

# EXPLORING THE EFFECTIVENESS OF THE PUBLIC SECTOR: TOWARDS A CLASSIFICATION OF LOCAL PUBLIC SECTOR FINANCES AND A COMPARISON OF DEVOLVED AND DECONCENTRATED FINANCES

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## INTRODUCTION

**M**ANY DEVELOPING COUNTRIES HAVE DEFICIENCIES in their ability to manage their government expenditures in an efficient and accountable manner, so as to effectively deliver critical, pro-poor public services such as basic education, health, and other public services that are essential to economic development and poverty reduction. An important — but often overlooked — element in sound public financial management is to make sure that resources flow down within the public sector to the local (sub-central) level where public services are actually delivered and where economic development takes place. Instead, public financial resources often remain stuck at the central government level, where these resources are either diverted or fund bloated and inefficient bureaucracies.

While fiscal decentralization and local government finance reform have been treated as an important theme in international development and in the design of country assistance strategies for developing economies, the system of intergovernmental finance is seldom treated as a cross-cutting policy issue. In their focus on fiscal decentralization and subnational public finances, international financial institutions, international development agencies, and the related research community have focused to a considerable extent on the distribution of financial resources within the context of countries that largely rely on devolved, elected local government for the delivery of key public services. The (near) exclusive focus on devolved expenditures in practice and in research ignores the fact that in about half the developing countries around the world, key public services are delivered in a deconcentrated manner, where the local public sector is formed by subnational departments (or territorial units) of the

state administration which report upward but are tasked to deliver public services at the local level. As such, the current measures of local government finance systematically fail to capture a broad array of deconcentrated subnational finances.

In the absence of systematic comparative data on the structure and nature of local public sector finances (including devolved as well as deconcentrated expenditures), cross-country studies that seek to estimate the ‘production function’ of public services are either forced to systematically exclude almost half of the world (countries with predominantly centralized deconcentrated public service provision) or make conclusions about the (in)effectiveness of the public sector while omitting details about the size and scope of deconcentrated expenditures. Without basic comparative data on local public sector finances, important real-world questions about public sector effectiveness, improvements in public service delivery, and the success of decentralization reforms are extremely difficult to answer.

A more comprehensive metric of (local) public sector finances ought to recognize that virtually no country around the world is purely devolved or purely deconcentrated, but rather, that the central authorities in each country simultaneously interact with residents, civil society and the private sector in three possible ways: through the direct or delegated delivery of public services (by central government entities); through deconcentrated departments or jurisdictions; or through devolved local governments.

In order to explore local public sector finance patterns in a more precise manner, the metric used to measure local public sector finances should be more nuanced and capture not only the size of devolved expenditures and revenues, but also capture the size and details of deconcentrated and centralized expenditures. As such, the first step that the research community has to take on this point is to formulate an accurate definition of devolved expenditures versus deconcentrated and delegated expenditures. However, local governments or local

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administrations do not necessarily have the same degree of discretion or control, either over devolved expenditures or over deconcentrated expenditures. As such, different types of local public expenditures and revenues should not merely be lumped together. Instead, in addition to measuring the size of the different types of resources flows, a comprehensive metric of local public sector finances should also capture qualitative (political, administrative, and fiscal) aspects of the local public sector, for instance, by capturing the degree to which local governments (or local administrations) actually have discretion or control over their expenditures.

The main purpose of this paper is to reflect on the current state of knowledge with regard to classification of (local) public sector expenditures across different countries and to arrive at a consistent classification of (local) public expenditures and revenues which allows us to identify what share of public expenditures is spent within the local public sector, especially in direct support of the delivery of public services that have a direct impact on the households and businesses that are the recipients of the services. Furthermore, to the extent possible, the classification scheme should be sufficiently detailed to identify what institutional mechanisms were used to make these expenditures. At the same time, the classification approach should be sufficiently easily to use that it can be operationalized in an effective manner.

