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Lessons for Effective Fiscal Decentralization in Sub-Saharan Africa

Niko Hobdari, Vina Nguyen,
Salvatore Dell'Erba,
and Edgardo Ruggiero

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Executive Summary

Fiscal decentralization is becoming a pressing issue in a number of countries in sub-Saharan Africa, reflecting demands for a greater local voice in spending decisions and efforts to strengthen social cohesion. Against this backdrop, this paper seeks to distill the lessons for an effective fiscal decentralization reform, focusing on the macroeconomic aspects. The main findings for sub-Saharan African countries that have decentralized, based on an empirical analysis and four case studies (Kenya, Nigeria, South Africa, Uganda), are as follows:

- Determinants and effectiveness: Empirical results suggest that (1) the major driving forces behind fiscal decentralization in sub-Saharan Africa include efforts to defuse ethnic conflicts, the initial level of income, and the urbanization rate, whereas strength of democracy is not an important determinant for decentralization; and (2) decentralization in sub-Saharan Africa is associated with higher growth in the presence of stronger institutions.
- Spending assignments: The allocation of spending across levels of government in the four case studies is broadly consistent with best practice. However, in Uganda, unlike in the other three case studies, subnational governments have little flexibility to make spending decisions as a result of a deconcentrated rather than a devolved system of government.
- Own revenue: The assignment of taxing powers is broadly in line with best practice in the four case studies, with the bulk of subnational revenue coming from property taxes and from fees for local services. However, own revenues are a very small fraction of subnational spending, reflecting weak cadaster systems and a high level of informality in the economy.
- Transfers: In some cases (for example, Kenya and Nigeria) most transfers are unconditional, with subnational governments having broad spending

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autonomy. But in most sub-Saharan African countries transfers are largely earmarked by the central government for the provision of specific services.

- Hard budget constraints: The authorities in the four sub-Saharan Africa case studies have generally succeeded in keeping borrowing by subnational governments under control using strict fiscal rules, including ceilings on subnational governments' debt stock (Kenya, Nigeria, Uganda) or tough sanctions for subnational governments if they ignore good fiscal practices instituted by the central government, complemented by a transparent mechanism for subnational bankruptcies (South Africa).
- Speed of transition: The fast speed of fiscal decentralization in Kenya and South Africa has not been commensurate with the capacity of subnational governments to effectively carry out the spending assigned to them. This created problems initially with service delivery at the subnational level, which were addressed gradually over time. This suggests a gradual decentralization through a process that goes hand in hand with strengthening the public finance management systems.

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CHAPTER

1 Context

At independence,[1] sub-Saharan African countries inherited a highly centralized model of territorial government and fiscal arrangements. Most post-colonial regimes promised a swift decentralization of power, resources, and responsibilities to subnational levels of government. However, not much changed across the continent for quite some time. Through the early 1990s the combination of administrative centralization with a nondemocratic political framework maintained an unaccountable and inefficient system in most sub-Saharan African countries. Owing to the chronic scarcity of resources, service provision and maintenance of basic infrastructure were neglected, particularly in the rural areas, and the very few resources devolved to local governments were concentrated in urban areas, especially the capital city (Brosio 2000).

Fiscal decentralization reforms started gaining momentum in sub-Saharan Africa in the early 1990s. Fiscal decentralization is most advanced in three sub-Saharan African countries—Ethiopia, Nigeria, and South Africa—where spending at the subnational government level represents about half of total general government spending (Figure 1 and IMF 2006). Only in a handful of other sub-Saharan African countries is spending at the subnational level significant—notably in Kenya, Rwanda, Tanzania, and Uganda, where it amounts to about 15–20 percent of general government spending. Subnational government spending in these countries is in line with the level in other emerging markets, although well below that in a typical Organization for Economic Co-operation and Development (OECD) country (Figure 2).

[1]Fiscal decentralization is generally defined as the authority over raising revenues and making decisions on spending and borrowing at the subnational level. The authority of subnational governments to make such decisions is typically broad in a devolved system of government (where decision making is transferred to elected subnational governments) and very limited in a deconcentrated system (where subnational governments are upwardly accountable to the central government and local officials are typically appointed, not elected).

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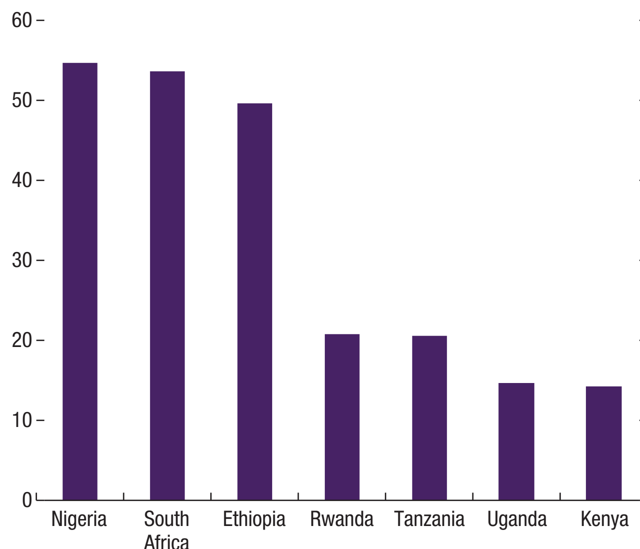
Figure 1. Subnational Government Spending
(Percent of general government spending)



Sources: Organization for Economic Co-operation and Developments database; and IMF staff calculations.

Decentralization has recently come to the forefront of the policy agenda in many sub-Saharan African countries. A number of sub-Saharan African countries have announced major decentralization reforms, including Lesotho, Liberia, Madagascar, Mali, and Zambia. This seems to reflect two driving forces: (1) a political evolution toward more democratic and participatory forms of government, which is creating demand for greater local voice in spending decisions, and (2) efforts to increase the participation of various ethnic groups or of former warring factions in the governance of the country, with a view to increasing social cohesion and reducing risks of secession.

Against this background, the paper seeks to distill the lessons of decentralization in sub-Saharan Africa and elsewhere, focusing on the macroeconomic aspects. Recent decades have seen a push toward fiscal decentralization around the world. For example, Aldasoro and Seiferling (2014) find an upward trend in expenditure decentralization since the mid-1990s in a number of advanced and emerging market economies. Dziobek and others (2011) on the other hand find that the level of decentralization has been relatively stable since the early 1990s, except the the transtion economies in the Eastern and Central Europe and several countries of the Former Soviet Union. This paper does not take a position for or against fiscal decentralization. Rather, given that decisions in this area reflect political preferences, the paper uses lessons from international experience to suggest how to mini-

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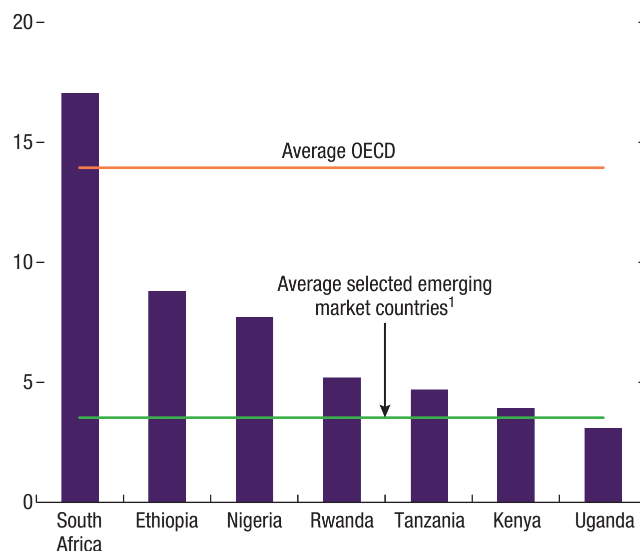
Figure 2. Subnational Government Spending
(Percent of GDP)



Sources: Organization for Economic Co-operation and Development (OECD) and IMF Government Finance Statistics databases; and IMF staff calculations.
[1]Includes Bolivia, Colombia, Honduras, Indonesia, Jordan, Paraguay, Peru, Russia, Thailand, Tunisia, Turkey, and Ukraine.

mize macroeconomic risks while strengthening the quality of public services when embarking on fiscal decentralization reforms. Section 2 covers the pros and cons of fiscal decentralization; Section 3 summarizes best practices for the main design elements of fiscal decentralization (focusing on the macroeconomic aspects); Section 4 takes stock of fiscal decentralization so far in sub-Saharan Africa; and Section 5 concludes. The experience in Kenya, Nigeria, South Africa, and Uganda is summarized in Annexes 1–4.

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CHAPTER

2 Pros and Cons of Fiscal Decentralization

The classic argument in favor of decentralization is that it can increase economic efficiency and reduce regional income disparity (Table 1). The traditional economic rationale for decentralization relies mainly on efficiency arguments related to the purported information advantage of local politicians (Musgrave 1959). This advantage is expected to increase both allocative efficiency, by better matching policies with citizens' preferences (Oates 1972), and productive efficiency; that is, more output for the same input (Ahmad, Brosio, and Tanzi, 2008). In addition, fiscal decentralization can help reduce regional income differences and can become a positive force in efforts to alleviate poverty. Fiscal decentralization also offers the potential to address perceived ethnic and political bias by giving local communities greater control over resources and decisions about service delivery, especially if the control is accompanied by greater transparency and accountability.

But fiscal decentralization can also have drawbacks (Table 1).

- *Macro-fiscal risks*: One of the main risks with fiscal decentralization is that it can undermine fiscal discipline. This risk arises because decentralization of spending is usually financed through a common pool of transfers from the center; as a result, subnational governments do not fully internalize the cost of local expenditure. Combined with soft budget constraints, this can result in overspending and lower tax effort at the subnational level (Escolano and others 2012). A mismatch between spending responsibilities and the ability to collect revenue has also been an issue. Indeed, several studies suggest that a faster decentralization of spending relative to that of revenue collection (resulting in large vertical fiscal imbalances) tends to increase the overall fiscal deficit and result in higher public debt (Eyraud and Lusinyan 2011; Aldasoro and Seiferling 2014) and weaken the discipline-enhancing effect of fiscal rules (Kotia and Lledó 2016).

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Table 1. Fiscal Decentralization Trade-Offs

Fiscal Policy Objective	Strengths of Decentralized Government	Potential Risks
Macroeconomic stability	• None	• Higher fiscal deficits • Less flexibility to respond to shocks
Equity and redistribution	• Better targeting • More resources for remote and rural areas	• Can exacerbate inequality, especially in resource-rich countries
Productive and allocative efficiency	• Better information on local needs and preferences • More accountability	• Lower spending efficiency if public fiscal management capacity is weak • Loss of economies of scale • Proliferation of nuisance local taxes

Source: Fedelino and Ter-Minassian 2009.

