Executive Summary

Most countries in Eastern Europe, Caucasus an Central Asia (EECCA) have engaged in a systematic devolution of responsibilities for the construction and maintenance of urban environmental infrastructure to subnational levels of government. As owners of the communal service infrastructure, municipalities are responsible for its rehabilitation, modernisation, and development. Now, devolution of responsibilities needs to be matched by ensuring access to the financial resources needed to implement the new mandates assigned to local and regional jurisdictions.

As EECCA municipalities are still largely dependant on fiscal transfers from central or regional budgets, they often have to co-ordinate their infrastructure development plans and capital expenditure budgets with national/regional plans and budgets. This makes strategic planning and investment at local level dependant on the policies at the national/regional level, and generates a risk that local investment plans will not be implemented due to budgetary constraints at other levels of government.

From a central government perspective, intergovernmental transfers are instruments that the central government can use to improve the performance and control of subnational public expenditure, and to create incentives for better coherence between national and local public policies.

Surveys in OECD countries confirm that the impact of intergovernmental grants on efficiency, fiscal discipline, and equity, largely depends on their design. The design varies significantly from one country to another, and is strongly influenced by policy objectives and the main features of the institutional context. Important lessons have also been learnt from European Union (EU) accession countries where intergovernmental transfers are a key dimension of relations between levels of government and a major source of finance for local jurisdictions.

EECCA countries mostly rely on inter-governmental transfers to bridge the financial gap that arises between the costs of local policies and services and the revenues to which local authorities have access. Each country has developed an array of instruments to transfer budgetary resources from
central to local level. Differences exist in the magnitude and the respective weight of each instrument, and in the modalities of their implementation.

In EECCA countries, general purpose transfers, typically in the form of equalization schemes, are frequently used but can have negative economic and financial consequences. In particular, they enable local budgets to increase their expenditure without raising additional tax revenues: local governments have no incentives to expand their own tax base or revenues from user charges.

Although water supply and sanitation (WSS) is not the only concern which presides over the design of these mechanisms, it is directly impacted by them. Considering the provision of water supply and sanitation (WSS) services in EECCA, intergovernmental transfer mechanisms should aim to be efficient and sustainable, and they should be designed in accordance with the following objectives:

- Channel significant volumes of finance to local jurisdictions. In the context of EECCA, national public funding is expected to remain a major source of finance for WSS for the foreseeable future, especially for capital expenditure. This is even more so in the context of the Millennium Development Goals (MDGs) which require investment which cannot be financed exclusively from user charges or private sources of finance.

- Generate stable revenue flows, which can be incorporated into comprehensive financial strategies. This requirement is even more crucial when local jurisdictions intend to incur debt, as their creditworthiness depends mainly on their capacity to generate stable revenue flows; stable rules for intergovernmental transfers contribute to this creditworthiness. Similarly, central governments should make efforts to honour their financial commitments vis-à-vis utilities, most notably by resuming payments of compensation for social services provided through utilities (such as reduced tariffs for certain categories of the population).

- Make sure that the money will not be diverted from the initial projects, while respecting the autonomy of the local governments to allocate resources to priority investments in the WSS. In a context where priorities are unstable, and where corruption cannot be ignored, targeted support, with the associated risk of inefficient resource allocation, may be preferable to block grants as the most effective way to transfer money from central to local governments in EECCA for WSS.
The country case studies in this volume – of Armenia, the Russian Federation and Ukraine – contain some positive examples in light of the criteria set out above. These include:

- The use of economic, demographic and geographic statistics (not tax revenue statistics) to estimate regional revenue capacities, expenditure liabilities, and need for equalizing transfers (the Russian Federation).

- Priority-setting and stipulating the procedure for considering proposals made by the regions (see the procedure introduced in the Ukraine in 2005 to allocate funds “for socio-economic development of regions, prevention of breakdowns and man-made disasters in the housing and utility sector and in other communal property assets and implementation of investment projects”).

- Allocating resources between regional governments on a competitive basis (see the Regional Finance Reform Fund in the Russian Federation).

- Introduce transfer mechanisms to allocate finance directly to investment projects (the Regional Development Fund in the Russian Federation, some instances in the Ukraine).