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CEPA strategy guidance note on

Fiscal federalism and decentralization

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The [United Nations Committee of Experts on Public Administration \(CEPA\)](#) has developed a set of principles of effective governance for sustainable development. The essential purpose of these voluntary principles is to provide interested countries with practical, expert guidance on a broad range of governance challenges associated with the implementation of the 2030 Agenda. CEPA has identified 62 commonly used strategies to assist with the operationalization of these principles. This guidance note addresses fiscal federalism and decentralization, which is associated with the principle of subsidiarity and can contribute to strengthening the inclusiveness of institutions. It is part of a series of notes prepared by renowned experts under the overall direction of the CEPA Secretariat in the Division for Public Institutions and Digital Government of the United Nations Department of Economic and Social Affairs. Funding for the sub-series on the principle of subsidiarity was generously provided by the United Nations Project Office on Governance.

In reading this guidance note, individuals in government ministries and agencies who are less familiar with the topic will be able to understand the fundamentals. Those who have perhaps taken initial steps in this area with limited follow-through or impact will be able to identify how to adjust elements of their practice to achieve better results and to better embed and institutionalize the strategy in their organizations. Those who are more advanced in fiscal federalism and decentralization will be able to recognize the practices which contribute to its success.

Understanding the strategy

Public sector decentralization has become a prominent global phenomenon. In recent decades many lower- and middle-income countries have adopted or strengthened decentralization in some form with a mix of stated objectives, including to improve public service delivery; to develop better public administration, management, governance, and accountability; to increase economic growth; to promote equity in development outcomes; and to foster peace and stability, among others. The goals and policies in a particular country reflect its specific context.

Part of the conceptual rationale for decentralization (and the associated principle of subsidiarity) is derived from a public economics theory known as fiscal federalism. As its name and disciplinary origins imply, it focuses on the economic benefits of decentralizing appropriate public sector functions and finances to subnational levels of government. Fiscal federalism has been instrumental in global development, but there are conceptual and practical limits to what it can offer policy makers and reformers. One major concern is that countries are immensely diverse and there can be no “one size fits all” approach. Another important consideration is that fiscal decentralization must work in tandem with other inherently interdependent elements of decentralization - administrative and political - if its expected benefits are to be realized.

The word ‘fiscal’ is often popularly associated only with funding, but fiscal federalism covers the broader assignment of both functions and revenue powers to subnational governments. Given central government advantages in revenue generation and the common insufficiency of decentralized own-source revenues to meet the expenditure responsibilities of subnational governments, intergovernmental fiscal transfers from higher levels of government are essential both to narrow the resulting fiscal gap as well as to alleviate resource disparities across subnational governments. Under more advanced fiscal conditions, borrowing can be an important way to finance subnational development spending.

The role of fiscal federalism in informing public sector reform has become all the more important in the context of the 2030 Agenda, which commits the international community to realizing an ambitious set of [Sustainable Development Goals \(SDGs\)](#) around the world in less than a decade. If this is to occur or even if credible progress is to be made, countries and their constituent subnational governments will need to work in new ways and with new partners, and they must effectively use all the governance, fiscal, and managerial mechanisms at their disposal. Calls for [localizing the SDGs](#) permeate the international community.

The 2014 United Nations Secretary General’s Synthesis Report on the SDGs states that “many of the investments to achieve the sustainable development goals will take place at the

subnational level and be led by local authorities.”¹ The High-Level Panel on the Post-2015 agenda claims that “cities are where the battle for sustainable development will be won or lost.”² The call for action in the [New Urban Agenda](#) (Habitat III) points to the need for particular attention to “addressing the unique and emerging urban development challenges facing all countries, in particular developing countries.”³ The [Addis Ababa Action Agenda on Financing for Development](#) highlights the subnational role in financing sustainable development and commits to scaling up international cooperation to support local and regional governments.⁴

The purpose of this guidance note is not only to explain in accessible terms the basics of fiscal federalism, but also to place this useful but narrow conceptual framework in the larger context of decentralization and intergovernmental relations. The note further outlines the challenges of making fiscal decentralization work in practice, highlights the need for strategic implementation, provides brief case studies that illustrate the application of fiscal federalism principles in the real world, and lays out how development partners support fiscal decentralization.

The elements of fiscal federalism

Fiscal federalism and associated theories offer a set of principles intended to enable subnational governments to play an appropriate, meaningful, and effective fiscal role in the public sector. Each level of government should have certain clear functions and bear some responsibility for financing them. Fiscal federalism has long provided the policy foundation for decentralizing expenditure and revenue functions. Its core principles, which are largely based on standard economic concepts interpreted in a spatial and multi-level context, are generally well defined and accepted.⁵ They have been reworked from time to time, and a number of principles have been added or embellished to move beyond the limited concerns of the original theory.

Although fiscal federalism principles are broadly relevant, they are commonly used assuming a devolved intergovernmental system (existing, in-process or desired) in which (elected) local governments have some autonomy over functions and resources assigned to them and are expected to be accountable to their local constituents. Devolution differs from deconcentration, a system in which local administrators are primarily upwardly accountable to

¹ United Nations General Assembly. 2014. *The Road to Dignity by 2030: Ending Poverty, Transforming All Lives and Protecting the Planet*. Synthesis Report of the Secretary General on the Post-2015 Sustainable Development Agenda. New York: United Nations General Assembly, p. 22, par. 94.

² United Nations. 2013. *A New Global Partnership*. Report of the High-Level Panel of Eminent Persons on the Post-2015 Development Agenda. New York: United Nations, p. 17.

³ UN-Habitat. 2017. *New Urban Agenda*. Nairobi: UN-Habitat, p. 9, par.19.

⁴ UNDESA. 2015. *Addis Ababa Action Agenda: Financing for Development*. New York: UN Department for Economic and Social Development.

⁵ Fiscal federalism was introduced in Oates, Wallace. 1972. *Fiscal Federalism*. New York, NY: Harcourt, Brace, Jovanovich and revisited in Oates, W. 1999. “An Essay on Fiscal Federalism.” *Journal of Economic Literature* 37: 1120-1149. A comprehensive overview of current intergovernmental and subnational finance thinking that has been built in part from fiscal federalism is included in Bahl, R. and R. Bird. 2018. *Fiscal Decentralization and Local Finance in Developing Countries: Development from Below*. Cheltenham, UK: Edward Elgar.

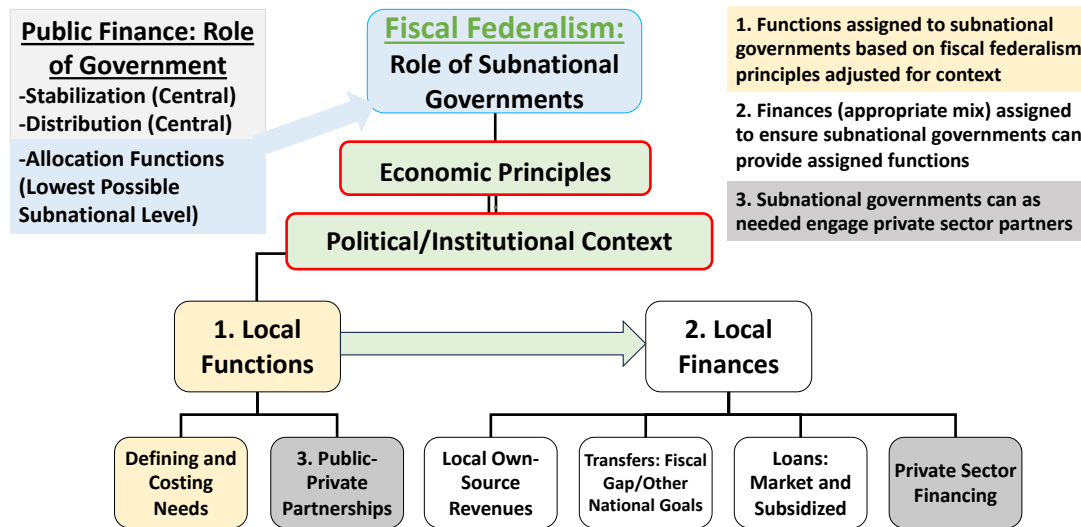
higher levels of government.⁶ Both can play important roles in the management of public sector responsibilities.

The assignment of subnational government functions

Fiscal federalism is based on traditional public finance theory, which identifies the main roles of public sector finance as stabilization of the economy, attainment of a desired distribution of income and wealth, and an efficient allocation of resources.⁷ Fiscal federalism considers how these roles should be shared - the assignment of public responsibilities and revenues among government levels. Figure 1 visually summarizes elements of the fiscal federal system covered in this section.

Stabilization and distribution are widely considered to be central government responsibilities. Since stabilization is about managing the national economy and how it relates to the global economy, there is consensus that this function must be managed centrally even if subnational governments can be involved in certain ways.⁸ Subnational governments can contribute to redistribution in their jurisdictions, but within limits because redistributive taxes that differ across subnational governments can affect the location decisions of businesses and residents (see below). In addition, only the central government can alleviate fiscal disparities among subnational governments by directing more national resources to disadvantaged jurisdictions.

Figure 1. Fiscal federalism: design of fiscal decentralization



Source: Author.

⁶ More summary detail on intergovernmental systems and institutions is summarized in Table 5.

⁷ The basic theory was first outlined by Musgrave, R. 1959. *The Theory of Public Finance: A Study in Public Economy*. New York: McGraw-Hill and is considered the foundation of modern public finance.

⁸ Specific concerns are raised in fiscal federalism about the potential gap between the desired and observed fiscal behavior of subnational governments as economic conditions improve or deteriorate.

In contrast, fiscal federalism posits a potentially strong role for subnational governments in allocation-making decisions about the use of resources for public action. Responsibilities should be decentralized where service demand is not uniform across subnational jurisdictions. This enhances public welfare because residents in a jurisdiction can choose the mix of public activities that best matches their preferences, which is a more efficient use of resources compared to uniform national services. Decisions can be made through political processes that help to determine local service demand and willingness to contribute to the public purse or through movement of citizens to a jurisdiction that provides their preferred revenue-expenditure package.⁹

Fiscal federalism also justifies the decentralization of public functions for other reasons. Expenditure decisions, for example, are likely to be tied more closely to real resource costs in smaller jurisdictions. More productive opportunities to experiment and innovate in service delivery and resource use are expected when service delivery providers in different jurisdictions have the power to try new ways of operating. Successful innovations in one local government provide lessons that can be adapted by other local governments. Subnational governments are also likely to consider local service delivery and development in a more integrated and holistic way compared to national ministries that specialize in particular functions and services.