- *Lower spending efficiency and higher nuisance taxes*: Weak administrative or technical capacity and typically higher corruption at the subnational levels may result in less efficient and effective provision of local services. In addition, decentralization of spending without adequate resources from the center can contribute to the imposition of nuisance taxes by subnational governments to close the fiscal gap, undermining the business environment. Decentralization may also contribute to increasing horizontal disparities rather than reducing them in cases of geographical differences in economic endowments (for example, countries that share much of their natural resource revenue with producing regions).
- *Political risks:* Devolution could undermine national unity by encouraging fragmentation along ethnic lines or by decentralizing corruption, leaving citizens worse off if local elites are able to capture resources to the detriment of the majority (World Bank 2012).

The push for fiscal decentralization often reflects political pressures. Economists tend to focus on efficiency arguments, but in many countries fiscal decentralization is driven by political demands for regional autonomy. In some countries (for example, Italy), the economic divide between rich and poor regions has led to demands for autonomy from the former. In some other OECD countries, moves toward fiscal decentralization have reflected ethnic or linguistic divides (for example, Belgium, Spain, and the United Kingdom). The OECD experience shows that the more culturally or ethnically identified the population of a region is, the more likely that it will push for decentralization. As for emerging and low-income countries, pressure for decentralization has come from various sources, including as a reaction to extended periods of centralized rule (Indonesia, Peru) and ethnically motivated secessionist pressures (Nigeria), and following social strife among different ethnic groups (Kenya).

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Evidence is inconclusive for the benefits of fiscal decentralization for enhanced service delivery, economic growth, and alleviating regional and ethnic rivalries.

- *Fiscal decentralization has an ambiguous impact on service delivery*: For example, Barankay and Lockwood (2006) find that educational attainment in OECD countries is positively and significantly correlated with the degree of decentralization, and Jimenez and Smith (2005) find that infant mortality in Canadian provinces is negatively correlated with the degree of decentralization. In sub-Saharan Africa, findings in Nigeria suggest that higher fiscal decentralization is associated with lower mortality and higher literacy rates (Akpan 2011). However, studies on convergence of service provision across regions suggest that if substantial equalization grants are not provided, decentralization actually increases regional disparities in service delivery. In addition, the degree of fractionalization seems to adversely affect access to public services in ethnically diverse jurisdictions (for example, Ghana) (Aramov and Asante 2009).
- *The impact of fiscal decentralization on growth is also inconclusive*: Empirical studies on this topic have yielded contradictory results. Thiessen (2000, 2003) finds a bell-shaped curve for OECD countries; that is, growth accelerates when countries move from low to medium levels of decentralization, but higher levels of decentralization reduce growth. The type of decentralization (decentralization of spending versus that of revenue) also can affect the impact on growth. Gemmell, Kneller, and Sanz (2013) find that spending decentralization in 23 OECD countries was associated with lower economic growth, whereas revenue decentralization has been associated with higher growth. Rodriguez-Pose and Kroijer (2009) reach a similar conclusion in a study covering 16 central and eastern European countries. Decentralization of spending has also been found to result in lower public investment, in part owing to larger public employment following decentralization, which tends to have an adverse impact on growth (Ahmad and Tanzi 2002).
- *Using decentralization to alleviate ethnic rivalries has not always worked:* Local elections may catalyze the expression of divisive demands and exacerbate interregional and interethnic competition for central resources. Such problems have tended to become acute in countries with regionally concentrated reserves of natural resources (Brosio 2000). As for the impact of decentralization on the redistribution of resources, there is some evidence from sub-Saharan Africa that decentralization has increased the share of resources directed to poorer regions. This includes South Africa (regarding expenditure on education) and Ethiopia, where centrally provided transfers have benefited the poorest regions, although the impact on educational outcomes has been uneven (Ahmad and Tanzi 2002).

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Conflicting results of fiscal decentralization reforms reflect the great variety of experiences, as well as the political legitimacy and effectiveness, of governments that have undertaken fiscal decentralization. For example, the effectiveness of decentralization depends on what drives it; that is, on whether decentralization is aimed at increasing democracy or at diffusing local separatist movements. In addition, the purported benefits of decentralization are more likely to be achieved under a devolved system (in which decision making on spending is transferred to subnational governments) than under a deconcentrated system (in which subnational governments have very little autonomy with regard to spending decisions). Also, the type of decentralization varies from giving more powers to large units (for example, states in federal countries) or much smaller ones (for example, local governments in unitary states). At the end of the day, the impact of fiscal decentralization depends largely on the design of intergovernmental fiscal relations rather than the ultimate extent of decentralization (Fedelino and Ter-Minassian 2009, and Fedelino 2010). Experience suggests that gradual decentralization is better than a big-bang approach, but it is important that all the pieces of fiscal decentralization are in the plan from the beginning (Bahl and Bird 2018). The following section reviews international experience to identify the key elements of effective fiscal decentralization.

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CHAPTER

3 Design Elements for Effective Fiscal Decentralization

For decentralization to be successful, it must be implemented as part of a comprehensive framework. A typical mistake that governments make is changing certain aspects of the intergovernmental fiscal framework in isolation; for example, modifying expenditure mandates, introducing new revenue-sharing schemes, or changing the transfer system. If they are not part of a comprehensive framework, such isolated changes may eventually create inconsistencies across government levels, undermining the effectiveness of fiscal policy and increasing macroeconomic risks (Fedelino and Ter-Minassian 2009, and Goerl and Seiferling 2014). In addition, there are various tradeoffs involved in designing decentralization, so it must be tailored to the priority goals and circumstances of each country (Prud'Home 2003). Having said that, experience suggests that the following four elements are essential for a comprehensive decentralization framework that maximizes potential benefits while minimizing risks: (1) clarifying spending responsibilities across levels of government; (2) allowing subnational government to raise own revenues to reduce vertical imbalances and increase fiscal responsibility; (3) designing a transfer system that encourages subnational governments to collect own revenue and manage their functions efficiently; and (4) imposing hard budget constraints on subnational governments to foster fiscal discipline (see Ter-Minassian 1997, and IMF 2009a and 2009b for a detailed discussion).

Assignment of Responsibilities

Few clear-cut rules exist for assigning spending responsibilities across levels of government. For some spending functions, responsibility can be easily assigned to different levels of government; for example, those related to the provision of pure public goods such as defense and foreign affairs to the central government, and local services such as garbage collection and street cleaning to the subnational governments. The provision of social protection

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(such as public pensions, unemployment insurance, and social assistance) is also typically centralized, and the center has expanded the provision of services with large positive network externalities, such as national transportation and energy transmission grids (Escolano and others 2015). However, many spending functions inevitably overlap and are jointly undertaken by all levels of government.

Lack of clarity in spending assignments contributes to the inefficient provision or underprovision of public services. A typical example is the separation between the assignment of responsibility for maintenance and operation of infrastructure facilities to the subnational governments and the assignment of responsibility for capital investment to the central government. This dichotomy tends to reduce the expenditures for both maintenance and capital infrastructure, because each level of government can blame the other for not doing its part, and each level expects that the other will ultimately replace or renovate and maintain the property. For example, as a result of such separation of spending assignments in Mexico's education system, neither maintenance nor new investment was adequate, resulting in most physical infrastructure being decrepit or poorly maintained (Mendoza and Vazquez 2000).

Failure to identify appropriate resources for spending responsibilities assigned to subnational government can lead to fiscal pressures. The mismatch of spending responsibilities with the necessary financing has been an issue in many countries. In some cases (for example, Brazil and China) the devolution of resources significantly outpaced that of spending, creating fiscal pressures at the central government level. In others (for example, the transition economies in Eastern and Central Europe in the early 1990s), spending mandates were pushed down to the subnational level without an adequate provision of resources, leading to the accumulation of debt or arrears, or to a significant deterioration in the quality of decentralized public services.

Against this background, fiscal decentralization reform should include legislative clarification of the responsibilities of each level of government and identification of appropriate resources for their financing. While there is no single best way to assign expenditure across the various levels of government, it is essential to have a concrete assignment of these responsibilities between the central and subnational governments. Best practice suggests that they should be specified in the law. Some countries list spending responsibilities in their constitutions, while many others do so in lower level legislation (such as the law on the budgetary system or the law on subnational budget). The latter approach is preferred, because tweaks are needed in the intergovernmental relations from time to time and changing the constitution is much harder than changing a law.

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Asymmetric decentralization can be considered in cases of strong cultural or linguistic differences or differences in the capacity of subnational governments to effectively carry out the functions assigned to them.

- *Cultural and linguistic differences:* Several countries in Europe (for example, Belgium, Italy, and Spain) have given certain regions more spending responsibilities because of a particularly strong historical, cultural, or linguistic identity that differentiates them from the rest of the populace (Ahmad and Tanzi 2002).
- *Different capacity at the local level:* Countries that face a disparity in the capacity of local governments can adopt an asymmetric approach by devolving functions and expenditure assignments first to local governments that have sound institutions and sufficient capacity (for example, Macedonia in the 1990s) or by giving more expenditure autonomy and taxing powers to urban centers (for example, in Bangladesh, Brazil, and India) (Bahl and Bird 2018). To operationalize this approach, the central government can make the devolution of spending responsibilities to individual subnational governments subject to compliance with minimum public finance management (PFM) requirements.

Own Revenues

Giving subnational governments revenue-raising powers may increase their fiscal responsibility. In this case, increased spending would require increased taxation, which could make the subnational governments more accountable to local voters. Own-source revenues for subnational governments may be preferable in a more heterogeneous country, because such revenues (and the associated downward accountability) allow for greater diversity in service provision compared with the standardization (and upward accountability) that comes from heavy reliance on transfers from the central government. Such transfers often have conditions attached that are based on central government preferences, which may be very different from those of a particular subnational government (Bahl and Bird 2008). Revenues also need to be decentralized at the same time as expenditures, ensuring that finance follows function (World Bank 1999).

A “good” local tax has an immobile base and a stable and predictable yield (Box 1). These criteria are generally met by property and personal income taxes, and user fees for services provided locally (for example, tolls on local roads and charges for business, vehicle registration, and use of local assets). Indirect taxes such as the value added tax (VAT) or the corporate income tax, which can be built into the price of goods and passed on to consumers outside the taxing jurisdictions, are not appropriate as local taxes (Escolano and others in IMF 2015).

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Box 1. Criteria for "Good" Local Taxes

Bahl and Bird (2008) suggest several criteria for what typically constitutes a good local tax:

- The tax base should be relatively immobile, to allow local authorities some leeway to vary rates without losing much of their tax base.
- The tax yield should be relatively stable and predictable over time.
- It should not be possible to export much, if any, of the tax burden to nonresidents.
- The tax base should be visible, to ensure accountability.
- The tax should be perceived to be reasonably fair by taxpayers.
- The tax should be relatively easy to administer efficiently and effectively.