#### THE CURRENT CATEGORIZATION OF LOCAL GOVERNMENT SUB-SECTOR FINANCES

The territorial-administrative structures of countries vary greatly between countries and over time in terms of the number of territorial-administrative levels, the number of jurisdictions at each level, and the functions and responsibilities assigned to each level. It is an ongoing challenge to accurately capture the territorial and administrative structures of countries in a comparative manner. Within most classification schemes, however, provision is made for three territorial levels of government or administration: (i) the central or national government; (ii) state, provincial, or regional-level jurisdictions; and (iii) local-level jurisdictions.

States, provinces, or regions can be defined as “the major administrative divisions of countries” (Law, 2006) or “the largest geographical area into which the country as a whole may be divided for political or administrative purposes” (IMF, 2001,

p. 14). From country to country, these jurisdictions may be described by other terms, such as governorate, cantons, republics, prefectures, or administrative regions.

Next, a local government or local administrative jurisdiction can be defined as the “institutional body for a specific local area — such as a town, county or district — that constitutes a subdivision of a major political unit, such as a central government or regional government.” The IMF (2001) defines local government units as “being restricted to the smallest geographic areas distinguished for administrative and political purposes.” The local government level can encompass a wide variety of different general-purpose or special-purpose local governmental units, such as counties, district administrations, municipalities, cities, towns, townships, village authorities, boroughs, school districts, water or sanitation districts, and so on.

The IMF’s Government Finance Statistics publications form the primary international data source for the comparative analysis of public sector finances, including subnational public finances. Therefore, the IMF’s (2001) classification of public sector structures provides the *de facto* global standard for classifying and categorizing public sector finances. Within the context of the IMF approach to classifying the public sector, in order to be treated as local government entities, the IMF relies on a combination of political, administrative, and fiscal features. In the Fund’s view, local (and state) governments must be institutional units “entitled to own assets, raise funds, and incur liabilities by borrowing on their own account. They must also have some discretion over how such funds are spent, and they should be able to appoint their own officers independently of external administrative control” (IMF, 2001, pg. 14). In other words, the IMF definition seeks to consider a combination of political, administrative and fiscal characteristics in defining what constitute ‘local governments.’

#### DEFINING THE LOCAL PUBLIC SECTOR

In the current thought experiment on local public sector finances, our interest is not to define sub-sectors of the public sector that are politically or operationally autonomous or independent, but rather, to identify that portion of the public sector that is “close to the people.” Then, the local public sector — in the way the term is used here — is largely, although not fully, consistent with a more

territorial definition of sub-central (regional and local) governance units.

As a working definition, the local public sector could be conceived of, or defined as, that part of the public sector that regularly interacts with residents, civil society, and the private sector; it is where residents and businesses receive services from the public sector and where residents interact with government officials. As such, the distinguishing feature of being part of the “local public sector” is not exclusively the governance status of a subnational public entity, but rather, whether the primary objective of the local entity or institutional unit is to interact with the public, in term of providing public services, regulation, public information, and so on.

In virtually all (if not all) cases, the local public sector fully encompasses the local government or administrative level (whether it is devolved or deconcentrated in nature), including front-line service delivery units and their administrative staff, such as schools and health clinics and teachers and local health workers. To the extent that the state or regional level or tier in a country is a direct provider of public services and/or interacts regularly with residents (for instance, in case of the regional level in Namibia), this government level could equally be considered to fall within the local public sector.

In rare instances, as further discussed below, some central government activities may (or may not) be considered to fall within the local public sector.

As already noted earlier, although in common parlance countries are often referred to as ‘deconcentrated’ or ‘devolved,’ in fact, the central government in any country often interacts with its citizens or residents in a number of different ways. For instance, a country that has a ‘devolved’ public sector structure (i.e., a country that predominantly relies on elected regional and/or local governments for the delivery of key public services) may nonetheless deliver certain public services in a deconcentrated manner, just as a predominantly deconcentrated country may engage in a limited amount of devolved expenditures. Indeed, an initial review of public sector structures would find it difficult to identify any countries that are fully consistent with any single one of the pure ‘textbook’ models for the public sector structure. As such, it is generally more appropriate to measure the relative share of centralized (direct) expenditures,

delegated expenditures, deconcentrated expenditures, or devolved expenditures in a country rather than characterizing an entire country as adhering to one approach or another. In addition, we would want to capture the institutional arrangements that surround each of these funding flows.