There are exceptions to the general rule of decentralizing to maximize efficient resource use. These include services that must be provided at a large scale¹⁰ (for example, smaller jurisdictions may be unable to provide major infrastructure projects at a scale that is cost effective) or that affect other jurisdictions¹¹ (such as one local government may impose costs on another by polluting its potable water source). Such functions should be the responsibility of a higher level of government, although it is often more practical to use alternative policies with the same overall effect, including cooperative agreements among subnational jurisdictions (which may be subsidized by transfers from the central government), or higher-level regulation. These various considerations provide the foundation for the overarching principle of subsidiarity, which posits that a public function should be provided at the lowest possible level of government.

In many cases, responsibility for public functions needs to be shared among levels of government. Some services—such as basic solid waste management and fire protection—have primarily local effects and fiscal federalism would assign them to subnational governments. Others—such as education and health—have broader effects beyond a local jurisdiction because better educated and healthier populations generally benefit society. Even if such functions are local responsibilities, higher level standards, regulations, and subsidization may be needed to ensure sufficient delivery. A number of functions have varied benefit areas,

⁹ The conceptual basis for the mobility approach is articulated in Tiebout, C. 1956. “A Pure Theory of Local Expenditures.” *Journal of Political Economy*, 64 (5): 416–424.

¹⁰ This is due to economies of scale in production.

¹¹ These effects are referred to as interjurisdictional externalities or spillovers.

for example, some roads are part of a national highway network, while others are regional or local.

Various stages of functional responsibility are often shared in different ways—policy and oversight; provision and administration; and production and distribution. Even if provision can be decentralized, higher level policy and oversight may be needed. In addition, a level of government with provision responsibility need not deliver a service—it can contract a higher or lower government level or private or nongovernmental actor to deliver the service in full or in part. Arrangements can vary substantially by function and country. Table 1 provides an illustrative depiction of how public functions in which subnational governments often have a role that may be shared among actors, but there is much variation across countries.¹²

Table 1. Illustrative subnational functional assignments

Function	Policy standards and oversight	Provision and administration	Production and distribution	Rationale/comments
Education	N,R,L	R,L	R,L,P	Positive effects beyond local area
Environment	N,R,L	N,R,L	N,R,L,P	Varied cross border effects
Fire Protection	L	L	L	Mainly local benefits
Health	N,R,L	R,L	R,L,P	Positive effects beyond local area
Natural Resources	N,R	N,R,L	N,R,L,P	Benefits vary in scope
Parks/Recreation	R,L	R,L	R,L,P	Benefits vary in scope
Roads	N,R,L	N,R,L	R,L,P	Benefits vary in scope
Solid Waste	R,L	R,L	L,P	Mainly local benefits
Social Welfare	N,R,L	R,L	R,L,P	Redistributional
Transport	N,R,L	R,L	R,L,P	Benefits vary in scope
Water/Sewers	R,L	R,L	R,L,P	Mainly local benefits

N=national; **R**=regional; **L**=local; **P**=private or nongovernmental. Elements of certain functions are local; others can be regional or national.; functions that are exclusively national, such as foreign affairs, defense, immigration, monetary policy, etc., are not included in this table; certain functions, such as environmental and pandemic control functions, have an important international dimension.

Source: Modified from Bahl and Bird (2018).

The assignment of subnational government revenues

The decentralization of public funding in the form of subnational government revenues is essential. The first justification is the core public finance principle that “finance follows function.” If subnational governments are to be given expenditure responsibilities, they need to be able to access the resources required to deliver them. The various revenue options, including own source revenues specifically assigned to subnational governments and various types of intergovernmental fiscal transfers (shared taxes and grants) are summarized in Table 2.

¹² Useful explanations of expenditure assignment are provided in Boex, J. 2015. *The Vertical Assignment of Functions and Expenditure Possibilities*. Washington, DC: Local Public Sector Initiative; Allain-Dupre, D. 2018 *Assigning Responsibilities Across Levels of Government*. Paris: OECD; and Bahl and Bird (2018).

Table 2. Types, characteristics, and relative importance of domestic subnational government (SNG) revenue sources

Type of revenue	Responsibility and allocation				Role of subnational government	Relative importance in SNG finance
	Choice of base	Choice of rate	Managed by	Allocation based on		
Own source	SNG	SNG	SNG	SNG tax base	SNGs have considerable control, e.g., property tax	Common but often secondary to tax sharing and grants
Centrally assisted	SNG	SNG	SNG/centre	SNG tax base	SNG tax collected or assisted by higher level at SNG request	Use varies; these practices can be productive but are fairly uncommon in most developing countries
Surcharge	Centre	SNG	Centre	SNG tax base	SNGs may add % to higher level tax, e.g., VAT, income tax, etc. on base in their jurisdiction	Use varies; these practices can be productive but are fairly uncommon in most developing countries
Tax sharing	Centre	Centre	Centre	SNG base or formula on central base	SNG shares % of higher-level tax set by taxing level, e.g., VAT, natural resource tax, etc.	Central tax sharing and grants often dominate
Grant/transfer	Centre	Centre	Centre	Criteria or formula from central pool	Many types of unconditional or conditional transfers (Table 3) share central taxes with SNGs	SNG finances, less so in urban areas and in some countries

Source: Author.

Subnational own source revenues

Own source revenues—over which subnational governments have some direct control—are an important element of the local social contract.¹³ Local public revenues create a direct link to local public services. Businesses and citizens are more likely to see a connection between the local revenues that they pay and the local services they receive compared to benefits they get from the taxes paid to central governments. If constituents are willing to pay local revenues, this indicates some trust in their subnational government and some degree of local accountability.

Local revenues also provide a means for subnational governments to increase the local services they provide in their territories (beyond using what they receive through transfers from the centre) in response to citizen and business demands, reinforcing the linkage between local costs and local benefits. If their constituents want more or better services and subnational

¹³Some useful summaries of subnational own source revenues include McCluskey and Franzen (2013); Martinez-Vazquez, J. 2013. Local Non-property Revenues, in Bahl, R., J. Linn and D. Wetzel, (eds.) *Financing Metropolitan Governments in Developing Countries*. Cambridge, MA: Lincoln Institute of Land Policy; Martinez-Vazquez (2013); UN-HABITAT. 2015. *The Challenge of Local Government Financing in Developing Countries*. Nairobi: UN-HABITAT and Bahl and Bird (2018).

governments have some control over local revenue sources, subnational governments can raise funds to meet the needs expressed in their jurisdictions.

Although the value of own source revenues is clear, conceptual issues limit the types of revenues suitable for decentralization. First, highly redistributive taxes in one jurisdiction may create incentives for businesses and wealthy residents to move to low-tax jurisdictions. This risk is the basis for the generally accepted norm that subnational tax assignments should focus on immobile tax bases (hence the prevalence of subnational land and property taxes). Second, some public revenue sources could affect national objectives, competing with central governments for essential revenues and even undermining national policies. A subnational government trade tax, for example, might interfere with the movement of inputs and outputs critical for economic development. Thus, such revenue authority should not be decentralized. Third, certain revenue sources require complex data, high-level skills, and good technology to administer, such as personal and corporate income and value-added taxation. Many subnational governments do not have such capacity, and even if they did, their separate systems would be costly and redundant of national systems. In local jurisdictions with limited economic bases, the cost of such systems might outweigh the revenues they could generate.

Intergovernmental fiscal transfers

The principles and facts outlined above suggest that subnational governments—as per the subsidiarity principle—are often suited to provide a range of public services in full or in part, but central governments invariably have a major public revenue generation advantage. This results in some subnational government dependence on intergovernmental fiscal transfers from national revenue sources to meet their responsibilities, but it has the advantage of consolidating revenue administration and reducing overall costs. It also enables the central government to pursue policies to redistribute resources to subnational governments without the fiscal capacity to raise adequate funds from the own source revenues that they are legally empowered to use.

Given the major role of transfers, it is important to understand that they can serve various purposes and be designed in varied ways. Transfers can improve subnational resource access and autonomy, as well as help to meet priority national service delivery and equity goals.¹⁴ Fiscal federalism provides for all of these purposes, but with some decisions and trade-offs involved. First, given own source revenue constraints, subnational governments require sufficient and predictable transfers. There are many demands for public revenues, so central governments cannot fully provide for all subnational needs and they also require flexibility to manage the macroeconomy in response to changing domestic and global conditions. At the same time, the total pool of transfer resources needs to be defined in a relatively predictable

¹⁴ Useful overviews of transfers include Bird and Smart (2002); Boadway, R. and A. Shah. 2007. *Intergovernmental Fiscal Transfers Principles and Practice*. Washington, DC: The World Bank; Shah, A. 2013. Grant Financing of Metropolitan Areas. In Bahl, R., J. Linn and D. Wetzel (eds.). *Financing Metropolitan Governments in Developing Countries*. Cambridge, MA: Lincoln Institute of Land Policy; and Bahl and Bird (2018).

way to limit disruptive variations in subnational government funding needed to serve the public.

Second, a decision must be made about the allocation of transfers to specific subnational governments. Transfers are often made from a pool of funds derived from multiple national revenue sources. In some cases, however, transfers take the form of sharing specific taxes with subnational governments, often, although not always, on a derivation basis (for example, a percentage of national VAT collected from a specific subnational government is returned to it rather than being shared among all jurisdictions in another way).

Third, another choice is whether the use of transfers should be subject to any conditions. Unconditional transfers offer subnational governments more autonomy to determine spending priorities among their assigned functions. Conditional transfers target national priority functions that have broader benefits beyond an individual subnational jurisdiction and serve specific purposes or populations. Either type can be structured to redistribute funds to poorer areas. Table 3 provides a summary of the roles played by unconditional and conditional transfers.