The yield from subnational taxes and fees is very limited, especially in low income countries (LICs). The property tax, which is usually the main tax source of local revenue, requires good information systems (such as effective cadaster systems), which are not in place in most LICs, especially outside the main cities. In addition, the yield in LICs from other fees (such as business or car registration fees) is very low owing to a high rate of informality in the economy. When major social expenditure is liberalized (such as health and education), the own-source revenue of subnational governments is usually insufficient (Ahmad and Tanzi, 2002). Indeed, own revenue in sub-Saharan African countries with significant fiscal decentralization is only a small fraction of subnational governments' overall revenue, ranging from about 5 percent in Uganda to about 30 percent in Ethiopia, much lower than in a typical OECD country or comparable emerging and developing market economies (Figure 3). The picture in other LICs is similar to that in sub-Saharan Africa, with the government finance statistics (GFS) database suggesting that own revenue at the subnational level in low-income and developing countries is, on average, about 20 percent of general government revenue. While GFS data are not consolidated and should thus be interpreted with caution, the share of subnational revenue in South East Europe is broadly similar, amounting to about 16 percent, on average, of total general government revenue (NALAS 2016).

Allowing subnational governments to tax freely can lead to a proliferation of low-yielding taxes with high compliance and administration costs. These "nuisance taxes" can end up undermining the business environment. To avoid this risk, countries can adopt national laws governing subnational revenues (over and above those granted to subnational governments in the constitution) or define a "closed list" of allowable revenue sources. Best practice is for the central government to either determine or at least set guidelines on bases and rates of local taxes.

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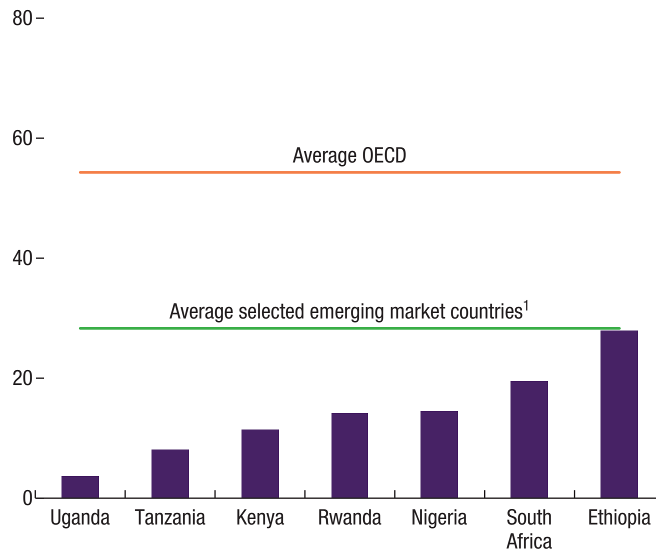
Figure 3. Own Revenue of Subnational Government
(Relative to total sub-national revenue, in percent)



Sources: Organization for Economic Co-operation and Development (OECD); and IMF staff calculations.
[1]Includes Bolivia, Colombia, Honduras, Indonesia, Jordan, Paraguay, Peru, Russia, Thailand, Tunisia, Turkey, and Ukraine.

Natural resource revenues are not suitable for sharing with subnational governments. Allowing producing regions to keep their natural resource revenues tends to contribute to significant fluctuations in the provision of public services in these regions, given the relatively volatile prices for natural resources (especially oil), and to exacerbate regional imbalances. However, political realities might dictate some form of regional taxation or tax sharing on natural resources. In any event, some sharing of natural resource revenue with subnational governments may make sense to compensate them for the costs associated with building infrastructure to enable the extraction of natural resources and for related environmental damage.

Transfers

Transfers to subnational governments from the center are inevitable, even in countries with modest fiscal decentralization. In most countries, including in European fiscal federations over the past 20 years, spending decentralization has outpaced revenue decentralization (Escolano and others 2012). As a result, own revenues are not sufficient to cover subnational spending. This is true even in rich countries, which have a greater capacity to collect revenue at the local level. In the OECD, for example, own revenue covers on aver-

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age just over half of subnational government spending, requiring significant transfers from the center to fill the fiscal gap. The required amount of transfers in sub-Saharan Africa is much higher, ranging from about 75 percent of subnational spending in Ethiopia to about 95 percent in Uganda.

The main lesson on transfers is that resources should be made available to subnational governments at the same rate as the assignment of spending responsibilities. As noted earlier, countries in which the devolution of resources significantly outpaced that of spending (for example, Brazil and China) faced significant fiscal pressures at the central government level. To avoid such problems, countries should first assign spending responsibilities to the subnational governments and then design an appropriate transfer system.

The key to an appropriate transfer system is to design it so that it combines transparency, simplicity, and equity, and builds incentives for mobilizing revenue and managing functions efficiently at the local level (Ahmad and Searle 2005). If the transfer system is not designed well, decentralization may actually reinforce and perpetuate disparities in the provision of public services rather than reducing them. International experience suggests the following principles for a transfer system:

- *Establish a transparent formula based on indicators outside the control of subnational governments:* Best practice is setting earmarked grants on minimum standards and setting equalization grants on objective criteria (for example, population, surface area, and relative income and poverty levels). To avoid manipulation, it is important that indicators included in the formula do not reflect discretionary policy choices by the recipient subnational government.
- *Ensure that transfers remain relatively stable to help subnational governments plan their budgets:* Good practice is to set transfers as a fixed proportion of central revenue in the context of a multiyear fiscal framework to enable long-term planning, especially for capital spending. Experience suggests that it is better to base transfers on overall central revenue than on particular taxes, as the central government tends to pay more attention to collecting the revenues that will remain with the center, which ends up distorting the structure of the tax system (Ahmad and Tanzi 2002).
- *Align incentives:* Design the transfer system to encourage subnational governments to collect own revenue and manage their functions efficiently. Transfers should fill the gap between *expenditure needs* and the *revenue potential* for each subnational government. This requires setting the amount of transfers for each subnational government ex ante during the budget process. The alternative (that is, ex post gap-filling transfers) contributes to weak fiscal discipline (Ahmad and Tanzi 2002).

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Table 2. Options to Control Subnational Borrowing

	Market Discipline	Cooperative	Rules-Based	Direct Controls
Approach	No controls and no bailouts	Limits set through negotiated agreement	Limits set by national legislation	Direct control on borrowing by central government
Advantages	Emphasis on self-control External monitoring	Promotes dialogue Enhances responsibility	Transparent May reduce need for bargaining	Central government control
Requirements	Track record of no bailouts Developed financial markets Transparency	Culture of fiscal discipline Constitutional underpinnings Institutional structure	Credible rules Transparency	Ability of central government to monitor and implement controls

Source: Fedelino and Ter-Minassian 2009.

- *Flexibility in the design of transfers can be useful:* Enshrining the main principles of a transfer system in the constitution can help ensure stability in the amount of transfers; however, change is inevitable. Several countries have set the formula for the transfer system in legislation, while providing for a periodic reassessment of the main parameters determining the amount of transfers to subnational governments; for example, the constitutions of South Africa and India require quinquennial assessments by dedicated finance commissions.

Hard Budget Constraints on Subnational Governments

Options to control subnational borrowing range from market discipline to administrative controls (Table 2). Experience indicates that sole reliance on market discipline is often not sufficient, unless several strict conditions are met. These include open capital markets, adequate information, responsiveness of the borrower to market signals, and a strict no-bailout policy by the central government. Few or none of these conditions are met in most LICs, creating the risk of excessive borrowing by subnational governments and exposure to contingent fiscal risks (for example, from public private partnerships (PPPs)).

Adoption of fiscal responsibility laws or limits on the debt and debt service burden of subnational governments helps foster fiscal discipline. Many advanced economies (including Germany, Korea, Spain, and Switzerland) rely on legally binding rules to restrict borrowing by subnational governments. One approach is to legislate debt thresholds that mimic market discipline. Among sub-Saharan African countries, Kenya has recently done this, setting limits on both debt and debt service (Annex 1). A "golden rule" (that is, allowing borrowing only to finance capital spending) is another fiscal rule aimed at preventing excessive borrowing by subnational governments. As noted earlier, however, fiscal rules may not be very effective in ensuring fiscal discipline if decentralization results in large vertical imbalances at the subnational level (Kotia and Lledó 2016). In addition, golden rules may create

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incentives to reclassify current spending as capital spending. Dipping into pension funds and using subnational corporations to borrow on behalf of the subnational government are other ways to bypass debt limits. Insolvency mechanisms for subnational governments can help align incentives and could thus be used to complement borrowing limits (Liu and Waibel 2008).

Enforcement of legislative limits or administrative controls on borrowing and on contingent fiscal risks by subnational governments is essential. In Argentina in the 1990s, constitutional limits on borrowing by provinces existed, but they were not enforced, leading to excessive borrowing by large provinces (for example, Buenos Aires). To avoid such problems, it may be useful to have clear penalties for exceeding legislative debt limits. Some countries impose administrative sanctions on officials who violate the rules (such as withholding salaries or subjecting the officials to criminal penalties or fines), while other countries impose sanctions on subnational governments that miss fiscal targets (for example, Germany suspends consolidation payments to states that miss their fiscal targets). Experience suggests that while such sanctions have a disciplinary effect if they are strictly enforced by the central government, they are not a substitute for a properly designed system of intergovernmental fiscal relations (see Eyraud and Sirera in IMF 2015). Establishing transparent mechanisms for enforcing bankruptcies of subnational governments (as is the case in South Africa) helps mitigate the moral hazard risk (see Annex 3).

A strong accountability framework will support the effectiveness of fiscal decentralization to subnational governments and help enforce fiscal rules. Accountability is a prerequisite for good public sector performance, and information is the key to accountability. Regular collection, analysis, and reporting of information on fiscal operations are critical elements of fiscal decentralization reforms, because the information can be used to verify compliance with policy goals and to strengthen citizen oversight.

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Chapter

4 Fiscal Decentralization in Sub-Saharan Africa

Trends

Fiscal decentralization in sub-Saharan Africa is much less common than in advanced and emerging market economies. Most sub-Saharan African countries remain centralized, with very limited spending autonomy for subnational governments. A limited number of sub-Saharan African countries have embarked on significant fiscal decentralization over the past two decades, but the decentralization of revenue is comparatively much lower than that of expenditure (Figure 4).

Determinants

The determinants of decentralization in sub-Saharan Africa are broadly consistent with findings in the literature. Studies generally find that the main determinants of decentralization are population density, country size, share of urban population, income level, degree of ethnic fractionalization, and level of democracy (see, for example, Bodman 2009). An empirical analysis suggests that these results broadly hold for sub-Saharan Africa. The findings from a logit model (summarized in Box 2) suggest that the probability for a sub-Saharan African country to decentralize increases with the initial values of GDP per capita and the degree of ethnic fractionalization, and decreases as the share of population living in urban areas rises. In contrast to most findings in the literature, however, the strength of democracy (as measured by the polity index) does not seem to be an important determinant for decentralization in sub-Saharan Africa. In addition, population density is statistically significant in only one out of four specifications.