Having taken into account that the public sector can be categorized geographically in central, regional and local level jurisdictions, perhaps one of the most intuitive ways to look at the local public sector is to consider the institutional ways in which the central public sector interacts with its residents and delivers public services (figure 1). Together, these four institutional arrangements — in one way or another — comprise the building blocks of the Local Public Sector.

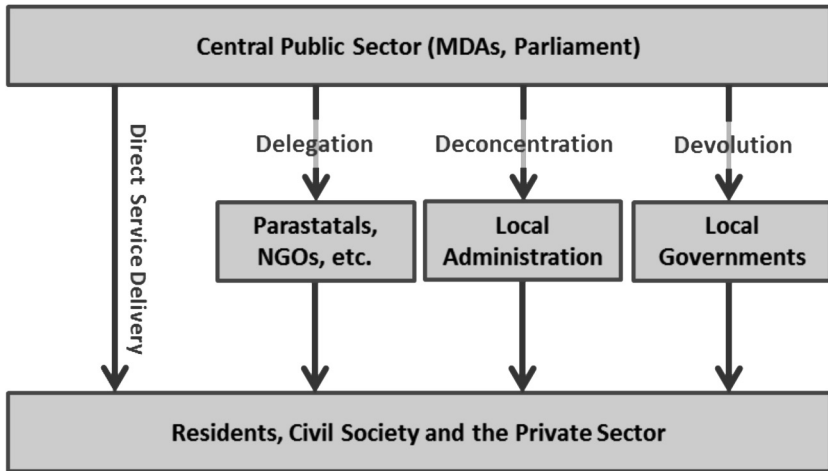
#### **Devolved (Elected) Local Governments**

Devolution can be defined as “the transfer of authority for decision-making, finance, and management to quasi-autonomous units of local government with corporate status” (Litvack and Seddon, 1999). In a devolved public sector, local governments have clear and legally recognized geographical boundaries over which they exercise authority and within which they perform public functions. While in some countries a broad range of public functions and services are assigned to the local government level (including basic education, health services, and so on), in other countries local governments are responsible for a narrower set of services (e.g., typical municipal services, such as local markets and solid waste management). A devolved governance structure enables residents to interact not only with local service providers and local administrators, but also with the elected officials that are responsible for supervising the delivery of government services at the local level.

#### **Deconcentrated Line Departments**

In countries without elected local government levels, the local public sector is typically formed by ‘deconcentrated’ subnational line departments or subnational territorial units of the national government, which form a hierarchical, administrative tier of the higher-level government. In these countries, the subnational administrative units are generally assigned the responsibility for delivering key government services — such as education, health services, and so on — within their respective geographic jurisdictions.

Figure 1: Interaction between the Central Public Sector and Residents, Civil Society and the Private Sector



Because deconcentrated departments or jurisdictions are merely a hierarchical part of the next-higher government level, unlike local governments, deconcentrated units are not corporate bodies. Nor do deconcentrated jurisdictions have their own budgets; instead their budgets are typically contained as sub-organizations within the budget of the higher government level. In deconcentrated systems, ‘local’ government officials are an integral part of the national public service and local executives (such as regional or district governors, as well as local department heads) are generally appointed by the central government. Even in countries that do have elected local governments, the central government often delivers certain public services in a deconcentrated manner. For instance, in many countries — even those with elected local governments — police services are often delivered in a deconcentrated (or even in a centralized) manner.

