such capture is more likely at the LG rather than CG level. Indeed it is possible to argue the reverse in that LG politicians are often closer to the people. Finally there is a paradox in that in urban governance discussions “growth coalitions” are seen as positive in encouraging economic growth. (Amis and Grant, 2001). It is not clear what distinguishes the behaviour of “elite capture” in rural areas and “growth coalitions” in urban areas.

23. The third claim is that “LG is more corrupt than CG”. Firstly there is no empirical evidence that supports this view; in addition given that more funds are present at the CG level it is possible to argue the reverse. In addition in most countries LG often faces a far more robust and investigative media than CG. Indeed in many countries the majority of the populace often sees criticising LG as fair game! There is an issue here about respect for LG and how in many countries LG is presented in the media and in literature in general.⁶

24. The final argument for not supporting LG is along the lines of “now is not the time or we have more important policy agendas at the moment”. There is clearly some validity in this in for example in the rehabilitation of “fragile states”; where solving problems at the CG level may indeed demand more attention. This might represent the situation of Rwanda following its genocide in 1994; however it is argued in other situations such as Sierra Leone that it makes more sense to start with LG and build from the bottom up first. The conclusion is when to support LG needs to be ascertained on a case-by-case basis.

SECTION TWO: THE NEW AID ARCHITECTURE AND FUNDING ARRANGEMENTS

The new Aid Architecture

25. In order to structure the argument that follows this section will provide a brief overview of the new Aid Architecture. Firstly as noted earlier there is a systematic move away from the project form as a mechanism for disbursing aid to an approach based on SWAps and GBS. This approach is usually focused on the development of a Poverty Reduction Strategy Paper (PRSP) which should describe broad policy agendas and allow a guideline to assist donors in aligning and harmonising their funding arrangements.

26. General Budget Support is a system of providing funds unearmarked directly to a recipient government’s account. It is seen as a more mature relationship between the donor and recipient. In theory the recipient has greater flexibility and predictability on how it uses the funds within a broad agreed framework.

⁵ Elite capture is the argument that local elites will gain effective control in their own interests rather than pursue pro poor policies

⁶ With the exception of the Mayor of Casterbridge it is difficult to think of a LG hero in English (UK) literature; they are more often portrayed in more negative/corrupt terms.

27. These frameworks (often called Performance Assessment Frameworks or matrixes) are used for monitoring the relationship and classically contain a range of indicators concerning policy and fiduciary risk. Recent research has suggested that GBS is an more efficient way of disbursing aid (IDD, 2006).

28. Sector Wide Approaches provide funds to specific sectors, whose policies and an agreed framework and a mechanism to facilitate donor harmonization usually support this. While it is not possible to directly track funds through the system SWAs are usually monitored through agreements related to the sector. (We shall discuss the European Commission's (EC) approach to Sector Planning in a later section.). SWAs are popular with the some donors as they provide greater targeting of funds and are useful in persuading domestic (Northern) constituencies that aid funds are being well utilised. An important feature of the new aid architecture is the MDGs and the commitment to poverty reduction as an outcome and primary policy objective.⁷

29. Finally it is worth underlining some of the main principles of the OECD 2005 Paris Declaration that seem particularly pertinent to LG:

- Use Government systems already in place
- Funds should be on budget⁸
- Harmonisation between donors
- Alignment with country systems, procedures and policies.

New systems for funding LG: SWAs and GBS

30. There are various ways that these new funding arrangements can interact with LG systems. Firstly there is still a role for traditional projects, particularly for capital intensive and time bound interventions; the relevance of this was noted in the recent GBS evaluation (IDD, 2006). This is worth stating as sometimes the impression is given that there is no role for projects in the new aid architecture. At the other end of the scale GBS funds can go through to LG as part of an overall CG transfer of resources. The third modality is via a sector approach. In this case it is important to make a distinction between two LG sector or SWA approaches. Firstly there is a potential sector approach which supports capacity building, policy reform and systemic issues with LG. Secondly there is a sector approach which is primarily concerned with channelling funds to the LG sector.