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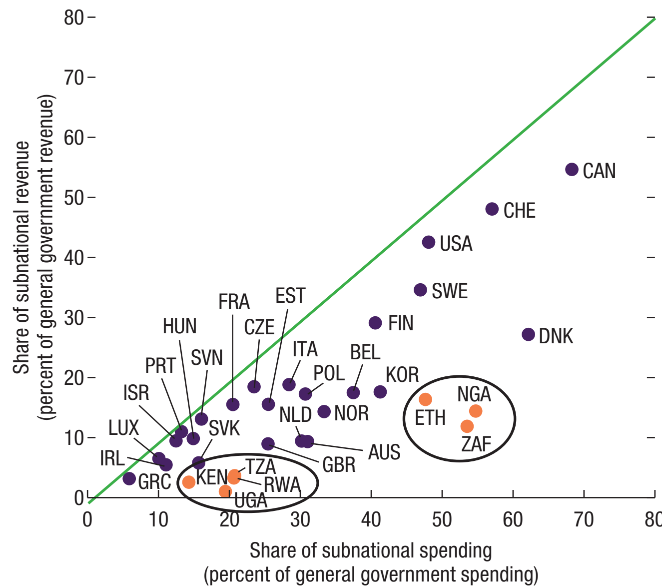
Figure 4. Spending versus Revenue Decentralization



Sources: OECD; and IMF staff calculations.

Effectiveness

Fiscal decentralization in sub-Saharan Africa seems to be positively correlated with better growth performance in the presence of better institutions but does not seem to be correlated with better income distribution (Table 3). As mentioned earlier, fiscal decentralization is expected to have two major benefits: (1) by promoting the efficiency of government spending, it eventually contributes to higher economic growth, and (2) it facilitates greater economic equality as resources are spread more evenly across the country. An empirical analysis using an ordinary least squares (OLS) approach suggests that decentralization in sub-Saharan Africa is positively correlated with higher growth in the presence of stronger institutions (as the interactive terms of decentralization and the quality of institutions have a statistically significant positive correlation with the GDP per capita). Decentralization in sub-Saharan Africa does not appear to have a statistically significant correlation with better income distribution; however, as expected, higher GDP per capita is positively correlated with lower income inequality, and a higher level of urbanization seems to be correlated with lower inequality and higher growth.

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Box 2. Likely Determinants of Fiscal Decentralization in Sub-Saharan Africa

In theory, it is generally expected that fiscal decentralization is positively correlated with the level of economic development, geographical size, population density, level of urbanization, extent of ethnic fractionalization, and strength of democracy.

To assess the effect of these determinants in sub-Saharan Africa, a logit analysis was carried out, which estimates the probability of an event (in this case, the probability of a country being decentralized) in response to one or more predictor (or independent) variables.

- The *dependent (binary) variable* in Table 2.1 below is decentralization, which takes the value 1 if the share of subnational spending is at least 5 percent of total government spending, and 0 otherwise. Of the 39 sub-Saharan African countries included in the analysis, seven countries (Ethiopia, Kenya, Nigeria, Rwanda, South Africa, Tanzania, Uganda) cross the 5 percent threshold.
- The *predictor variables* reported in Table 2.1 below include GDP per capita, population density, share of urban population, the polity index (which measures the extent of democracy, with an increase in the index implying a higher level of democracy), and the degree of ethnic fractionalization.[1] Geographic size and a dummy for resource-rich countries were not found significant in any of the specifications and are thus not reported.

Table 2.1 Logit Analysis on the Determinants of Decentralization in sub-Saharan Africa

	(1)	(2)	(3)	(4)
GDP per capita (log)	0.37*	0.21*	0.31**	0.32*
	(0.16)	(0.1)	(0.12)	(0.13)
Population density (log)	0.16*	0.083	0.14	0.16
	(0.08)	(0.06)	(0.09)	(0.1)
Urban Population (%)	−0.025*	−0.014**	−0.023**	−0.025**
	(−0.01)	(−0.01)	(−0.01)	(−0.01)
Polity index	−0.0091	−0.012	−0.0095	−0.012
	(−0.02)	(−0.02)	(−0.02)	(−0.02)
Ethnic-SM	1.33*			
	(0.55)			
Ethnic-Fearon		1.01*		
		(0.41)		
Ethnic-Bah			1.3	
			(0.7)	
Ethnic-Roeder				1.20*
				(0.57)
Number of Countries	39	38	37	38
Predicted probability	0.2	0.15	0.2	0.15
Pseudo R-squared	0.33	0.37	0.34	0.42

Note: Robust standard errors are reported in parenthesis. Coefficients are marginal effects with explanatory variables set equal to their median values in the sample.
*$p < .05$, ** $p < .01$, ***$p < .001$.

[1]The degree of ethnic fractionalization is measured as a Herfindahl concentration index of the various ethnic groups in each country. The indicators of ethnic fractionalization reported in the table have strong pairwise correlations (above 0.7) (see Posner 2004).

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Table 3. Does Decentralization Improve Income Distribution or Increase Growth?

	Gini Index	Gini Index	GDP/capita	GDP/capita
GDP per capita (log)	3.83***	3.27**		
	(1.10)	(1.05)		
Urban population	−0.23***	−0.20**	0.031***	0.032***
	(0.07)	(0.07)	(0.00)	(0.00)
Polity index	−0.33***	−0.34***	−0.00031	−0.0011
	(0.06)	(0.05)	(0.00)	(0.00)
Ethnic fractionalization	2.52	2.56	−0.96*	−0.95
	(5.01)	(4.96)	(0.48)	(0.52)
Decentralized	−1.67	−2.51	0.23	0.15
	(2.85)	(2.79)	(0.28)	(0.30)
Effectiveness	−0.40		0.069	
	(0.76)		(0.04)	
Decentralization*Effectiveness	2.04		0.19*	
	(1.36)		(0.08)	
Worldwide Governance Indicators		1.13		0.076*
		(0.71)		(0.04)
Decentralization*Corruption		0.18		0.18
		(1.26)		(0.07)
Constant	22.7**	26.8***	7.22***	7.19***
	(8.33)	(7.85)	(0.33)	(0.36)
Observations	426	426	722	722
Overall *R*-squared	0.065	0.077	0.48	0.45
Between *R*-squared	0.024	0.040	0.47	0.44

Source: Authors' calculations.
Note: Robust standard errors in parentheses. Random effect panel regression.
*p $<$ .05, **p $<$ .01, ***p $<$ .001

Accountability Framework

The sub-Saharan African countries that are most fiscally decentralized tend to have better overall government effectiveness indicators (Figure 5). A strong accountability framework is key for supporting fiscal decentralization. It enables central monitoring and evaluation of local performance, which helps enforce the fiscal rules on subnational governments and improves service delivery at the local level. However, the quality of governance is relatively weak in some of the sub-Saharan African countries that are planning to embark on fiscal decentralization reforms (for example, Madagascar and Mali). This situation suggests the need for a gradual approach to the assignment of responsibilities and of the necessary financing, as the capacity of subnational governments and the quality of PFM system strengthens.

Lessons Learned about Decentralization from Four Case Studies

A review of fiscal decentralization in four sub-Saharan Africa case studies—Kenya, Nigeria, South Africa, and Uganda—suggests that it was driven mainly by efforts to defuse ethnic conflicts. Table 4 summarizes the main aspects of fiscal decentralization in these case studies. Specifically, in Kenya,

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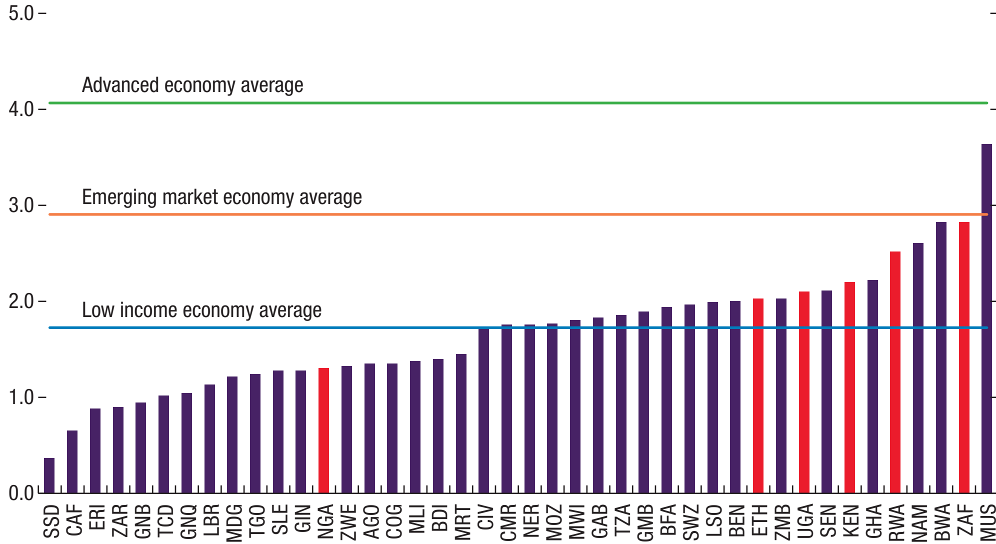
Figure 5. Government Effectiveness Index[1]
(Ranges from 0 lowest to 5 highest)



Source: World Bank Development Indicators database.
[1]The most fiscally decentralized sub-Saharan African countries are highlighted in red.

a major devolution was launched in 2013–14 following deadly postelection violence in 2008. The violence was precipitated by the systemic exclusion of certain ethnic groups, which had resulted in glaring regional disparities (Annex 1). In Nigeria, fiscal decentralization began in 1967 with the creation of a federal state, in an effort to diffuse strong regional and tribal rivalries reflecting the country's significant ethnic and cultural diversity (Annex 2). In South Africa, fiscal decentralization was introduced soon after the collapse of the apartheid system in 1994 to address a legacy of severe economic disparity across social groups and regions (Annex 3). In Uganda, fiscal decentralization was initiated following the end of the civil war in 1986 as part of a broader strategy to reduce ethnic tensions (Annex 4).