Table 3. Main types and objectives of intergovernmental fiscal transfers (grants)

Type of transfer	Objective		
	Enhance SNG revenue	Promote redistribution/ fiscal equalization	Meet national development priorities
Unconditional	Both types can increase SNG revenues but must be allocated so as not to create	Can alleviate fiscal disparities depending on how central funds are allocated to SNGs	Can promote spending on national priority services if also prioritized by SNGs
Conditional	disincentives for SNGs to generate their own-source revenues	Can be redistributive (depends on purpose/conditions and how funds are allocated)	Will support national priorities with appropriate allocation, incentives, and monitoring

Source: Author.

Fourth, whether unconditional or conditional, fiscal decentralization norms require transfers not shared on a derivation basis (being returned to the jurisdiction from which they are collected) to be allocated transparently using objective criteria rather than on a discretionary or ad hoc basis. The use of a transfer formula based on clearly defined criteria can limit politicization of transfers and improve transparency so that subnational governments understand exactly why they are getting a certain amount of funding.

Fifth, there is a general understanding that too many or fragmented transfers can be administratively burdensome, create practical challenges (for example, there is a transfer to build health clinics but not to operate and maintain them), and/or complicate measuring the attainment of objectives (such as one transfer is redistributive and another favours wealthier jurisdictions). These issues point to the value of having a more limited and coordinated set of transfers with clearly specified purposes.

Sixth, it is important to understand the types of incentives created by intergovernmental fiscal transfers. If transfers are very large and the allocation formula fails to include appropriate incentives, for example, they may discourage subnational revenue generation as well as borrowing by creditworthy subnational governments whose transfer allocation could be partly directed to more disadvantaged jurisdictions. In addition, excessive conditionality could hinder the flexibility of subnational governments to make more locally appropriate spending decisions.

Fiscal federalism principles do not provide a uniform approach to the design of intergovernmental fiscal transfers. The size and mix of transfers and the criteria used to allocate them depend on economic and fiscal conditions in a particular country and the national objectives of the transfer system. The key concerns are ensuring that a sufficient volume of resources will be made available; getting the right balance among the various types of transfers in terms of national and local goals; and creating incentives for subnational governments to behave in a developmental and fiscally responsible manner.

Subnational government borrowing for capital investment

A final source of funding relevant for subnational governments to attain the goals of fiscal federalism is borrowing.¹⁵ Subnational governments in high-income countries often borrow for public investment, but those in developing countries rely more on intergovernmental fiscal transfers because domestic capital markets are insufficiently developed and many subnational governments are not creditworthy. Subnational borrowing, which is only allowed for capital expenditures in many countries where it is permitted, has both advantages and disadvantages. On the positive side, it allows subnational governments to undertake investments that can have an important developmental impact and spread their costs over time.

However, excessive borrowing can have a negative fiscal impact and pass too heavy an infrastructure finance burden to the future. (See guidance note on [long-term public debt management](#) for intergenerational equity.) A major consideration is that if wealthier subnational governments are enabled to borrow more, resources used for intergovernmental fiscal transfers to them can be redirected to poorer subnational governments that are unable to borrow. To deal with differences in the fiscal capacity/creditworthiness of subnational governments and differences in the financial viability of subnational governments, different combinations of transfers, subsidized loans, and market-rate loans are likely to be needed. A

¹⁵ Reviews of infrastructure and subnational borrowing include Friere, Mila and John Peterson, (eds.). 2004. *Subnational Capital Markets in Developing Countries: From Theory to Practice*. Oxford: Oxford University Press; Platz, Daniel. 2009. *Infrastructure Finance in Developing Countries: The Potential of Sub-Sovereign Bonds*. New York: UN Department of Economic and Social Affairs; Eichler, J., A. Wegener and U. Zimmerman. 2012. **Financing Local Infrastructure: Linking Local Governments and Financial Markets**. Bonn: GIZ; Canuto, O. and L. Liu. 2013. *Until Debt do Us Part: Subnational Debt, Insolvency and Markets*. Washington, DC: The World Bank; Ahmad, E. 2014. *Public Finance Underpinnings for Infrastructure Finance in Developing Countries*. London: London School of Economics and Political Science; OECD. 2015. *Infrastructure Financing Instruments and Incentives*. Paris: Organisation for Economic Co-operation and Development; Frank, J. and J. Martinez-Vazquez. 2016. *Decentralization and Infrastructure in the Global Economy: From Gaps to Solutions*. Cheltenham, UK: Edward Elgar; UNDESA and UNCDF. 2017. *Financing Sustainable Urban Development in the Least Developed Countries*. New York: UN Department for Economic and Social Affairs Financing for Development Office and UN Capital Development Fund; Smoke, P. 2019. *Improving Subnational Government Development Finance in Emerging and Developing Economies: Toward a Strategic Approach*. Tokyo: Asian Development Bank Institute (ADB); and Martell, C., T. Moldogaziev, and S. Espinosa. 2021. *Information Resolution and Subnational Capital Markets*. New York, NY: Oxford Academic.

schematic representation of the kinds of investment financing arrangements that may be needed is presented in Table 4.

Table 4. Finance options by investment type and subnational government features

Type of investment	SNG income level/creditworthiness		
	Low	Medium	High
Self-financing	Mix of loans (possibly subsidized) and transfers	Mix of loans (possibly subsidized) and bonds (if feasible)	Mix of bonds and loans
Partially revenue generating	Mix of loans (likely subsidized) and transfers	Mix of loans (likely subsidized) and transfers	Mix of loans (possibly subsidized) and transfers (if justified)
Non-revenue generating/social purpose	Transfers only	Mix of loans (possibly subsidized) and transfers	Mix of loans (possibly subsidized) and transfers (if justified)

Source: Adapted from Smoke (2022).

Public sector situation and trends

Many countries, both industrialized and developing, generally follow fiscal federalism principles for functional assignment in a very broad way, although there are many documented variations.¹⁶ On the expenditure side, there is a tendency to balance varied preferences (which justify decentralization) with scale economies and externalities (which justify higher-level responsibility) in assigning functions (illustrations in Table 1). Some trends are easily observed in practice, for example, central governments are responsible for defense and foreign affairs, while subnational governments are often assigned local sanitation and local road services. Many services involve multiple levels (such as national hospitals, regional health centres, and local clinics). Beyond such common practices, the mix of responsibilities across levels of government is diverse to the extent that there is relatively limited scope for generalization.

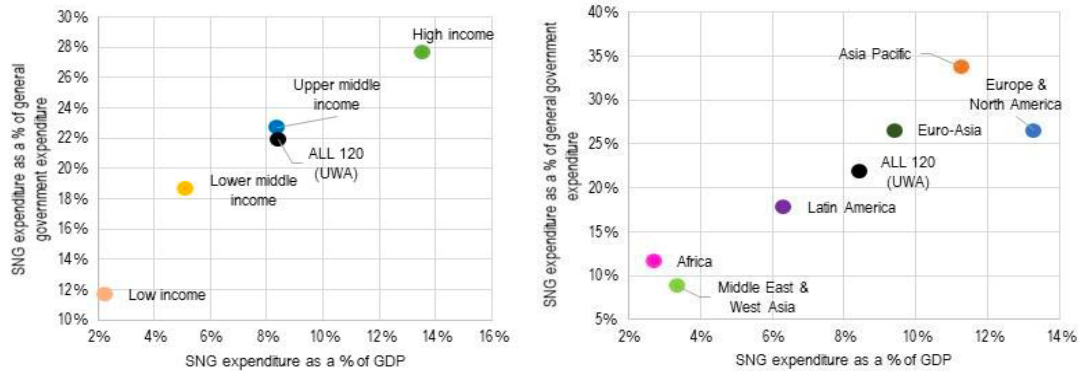
Several deviations from principles are fairly widespread. Informality and/or insufficient clarity in functional assignments among levels is common in developing countries, and functions may be co-provided in ways that complicate service delivery and accountability (since citizens must understand which level of government to hold accountable). Certain inefficiencies also occur, such as centralizing investment authority in sectors where subnational governments are in charge of operations; assigning functions to subnational governments without resources to provide them (unfunded mandates); and heavy central engagement in services that are (or should if principles are followed) legally subnational functions. Other issues are less common,

¹⁶There is a large body of literature on this topic. Examples of overviews and synthetic treatments include UCLG. 2010. *Financing Local Government: The Challenges of the 21st Century*. Second Global Report on Decentralization and Local Governance. Barcelona: United Cities and Local Governments; Bahl, R., J. Linn and D. Wetzel. 2013. *Financing Metropolitan Governments in Developing Countries*. Cambridge, MA: Lincoln Institute of Land Policy; UN-Habitat (2014), and Bahl and Bird (2018).

such as decentralizing too large a burden of major social services, which can be particularly problematic without adequate service delivery standards and central financial support.

Overall, the relative importance of subnational governments in public expenditures is much lower in low-income than in high-income countries. Figure 2 reports subnational government expenditure as a share of total government spending and gross domestic product (GDP) in different country income groups and regions. The disparity among income groups is enormous, and there are equally large differences across regions, with Africa and Western Asia faring particularly poorly. There are, of course lower- and middle-income countries where subnational governments play a major role, but in many cases subnational governments seem not to have the level of empowerment fiscal federalism suggests they could assume.

Figure 2. Subnational government expenditure as a share of government spending and GDP by income group and world region, 2020



Source: OECD-UCLG SNG-WOFI database 2022: www.sng-wofi.org.

