

EAP Task Force

Document 10

Joint Meeting of the EU Water Initiative's EECCA Working Group and the EAP Task Force Environmental Finance and Water Networks

29 March –1 April 2005, Chisinau, Moldova

Outline of the Background Paper on Decentralisation

How can central authorities strengthen sub national levels of
government for environmentally related services

Participants are invited to take note of the document and to provide their comments on its content. In particular delegates are invited to provide their views on the key messages contained in the document and to highlight any country experience that they would wish the secretariat to include in the document when it will be developed into its full length.

ACTION REQUIRED: For information and discussion.

1. Objective of the discussion

Decentralisation is one of the key governance challenges facing EECCA countries. Beyond mere institutional reform, it relates to two main issues:

- The capacity of local authorities to make decisions and to allocate resources;
- The capacity of these institutions to fund these decisions, and to raise adequate revenues.

Success in this area could have an important bearing on the achievement of internationally agreed targets in the water supply and sanitation sector.

The report sketched out here aims at scoping the key issues related to this challenge. It should identify innovative schemes, bottlenecks and opportunities in EECCA countries, build on lessons learnt from economies in transition (possibly in the CEE), and set the stage for further investigations that would lead to targeted policy recommendations for EECCA.

The discussion should help:

- To identify innovative schemes in the region, which are relevant and deserve further investigation;
- To sketch the key policy options that should be given prominence;
- To focus the project paper on the key issues that are relevant for the Ministers' discussion.

Note that this paper will also touch upon issues that relate to harnessing local credit systems for water and sanitation infrastructure in EECCA, an issue that will be addressed further in session 8 of the agenda.

2 Key issues

The decentralization of the water sector in EECCA, that took place in the late 1990s, has failed to produce the expected results. This is partly due to the lack of appropriate institutional reforms. The Almaty Guiding Principles address this issue, pleading for a reform of institutions and a clarification of their roles. In particular, the Guiding Principles advocate that the role of national authorities should be to set the framework for managing urban water supply and sanitation by decentralisation, where decentralisation entails:

- Decentralising responsibility for services to the municipal level, avoiding excessive fragmentation;
- Establishing the legal and institutional framework for sound and sustainable municipal finance, including effective planning, supervision, and fiscal control systems for municipalities.

These recommendations are in line with key findings of the Camdessus Report. In particular, the Report noted that national governments should establish the policy and institutional framework to enable subnational entities, such as municipalities, regional water boards, and water utilities, to generate and attract finance for investment. In addition, IFIs are invited to take steps to remove obstacles to their lending to subsovereign entities.

Since then, the EAP Task Force has monitored a number of legislative and institutional initiatives that have come into force or will shortly be implemented that could help to create a basis for an improvement of the situation. At the same time there are also a number of important legal and institutional reform areas that require significant additional efforts.

This paper focuses on the role that central governments can play to help strengthen local authorities, and to enhance their creditworthiness. Central governments have an important role in encouraging and accompanying the decentralization of responsibilities to local authorities and in facilitating their access to the financial resources needed to face these responsibilities. In particular, this requires an adequate framework to establish the creditworthiness of local authorities, and to facilitate their access to local capital and financial markets within a clear, prudent scheme.

Fiscal decentralizations has three main components:

- The ability of local governments to raise revenues to meet their delegated responsibilities. This can be divided into two categories:
 - The ability of local authorities to collect taxes. In EECCA, tax responsibilities are assigned mostly to central governments, which do not trust the capacity, integrity, and fiscal discipline of local governments. This issue will not be addressed in the framework of this paper;
 - Intergovernmental transfers. EECCA countries mostly rely on such mechanisms to bridge the financial gap that arises between the costs of local policies and services and the revenues to which local authorities have access. In this context it is crucial that intergovernmental transfer mechanisms lead to an effective and efficient allocation of resources.
- The autonomy of local governments to make expenditures. Again, the central and regional governments are currently not very keen on delegating expenditure responsibilities to local authorities. This requires both an adequate institutional framework, and managerial capacities related to budgetary decision making and financial planning;
- The authority of local government to incur debt. Restrictions of local governments access to credit are patent, and can be justified, in a certain context.

In this perspective, the paper would focus on the economic, institutional, and managerial aspects of fiscal decentralisation:

- First, it would establish the relevance of fiscal decentralization, in the context of EECCA countries. This section would take into account the institutional and economic features of selected countries, taken as ideal-types. It will make clear that decentralization, although it is a sound concept, should be declined in a very pragmatic way, to account for the features of each country (size, geography, demographics, urban density and rural areas, level of equipment, etc.);
- Second, it would explore the mechanisms for intergovernmental transfers. If intergovernmental transfers are the dominant source of revenues for sub-national governments in EECCA, the design of these mechanisms is consequential for the efficiency and the effectiveness of local service provision. Such mechanisms should take into account the current and future magnitude of such transfers; thus, a review of the existing schemes should be most inspiring;
- Third, it would also explore the opportunities that derive from the development of local capital and financial markets. If one considers seriously that increased use of market-oriented credit is both necessary and desirable in the financing of water and sanitation infrastructures, it will be critical to tap the private savings market o help in investment financing; it should be recalled that this mechanism is widely spread in OECD countries, and that the situation is highly contrasted among EECCA countries;
- Fourth, it would consider accompanying measures at the municipal level, including support to improve the quality and transparency of local government budgeting; to develop multiyear investment plans; and to develop the capacity to incur and to manage debt. Indeed, the capacity to manage funds properly and to allocate resources is a prerequisite to access more financial resources.

It would rely on three sets of sources:

- desk research and the analysis of the existing literature, in particular on transfer mechanisms and the experience of OECD countries;
- characterization of some relevant institutional features of selected EECCA countries, related to fiscal federalism; this includes a survey of the magnitude and the dynamics of decentralization and the mobilization of financial resources by local authorities;
- lessons learnt from related projects implemented in the region, and from economies in transition. The Polish experience, for instance, demonstrates that it is possible to decrease central government transfers while increasing local government financing for water infrastructure.

3 Relevant Task Force and Project Preparation Committee inputs

The following inputs will be used to develop the report:

- Selected country case studies on local credit systems for municipal environmental infrastructure
- Lessons learnt from support to municipalities to improve their financial planning capacities. In particular, experience related to the dissemination of a tool that supports multiyear investment planning in municipalities
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4 Other relevant inputs

- Academic literature on fiscal decentralization in OECD countries and transition economies
- Work undertaken by the IPWA Financial Tools Task Force in the CEE/CIS region (including USAID's review of their proposed pooled financing initiative for the Eastern Europe and Eurasia Region).
- Lessons learnt from Central and Eastern Europe.

5 Possible issues for discussion and next steps

Ministers could be invited to discuss the following issues during their consultations:

- To which extent should fiscal decentralization apply in your country?
- Are the current mechanisms for intergovernmental transfers appropriate, effective, and sustainable?
- Which could be the role of IFIs and donors to support decentralization?
- What are the basic requirements for local authorities to access local credit and financial markets?