Developing LG SWAs has proved very problematic

31. The following reasons seem to explain why it difficult to design such programmes for the local government/decentralisation sector:

- LG is a more complex sector than for example Health and Education which are the sectors where SWAs have historically been developed

⁷ While poverty is still agreed as the main objective the means to achieve this is somewhat more contested than it was in the early 2000s. The dominant service delivery paradigm focussing on a market led approach with an emphasis on investment in primary education and health has to some extent been challenged by approaches, which are more clearly focused on economic growth. The theme of the forthcoming CHOGM in Kampala around "transformation" to some extent mirrors this debate.

⁸ This is in contrast to the common donor practice often but not exclusively associated with projects of donors setting up separate systems and not going through the host nations budgetary and public finance systems.

- The number and diversity of stakeholders
- Potential confusion as to who are the key stakeholders: Ministry of Finance, the Ministry of Local Government or the local government bodies themselves
Donors unable to agree about their appropriate approach to decentralisation⁹
- Tension with the Ministry of Finance: Who ultimately should control the funds and how they are allocated to other spheres of government?
- Weak financial and management capacity both at the Ministry of Local Government and with local government bodies themselves. In most countries the MoLG is often one of the weaker line ministries.
- Confusions with other line Ministries namely Health and Education who may already have programmes at a devolved level
- A tendency for Public Sector Reform programmes to not include local government in their overall programmes
- Public Finance Management (PFM) programmes which ignore LG finance
- Problems of compatibility between systems of LG financial accounting and CG national accounts.

32. As an endnote to this discussion from a Commonwealth perspective it worth noting that the majority of LG interventions are not led by Commonwealth countries. Broadly speaking, at least within Sub Saharan Africa, Northern European donors (Scandinavia, Germany and Netherlands) are the most active in this sector; Commonwealth donors are involved but are usually only one amongst many donors.

The Uganda Experience: successful decentralisation getting earmarked funds but significant concerns exist about upward accountability and local revenue collection

33. As part of the overall evaluation of Budget Support a special study was commissioned on the relationship between GBS and decentralisation in Uganda (see Jesper Steffensen in Lister et al, Annex 6, 2006). The following are the main conclusions:

- GBS strongly facilitated an increase in funding to local government and related service delivery functions which would not have happened with other aid modalities. The combination of GBS –with the Poverty Action Fund (PAF) ring fencing of funds, some SWAps and inter-governmental fiscal transfers - all provided both sector ministries and donors sufficient confidence to channel funds to local government service delivery. It should be noted that these funds have been tightly earmarked.
- This was supported by capacity building, harmonisation and alignment with Ugandan Government procedures and processes
- There have also been problems with local government autonomy and local flexibility, but most importantly concerns with sustainability and local revenue collection. The Government of Uganda has recently abolished graduated tax as a

⁹ It is tempting to suggest that the donor community has a tendency to seek to replicate their own country's system of local government more than other sectors. Thus there are more competing "models" and examples of "best practice" in this sector than in others. Or that the differences are at a more fundamental level and thus harder to get agreement that in other sectors say education and health. This observation is partly based on discussions with Danida, DFID, GTZ and USAID representatives often while doing consultancy missions.

source of revenue for LG in Uganda. (Graduated tax was the main source of own revenue for LG in Uganda).

- There was also a tendency to increase upward accountability with conditionalities associated with SWAp and PAF funds. It is pertinent to note that these conditionalities are due to a large extent to the fact that these funds were debt relief. These conditionalities were to a great extent necessitated to reassure Northern taxpayers that these “write offs” were being used for poverty objectives.
- There is considerable concern with some of these issues with the ongoing development of Uganda’s new Fiscal Decentralisation Strategy which seeks to address some of the problems with excessive earmarking and schemed to improve LG revenue generation (Steffenson, 2006).

34. The central question that needs to be posed is do these new mechanisms of aid disbursement strengthen or weaken local systems of government? Or to put it another way is decentralisation compatible with the new aid modalities, increased funding flows and related commitment to meeting the MDGs?

35. One interpretation suggests that by increasing funding from the centre that upward accountability to line ministries greatly increases with a resultant “hollowing out” of the local government system. This was apparent in Uganda in the early 2000s where it made more sense for local government officials to spend time working and accessing funds from their respective line ministries than either a) collecting local taxation and/or b) working to coordinate activities within the local government system. These processes seem particularly likely in new aid disbursement systems, which have a strong sector approach.