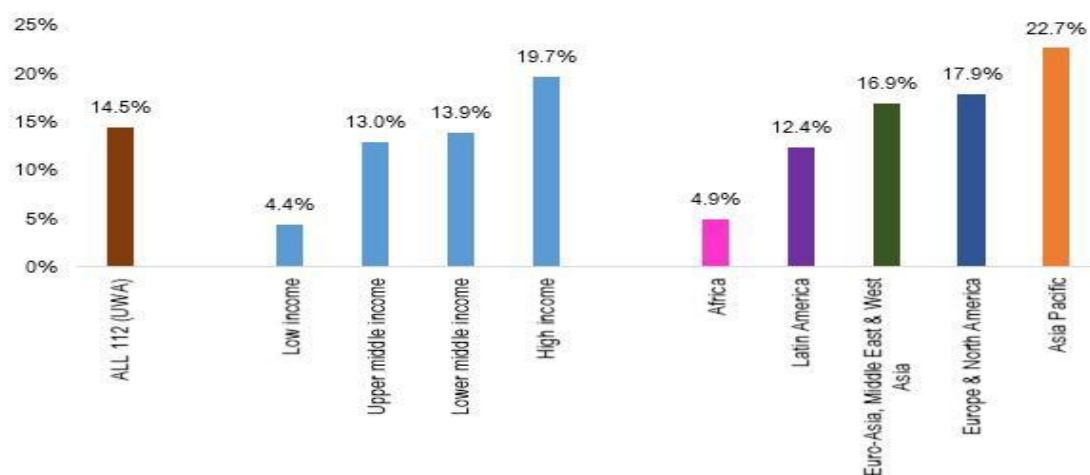
On the revenue side, countries also broadly follow basic fiscal federalism principles. Central governments typically assign subnational revenue bases that are relatively immobile, do not compete with central taxes, and do not create perverse behavioural incentives (such as driving citizens and businesses from high-tax jurisdictions) noted above. There are exceptions (such as taxes on the movement of goods across jurisdictional boundaries, which disrupt interregional commerce and economic development), but they are limited to particular countries. Common subnational sources include property tax, user charges, and local licenses and fees. In some cases, mostly intermediate or urban governments, motor vehicle revenues, and limited business or sales taxes are permitted. Piggybacking (allowing lower levels to add at their discretion a small percentage to higher level taxes) is often recommended and sometimes practiced, especially at intermediate tiers.

Common subnational own source revenues are rarely controversial but may be insufficient. First, many developing countries assign fewer revenue sources to subnational governments than is justified by fiscal federalism. Second, devolved revenue sources are often overly controlled and regulated by the central government, reducing subnational power. If, for example, a local property tax is subject to strict regulation of the tax base, the property

valuation method, and/or the tax rate, subnational governments may have insufficient autonomy to effectively use the tax in a way that is consistent with fiscal federalism and its purported benefits. Third, the extent to which subnational revenues are successfully used varies considerably. In some cases, legally assigned revenues have not been fully decentralized either because national agencies restrict their use or individual subnational governments may not use permitted sources if their constituents do not demand better services or intergovernmental transfers substitute for locally collected revenues.

Subnational government revenue generation tends to be less important than subnational spending for the reasons explained earlier. Subnational tax revenue, for example, accounts for a relatively low share of total government tax revenue, as shown in Figure 3. Subnational governments in low-income countries collect less than 5 per cent of total taxes while the share rises to nearly 20 per cent in high-income countries. As on the expenditure side, subnational governments in Africa generate considerably lower revenue shares than other regions. Since these numbers are averages, they do not capture variations across or within countries.

Figure 3. Subnational tax revenue as a percentage of total public tax revenue by income group and world region, 2020



Source: OECD-UCLG SNG-WOFI database 2022: www.sng-wofi.org.

Although the fiscal transfer principles outlined above—stable resource pool, allocation by transparent formula, etc.—have been commonly adopted, the practice is highly diverse. Many countries increasingly define clear rules to determine the annual transfer pool, for example, basing it on a share of taxes or national revenue sources (as in Ghana, Indonesia, Kenya, Mexico, and the Philippines). In other cases, the pool is determined annually in the national budgeting process (as in Cambodia, South Africa, and Uganda) or is set for a specific time period (for example, five years in India and Pakistan based on National Finance Commission recommendations).

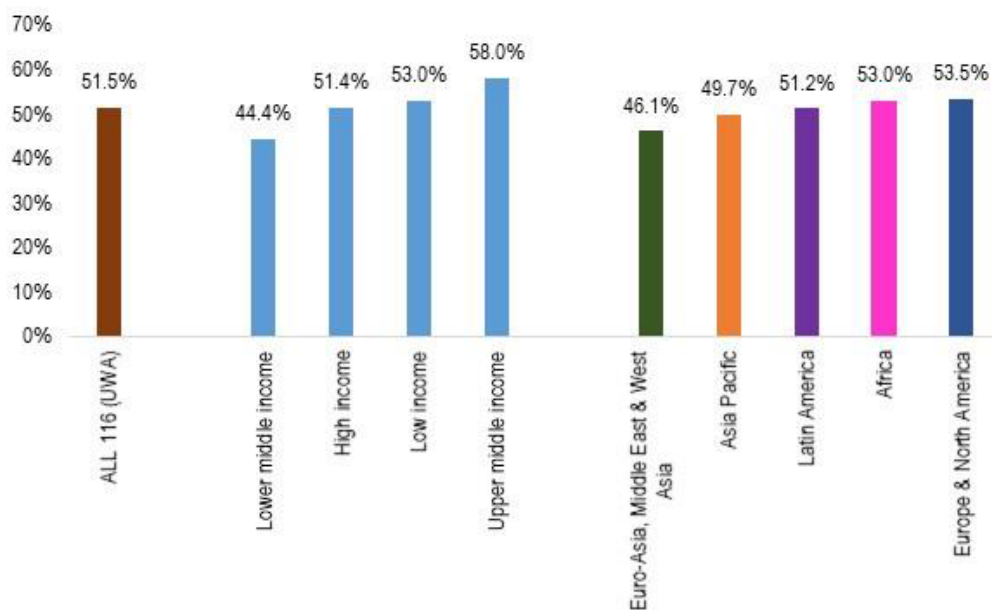
Some countries have consolidated systems, for example, with one major unconditional formula-based transfer in Ethiopia, Indonesia, Kenya, the Philippines, and South Africa.

Other countries use multiple major transfers or place conditions on using general revenue-sharing funds, as in Ghana and Uganda. Conditionality can shift over time, as in Uganda, where the centre increased restrictions on shared funds use, tilting the balance heavily to conditional transfers. In other cases, such as Indonesia, Kenya, and South Africa, an unconditional transfer still dominates, but with an increase in conditional transfers since their respective decentralizations were initiated in order to motivate subnational governments to spend on national priority services.

Many countries share national revenue with each government level. In some countries (especially federal systems but also in other cases), however, including Canada, Ethiopia, India, Nigeria, Pakistan, and the United Kingdom, most fiscal transfers go to the intermediate tier, leaving the sharing of national resources with lower levels largely a state/provincial/regional decision. Brazil is an exception—the federal government bypasses states with certain transfers that go directly to municipalities, although critics allege these transfers are too conditional.

Even though subnational governments in richer countries generate more of their own revenue than in lower-income countries, dependence on shared revenues and transfers relative to total subnational revenue is high across the board. Figure 4 indicates some differences in grants and subsidies as a share of subnational government revenues across country income classes and regions, but the high-income countries and those in the wealthiest regions show even higher dependence. This reinforces the important role of transfers in all intergovernmental fiscal systems even where subnational governments can raise substantial revenues.

Figure 4. Grants and subsidies as a share of total subnational government revenue by income group and world region, 2020

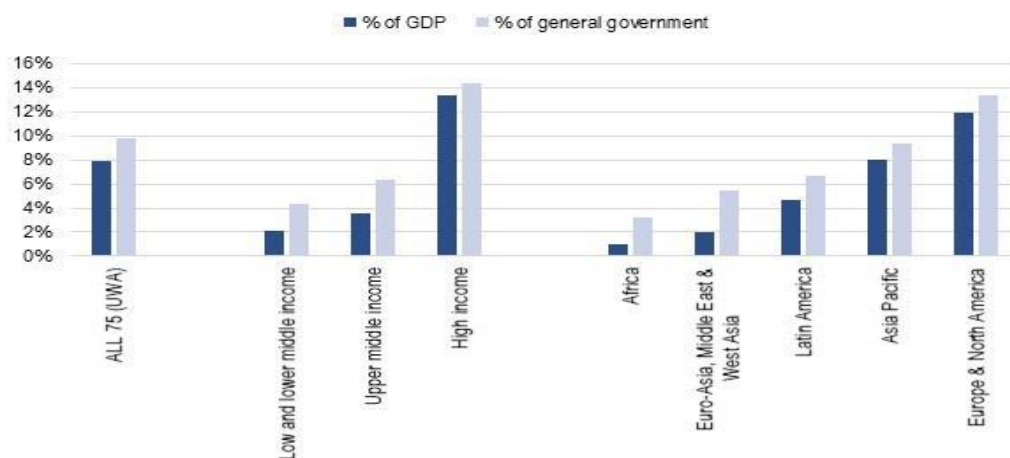


Source: OECD-UCLG SNG-WOFI database 2022: www.sng-wofi.org.

In terms of the relative balance of subnational revenues and transfers, four overall approaches are observed globally.¹⁷ These include: 1) empowering subnational governments to develop their own independent revenue systems; 2) centrally owning all revenues but sharing them with subnational levels through transfers; 3) exclusively assigning subnational governments certain revenues; and 4) sharing certain national revenues with subnational governments. There are possible advantages and disadvantages to each approach. There is not a universal normatively preferred or “optimal” approach, since the choices a country makes depend on technical considerations, historical trajectories, political dynamics, and other factors discussed below.

The experience with subnational government borrowing also varies considerably across countries,¹⁸ although there has been increasing attention, partly in response to investment demands generated by the SDGs, the climate change crisis, and the Covid-19 pandemic, among others. The overall shares of subnational debt as a percentage of GDP and total government debt diverge greatly across countries and regions, but access to and use of debt are much more important in wealthier areas, as demonstrated in Figure 5. Access to loans from capital markets is widespread in high-income countries, but in most middle- and low-income countries this is at best an option for a limited number of creditworthy cities and regions. Municipal bonds have been issued, for example, in India, South Africa, and multiple other fiscally sound middle-income countries.

Figure 5. Subnational government debt by income country group and world region as a percentage of GDP and general government debt, 2020



Source: OECD-UCLG SNG-WOFI database 2022: www.sng-wofi.org.

¹⁷ These are explained in more detail in Tanzi, V. 2010. Revenue Sharing Arrangements: Options and Relative Merit. *The Pakistan Development Review*. 49 (4): 311-322.

¹⁸ The most current comprehensive data are provided in OECD and UCLG. 2022. *World Observatory on Subnational Government Finance and Investment*. Paris and Barcelona: Organisation for Economic Co-operation and Development and United Cities and Local Governments.

Where direct subnational government access to capital markets is not feasible, financial intermediaries (public or quasi-public), such as municipal development banks and funds, are used. Such entities have not always been successful, but a number of countries use them effectively, including Colombia and the Philippines. Others, such as Indonesia, recently created new ones. In some large federal countries, financial intermediaries that serve third-tier governments have been set up at the state level, as in Brazil and India.