The rapid pace of fiscal decentralization in Kenya and South Africa created challenges for containing spending and maintaining service delivery. The pace of fiscal decentralization in Kenya and South Africa was very fast, owing to strong political pressures, with the subnational authorities receiving the authority to spend significant amounts over a very short period. This created challenges in both countries for controlling spending and ensuring service delivery, as many of the subnational governments lacked the capacity for budgeting or for monitoring and reporting fiscal developments. As a result, national governments in both countries were forced to intervene to contain spending, including freezing public sector employment. Nevertheless, in

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Table 4. Main Aspects of Fiscal Decentralization in the Four Case Studies[1]

	Kenya	Nigeria	South Africa	Uganda
Type of Decentralization	Unitary state with devolved functions to 47 county governments	Federal state with devolved functions to the capital city and 36 state governments	Unitary state with devolved functions to municipalities	Unitary state with deconcentrated functions to 111 districts within four regions
Expenditure Assignments	Counties are responsible for the provision of primary local services, such as agriculture, health, local roads, water, and preschool education	States provide education, health, and public works Local governments act as agents of the states but also provide local services such as water, sanitation, and waste collection	Provinces implement national policies on key services (health, education, welfare, and housing) Municipalities have autonomy for spending on local services (streetlights, local roads, and garbage collection)	Districts deliver basic services, such as primary education, primary health care, rural water services, agricultural extension services, and district roads, but have little flexibility to make spending decisions
Own Revenue	Limited to property and entertainment taxes, fees for business licenses, and charges for local services	Include: (1) for states, personal income tax, 13 percent of oil proceeds for oil-producing states, road taxes, business registration fees, and lease fees; and (2) for local governments, property tax and user fees for local services	Provinces can impose surcharges on personal income tax and fuel levy, in consultation with the central government Municipalities charge property taxes and generate revenue from charges on electricity and water	The main revenue instruments for the districts are a property tax and a series of market dues The districts do not have the ability to modify tax bases or tax rates
Transfers	Constitution requires that transfers are at least 15 percent of last audited annual revenue Transfers are mostly unconditional and based on a transparent and equitable formula	States and local governments receive transfers based on a transparent formula that includes the amounts collected in the Federation Account (financed by oil revenues, corporate income taxes, custom duties, and excise taxes) and the value added tax revenue	Unconditional transfers account for about 80 percent of overall transfers to provinces and 50 percent of transfers to municipalities, and are based on a transparent formula that is updated every five years with data from census surveys	Transfers to districts are largely earmarked by the center for the provision of specific services and are extremely variable from year to year There are currently 38 conditional grants, each with its own formula
Subnational Borrowing	The PFM law limits counties' stock of debt and debt service (20 percent and 15 percent, respectively, of the county's revenue in the preceding year)	Borrowing is limited for capital projects and not allowed if the state is in arrears in debt service External loans require a central government guarantee Stock of debt may not exceed 50 percent of last year's revenue	Constitution allows provincial and local governments to borrow for capital spending and bridging purposes only Central government guarantees for borrowing by the municipalities is prohibited	Borrowing by districts is allowed by law but is subject to a cap (25 percent of locally generated revenue) and requires approval by the central government

[1]Summary of Annexes 1–4.

Kenya recurrent spending has risen by about 2 percent of GDP compared with the pre-devolution period, putting pressure on fiscal balances.

Initial problems have been addressed over time. In South Africa, for example, a monthly reporting system by subnational governments was created and, in the late 1990s, the national treasury started helping provinces prepare realistic budgets. The implementation of a multiyear budget framework from 1998 onward also helped provinces prepare more realistic budgets, and bench-marking of spending helped them identify cost drivers. In Kenya, the initial challenges in service delivery, especially in the health sector, have largely

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been addressed, although difficulties in preparing realistic budgets at the county level persist, requiring frequent expenditure reallocations during the course of the year.

The division of powers and functions at the various levels of government are clearly defined in legislation and broadly consistent with best practice (see Table 3). In all four countries the functions assigned to the national level relate mainly to policy, standard setting, and the provision of public goods such as national security and macroeconomic policy. Subnational governments are responsible for policy implementation and local service delivery, such as health, water, local roads and transportation, most agriculture extension services, and primary education (except for Kenya where the subnational governments provide only preschool education.)

The authority of subnational governments to make independent spending decisions varies. The subnational governments in Kenya, Nigeria, and South Africa have broad authority to make independent decisions for spending financed by own revenue and unconditional grants, which comprise most of their overall funding sources. This reflects the fact that decentralization in these three countries has taken the form of devolution, with decision making on spending at the local level transferred to elected subnational governments. In Uganda, subnational governments have little flexibility to make significant resource allocation decisions, with the majority of the transfers earmarked for the provision of specific services determined by the central government (Ahmad, Brosio, and Gonzalez 2006). This reflects Uganda's deconcentrated rather than devolved system of government (as noted earlier, subnational governments in a deconcentrated system are upwardly accountable to the central government and have little authority on spending decisions).

The assignment of taxation powers is broadly in line with best practice. Except for Nigeria (where the personal income tax is collected by the states), the national government maintains full control over the major taxes, such as personal and corporate income taxes, VAT, excises, and custom duties. As for the subnational governments, the bulk of their revenue in Kenya, South Africa, and Uganda comes from property taxes and fees for local services. Own revenues are a very small fraction of subnational spending in all four countries: about 5 percent in Uganda, 10 percent in Kenya, 15 percent in Nigeria, and 20 percent in South Africa. This reflects the weak cadaster systems and high level of informality in these countries. Only in the richest areas does the property tax finance the provision of local services, which is usually the responsibility of municipalities and other small-area jurisdictions (for example, the rich urban areas in South Africa) (Ahmad and Tanzi 2002).

The design of the transfer system to subnational governments varies greatly.

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- As noted earlier, most transfers in Kenya, Nigeria, and South Africa are unconditional, with subnational governments having broad spending autonomy. In all three countries, the redistribution element in the formula is quite strong (taking into account primarily population and income distribution). In Kenya and South Africa the formula is reviewed every five years to reflect changes in the main parameters.
- In Uganda, on the other hand, the transfers to subnational governments are largely conditional; that is, earmarked by the center for the provision of specific services. In addition, the formula used to determine grants for each subnational government is quite complicated (there is a separate formula for each of some 38 different conditional grants), which undermines the transparency of the system.

The case study countries have kept subnational spending aligned with available resources. All four countries have strict fiscal rules aimed at preventing excessive borrowing by subnational governments. Specifically, all four countries limit long-term borrowing by subnational governments to financing development projects (golden rule) and short-term borrowing to liquidity management. In addition, any long-term borrowing in Kenya, Nigeria (for external debt only), and Uganda is subject to approval by the national government (requires a guarantee in the case of Kenya and Nigeria), and there is an overall cap on the stock of debt for subnational governments in these three countries (20 percent of the previous year's audited revenue in Kenya, 50 percent in Nigeria, and 25 percent in Uganda). In South Africa, legislation prohibits the national government from guaranteeing subnational government debt. To address moral hazard and help ensure that the strict no-bailout commitment is observed, a transparent mechanism for public bankruptcies is in place, complemented by tough sanctions if subnational governments ignore good fiscal practices.

In Nigeria, the sharing of oil proceeds with the oil-producing states has exposed those states to large swings in revenue and has undermined the regional income equalization objective. For example, Ahmad and Singh (2003) find that a 10 percent fall in the oil price caused a 20 percent decline in federal oil revenues but a reduction by more than a third in oil-producing states. This situation has hampered a sound budget process in the oil-producing states and exposed them to large oil price declines. Indeed, after the latest oil price shock, many state and local governments ran large salary arrears in 2015. This forced the federal government to provide a partial bailout to 23 states and to facilitate the restructuring (longer maturities and lower rates) of commercial bank loans (IMF Country Report No. 16/101).

South Africa's experience shows that a country cannot enjoy the benefits of decentralization without simultaneously reforming its budget process. From the beginning of fiscal decentralization in the mid-1990s, the authorities in

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South Africa have simultaneously addressed the problems of capacity, information, and financial management, while ensuring that the political system is responsive at the subnational level. To spread best practice, the authorities have showcased the subnational governments that have demonstrated their capacity to perform through a peer learning and mentorship approach, combined with benchmarking to identify and address the main cost drivers. Improving budget formats, introducing a new GFS classification system, improving the accounting standards, and reforming the chart of accounts have been essential elements for reforming the financial management system and improving the collection of information used for benchmarking.

The fiscal decentralization reform in Kenya underscores the importance of implementing devolution gradually in line with implementation capacity at the subnational government level (see Annex 1). Kenya's recent devolution involved transferring substantial powers and resources (to about 5 percent of GDP beginning in 2013/14 from less than 1 percent previously) to entirely new units of subnational government (47 counties). In line with best practice, this was done as part of a comprehensive framework based on a new constitution and a new PFM framework. However, the big-bang rollout (in one year rather than over three years as originally envisaged) created challenges in service delivery, especially in the health sector. In addition, as discussed earlier, recurrent spending in the post-devolution period has increased considerably (by about 2 percent of GDP), in part reflecting a duplication of functions between the central and county governments. At the same time, Kenya has kept borrowing by counties under control with the adoption of prudent ceilings on their borrowing and debt service (respectively, 20 percent and 15 percent of the previous year's audited revenue). Excessive borrowing by subnational governments has been one of the pitfalls that has befallen countries that embarked on similar big-bang approaches; for example, Latin America during the 1980s and 1990s (Giugale and others in World Bank 2000).

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Chapter

5 Conclusions

Most sub-Saharan African countries retain a highly centralized model of territorial government and fiscal arrangements. Only a handful have embarked on meaningful fiscal decentralization, and even in these countries, subnational spending is well below the levels in a typical OECD country, especially as a share of GDP.

The determinants of fiscal decentralization in the few sub-Saharan African countries where it has taken place are consistent with experience elsewhere. Empirical results presented in this paper suggest that the decision to decentralize increases with the initial values of GDP per capita, population density, and the degree of ethnic fractionalization. The last factor is confirmed by the four case studies—Kenya, Nigeria, South Africa, and Uganda—where fiscal decentralization has been driven mainly by efforts to reduce regional and ethnic tensions.

Fiscal decentralization is correlated with higher growth in the presence of better institutions, but it does not seem to affect income distribution. The combination of decentralization with a better quality of institutions has a statistically significant correlation with GDP per capita. However, decentralization does not appear to have had the expected impact on reducing income inequality in sub-Saharan Africa.

Among the few sub-Saharan African countries that have embarked on significant decentralization, the macroeconomic risks have largely been contained, although in some cases political imperatives have caused the speed of decentralization to be faster than warranted by capacity implementation at the subnational level.

- *Strategy:* The recent fiscal decentralization in Kenya underscores the importance of implementing such reforms as part of a comprehensive framework,

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encompassing spending assignments, own revenue, the transfer system, and subnational borrowing.

- *Spending assignments and fiscal autonomy of subnational governments:* The division of the spending function across levels of government in the four case studies is broadly consistent with best practice, although there are differences in spending powers. For example, in Uganda subnational governments have little flexibility to make spending decisions as a result of an effectively deconcentrated rather than a devolved system of government; in the other three countries, the subnational governments have broad spending autonomy, reflecting a political rather than merely administrative decentralization.
- *Own revenue:* The assignment of taxing powers in the four case studies is also broadly in line with best practice, with the bulk of subnational revenue coming from property taxes and fees for local services. However, own revenues are a very small fraction of subnational spending, reflecting weak cadaster systems and a high level of economic informality. In Nigeria, the sharing of oil revenue with oil-producing states has undermined the regional income equalization objective and exposed the oil-producing states to large swings in revenue.
- *Transfers:* In three of the four case studies (Kenya, Nigeria, South Africa) most transfers are unconditional and based on transparent formulas with strong redistributive elements. In these countries, the subnational governments have broad spending autonomy. But in Uganda, the transfers are largely conditional; that is, earmarked by the center for the provision of specific services, leaving little autonomy to the subnational governments.
- *Hard budget constraints:* Governments in the four case studies have succeeded in keeping borrowing by subnational governments under control. This reflects strict fiscal rules aimed at preventing excessive borrowing by subnational governments, including ceilings on debt stock (Kenya, Nigeria, Uganda) or a transparent mechanism for public bankruptcies complemented by tough sanctions if subnational governments ignore good fiscal practices (South Africa).