36. That the SWAp approach may be harmful to processes of decentralisation is a relatively familiar argument and concern amongst reflective practitioners in the field. This observation is one of the main reasons that led to some recent initiatives by the Joint Africa Institute (JAI, 2006). Nevertheless as noted there are measures, which are being put in place, which are trying to address these issues. In conclusion, while not underestimating the current position, the Uganda story does illustrate how the new aid mechanisms can support and direct funds to LG and thus begin to address the MDGs (Lister et al, 2006).

Ethiopia – An interesting case of unearmarked funds

37. Ethiopia represents an interesting contrasting case to Uganda. The present aid system namely the Provision of Basic Services (PBS) has an unusual history. Ethiopia was receiving GBS which was suspended as a result of civil conflict following the disputed 2005 election. The PBS was a programme to continue direct support to the delivery of basic services to the poor which would not be withheld and thus protect the poor from the stop-go dynamics of Aid. PBS is designed to augment the CG transfers to LG; these are unearmarked allowing LG some flexibility in using the resources at the local level. The PBS approach is based on the following principles:

- ‘Additionality’: thus the PBS transfers are conditional on CG also increasing its financial commitment to the sector (This avoids the problem of the CG reducing its commitment as the PBS increases.¹⁰)

¹⁰ DFID had a complex series of discussions in India around its provision of GBS to State level Governments (Andhra Pradesh) around whether the Government of India (CG) would then reduce its funding to the State level.

- Fiduciary responsibility
- A “fairness review” around general issues of intergovernmental transfers.

38. This is a recent innovation, which has only just started in 2006 but does illustrate that there are new funding mechanisms that can support LG but do not necessarily have a LG label on them. This is particularly the case in financing arrangements that are, as discussed earlier, primarily concerned with moving funds to LG.

Funding for Urban Development: the NURM programme in India

39. India as part of its recent National Common Minimum Programme has launched in 2005 a new programme entitled the Jawaharalal Nehru National Urban Renewal Mission (JNNURM)¹¹. The rationale for the programme is an increasing realisation that the weakness of urban infrastructure is increasingly being identified as a major constraint on India’s desire to accelerate its already high GDP growth rate from 9 per cent. The programme will provide US\$12.5 billion as a central grant which aims to leverage contributions from State Governments, institutional finance, private sector funds and beneficiary contribution. JNNURM involves 63 urban areas and helps them prepare a comprehensive City Development Plan including funding issues but also important aspects of a reform agenda. From this Plan more detailed project plans for funding, including provision for future operation and maintenance are developed. This programme represents a significant new approach to funding urban infrastructure in India; the emphasis on City Development Plans, funds for infrastructure for the poor, and institutional reform should be noted.¹²

40. This is a welcome development as a recent review of Commonwealth PRSP programmes suggested they had a very limited focus upon urban poverty and infrastructure issues. This, it was argued, limits the extent to which donors can direct funds to target urban MDGs. (Commonwealth Secretariat, 2005). The policy suggestion is of the importance of having specific budget lines for urban upgrading.¹³

Other Relevant Cases: European Commission Sector Funding and UNCDF LDP

41. The EC is an important donor in the new aid architecture as it has a policy commitment to disburse funds via a programme based approach. Sector funding is one of its main vehicles, which are often funding service delivery agencies and LG. These funds are not tied but the EC does have an approach which seeks to monitor their use. First is the principle of additionality –namely an attempt to monitor what CG would have been spent in a specific sector without additional assistance. Second and related is an attempt to monitor expenditure patterns in general. The next key component is that all funds should be “on budget” and work through CG and LG systems. As in the case of Ethiopia it is worth noting that such sector support is often less politicised than GBS as it does necessarily carry the implicit “seal of approval” that the latter does. Thus it can be a useful aid instrument within the family of aid modalities as it potentially can contribute to predictable funding schemes.¹⁴

¹¹ This section is based on a paper by Kumari Selja, Minister of Housing and Urban Poverty Alleviation. Government of India at the CLGF conference in Auckland 2007.

¹² There is much in common here with the approaches that the Cities Alliance has been promoting but the JNNURM is broader in including a clear emphasis on institutional reform; as such it is a more holistic approach.