Many countries increasingly recognize that they need a range of options to increase subnational borrowing, ranging from facilitating access to capital markets by creditworthy subnational governments to improving options to offer qualified subnational governments subsidized loans through special financial intermediaries. Subnational governments that cannot access either market or subsidized loans will need to continue to rely on intergovernmental transfers, but some can be supported to borrow small amounts that begin to build their creditworthiness and should begin to improve their prospects for more substantial borrowing over time.

To enhance subnational government borrowing, countries are increasingly making efforts to improve the legal environment.¹⁹ Some countries have adopted new subnational borrowing/fiscal responsibility frameworks and have been reinventing special subnational financial intermediaries that are more professional than previous versions and operate on more market-based principles, as well as opening financial markets directly to eligible subnational governments. Other approaches to enhance subnational access to loans include, for example, risk mitigation strategies, such as central government credit guarantees, co-financing initiatives, secondary market support, bond banks, and credit pooling for groups of subnational governments.

Methods of implementation

There is no standard approach for implementing fiscal federal principles. Countries that wish to pursue or improve fiscal decentralization have highly diverse systems, varied goals, and different contextual circumstances that shape the steps that are desired and need to be taken. This means that both system design and implementation have varied across countries. There has long been literature questioning how to use fiscal federalism, which was developed largely in the context of industrialized nations, in developing countries.²⁰ Certain explicit and implicit assumptions underlying the approach may be violated in some developing countries. The

¹⁹ See, for example, Liu, L. and M. Waibel. 2010. *Managing Subnational Credit and Default Risks*. Washington, DC: The World Bank; Martinez-Vazquez, J. and V. Vulovic. 2017. How Well Do Subnational Borrowing Regulations Work? In N. Yoshino and P. Morgan, eds. *Central and Local Government Relations in Asia: Achieving Fiscal Sustainability*. Cheltenham, UK: Edward Elgar; Vammale, C. and I. Bambaite. 2021. *Fiscal Rules for Subnational Governments: The Devil's in the Details*. Paris: OECD; and Saxena, S. 2022. *How to Manage Fiscal Risks from Subnational Governments*. Washington, DC: International Monetary Fund.

²⁰ Early examples include Smoke (1989); Prud'homme, R. 1995. The Dangers of Decentralization. *World Bank Research Observer* 10 (2): 201-220; Tanzi, V. 1996. Fiscal Federalism and Decentralization: A Review of some Efficiency and Macroeconomic Aspects. *Proceedings of the 1995 Annual World Bank Conference on Development Economics*: 295-316; Ter-Minassian, T. ed. 1997. *Fiscal Federalism in Theory and Practice*. Washington, DC: International Monetary Fund; and Smoke, Paul. 2001. *Fiscal Decentralization in Developing Countries: A Review of Current Concepts and Practice*. Geneva: United Nations Research Institute for Social Development.

applicability of political models of local democratic decision-making and the assumption of an adequate legal basis for a well-functioning intergovernmental system, for example, are among the potential concerns, although these “violations” may be alleviated by building better institutions.

Even if fiscal federalism assumptions are essentially valid, local priorities and conditions may affect how core principles are interpreted. Widespread poverty in developing countries, for example, may indicate less diverse needs and preferences, suggesting a conceptual rationale for more centralization to ensure the provision of a minimum level of basic services. This could be offset, however, by spatial diversity in economic bases, environmental conditions, and cultural influences, which may justify varied subnational functional and revenue priorities and modalities. Such variations—among others discussed below—reinforce consensus that there is no single best approach to implementing fiscal decentralization and that what is appropriate could evolve as a country develops over time.

Well-known issues with implementing fiscal federalism

Multiple factors affect how fiscal federalism is used in practice. Beyond defining the legal role of subnational governments, fiscal decentralization depends on broader enabling provisions. Property rights, for example, affect property tax use, and laws protecting citizens’ rights allow civic engagement that enhances citizens’ awareness of subnational government responsibilities and provides input that can discipline and improve subnational government performance.

Second, technical aspects of system design are not straightforward. Difficult trade-offs are embedded in fiscal federalism, and this complicates finding a workable mix of subnational functions. For example, using fiscal transfers to target impoverished areas for equity purposes may limit funds for areas with greater potential for job creation and economic growth. (See the note on [policy coherence](#) for the principle of sound policymaking for more information.)

Third, the lack of appropriate and reliable data for good policy design and administration can create challenges for following fiscal federalism principles. Available information may be kept by different agencies, and some definitions of data and indicators may change over time, making the assembly and efficient use of consistent data more challenging.

Fourth, insufficient capacity often limits subnational government roles. The underlying concern is that even if the centre devolves functions and revenues, some subnational governments do not have adequate capacity to implement those functions. In addition, some claim that fiscal reform initiatives may build capacity in an unbalanced way, focusing too much on technical skills at the expense of attention to governance skills.

Finally, economic realities constrain subnational service delivery and revenue generation. Regional and metropolitan governments more often have resources to deliver services than poor rural governments. Even in productive agricultural areas, services and revenue sources are often controlled by the centre, leaving subnational governments dependent on fiscal transfers and creating challenges for developing a subnational benefit-revenue link.

Neglected contextual factors that affect the implementation of fiscal federalism²¹

Academics and practitioners often recognize the issues noted above, and they typically consider them in applying fiscal federalism principles. Mainstream analysis, however, too often does not reflect sufficiently on other factors that affect fiscal frameworks, including institutional diversity, linkages among decentralization components, national politics, bureaucratic dynamics, subnational contexts, and insufficient strategic management. Implementation of even conceptually compliant frameworks can be weakened by these factors.

Diversity of institutional contexts

The diversity of intergovernmental systems complicates the application of basic intergovernmental relations and decentralization principles, which are framed in a “central versus local” policy space. Few countries, however, are that simple—most are unitary systems but some are federal, and they have varying levels of government with differences in authority. Some levels may have the stronger powers associated with devolution, and others may be more like deconcentrated entities. The starting point for thinking about feasible reform is to document and understand the current situation. Table 5 presents a simplified outline of possible institutions, empowerment, and relationships that incorporate several system features discussed earlier.

The number of subnational government levels varies across countries. Kenya has only one, but most countries have more. Indonesia and South Africa devolve many powers, while Cambodia and Egypt devolve few. Ethiopia and Pakistan prioritize regional government empowerment, while Indonesia and the Philippines privilege local governments. Uganda has only local governments, while Ghana has administrative regions but elected local governments. The levels may be relatively independent or hierarchical (such that lower levels need higher-level approval). In federal countries, lower tiers may be subject more to state/regional than to central oversight. Whether these varied power-sharing arrangements are compatible with fiscal federalism principles or not, they exist for (often resilient) historical and political economy reasons.

Also noteworthy is that countries with multiple subnational levels often blend the forms of decentralization (devolution, deconcentration, delegation) in varied ways. One form may dominate, or the form may differ across levels of government, for example, devolution at one and deconcentration at another. Dimensions of decentralization (administrative, fiscal, and political) may also vary; for example, provinces have more fiscal resources but only local governments are elected.

²¹ Part of this section is adapted from Smoke, P. and Nixon, H. 2016. *Sharing Responsibilities and Resources among Levels of Government: Localizing the Sustainable Development Goals*. New York: UN Department for Economic and Social Affairs, Division of Public Administration and Development Management and Smoke, P.

Table 5. The landscape of decentralization and intergovernmental institutional options

Features	Elements	Comments
Government structure	Federal: central government shares sovereignty with intermediate tier Unitary: authority rests fully in the centre	In federal systems, states/regions/ provinces tend to have moderate to strong authority over lower tiers
Intergovernmental structure	Intermediate: state, region, province Local: cities, towns, counties, districts, etc.; may be subdivisions under any of these Special: entities with specific functions may cover multiple general-purpose governments	There can be variation in relative size and empowerment; intermediate or lower tiers can have more powers; certain government types, e.g., cities, may also have greater authority
Forms of decentralization	Deconcentration: primarily upward accountability Delegation: delegated entity accountable to delegating entity Devolution: stronger accountability to elected subnational governments	Commonly, some mix of these three forms in particular countries; variation can occur in multiple ways, including across different levels of government or across different government functions
Dimensions of decentralization	Administrative: managerial functions, including financial and human resources Fiscal: expenditure and revenue (including borrowing) functions Political: electoral and non-electoral accountability mechanisms	Certain key dimensions closely related to specific forms (e.g., political elections in devolved systems), but the strength and mix of these dimensions can vary considerably in any decentralized system
Vertical intergovernmental relations	Independent: each level has clear autonomy over specific functions Hierarchical: lower tiers are subordinate and must seek approval from higher tiers Collaborative: means and rules exist for sharing functions and decision making	Degrees of independence and hierarchy can vary extensively in any system and may differ across functions; various forms of collaborative arrangements are used among government levels
Horizontal intergovernmental relations	Compulsory: collaboration with neighbouring subnational governments is not optional Voluntary: decision to participate is made by eligible subnational governments that choose to work together	Collaboration mechanisms, e.g., metropolitan development authorities, may be mandated and financed (by the centre or optional and funded by voluntary member contributions)
Partnerships/non-governmental actors	Quasi-governmental: government entity with an element of broader governance Private: contacting of private actors for minor or major public functions Other nongovernmental: partnership with community-based/civil society actors	Various contractual and accountability arrangements are used for many purposes; may involve only one level or multiple levels of government; can involve multiple types of private and nongovernmental actors

Source: Adapted from Smoke and Cook (2022).

Another consideration is the varied degree of intergovernmental institutional development. Some countries have long had functioning subnational governments, and the current policy concern is to improve their effectiveness. Others are transitioning from deconcentrated (centrally managed) systems to devolved systems with elected local governments. In still other cases, such as fragile or post-conflict countries, new subnational governments and related systems and procedures are being developed. Any of these situations may occur in highly diverse political and institutional contexts that will shape the kinds of reforms that are feasible.

Linkages among dimensions of decentralization

Although they are interdependent, the administrative, fiscal, and political dimensions of decentralization are often unbalanced in practice. Administrative decentralization provides systems and processes that support the management of local functions, finances, and staff critical for effective governance and results. Without fiscal decentralization of functions and finances, however, administrative decentralization is not empowered to perform. Fiscal decentralization without administrative decentralization risks poor management and inefficient use of the powers and resources assigned to subnational governments.