Against this background and in light of the generally weak PFM systems in sub-Saharan Africa, countries that decide to proceed with fiscal decentralization should do so in phases. The big-bang approach to decentralization has in some cases resulted in excessive accumulation of debt at the subnational level; for example, the abrupt decentralization in a number of Latin American countries in the 1980s and 1990s. While the rapid pace of fiscal decentralization in some sub-Saharan African countries (for example, Kenya and South Africa) has not been accompanied by excessive borrowing at the subnational level, it has nonetheless created challenges for controlling current spending (creating fiscal pressure at the center) and ensuring service delivery,

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as subnational governments lacked the capacity for budgeting or for monitoring and reporting fiscal developments. In light of the relatively weak quality of governance in some of the sub-Saharan African countries that are planning to embark on fiscal decentralization reforms, a gradual approach would seem appropriate and consistent with the pace of strengthening the PFM systems at the subnational level.

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Annex 1

Case Study: Kenya

Kenya is a very diverse country, with 10 major and more than 30 minor ethnic groups. Needs are very different between the arid and semiarid North and the highlands; between the rural Northern Rift and the urban centers of Mombasa, Nairobi, and Kisumu; and between the coast and western Kenya.

Despite such diversity, Kenya was a very centralized state until the late 1990s. At independence in 1963, Kenya inherited a system of self-governing local authorities—relatively powerful and well-functioning organizations that delivered a wide range of services. Over the years, the role of the local authorities progressively weakened; for example, in 1969 the Transfer of Functions Act transferred major services from local authorities to the central government. However, in the late 1990s the pendulum started to swing the other way, owing to widespread dissatisfaction with the high concentration of political and economic power in the hands of a few, which had resulted in a spatially uneven and unfair distribution of resources and corresponding inequities in access to social services.

A decade of relatively piecemeal decentralization began in the late 1990s. The authorities gradually introduced geographically earmarked funds in an attempt to address spatial inequality. The most notable were the Local Authority Transfer Fund (1998), the Constituency Development Fund (2003), the Rural Electrification Fund (2006), and the Road Maintenance Levy Fund (2007). But despite these efforts to address inequality in resource distribution, overall spending by the local governments amounted to only about 1 percent of GDP by the late 2000s.

Following the adoption of a new constitution in 2010, Kenya launched a major devolution. Efforts to adopt a new constitution had been thwarted in 2005, but the 2008 postelection violence triggered popular support for a major overhaul of subnational powers to reduce ethnic tensions. The

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adoption of a new constitution in September 2010 introduced a structure of governing power that defined the public sector as comprising two levels of government: a national government and 47 elected county governments (which replaced some 175 local governments). The main elements of the devolution were (1) a significant transfer of political power to county governments, whose officials are elected every five years; (2) greater administrative power for subnational governments, with the constitution assigning specific functions to counties but allowing the national government to retain power to impose standards and norms on counties and to intervene if a county fails to perform or comply with PFM laws; and (3) significant transfer of fiscal power, with counties given the discretion to formulate their own budgets. Funding for the counties is coordinated by the Intergovernmental Budget and Economic Council, which is chaired by the vice president and consists of 47 county finance ministers plus the cabinet secretary for the national treasury and some key independent commissions.

Expenditure Assignments

Kenya's devolution largely follows international practice regarding the intergovernmental division of responsibilities. The functions assigned to the national level relate mainly to policy and standard setting, and the provision of public goods such as national security and macroeconomic policy, while county-level functions focus on policy implementation and local service delivery in four key sectors (health, agriculture, transport, and water). The counties are responsible for all personnel engaged in these functions. When it comes to health, for example, the 47 county governments are responsible for managing all aspects of service delivery, while the central government is responsible for regulation through policy formulation and monitoring. In education, only preprimary education has so far been devolved, unlike other decentralized countries that overwhelmingly devolve at least primary education.

Kenya took a big-bang approach to the devolution of spending to counties. The new constitution envisaged that functions would be transferred gradually over a three-year period, as county governments developed the capacity to assume them. However, following strong lobbying by county governors, the Transition Authority approved the transfer of almost all functions to counties in one go, which quadrupled spending at the county level within one year. Even though roles and responsibilities were elaborately outlined, in practice the transition from national to county governments was marred by inconsistency, poor understanding of the system, management challenges, and lack of coordination between the national and county governments.

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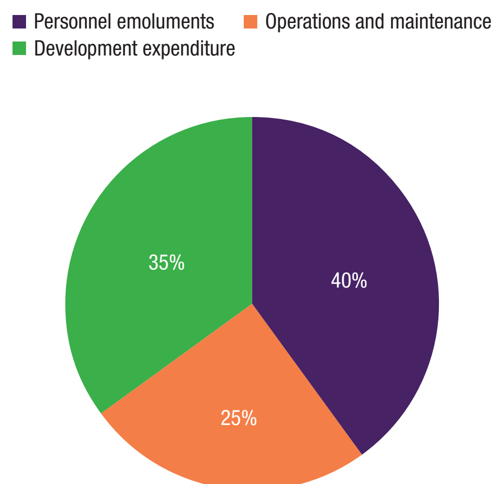
Figure 1.1. Kenya: County Expenditure by Economic Classification, 2015/16
(As share of total county spending)



Source: Controller of the Budget, Kenya.

The rapid pace of devolution contributed to a significant increase in overall government spending and created challenges for service delivery. Total spending in the year devolution was rolled out increased by about 2 percent of GDP compared with the pre-devolution period, putting pressure on fiscal balances. In addition, the fast pace of devolution adversely affected service delivery, especially in the health sector, and contributed to poor working conditions at the county level, including delays in salary payments. The service delivery issues have largely been addressed, and there is evidence lately of improved indicators in services provided by counties, such as gross enrollment in preprimary education, student enrollment in youth polytechnics, births registered in health facilities, and access to maternal health care. Nevertheless, frequent expenditure reallocations persist, suggesting challenges in prioritizing expenditures and constructing reliable forward estimates within a sustainable fiscal framework.

Containing current spending in counties has proved difficult. Subnational governments are required to allocate 30 percent of their budgets for development spending. While development spending averaged about 35–40 percent during fiscal years 2013/14–15/16 (see Annex Figure 1.1 for the breakdown in 2015/16), about a third of the counties missed the target in 2015/16 (Annex Figure 1.2). At the same time, it has been difficult to contain wage spending, which amounted to about 40 percent of county spending in 2015/16, an increase of about 15 percent from the previous year (a nearly

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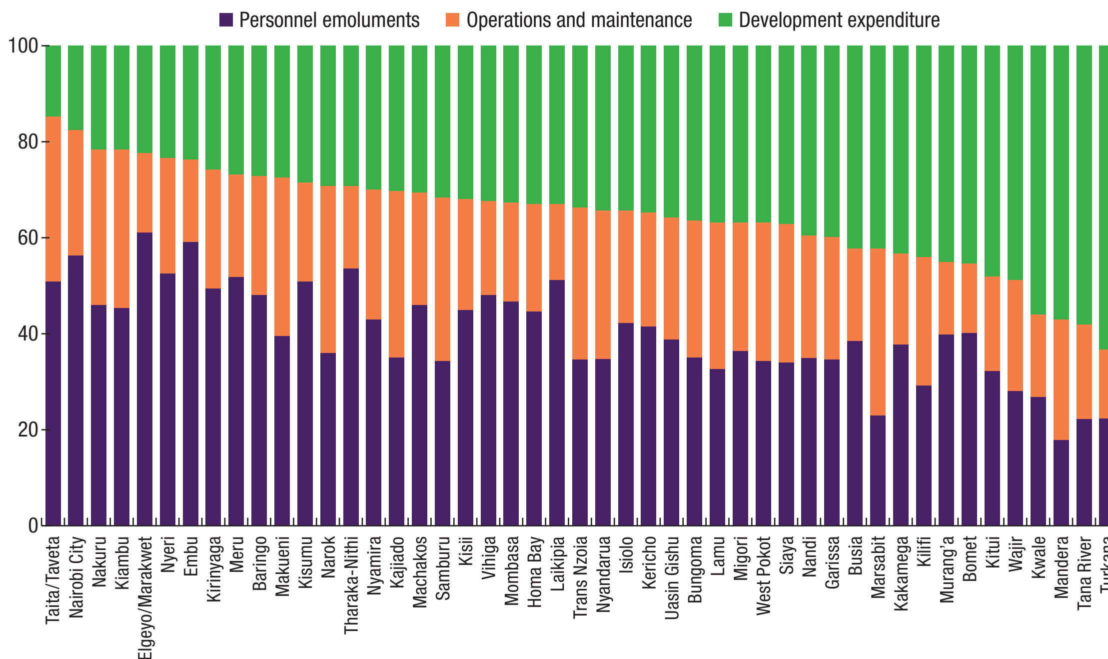
Figure 1.2. Kenya: Composition of Spending by Counties, 2015/16



Source: Controller of the Budget, Kenya.

double-digit increase in real terms). The high wage bill of counties reflects a large number of staff inherited from the previous local governments, new recruitment by counties (sometimes above the pay scales recommended by the Salaries and Remuneration Commission), and high wage increases for county assembly members and support staff.

Own Revenue

The assignment of own revenue sources to Kenya's counties is in line with best practice. The constitution establishes that only the central government can impose income taxes, value added taxes, custom duties, and excises. The constitution assigns to county governments the property tax, entertainment tax, and trade licensing fees. The Public Finance Management Act of 2012 allows county governments to collect fees for the services they provide.