Deconcentration is often considered a relatively weak form of decentralization. Within this category, however, policies and opportunities for sub-national input vary: deconcentration can merely shift implementation responsibilities from central government officials in the capital city to those working in regions, provinces, or districts, or it can create strong local administrative capacity where a degree of operational and budgetary discretion is

yielded to deconcentrated line departments under the supervision of central government ministries (Litvack and Seddon, 1999).

#### Delegation to Parastatals and NGOs

In some instances, central line ministries or agencies may deliver government services and interact with the public through parastatal organizations that are part of the central government, but that are not on-budget central government entities. For instance, although national hospitals and public universities generally are funded by — and report to — their respective central government line ministries, these institutions typically have a degree of legal, administrative, and financial autonomy as parastatal entities. By establishing these entities as parastatal entities, these organizations tend to gain discretion in managerial and budgetary decision-making, as the construct may allow them to be exempt from constraints on regular civil service personnel and enable them to charge users directly for services.

Alternatively, central government agencies sometimes deliver government services by delegating the responsibility for providing the services to non-governmental organizations (NGOs) which are contracted to act as agents of the public sector. Religious-based organizations that are contract to provide health care services or nonpublic schools

that receive public sector funding could also be counted as being part of local public sector expenditures. Since in these cases NGOs act as agents of the public sector, such delegated expenditures should be considered to be part of local public sector expenditures.

### **Direct Interactions Between Residents and Central Government Institution**

Finally, central governments sometimes (albeit not very often) interact directly with their residents and/or deliver government services directly to the general public. It is not uncommon for border control, the issuance of passports and national identity papers, the issuance of certain (business) licenses, and the collection of national taxes and revenues to be conducted directly by central government line ministries or central government agencies. In addition, in many countries, the provision of law and order (or police services) is also a central government function, which is often fully funded through the central government budget.

In addition, it is not unusual for central line ministries to incur capital infrastructure expenditures and other expenditures (such as spending on school books and drugs and medical supplies) that are used for front-line services delivery by the local public sector. A broad definition of local public sector spending could count such expenditures as a centralized expenditure towards local public sector service delivery.

### **NEXT STEPS**

How to move forward from here? The inception of this manuscript was the realization that our current understanding of subnational governance and local public sector expenditures was poorly being served by existing measures and definitions of local expenditures and revenues. With that void in the state of knowledge in mind, the description of the Local Public Sector in the previous section starts to delineate a measurable metric of sub-central expenditures and revenues that defines the sub-national public sector beyond the Local Government Sub-Sector as defined by the IMF (2001). Having a metric that captures all sub-central expenditures, in addition to a more comprehensive picture of subnational institutional arrangements, should enable the community of development scholars

and practitioners to link more closely the degree to which public sector governance is able to.

The next logical step in the process would be to operationalize this thought experiment by collecting data on local public sector finances in a variety of countries, including countries who predominantly rely on devolved local governments, as well as those who predominantly (or exclusively) rely on centralized or deconcentrated government expenditures. In addition to collecting local public sector budget and fiscal data for these countries, it would be prudent to pursue gathering systematic qualitative information about the political, administrative and fiscal dimensions of the local public sector in these countries as well.

If a sufficiently large comparative data set of local public sector finances emerges, the community of public policy researchers and practitioners will have a data set to answer basic policy-relevant questions linking governance and public sector effectiveness. For instance, are devolved systems better able to achieve vertical fiscal balance when compared to deconcentrated countries? Or alternatively, does the degree of political discretion bestowed on elected subnational governments limit the political appetite for decentralizing functions and expenditure responsibilities?

Possibly the most challenging set of questions to answer is whether — and if so, under which circumstances — certain intergovernmental institutional structures are more effective at transforming fiscal inputs into policy outputs and outcomes. Answering this question will require combining detailed information about local public sector finances with information on governance structures and systems in different countries, along with information on (poor) public service delivery outcomes. Of course, this set of questions — if answered authoritatively — will have important implications for public sector structures around the world, in addition to the implications that these questions hold for the way in which the global development community supports economic and public sector development.

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