Even well-designed fiscal and administrative systems cannot attain the goals of decentralization without adequate political decentralization. In fiscal federalism, expected gains from fiscal decentralization depend on the ability of subnational governments to understand and act on the needs and preferences of local people better than the central government. This requires a well-developed and inclusive local political process. Decentralization (devolution) implies a reduction in accountability of subnational governments to the central government. If reduced upward accountability is not replaced by downward accountability to local people, subnational officials may become primarily accountable to themselves and influential local elites.

Despite the importance of political decentralization for accountability, it does not mean much without adequate administrative and fiscal decentralization. If citizens participate in local elections but see little impact because local officials do not have the fiscal and administrative powers needed to deliver services, decentralization will have little impact and voters may lose trust in their local governments.

In short, fiscal federalism does focus on sensible normative principles for fiscal decentralization, but fiscal systems do not operate in a vacuum. Their effectiveness depends on appropriate administrative and political decentralization, and this must be recognized in the use of fiscal federalism principles for intergovernmental system design and implementation.

National historical and political context

The structure of intergovernmental systems must be understood in terms of historical factors and current conditions in a particular country.²² Existing government levels and roles can be a product of traditional governance, external/colonial influences, and ethnic or religious factors,

²² There is a considerable literature base that is relevant for this topic. Some overview pieces and edited collections include Bardhan, P. and D. Mookherjee, (eds.). 2006. *Decentralization and Local Governance in Developing Countries: A Comparative Perspective*. Cambridge, MA: MIT Press; Connerley, E., K. Eaton and P. Smoke, (eds.). 2010. *Making Decentralization Work: Democracy, Development and Security*. Boulder, CO: Lynne Rienner Publishers; Eaton et.al. (2011); Martinez-Vazquez, J. and F. Vaillancourt (eds.). 2011. *Decentralization in Difficult Environments*. Cheltenham, UK and Northampton, MA: Edward Elgar; Faguet, J. and Pöschl, C. 2015. *Is Decentralization Good for Development? Perspectives from Academics and Policy Makers*. Oxford: Oxford University Press; Smoke, P. 2015a. Rethinking Decentralization: Assessing Challenges to a Popular Public Sector Reform. *Public Administration and Development* 35 (1); Rodden, J. and E. Wibbels. 2019. *Decentralized Governance and Accountability: Academic Research and the Future of Donor Programming*. Cambridge: Cambridge University Press; and Jackson, D. (ed.). 2022. *Local Government Finance is Development Finance*. New York, NY: United Nations Capital Development Fund.

among others. No matter what fiscal federalism principles may suggest, these factors and current circumstances will influence how the principles are actually used.

Although fiscal federalism aims to use public resources as effectively as possible, that may not be the main decentralization goal in some countries, at least initially. Decentralization can be adopted largely to establish political credibility and state legitimacy, especially in countries facing a significant political transition. In post-conflict situations, core normative goals like better services and governance are likely to be secondary to promoting peace and security. In countries in democratic transition, introducing local elections may be the primary initial goal. Visible improvements in public service delivery, however, may be the principal objective in countries where existing subnational governments have not performed satisfactorily.

Many goals are related. Improved services, for example, can stabilize post-conflict situations, although gains may not be sustained without institutional development. Similarly, targeting stronger democratic engagement through elections can create subnational credibility and create a foundation for improved services and local development. The strategy to adopt or reform intergovernmental systems can prioritize varied initial goals that may help to attain others. Presumably many countries ultimately desire the normative goals of economic development and social well-being, but their immediate importance and the path to attaining them can vary.

A major political consideration is that intergovernmental reforms in some countries were adopted in response to acute political or economic crises that create pressures for action. If the response is rushed, there may not be enough time to build broad consensus on reform, and there may be limited interest in using conceptual frameworks, such as fiscal federalism, to develop the well-conceived policies and measures required to implement reform. The primary impetus for reform depends on the nature and strength of the incentives faced by national politicians to pursue reforms that decentralize powers. Even countries that pass strong constitutional and/or legal frameworks that signal commitment may fail to fully design and implement the necessary reforms.

Political circumstances that motivate decentralization and seem similar can result in different reforms. Ethiopia and Indonesia, for example, pursued decentralization following domestic crises precipitated by the secession of provinces, but in distinct ways. Ethiopia constitutionally empowered ethnically identified regional states in an effort to preserve the union, while Indonesia passed laws to weaken provinces and strengthen local governments in a different context. In federal countries, states may block local government empowerment and maintain control over federal resources, as occurred in some Indian states following the passage of constitutional amendments intended to strengthen local governments. Brazil's post-military-rule constitution, in contrast, bypassed states by allowing direct federal transfers to municipalities.

The main point is that historical trajectories as well as national and intergovernmental political dynamics influence the form and strength of subnational government structures and powers.

Fiscal federalism principles may point to service provision at regional rather than local levels, but this may not be feasible. Moreover, contextual change can be rapid. If a new national party wins power or a crisis creates incentives to alter policy, functions and resources may be de- or re-centralized. Policymakers should understand historical factors and political dynamics if they are to develop realistic and productive reforms and respond to shifting conditions as they occur.

National institutional design and bureaucratic dynamics

Development experts working on fiscal decentralization often do not give essential national institutional and managerial considerations enough attention in pursuing reforms. Although national politics may determine the key parameters of intergovernmental systems, central government administrators operating in complex bureaucratic settings are typically responsible for detailed design and implementation.²³ National agencies play different roles. There are ministries with broad mandates in general public functions (civil service, finance, planning), those in charge of subnational government oversight (local government, home affairs, interior), and those that regulate specific public services (education, health, water.)

Even with national political consensus for fiscal decentralization, individual agencies may have different goals in designing or managing such a system. If policies and systems that must work together are poorly coordinated or in conflict, the resulting system may suffer. Examples of such central agency behaviour are plentiful: conflicting initiatives from local governments and finance ministries; excessive control of subnational staffing or operational decisions by civil service commissions or sectoral ministries; gaps between subnational spending authority and access to revenues; or fiscal transfers with disincentives for subnational revenue collection.

The best designed and harmonious national policies, systems, and procedures can be constrained by other factors. Political intrusion in operations, weak national agency accountability, insufficient civil service compensation, and durable clientelistic behaviour, for example, can undercut even normatively compliant systems. Such challenges can be hard to identify and can be resistant to corrective measures, but there are often ways to improve the status quo.

Central governments have a legitimate role in the regulation and oversight of subnational governments. Most countries create national systems and standards, including for financial and human resource management, transparency, accountability, and service delivery. Problems arise mainly if functions under the mandate of different agencies are poorly defined, excessive, conflicting, or capriciously applied. Finding an appropriate balance between central regulation and subnational autonomy as well as coordinating the actors involved in central oversight can be difficult, but such a balance is essential. More attention is needed to develop better harmonized national oversight of subnational governments if the latter are to be able to meet

²³ This is discussed, for example, in Connerley et. al. (2010); Eaton et. al. (2011); and Smoke, P. 2017. Looking Beyond Conventional Intergovernmental Fiscal Frameworks: Principles, Realities and Neglected Issues, in N. Yoshino and P. Morgan (eds.) *Central and Local Government Relations in Asia: Achieving Fiscal Sustainability*. Cheltenham: Edward Elgar.

their potential. It is also important to develop new capacities for central actors to assume altered roles as they transition from a focus on controlling and supervising subnational governments to providing them with strategic coordination, facilitation, and support to meet their responsibilities.

Subnational institutional and political context

Even if national frameworks are well designed and national actors support reform, challenges can emerge at the subnational level if political dynamics are non-inclusive. Use of authority by subnational governments reflects local political power and bureaucratic incentives. Major players could include political parties, economic elites, ethnic/religious groups, patronage networks, and civil society actors, among others. Power imbalances may allow certain actors to capture a disproportionate share of the benefits of decentralization and limit broader increases in accountability and improved performance. Good outcomes are possible, but far from guaranteed.

Competitive elections are seen as the foundation of local governance, but their impact depends on the national framework and local context. Electoral rules, customs, ethnic loyalties, and the nature of political parties, among others, can influence whether elections enhance accountability or allow anti-democratic behaviours. Even well-functioning elections allow citizens to vote only on a broad platform of policy promises and only every few years.

More frequent auxiliary accountability mechanisms, such as participatory budgeting, user committees, town meetings, complaint bureaus, and citizen report cards are common. They can raise awareness of subnational government actions and promote civic engagement. The impact, however, depends on inclusive participation and use of the results in subnational government fiscal decisions. A further concern is civic awareness and perceptions of such tools. If citizens are reluctant to engage out of apathy or fear, these mechanisms are ineffective. (See guidance notes on inclusiveness and particularly on [participatory budgeting](#).)

A neglected feature of subnational governance is horizontal accountability between elected and appointed officials. In historically centralized countries, staff transferred from the centre to newly empowered subnational governments may, at least for some time, maintain strong upward links to their former employers. If local councils cannot exert sufficient control over local staff, they may be unable to respond to the demands of the constituents who elected them.

Another subnational context issue emerges if there are multiple subnational accountability channels. Elected governments may exist in parallel with deconcentrated administrations, especially in newly decentralizing systems. There is often uncertainty about the operational boundaries between these actors, and deconcentrated agencies may have superior funding. Some countries have constituency funds that allow national legislators to fund services that are legally subnational government functions. Community driven development efforts and nongovernmental organizations may also compete with subnational governments in certain service sectors. Ambiguities may arise as new service delivery mechanisms are added in

evolving systems without efforts to coordinate with or discontinue existing mechanisms, as in Indonesia and Kenya. Such situations also result from rapidly implemented transitional decentralization, as in Cambodia, Afghanistan, and Myanmar. If the channels for service delivery are well coordinated, they could potentially promote stronger local governance and development, especially in poorer countries. But without clarity on the respective functions of each approach and how they might work collaboratively, empowering multiple lines of funding and accountability may confuse citizens and result in gaps, duplication of effort, and inequities in service provision.

Pursuing more informed and strategic implementation²⁴

The design of intergovernmental fiscal reforms often receives much more attention than the even more challenging task of their implementation, which fiscal federalism theory does not address. Since reforms are often demanding and require substantial operational and behavioural changes, there is growing recognition that more attention to how and over what time period new systems and processes are rolled out can influence the quality and sustainability of outcomes.