Weak collection of county own revenues has contributed to higher rates for taxes and fees, which could potentially have a negative impact on investment. Overall, the collection by counties of own revenue currently amounts to only about 0.5 percent of GDP, which is equivalent to about 10 percent of total spending by counties. Property taxes have the potential to provide significant

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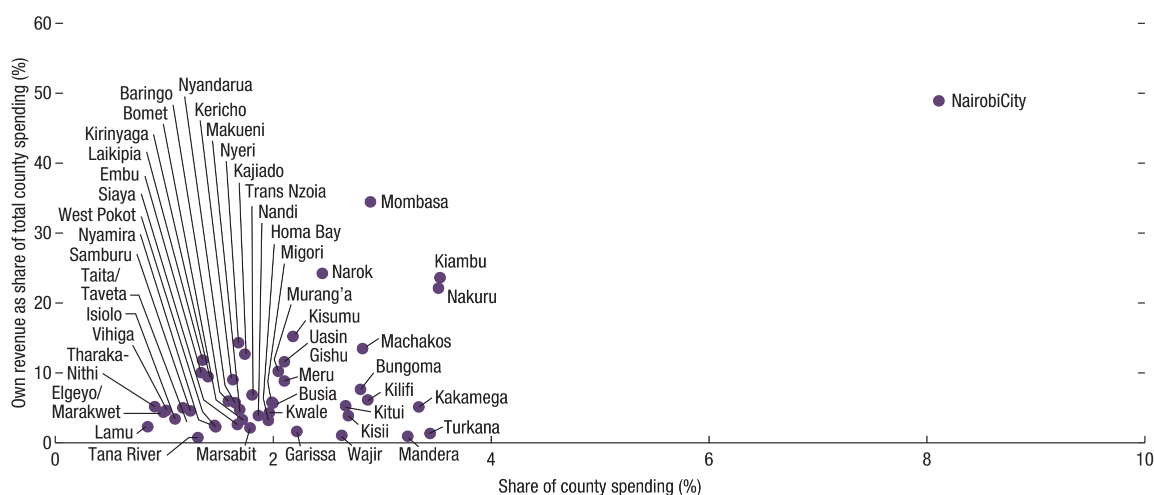
Figure 1.3. Kenya: County Size and Capacity to Collect Own Revenue



Source: Controller of the Budget, Kenya.

revenues to counties. However, as in most LICs, cadastral information is weak in Kenya, especially away from the large urban centers, and valuation rolls are incomplete and out of date. As a result, collection of property taxes is low, especially in the more rural counties were land is not titled, values are low, and citizens have a limited capacity to pay. Own revenue in Nairobi and Mombasa, the two largest cities in Kenya, is about 50 percent and 35 percent of their respective total spending, but it is below 15 percent in most other counties (Annex Figure 1.3). Faced with these difficulties, many counties have imposed higher rates for taxes and fees. In Nairobi, for example, the county authorities raised an array of fees, including those for business permits; a number of licensing fees (for example, for hygiene, parking, and transport); building permits; and advertising on billboards (Economist Intelligence Unit 2014). These increases may have adverse effects on Kenya's business environment, and the central authorities (both Parliament and the national treasury) have called for caution by the county authorities going forward.

Transfers

The constitution requires that counties receive no less than 15.5 percent of the previous year's central government's audited revenue. Of these, 15 percentage points should be in the form of unconditional transfers. The remaining 0.5 percentage points are to be transferred into the Equalization Fund, which is used to provide basic services including water, roads, health facilities, and electricity to marginalized areas. The actual amount of unconditional share transfers to counties is set every year as part of the annual budget

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Annex Table 1.1. Kenya: Formula for Transfers to Counties
(percent of total)

	2012/13–15/16	2016/17–18/19
Population	45 percent	45 percent
Equal share	25 percent	25 percent
Poverty level	20 percent	18 percent
Land area	8 percent	8 percent
Fiscal effort	2 percent	1 percent
Development needs	—	1 percent
Personal emoluments	—	2 percent

Source: Commission on Revenue Allocation, Kenya.

process, based on the proposal by the Commission on Revenue Allocation. For the first four years the new fiscal decentralization system was in operation—2013/14 through 2016/17—the transfers to counties were much higher than the minimum required under the constitution (over 20 percent of the previous year's audited revenues).

The formula for allocating unconditional transfers among counties is transparent and highly equitable. The unconditional share transfers are allocated to counties based on a formula approved by Parliament (Annex Table 1.1). While not grounded in a detailed estimation of individual county needs, the formula has the merit of being highly transparent and highly redistributive. Indeed, the share of equitable transfers varies from about half of spending in Nairobi County to as much as 95 percent in the poorest counties. During the first year of implementation (2013/14), transfers were made to counties even though some functions remained with the national government, resulting in financial pressures on the central government.

The constitution stipulates that the formula for the equitable share transfers be reviewed by Parliament every five years.

Borrowing

The Kenyan authorities have established several fiscal rules for county borrowing with a view to maintaining fiscal sustainability. The 2010 constitution states that borrowing by counties (except for short-term borrowing for liquidity management) requires government guarantees and is limited to financing development projects (the golden rule). In addition, the 2015 amendments to PFM regulations establish limits on both the stock of gross debt and debt service for counties (up to 20 percent and 15 percent, respectively, of the county's last audited revenues); require annual publication of county financial accounts; and specify financial and criminal penalties for the violation of PFM regulations.

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Annex 2

Case Study: Nigeria

Nigeria became a federal state in 1967 when four regions were divided into 12 states and three levels of government were established: federal, state, and local. In an effort to diffuse regional and ethnic rivalries against a background of significant ethnic and cultural diversity in the country, the government increased the number of states over time, reaching the current level of 36 (plus the federal capital) in 1996.

Intergovernmental relations in Nigeria have been characterized by the occasional flare-up of tensions between the oil-producing states and the (poorer) non-oil-producing states, with the former demanding to retain more of the oil revenue generated locally and the latter calling for a larger redistribution of oil revenues. The Biafra War (1966–70) actually broke out over disagreement on how to share oil revenue. Over time, the share of oil revenue going to the oil-producing states has declined, from 50 percent right after independence to 13 percent now.

Expenditure Assignments

The assignment of responsibilities among the various tiers of the Nigerian federal system is set out in the Nigerian Constitution and broadly reflects the pattern in modern federations. The federal government is responsible for defense, foreign affairs, law and public order, railways, posts and communications, national roads, and air and sea travel. The states provide education, health, and public works within their jurisdictions. The roles of local government vary widely. In most cases, they act as agents of the respective state government, although some are responsible for the provision of urban infrastructure and related services, such as water, sanitation, and waste collection (Ahmad and Singh 2003).

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Annex Table 2.1. Nigeria: Federal-State Shares of Oil Proceeds from Distributable Pool
(in percent)

Year	Producing State	Federation Account
1960–69	50	50
1969–71	45	55
1971–75	45 (minus offshore)	55 (plus offshore)
1975–79	20 (minus offshore)	80 (plus offshore)
1979–81	—	100
1982–92	1.5	98.5
1992–99	3	97
1999–Current	13 (minus offshore)	87

Source: Akujuru 2015.

The state governments have principal responsibility for basic services such as primary health and primary education. However, while most health spending has been devolved to subnational governments, the federal government retains responsibility for public goods such as immunization and communicable diseases. In education, the federal government is still responsible for budgeting and hiring, but local governments are responsible for operating and maintaining schools, and are often involved in hiring teachers.

Own Revenue

The own revenues for the states include the personal income tax, 13 percent of oil proceeds for oil-producing states (Annex Table 2.1), stamp duties, road taxes, business registration fees, and lease fees for state lands. While the fees and other levies are set by the states, the rates and bases of the main taxes are set at the federal level. Own revenues for local governments include the property tax and fees charged for the use of motor parks and for sewage collection. Except for the VAT, the rates and bases of other local taxes and fees are set by the local government or by the respective state. As for the VAT, half of the VAT allocation is distributed according to population, 30 percent in equal amounts for all governments, and 20 percent on the basis of the actual collection in each jurisdiction.

The sharing of oil proceeds with the oil-producing states has exposed these states to large swings in revenue and has undermined the regional income equalization objective. For example, Ahmad and Singh (2003) find that a 10 percent fall in the oil price caused a 20 percent decline in federal oil revenues but a reduction by more than a third in oil-producing states. This has interfered with the budgeting process in the oil-producing states and exposed them to large oil price declines, requiring a partial bailout in 2015 (as discussed in Section 4).

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Annex Table 2.2. Nigeria: Formula for Federal Account Allocation to States and Local Governments

Indicator	Percent
Equal Share	40
Population Size	30
Social Development Factors	10
Internal Revenue Effort	10
Landmass	5
Type of Terrain	5

Source: Akeem 2011.

Transfers

Intergovernmental transfers in Nigeria come from the Federation Account, which is financed by oil revenues, the proceeds of corporate income tax, custom duties, and excise taxes (Ahmad and Singh 2003).[1] The states and local governments receive 26.7 and 20.6 percent, respectively, of the amount deposited in the Federation Account. The actual allocation to each state and local government is made based on the formula specified in Annex Table 2.2. The VAT revenue is also shared, based on a different formula: 15 percent to the federal government, 50 percent to the states, and the remaining 35 percent to local governments.

Borrowing

The main borrowing rules for the state and local governments in Nigeria are set in two key acts of 2007, the Fiscal Responsibility Act and the Investment and Securities Act. The federal government and the 36 state governments also approved a National Debt Management Framework agreement for 2013–17 that includes additional guidelines for external and domestic borrowing.

- *Fiscal Responsibility Act:* (1) Empowers the president, subject to approval by the National Assembly, to set overall limits on consolidated debt of the federal and state governments (these limits are proposed by the Federal Debt Management Office as part of the annual budget exercise); (2) limits public borrowing to capital projects, with no tier of government allowed to borrow if it is in arrears in debt service; and (3) requires that any state government or its agencies may obtain external loans only through the federal

[1]The amount of oil revenue transferred to the Federation Account is equivalent to 87 percent of overall revenue minus first charges (including external debt service, government share in the production cost of oil, the cost of government-sponsored projects, and the expenditure of the National Judiciary Council), which have varied over time depending on the economic priorities of the federal government.

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government and that such loans must be supported by a federal government guarantee approved by the National Assembly

- *Investment and Securities Act:* Allows state and local government borrowing only if the total amount of loans outstanding at any particular time, including the proposed loan, does not exceed 50 percent of actual revenue for the preceding year
- *National Debt Management Framework agreement for 2013–17:* Sets guidelines for contracting and reporting commercial debts by the states and local governments[2]

[2]For more details, see National Debt Management Framework for 2013–17.

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Annex 3

Case Study: South Africa

Fiscal decentralization in South Africa increased significantly shortly after the collapse of apartheid in 1994. The increase was the product of political compromise rather than the reflection of economic or fiscal considerations and aimed at preventing further social strife. Owing to strong political pressures to decentralize at a rapid pace in the immediate post-apartheid period, the authorities did not have the luxury of carefully sequencing the devolution process in line with the pace of capacity strengthening at the local level.

South Africa retained the unitary form of government in the post-apartheid period but adopted a fairly decentralized system. The constitution established three spheres (levels) of government—national, provincial, and municipal. The largest metropolitan areas are governed by metropolitan municipalities, while the rest of the country is divided into district municipalities, each of which consists of several local municipalities. Currently, there are nine provinces, eight metropolitan municipalities, 44 district municipalities, and 226 local municipalities in South Africa. The national government is responsible for policy development, national mandates, setting national norms and standards for provincial and municipal functions, and monitoring implementation for concurrent functions. The constitution also establishes cooperative governance among the three levels of government, which mandates negotiation rather than litigation to resolve political and budgeting problems among levels of government. Negotiation is supported by numerous intergovernmental forums that facilitate cooperation and consultation in the budget process (Momoniat 1998).