¹³ Personal Communication Ruth McLeod, CLGF conference in Auckland 2007.

¹⁴ One of the observations of the IDD evaluation was that predictability of funding in GBS (in theory one of its main advantages) is often compromised through political considerations (IDD, 2006)

42. An obstacle remains in the European Commission. Although under the Cotonou Agreement governing aid relations, local government has been officially acknowledged as a state actor, officials have been slow in understanding this. Consequently, the Cotonou Agreements have only rarely been operationalised with respect to local government either at in-country delegations or in Brussels.

43. UNCDF through its Local Development Programme has been an innovative donor in the field of LG funding. UNCDF has been particularly concerned with the tension between the vertical logic of intervention, which is represented, by GBS and SWAPs and the potential horizontal logic represented by an approach which strengthens LG systems and the decentralisation process in general (UNCDF, 2006). One of the major innovations that UNCDF has piloted with some success is the linking of CC to LG transfers to improved performance in LG revenue collection performance. Thus the amounts of funds transferred are linked to LG performance. While intellectually satisfying the evidence from elsewhere – for example DFID’s APUSP (Andhra Pradesh Services for the Poor) often suggests that the political process tends to lead to such transfers becoming de facto entitlements rather than being clearly based on performance. This is a very important innovation, which requires further monitoring. As we shall see this is clearly an important approach for the future.

GBS issues and concerns from a LG perspective: the need for LG to be a stakeholder

44. From a LG perspective (and also from a MoF perspective) it is becoming clear that the use to which GBS funds can be directed efficiently is intimately related to the nature of CG to LG transfers. This is in turn related to the mechanisms that are used to support and calculate such transfers. In most cases this is the result of specific formulae that allocate funds. Unfortunately a recent World Bank publication on the subject suggests that in most cases the design of these formulae in terms of incentives “remains flawed” (Shah and Shah, 2006: 42). Nevertheless the importance of robust formulae to allocate and determine CG to LG transfers cannot be underestimated. The design of such systems is absolutely critical in determining the extent to which LG can benefit from new approaches to aid.

45. A major recommendation of this section and of this paper as a whole is for MoLG and LG to be considered as a key stakeholders in the GBS and other central policy making activities. A recent OECD report on *Lessons learnt on Donor support to Decentralised and Local Governance* (2004) noted the following in relation to *Better dialogue on SWAPs, PRSPs and decentralisation*:

“There is a need for a more extended dialogue between governments in developing countries and the donor community concerning the extent to which the Poverty Reduction Strategy Paper (PRSP) process and Sector Wide Approaches (SWAPs) support or undermine decentralisation efforts. Partner governments that have embarked on decentralisation reforms should make sure they keep to their commitments concerning decentralisation in practice. Donors, for their part, should clarify their policies both towards SWAPs, PRSPs and decentralisation and identify those aspects of their country support that lack coherence and compatibility. A review assessing the need for developing a poverty-reduction strategy credit similar to the present central government budget support system is also required.” (OECD, 2004: 55).

46. A recent innovation which illustrates the importance of involving LG has been the case with work on the MDGs in Uganda. The CG of Uganda has been doing an “audit” on the extent to which its expenditure patterns are addressing the MDGs. The result of this exercise has been to substantially increase the amount of funds that are now allocated to LG.¹⁵

SECTION THREE: POLICY OPTIONS

47. In this final section we shall consider some possible policy options for consideration. These should not be considered as mutually exclusive; indeed to some extent they could be considered as complementary. The first four suggestions are primarily concerned with LG systems while the remaining three are primarily concerned with mechanisms to facilitate financing for urban development.

Strengthen Independent Institutions to monitor CG and LG relations

48. This follows clearly on from the arguments above that the efficiency of GBS as a mechanism for funding LG to a large extent hinges on the robustness, effectiveness and efficiency of the formulae that determine such transfers. In federal systems of government – which are somewhat rare in the Commonwealth - the adjudication between LG and CG is the responsibility of the Courts. The argument here is around strengthening independent Institutions to monitor the nature of CG and LG relations. There are some examples in the Commonwealth; both Uganda and India have set up Finance Commissions to monitor CG and LG financial arrangements (Steffenson: 2006; Om Prakash Mathur, 2006)

49. An alternative but also complementary approach, which fits in very well with CLGF’s mission, is to seek to strengthen LG associations to fulfil the same role. In almost all systems LG associations are the natural lobbyists on behalf of LG but also need to be considered as key stakeholders.