The national aspects of implementation are critical. It is essential to carefully define and sequence reforms and coordinate the actors involved. Fiscal federalism implies that the centre will issue policies that will be followed by all relevant parties—what might be called a “sink or swim” approach. At the other extreme, the centre pursues a highly managed gradual reform process based on its own judgment—a somewhat “paternalistic” approach. The former assumes all actors—central and subnational—can and will comply with reforms. The latter assumes the centre will competently, responsibly, and fairly advance decentralization reform.

There are, however, approaches between these two extremes. A compromise “developmental” approach could involve systematic (criteria-based) treatment of subnational governments that recognizes their asymmetric conditions and capacities and allows them to assume new roles at an appropriately varied pace. Under this approach, more capable subnational governments would receive powers and more revenue autonomy more rapidly, while weaker counterparts could advance more gradually in conjunction with targeted technical assistance and capacity building.

Fiscal federalism purists object to withholding legal powers to some subnational governments once they are enshrined in laws and policies, but the counter argument is that moving too quickly without basic capacity in place is almost certain to result in inadequate performance. Subnational governments can be more genuine partners in this approach if invited to negotiate their steps and pace in the reform process, which places responsibility on them to comply with

²⁴ See, for example, Litvack, J., J. Ahmad, and R. Bird 1998. *Rethinking Decentralization in Developing Countries*. Washington, DC: The World Bank; Connerley et. al. (2010); Eaton et. al. (2011); Bahl, R. and J. Martinez-Vazquez, Sequencing Fiscal Decentralization (2013). *Annals of Economics and Finance* 14 (2): 623-670; Smoke, P. 2015. Managing Public Sector Decentralization in Developing Countries: Moving Beyond Conventional Recipes. *Public Administration and Development* 35 (4); and Smoke, P. 2021. Political Economy Perspectives on Intergovernmental Fiscal System Design and Implementation in Asia, in J. Kim and S. Dougherty (eds.). *Local Public Finance and Capacity Building in Asia*. Paris: OECD, pp. 33-54.

what they agreed to (relative to simply following central government mandates). Such an implementation approach requires a transparent process and a clear path to greater empowerment as subnational governments attain capacity and performance standards. Although challenging, a committed centre can leverage its control over assigning powers, awarding funding, and providing technical assistance to encourage subnational governments to adopt needed reforms progressively.

Related to the development of an implementation strategy is the process for designing and managing it. As suggested above, decentralization is likely to work best if relevant actors with a role in or affected by the proposed reform(s) are involved in formulation discussions and subsequent implementation arrangements. Global experience suggests that fiscal (and other) decentralization reforms are often designed in a closed process. Even a finance ministry that would lead on fiscal decentralization can benefit from engaging other players whose support of a reform and collaboration in implementation is needed. Such actors could include, for example, sectoral ministries involved in services to be assigned through the reforms and subnational governments or departments that are the target entities.

There may be challenges in using this approach in federal systems. If reforms target local governments, there will be questions about what to standardize nationally versus allow more control by states/provinces, and at what stage local governments can be included in discussions. There is no ideal process, and different states/provinces may have their own credible preferences for engaging constituent local governments. Appropriate engagement, however, has the potential to help develop better reforms and facilitate their implementation and sustainability.

If a decision is made to pursue more strategic implementation on fiscal decentralization reforms, a number of steps could be considered:

- *Determine starting points for the sequencing of reform(s).* The specifics will vary by the scope of the effort, but this requires prioritizing reforms, perhaps focusing on simpler tasks that don't excessively overwhelm capacity and may be more likely to succeed. It is important to choose something that begins to move the system in a better direction, and to set up a criteria-based process to define and sustain the progression of reforms. Asymmetric starting points can be productive, and for certain types of reforms, sequencing may be at least partly negotiated with subnational governments, a feature that places a degree of responsibility on them to comply with steps they voluntarily agree to.
- *Consider the use of piloting and experimentation before mainstreaming reform design.* Not all reforms require pre-adoption testing, but those that involve the application of new systems and technologies, the development of new skills for subnational staff, or that use partnerships among actors not accustomed to working together may benefit considerably from experimentation. This is particularly true if multiple approaches or technologies are under consideration and merit systematic comparison in practice.

Successful piloting not only provides a justification to generalize and institutionalize a reform, but it can also generate interest among other subnational governments to adopt proven reforms.

- *Use appropriate reform incentives.* Once reforms and sequencing are determined, positive or negative incentives (rewards and penalties) for subnational governments to adopt them may be productive. Various approaches are used globally, including 1) enforceable accountability mechanisms, such as central or state government contracts with local governments; 2) financial incentives to adopt reforms and improve performance, such as performance-based grants; and 3) tournament-based approaches to recognize improved. The utility of such mechanisms will depend on the political/bureaucratic culture in a particular country and the efforts/costs involved in developing and monitoring them.
- *Appropriately enhance capacity development.* Capacity building and technical assistance for subnational actors may be needed for successful reforms. Critics have argued that capacity building is often framed in a standardized and mechanical way, with a bias toward central supply-driven training in technical skills. There is less emphasis on governance skills that are essential for some types of subnational fiscal reforms, such as how a subnational tax administration can engage with business and citizen taxpayers to increase their understanding of how funds are used and facilitate compliance. A greater role for demand-driven capacity support may also be beneficial. This would include, for example, on-the-job/on-site training in skills needed for specific in-process reforms requested by a subnational government, which can enhance skill building and retention.
- *Adopt an ongoing learning and adaptation approach to intergovernmental fiscal reform.* Even with strong consensus, good policies, and carefully designed implementation strategies, problems can emerge. Some aspects of reform may not work as planned, suggesting design flaws or unanticipated obstacles—or challenges in specific subnational jurisdictions may require attention. Equally as important, economic, fiscal, and political conditions may change, which may justify modifications in the original design and implementation strategy. Such an approach requires institutionalizing capacity for sufficient routine coordinated monitoring and evaluation of reform efforts and enforcement mechanisms to ensure that the results of these efforts are used in practice.

These are only illustrative elements of a strategic approach to intergovernmental fiscal reform implementation, but they offer a sense of the types of steps that may be productive. Such an approach risks being politicized, and subnational governments could learn to game the system. Although a developmental approach is no sure bet, it seems worth experimentation given the key role of subnational governments in achieving the SDGs and the underperformance of

some past efforts. More generally, this approach is consistent with the growing general interest in incremental, problem-driven, and iterative approaches to public sector reform.²⁵

Beyond the national perspective, subnational governments also face implementation challenges when taking steps to adopt new fiscal responsibilities and improve performance. Even the most capable among them needs to be pragmatically strategic in sequencing reforms that require operational changes, new skills acquisition, and behavioural modifications. If, for example, subnational governments attempt to implement new revenue powers too quickly, they may face taxpayer opposition. A more strategic approach would be to raise revenue assessments incrementally, perhaps linking them to specific and visible service delivery enhancements.

Subnational governments pursuing reform can also use measures to engage their constituents more substantially. Augmenting civic education efforts, creating consequential avenues for participation, and improving oversight and transparent reporting may raise public awareness, produce valuable input for decision makers and managers and increase public trust in subnational governments. The risk of mechanical reforms was noted above but committed subnational leaders can use the types of approaches and mechanisms outlined above and others to build downward accountability strategically and progressively.

Case studies

Examining cases can offer insights into how fiscal decentralization has been pursued in particular countries. No country uses only fiscal federalism to define intergovernmental reforms since it only covers part of what is needed for decentralization to work. Moreover, even a system consistent with fiscal federalism principles can only be considered successful once implemented, and fiscal federalism provides no guidance on how to make the principles work in practice.

Given this reality, it is not possible to identify “best practice” cases of using fiscal federalism principles to pursue decentralization. Most efforts are more holistic and do not focus only on fiscal reforms, and while principles typically figure into more comprehensive reforms, countries use them selectively in ways and in sequences that reflect their broader contextual realities. It is possible, however, to provide a few vignettes of countries that took different approaches, which helps to illustrate how fiscal decentralization principles are used in practice in diverse ways.

Ethiopia pursued a decentralization strategy in which (largely but not exclusively) ethnically identified states were empowered by a new constitution to hold the country together after the

²⁵ See, for example Andrews, M. 2012. *The Limits of Institutional Reform in Development: Changing Rules for Realistic Solutions*. Cambridge: Cambridge University Press; Andrews, M., L. Pritchett, and M. Woolcock. 2013. Escaping Capability Traps through Problem Driven Iterative Analysis. *World Development*. 51 (2013): 234-244; and Andrews, M., L. Pritchett, and M. Woolcock. 2017. *Building State Capability: Evidence, Analysis, Action*. Oxford: Oxford University Press.

secession of an important regional state, Eritrea. In that case, subnational empowerment was focused at the regional state level and generous tax sharing and formula-based transfers were used to finance their functions. Limited attention was paid to sub-state decentralization until years later. National leaders were initially less concerned with democratic decentralization and development, and instead aimed to satisfy regional states sufficiently to keep them part of the country, mitigate cross-regional tensions, and offer an opportunity for them to assume public functions more independently. This approach created sufficient stability to allow the productive evolution of public sector systems, service delivery, and development over time. The growing development orientation led to the adoption of a second decentralization phase to the sub-state level, including resource sharing. Despite a strong centre and different regional preferences for control over local public resource use, there has been some innovation, capacity building, and governance development at the local level. This seems to have been possible partly because the central government had substantial time between the first and second reform phases to gradually build adequate systems for managing public resources and partly because higher levels cannot effectively monitor and control everything that goes on in the many local jurisdictions spread out over a large country.