Expenditure Assignments

The division of powers and functions among the various levels of government are clearly defined in the constitution. Specifically, the national and provin-

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cial governments are concurrently responsible for key social services, such as education, health, welfare, and housing. In practice, the national government determines the policy, and the provincial governments are responsible for implementation. Provincial governments are exclusively responsible only for provincial roads, while local governments are responsible for local services, such as access roads, streetlights, garbage collection, sanitation, and town planning.

Government employees at all levels receive similar remuneration for similar qualifications. The public servants employed by the national and provincial governments belong to a single public service, which ensures similar remuneration for similar rankings, irrespective of functions. Local government employees are not part of the national public service, but the high level of unionization and collective bargaining has caused their pay to converge with that of comparable employees at the national and provincial levels (Momoniat 1998).

Most provinces initially struggled with the new system because of a lack of experience in managing public finances. Because the budget process had been centralized before 1994, the provinces had to develop the capacity to budget as the new, more decentralized, budget system began to be implemented. In addition, the newly established provincial treasuries were not in a position to monitor or check expenditures for a number of years, and the provinces struggled to implement nationally determined policies. As a result, provinces' treasuries were unable to curb spending in line with approved budgets, and there were long delays before financial statements were completed. The national government was forced to impose stringent measures in the provinces, such as employment freezes and cutbacks in non–social security expenditure. Over time, a monthly reporting system was created and, beginning in the late 1990s, the national treasury helped provinces draw up realistic budgets. These simple but critical measures helped dramatically turn around provincial finances; the provinces stabilized their personnel expenditure and began to shift funds toward nonpersonnel budgets and debt payments. The implementation of a multiyear budget beginning in 1998 also helped provinces prepare more realistic budgets. Another impetus for reform emerged through benchmarking among the provinces, which identified cost drivers and emphasized the need for additional reforms in lagging provinces.

Own Revenue

The taxing powers of the three levels of government are consistent with best practice. Only the national government may impose corporate income tax, VAT, excises, and custom duties. The provincial governments may impose

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surcharges on the personal income tax and fuel levy, but this is subject to national objectives and requires consultations with the national government. Municipal governments have more taxing powers than the provincial governments; they can charge property taxes and generate revenue from user charges on the provision of electricity and water.

The fiscal autonomy of the provinces is low, whereas that of municipalities is substantial. Only a small fraction of the provinces' revenue derives from taxes (about 3 percent of provincial budgets in 2014/15); transfers from the central government fill the gap, with provinces having very little autonomy to make spending allocation decisions. In this sense, the role of provinces is similar to that under a deconcentrated system. The municipalities, on the other hand, have significant autonomy to make spending allocation decisions with oversight from the national government. Property taxes and utility fees account for over 90 percent of the municipalities' overall revenue.

Transfers[1]

There are two types of transfers to subnational governments in South Africa: equitable share transfers and earmarked transfers. In recent years, equitable share transfers have accounted for about 80 percent of total transfers to provinces, whereas for municipal governments the share is roughly 50:50 (including general levy sharing with metropolitan municipalities). The formulas for both types of transfers are largely population-driven, and are reviewed and updated with new data from census surveys.

Provincial and municipal government equitable share allocations are based on estimates of nationally raised revenue. If this revenue falls short of the estimates in a given year, the equitable shares of the provinces and the municipal government will not be adjusted downward. Allocations are assured (voted, legislated, and guaranteed) for the first year and are transferred according to a payment schedule. In the interest of longer-term predictability and stability, estimates for an additional two years are published with the annual proposal for appropriations. In the 2015/16 budget, after providing for debt costs and the contingency reserve, about 48 percent of spending was allocated to the national government, 43 percent to provincial governments, and 9 percent to municipal governments.

[1]For details on the formulas used to determine transfers to the provincial and municipal governments, see the South Africa Treasury webpage, http://mfma.treasury.gov.za/Media_Releases/LGESDiscussions/Pages/default.aspx.

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The provincial equitable share formula uses a number of services for the determination of the shares for provinces. For the 2014/15 budget, for example, the formula components were set out as follows:

- An *education component* (48 percent) based on the size of the school-age population (ages 5–17) and the number of learners (grades R through 12) enrolled in public schools
- A *health component* (27 percent) based on the risk profile of each province and its health system caseload
- A *basic component* (16 percent) derived from each province's share of the national population
- An *institutional component* (5 percent) divided equally among the provinces
- A *poverty component* (3 percent) based on income data (This component reinforces the redistributive effect of the formula.)
- An *economic output component* (1 percent) based on GDP-R data (GDP-R is a measure of regional gross domestic product produced by Statistics South Africa.)

A new formula for the local government equitable share was introduced in 2013/14. This followed a review of the previous formula by the national treasury, the Department of Cooperative Governance, and the South African Local Government Association, in partnership with the Financial and Fiscal Commission and Statistics South Africa. The new formula is based on data from the 2011 Census, which resulted in major changes to some allocations. To smooth the fluctuations, the new allocations were phased in over a five-year period ending in 2017/18. The formula uses demographics and other data to determine each municipality's share of the local government equitable share. It has three parts, made up of five components:

- The first part of the formula is the *basic services* component, which provides for the cost of free basic services for poor households.
- The second part enables municipalities with limited own resources to afford basic administrative and governance capacity, and perform core municipal functions. It does this through three components: (1) the *institutional component,* which provides a subsidy for basic municipal administrative costs; (2) the *community services component,* which provides funds for core municipal services not included under basic services; and (3) the *revenue adjustment* factor, which ensures that funds from this part of the formula are provided only to municipalities with limited potential to raise their own revenue.
- The third part of the formula provides predictability and stability through a *correction and stabilization factor*, which ensures that all the formula's guarantees can be met.

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There are four types of provincial conditional grants. They are (1) general grants that supplement various programs partly funded by provinces, such as infrastructure and central hospitals; (2) specific grants to fund responsibilities and programs implemented by provinces; (3) allocations-in-kind, through which a national department implements projects in provinces; and (4) transfers to provinces to help them deal with a natural disaster.

Borrowing

Borrowing is allowed by all subnational units but is subject to central government regulation and oversight by the Ministry of Finance. The South African Constitution allows provincial and local governments to borrow for capital spending and bridging purposes only; in practice, only municipalities borrow, and the major cities have issued municipal bonds. Macro-fiscal risks have remained under control in South Africa despite a substantial devolution of expenditure, thanks to sound national fiscal policy and effective management of subnational financial policies by the national treasury. Legislation prohibits central government guarantees for borrowing by the municipalities. In case of default by the municipalities, the central government has the right to intervene to clarify the rights of lenders.

To date, there have not been any defaults of subnational governments in South Africa that would have required a bailout from the national government. In the early years of decentralized government, some subnational governments showed a deficit bias and expected the national government to provide support when they got in trouble. In the mid-1990s, for example, Johannesburg did not adjust its spending to lower revenue, and the national government had to intervene to enforce fiscal discipline and design a restructuring plan to turn the city's finances around. Over time the central government has adopted a proactive approach to complement the transparent mechanism for bankruptcy procedures of municipalities; it includes tough sanctions, such as a substantial loss of political autonomy for municipalities in case of default. So far this approach has been quite successful in addressing moral hazard that could lead to excessive borrowing at the subnational level and thus helping avoid defaults by subnational governments.

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Annex 4

Case Study: Uganda

Fiscal decentralization in Uganda started following the end of the civil war as part of a broader strategy to reduce ethnic tensions. At the time of independence in 1962, Uganda had a deconcentrated system of government, in which local governments were responsible for significant expenditure functions but effective administrative control was retained by the center. However, this relatively centralized system was dismantled shortly after independence and replaced by a very centralized one. Following the end of the civil war in 1986, a gradual process of fiscal decentralization started; it was formalized in 1993 through the Local Government Statute, enshrined in the 1995 Constitution, and later in the Local Government Act of 1997 and the Local Government Financial and Accounting Regulations of 1998.

The number of local governments and overall number of staff increased rapidly with decentralization, reflecting political pressures. To achieve national consensus among various groups, the central government enabled a proliferation in the number of districts (originally the highest government tier). By 2005, the government also had reached agreement with regional and tribal leaders to establish regions—an intermediate tier of local authority comprising districts that essentially represent tribal kingdoms. Uganda has four regions (Central, Western, Eastern, and Northern) that are divided into districts. In 2002 there were 56 districts; by 2010 there were 111 districts plus Kampala. At the same time, there was an upward drift in government staff outside the ministerial civil service, including staff of special independent commissions, secondary and tertiary schools, police, prisons, and central government staff delegated to districts (Langseth 1995; Golola 2001; Kjaer 2004).

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Spending Assignments

The allocation of sectoral expenditure responsibilities between central and local authorities is broadly along the lines suggested by theory. Subnational authorities are charged with delivering basic services that directly affect their communities, which strengthens the link between delivery and accountability. These services include (1) primary education; (2) primary health care and district hospitals; (3) rural water services; (4) most agricultural extension services; and (5) district, feeder, and municipal roads.

Subnational governments have little flexibility to make significant resource allocation decisions, reflecting a deconcentrated rather than a devolved system of government. The amount of spending carried out by the subnational governments proceeded relatively fast, accounting for about 35 percent of overall spending by the mid-2000s (excluding donor projects). But much of this devolution was implemented through a detailed conditional grant system decided at the central level. This allowed close supervision of spending by the center but did not encourage the development of horizontal accountability between the local governments and their constituencies, which undermined local autonomy.

Own Revenue

The assignment of revenue sources to subnational governments is broadly in line with best practice. The main local revenue instruments are a property tax and a series of market dues. A graduated income tax applied to individuals (which had been the main source of revenue for local governments) was suspended in the mid-2000s.

The revenue capacity from these sources is limited. The share of revenue collected at the subnational level represents less than 5 percent of local spending, reflecting a weak cadaster system, especially outside the main urban centers, and a large extent of informality in the economy. The subnational authorities do not have the ability to modify tax bases or tax rates.

Transfers

Central government transfers to subnational governments are largely conditional; that is, earmarked for the provision of specific services. Over time, conditional grants have grown in share (from 62 percent to 89 percent of all grants) and in number (from 16 in fiscal year 2002 to 38 in fiscal year 2011), and have become more restrictive. These grants are conditional upon the provision of specific services, such as health and education. The remain-

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ing 20 percent are equalization and unconditional grants. In practice, the unconditional transfers are used primarily to cover administrative costs, including wages and allowances at the local level, rather than to deliver direct services to the public.

The formulas used to determine the amount of grants to each subnational government are complicated, which undermines the transparency of the system. Both types of transfers are allocated on the basis of formulas that include population and poverty indicators. Currently, 38 conditional grants are made each year to each local government, and each grant has its own formula. The overall amount of unconditional grants varies quite a bit from year to year. The formula for these grants takes into account population (85 percent) and land area (15 percent).

Borrowing

Local government use of formal debt financing has been very limited in Uganda. Borrowing by local governments is permitted by law, but it has a very stringent cap (25 percent of locally generated revenue) and is subject to central government conditions and approval. This system has succeeded in containing formal indebtedness by local authorities.

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