Strengthen lessons from LG experience

50. An important policy area where the Commonwealth can contribute is lesson learning and the development of examples of “good” or “better” practice. A very clear example of such a process is the rapid transfer of Uganda’s reform in publishing CG/LG transfers in the media and providing details of such transfers in public spaces. This innovation has been transferred widely in Sub Saharan Africa and beyond.

51. There is an enormous potential in learning from other people’s experience. For example in the case of GBS and LG there are many important lessons that can be learnt from the experience of Uganda. In almost all LG systems there are considerable variations in LG experience and the potential for significant within country lesson learning. The challenge is to design and implement such programmes.

The need to hardwire LG into the system

52. A key suggestion of this is to “hardwire” LG into the overall governmental system. The following are the areas where this needs to be done:

¹⁵ Personal Communication John Kiyaga-Nsubuga

- It is essential to have a LG component of the PRSP and PRSC process
- LG needs to be included in general Public Sector Reform Programmes and Processes
- LG needs to be integrated into overall Public Finance Management (PFM) discussions
- There is a separate need to work towards making national statistics and financial accounting procedures compatible with LG systems
- As far as practical, all policies need to spell out which level of government (CG and LG) will be concerned with implementation. This is particularly important with sector plans and sector policies
- LG needs to be included in all SWAp and sector discussions which have a local service delivery component
- LG needs to be involved in the design of Performance Assessment Frameworks for the monitoring of SWAs and GBS programmes
- Finally it is proposed that there should be a separate budget head for MD7 (Slum Upgrading).

Working with other ongoing LG initiatives

53. For any Commonwealth approach it is also important to work with and as far as possible seek to synthesize with other ongoing initiatives. In relation to LG some of the ongoing work of the Joint African Institute are clearly relevant. Their concerns are very similar to those outlined in this note in particular: the importance of LG in meeting the MDGs; a concern with whether new systems of aid are weakening LG; an approach which seeks to work with the Paris Agenda; and finally a desire to build a new framework. Thus they are currently in the process of designing:

“the strategic and technical bases for government-led programmes of harmonized, performance-orientated support to local governance in Sub-Saharan Africa by establishing a common framework of operational objectives and indicators which can be adapted to country context as a basis for government-partner collaboration” (JAI, 2006: 5)

54. Given the above it is important that the suggestions in this note need to support and work with other parallel ongoing initiatives.

The importance of alternative mechanisms: the role of private finance

55. Given the nature and the extent of urbanisation it is clear that the enormous needs for urban infrastructure cannot be met solely from the public sector. It is therefore critical to design systems to encourage private sources of funding. One model is the provision of municipal bonds alongside the development of a credit rating system. CLGF has recently produced, with the Development Bank of South Africa, a useful working paper concerning the relevant issues. This is a relatively new innovation for the developing countries of the Commonwealth but there have been some successful experiments in South Africa, Zimbabwe¹⁶ and India. Within India so far it is estimated that 14 cities have been assessed and have received a municipal bond. In addition 40 more bodies have subjected themselves

¹⁶ The recent developments in Zimbabwe have undermined such initiatives

to a credit rating agency, which highlights the importance of market-orientated reforms and the use of these ratings as a source of benchmarking (Om Prakash Mathur, 2006: 193-195). The demand driven nature of this instrument in contrast to many forms of aid disbursement, which are implicitly supply driven is worth noting. This is clearly an important financial instrument for the future.

Municipal Development Banks

56. An alternative financing mechanism for LG is the Municipal Development Bank. A Municipal Development Bank is usually a publicly owned organisation whose objective and brief is to lend money to LG on commercial terms. It is seen as an instrument which can be used to provide capital funds to LGs. HUDCO in India is an organisation that essentially operates on these lines. In continental Europe these banks are often linked and sometimes owned by LG associations. The shareholder composition varies but in many cases the LG association is a major stakeholder. In principle this is an attractive option; unfortunately the research evidence tends to suggest that such organisations are often put under political pressures, and that in reality they often do not deliver on the promise that all loans are provided on commercial terms (Davey, 1996).