Indonesia pursued decentralization when faced with a severe predicament after the 1997 Asian financial crisis, the precipitous fall of the Suharto regime, and the loss of East Timor province in a popular referendum. In contrast to Ethiopia, the decentralization reform empowered the local tier (cities and regencies) and—compared to their pre-decentralization role—initially weakened the intermediate tier (provinces). Decentralization benefited from local governments in some parts of Indonesia having the capacity to deliver services because they had done so as part of a deconcentrated central administration before the devolution to elected local governments. Although the focus was on the local level, the bulk of local resources came in the form of intergovernmental fiscal transfers with limited strengthening of own-source revenues. In addition, the provinces that seemed most likely to consider secession (given ethnic and religious divides) and were important nationally for economic reasons (natural resource endowments) successfully negotiated for greater autonomy and benefitted from generous revenue-sharing schemes (largely linked to national natural resource taxation on their rich resource bases). Over time there have been achievements, although performance has been somewhat less than expected given the scale of the resources devolved to local governments. Some analysts attribute this in part to the weaker role of the provinces (the "missing middle"), which had played a major developmental role under the old system, the generous revenue sharing with local governments with limited conditions attached, and the slow development of local accountability to discipline local governments. In response to the performance concerns, later reforms introduced some modest measures of recentralization and a stronger role for provinces, including budget reviews and greater use of conditional transfers, and there have been efforts to build greater subnational government capacity and create incentives, including the adoption of some performance-based transfers.

Uganda is an interesting case of decentralization in a post-conflict environment where state-building was seen as imperative. Unlike in many developing countries, decentralization was

unusually homegrown (inspired by major political change) and initially very substantial for a low-income country. The reform targeted local governments, which were empowered with considerable responsibilities and resources (largely transfers rather than own sources), and it specifically avoided the empowerment of regional governments because of links to traditional kingdoms that the centre did not believe should be formal government actors. In the early years, decentralization was lauded as a model for developing countries, and it generated public support, broad national enthusiasm, and substantial external resources to support intergovernmental fiscal system development. There was genuine progress, but over time several national policies weakened local government autonomy. These policies were partly political but also responded to the over-ambitious nature, pace, and trajectory of decentralization and reflected the heavy emphasis on developing public sector fiscal and managerial systems with less attention to local accountability and governance. Equally important, central agencies that originally supported decentralization began acting to protect their interests when they recognized the implications of decentralization for their own role, and documentation of local government performance issues also generated some weakening of the initially robust devolution. Despite the partial reversal, decentralization has clearly played a role in state building and local capacity development and there is likely space for decentralization to become stronger in the future.

Cambodia is an example of a modest decentralization that generated some potential benefits without following fiscal federalism principles carefully. The deconcentrated administrative system originally developed by the French fell into disrepair during decades of post-colonial civil war and turmoil, and strengthening it was not a priority for the weak and fractious national government in the early post-conflict years. The foundation for a local government system, however, was laid by donor experiments. A post-conflict resettlement, reconciliation, and service delivery program initially funded by the United Nations was transformed into a broadly supported local institution-building and governance effort in the late 1990s. This was facilitated by the use of donor-designed institutional structures and procedures to plan, finance, and deliver simple local services, mostly in rural areas. The success of the initiative and prospects for external support to expand made it attractive to the national government. Thus, the country began a formal limited decentralization to elected governments at the commune (sub-district) level in 2002. The resources channelled to communes were modest (small formula-driven transfers, very limited local sources) and there were few specific functional assignments, so they did not follow fiscal federalism principles. But the transferred resources conferred benefits on localities in a visible way, helped defuse post-conflict tensions, and generated some political credibility without threatening the authority of central agencies that might otherwise have tried to obstruct reforms. It also built modest local technical and governance capacity that seems to have been somewhat durable. When decentralization was later extended to higher levels (districts, municipalities, and provinces), the design created more central control and upward accountability for those actors, but the commune system remains in place. Efforts to strengthen fiscal decentralization are not likely to be a priority in

the near-term, but the dynamics and capacity unleashed at the local level by the original decentralization may bode well for future stronger subnational governments.

It is difficult to summarize this selective and diverse range of country experiences, but they reinforce many general points raised earlier in this note. Elements of fiscal federalism were used in system design in most cases, but in ways that reflected the broader context in each country (in some cases dealing with political turning points and post-conflict recovery), and with some evident deviations. Most notably, own source revenue powers were limited in all cases, which as indicated in the earlier discussion, is not uncommon in developing countries. All of the countries, however, used transfers that were for the most part transparently and objectively allocated by formula—and well-funded in all but one case. Lack of fuller adherence to fiscal decentralization norms reflects larger national political economy realities and other issues, such as capacity constraints. Few decentralization reforms in developing countries meet the textbook “gold standard” principles of fiscal federalism and devolution in their early stages. This is often appropriate, especially as a starting point for piloting reforms, introducing new and unfamiliar systems and processes to governments and citizens, improving state stability and credibility, and building capacity in challenging environments. The ultimate question is whether the starting point can progressively evolve into a more advanced and sustainable intergovernmental fiscal system that appropriately incorporates fiscal federalism principles.

Peer-to-peer learning and research

There are no specific organizations or initiatives that consider their primary mission to be focused on fiscal federalism. There is, however, a broad spectrum of initiatives targeting decentralization that involve a range of development partners, international finance institutions, membership organizations, and nongovernmental actors. Some of these are heavily involved in fiscal decentralization, intergovernmental fiscal relations, municipal finance, and urban development activities. These are covered in the other guidance notes, particularly the note on [strengthening municipal finance and local finance systems](#).

International development cooperation

The role of international development agencies in supporting fiscal decentralization has been substantial, especially in aid dependent countries.²⁶ Interest in fiscal decentralization emerged as many developing countries began to democratize and decentralize as early as the 1970s. It became increasingly prominent as more countries adopted such reforms and more development partners entered the field. Fiscal decentralization did not initially receive as much

²⁶ There is little written specifically on development partner support to fiscal decentralization beyond a range of documents of particular agencies that focus on their own priorities and programmatic efforts. Support to decentralization more generally is discussed in Romeo (2003), OECD (2004), Fritzen (2007), DeLoG (2011), Eaton, et. al. (2011), Dickovick (2014) and OECD (2019), among others. Smoke and Uwayo (2023) review donor support for municipal finance.

attention as administrative aspects, most likely because national finance ministries and international financial institutions were cautious about devolving major fiscal powers.

As awareness grew about the potentially productive role of subnational governments in governance and finance, global development agendas evolved - the 2030 Agenda and other initiatives were discussed early in this paper. Pressures also arose from persistent urbanization, rising inequality, evidence of major and unevenly distributed local infrastructure and service delivery gaps, regional and global financial crises, growing climate change demands and challenges exposed by the Covid-19 pandemic.

No development partners specifically frame programs around fiscal federalism, but several have dedicated efforts in fiscal decentralization or municipal finance. Many partners, however, embed fiscal decentralization work in their broader public sector reform support, comprehensive decentralization programs, or activities undertaken as part of efforts to support urban development or local public service delivery in specific sectors (education, health, transport, water, etc.). This means that programming relevant for fiscal decentralization may be spread out across multiple departments or divisions within a particular development partner.

Many development partners have web pages and publications about fiscal decentralization, but few have dedicated agency-wide policies to guide all of their activities in this area, and there is not always a dedicated webpage that synthesizes a partner's full portfolio in this field. Development partners also vary in terms of how they report fiscal decentralization activities and the level of detail made public. Following is a list of some of the main partners involved and illustrative links that offer information on some of their priority policies and programming.

- All of the major international finance institutions - the [World Bank](#) and the main regional development banks, [African Development Bank](#), [Asian Development Bank](#) and [Inter-American Development Bank](#) - work on decentralization, including intergovernmental fiscal policy and subnational finance, in some substantial way.
- Several United Nations agencies, including [UNCDF](#), [UNDESA](#), [UNDP](#) and [UN-Habitat](#) have significant if varied activity in the fiscal decentralization field. UNCDF has a primary engagement in subnational finance, for example, while UN-Habitat is more focused on the central role of finance in city and municipal planning and development.
- Other United Nations agencies, such as [UNICEF](#) and [UN-Women](#) engage in fiscal decentralization activities to the extent that such activities support their specific mission.

- The [European Union](#) is very active in supporting decentralization and territorial development and finance, and the [OECD fiscal federalism network](#) does extensive work on fiscal decentralization, some of which extends beyond OECD member states.
- Certain bilateral development agencies support fiscal decentralization or specific elements of it, such as [AFD](#) (France), [GIZ](#) (Germany), [SDC](#) (Switzerland) and [USAID](#) (United States). GIZ, SDC, and USAID frame finance as a core element of decentralized governance, while AFD focuses more on development finance for local infrastructure.
- Others bilateral agencies, such as DFAT/Australia, FCDO/UK, NORAD/Norway, and SIDA/Sweden—have some finance-related efforts to support decentralized governance, albeit to different degrees and with different primary focus areas.
- Additional information on relevant donor programming can be found in the guidance note on [strengthening municipal finance and local finance systems](#).

Although there is variation across development partners, the main types of support for fiscal decentralization include some mix of technical assistance, capacity development, and investment support. Some partners target specific goals, functions, or processes while others follow a more integrated comprehensive approach. Large multilateral development banks often have more diverse and multi-sector portfolios, while United Nations agencies and bilateral donors tend to offer support through somewhat more specialized lenses. Large partners with multiple policies and portfolios in subnational finance managed by different internal departments, however, may insufficiently coordinate their policies and programs. Teams that support finance, governance, or urban development, for example, may all be involved in subnational finance, but they tend to operate relatively independently. There may be better integration at the country level if an agency's country director is able to work with urban, sectoral, and public finance field managers to link their programs and projects rather than duplicate efforts.

Development partner programming also uses different means of funding. Major development banks commonly provide finance primarily through loans, so they typically fund larger fiscal decentralization projects, often with major investment components. Most other multilateral and bilateral development partners tend to favour grants over loan financing, so they rarely have initiatives at the scale of the development banks, typically focusing on institution building, governance, and fiscal decentralization policy advice. Several partners increasingly employ innovative approaches, such as performance-based financing and technology adoption. Other efforts include cultivating partnerships between subnational governments in client countries and wealthier countries as well as in peer countries (South-South cooperation).

Countries seeking fiscal decentralization support from development partners should carefully assess their options. International development agencies have made great contributions to countries pursuing fiscal decentralization and have much to offer, but the types and levels of

support vary considerably. In addition, concerns have been raised about insufficient engagement among partners and even among divisions of the same partner on how they structure and coordinate their fiscal decentralization programs in a particular country. Officials of countries that benefit from such assistance need to be aware of the opportunities and challenges involved and do their best to work with development partners in a way that generates effective and sustainable programs and produces results for their country and their citizens.

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