Sharing good practice

57. International local government associations, such as the Commonwealth Local government Forum (a designated Commonwealth body comprising ministries and local government associations as its key members), have a critical role in sharing good practice, developing policy and building technical skills through its various programmes. It is also engaged in improving local governance, making it more robust and accountable.

Can we design SWApS or GBS for urban development and municipal government?

58. Given some of the needs for funding for infrastructure and urban development it is worth asking whether it might be possible to design SWApS or GBS for this sector. Firstly it should be noted that this should be seen as complimentary to other general LG programmes, which might support LG in rural areas. The rationale for such an intervention would include the following:

- Firstly some Municipal areas are certainly large enough economic entities to justify such an intervention; thus for example Johannesburg is clearly larger than Malawi. The latter is a recipient of GBS while the former is not
- The need to support recurrent expenditure to maintain infrastructure assets is a particular urban phenomena
- Municipal governments would benefit from the holistic approach to policy, budgeting and capacity building that is integral to GBS
- Such an approach would support and integrate the current direction of the Cities Alliance and other policies in terms of City Development Strategies and Wholesale Squatter/Slum Upgrading
- The issue of additionality would need to be addressed in terms of a) such approach working as a substitute for CG to LG transfers and b) making sure there are incentives to encourage local revenue collection
- Municipal government-given its roles and responsibilities- is less likely to suffer the stop-go aid dynamics.

59. Finally in conclusion it is worth noting that DFID's relatively successful slum improvement project in India was effectively using a very similar method by providing funding directly to Local Governments, albeit with conditions of expenditure and a process of monitoring (Amis, 2001a).

Conclusion: Towards some LG principles; a note for Finance Ministries

60. A case could be made for a series of principles that might guide the relationships between central policy making units (MoF and economic planning) and processes of decentralisation and LG. This would to some extent involve institutionalising some of the principles of the 2005 Paris Declaration at the local level¹⁷. These might include the following

- Accept the importance of LG
- Use LG as a key stakeholder
 - First it is essential to have a LG component of the PRSP and PRSC process
 - LG needs to be included in general Public Sector Reform Programmes and Processes
 - LG needs to be integrated into overall Public Finance Management (PFM) discussions
 - There is a separate need to work towards making National Statistics and Financial accounting procedures compatible with LG systems
 - As far as practical, all policies need to spell out which level of government (CG and LG) will be concerned with implementation. This is particularly important with Sector Plans sector policies
 - LG needs to be included in all SWAp and Sector Discussion which have a local service delivery component
 - LG needs to be involved in the design of Performance Assessment Frameworks for the monitoring of SWAps and GBS programmes
 - Finally it is proposed that there should be a separate budget head for MD7 (Slum Upgrading)
- That, as far as possible, that all funds should be routed through and on LG Budget
- Design of interventions should seek to strengthen and not weaken LG systems and revenue
- Help build the capacity of local government associations so that they can interact effectively with central government counterparts and be a stakeholder in finding solutions
- Independent Institutions to monitor the LG/CG interface.

¹⁷ As noted above this is one of the dimensions of the parallel Joint African Institute initiatives.

ANNEX 1: The Role of Local Government in Delivering on the MDGs

MDG	Fire fighting and Police	Solid Waste Management	Roads	Primary Education	Water and Sanitation	Primary Health	Public Health	Land Use Planning	Economic Development
1 (Poverty)	■■	■	■■	■■	■■	■■		■■*	■■*
2 (Primary Education)			■	■■■	■	■		■	
3 (Gender Equality)	■■			■■			■■		
4 (Child mortality)		■■	■■	■■	■■	■■■	■■	■	
5 (Maternal health)	■	■	■■	■	■■	■■■	■		
6 (HIV/Aids malaria)		■■		■	■■	■■■	■	■	
7 (Slums and Water)	■	■■	■■■	■	■■■	■	■■	■■■	■
8 (Partnership)									■

Key ■■■ Direct Provision
 ■■ Indirect Relationship
 ■ Some Relationship
 * In some cases LG through bad governance can influence this MDG negatively

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