Committee of Experts on Public Administration
Eighteenth session
8–12 April 2019
Item 7 of the provisional agenda*
Strengthening fiscal management at the
national and subnational levels

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Note by the Secretariat

The Secretariat has the honour to transmit to the Committee of Experts on Public Administration the paper prepared by Committee member Cristina Duarte in collaboration with Linda Bilmes and Juraj Nemec.

* E/C.16/2019/1.
Strengthening fiscal management at the national and subnational levels

Summary

The 2030 Agenda for Sustainable Development generates new demands for integrated and coherent public policies, including effective and efficient fiscal management. Integrated fiscal systems and policies and consolidated budgets are pivotal to sustainable and inclusive growth, particularly through effective domestic resource mobilization, which requires sound fiscal management at both the national and subnational levels.

The present report contains five main observations regarding the features of sound fiscal management and underscores the importance of specific improvements in efforts to strengthen financing for development and accelerate progress towards sustainable development:

(a) Managing national budgets should no longer be the sole responsibility of the Ministry of Finance (Treasury), but of all relevant stakeholders through processes of coordinated and comprehensive actions;

(b) Transparency in public finance is a necessary but insufficient condition to ensure the accountability of fiscal management bodies;

(c) Participatory and performance-based budgeting should be more frequently used, especially at subnational levels, since those strategies increase ownership and link budgets more closely to priorities;

(d) Fiscal decentralization can lead to effective governance, provided that its implementation is calibrated to different levels of institutional (and general) readiness for decentralization;

(e) Illicit financial flows have a critical effect on the mobilization of domestic resources and consequently on financing for development. They should be tackled by identifying their sources and triggering factors, raising awareness of their various types, magnitudes and risks, creating coherent national and international normative frameworks (vertical coherence) and taking into consideration critical actions across economic, social and environmental dimensions (horizontal coherence). To that end, the strengthening of fiscal management systems is crucial.

Regarding the first point, traditional budgeting directed by the Ministry of Finance (Treasury) as the sole player in fiscal management should be changed. Progress towards the achievement of the Sustainable Development Goals through consolidated fiscal management is only possible if the principles of partnership, cooperation and collaboration are comprehensively implemented in the fiscal domain. Governmental stakeholders, including specialized analytical (policy advising) units, such as “value for money” units, institutes of fiscal policy, fiscal councils and oversight bodies, should be more integral and proactive in fiscal management, as should non-governmental stakeholders, including, notably, civil society organizations and the media.

Regarding the second point, budget transparency is a valuable tool to hold governments and public bodies accountable, but it does not automatically make them accountable. Access to information on government transactions and finances helps only if people have adequate access to channels to fight corruption and the mismanagement of public funds. Fiscal transparency is still in its infancy in many developing countries and a plethora of vulnerabilities in fiscal systems can hamper it.
For the third point, participatory budgeting and performance-based budgeting have been found to be instrumental in enhancing budget transparency. Interest in performance-based budgeting began more than 50 years ago, and most developed countries have the capacity to implement it in an effective and efficient manner. However, in some developing countries, performance-based and participatory budgeting have led to increased administrative costs due to the high degree of inclusive participation required.

Regarding the fourth point, decentralization and fiscal decentralization are usually, but not always, associated with improved governance, including in terms of the rule of law, the prevention of corruption, transparency and accountability, as well as enhanced subnational revenue mobilization. Successful fiscal decentralization depends on factors such as the capacity of subnational governments, the extent to which the central and subnational governments agree on the sharing of tasks and the overall fiscal framework.

For the fifth point, effective domestic resource mobilization goes hand in hand with the reduction of illicit financial flows, which can otherwise undermine sustainable development by reducing the resources available for essential public services, limiting a country’s capacity to attract investors and weakening trust between citizens and the State. The cross-cutting nature of illicit financial flows requires policymakers and other stakeholders to act strategically when addressing that complex problem.
I. Imperative of sound and smart fiscal management

1. The 2007–2008 world financial and economic crisis has left a fiscal legacy characterized by low levels of sustainable public finances. High public debts, stimulus policies that have not succeeded in triggering a sustained recovery and large public deficits, combined with the lack of an adequate fiscal space to accommodate strategic public investments, have put significant stress on public budgets and consequently on financing for development. Ten years after the crisis and despite significant public expenditures to cope with it, global financial instability is still threatening, putting the implementation of the 2030 Agenda for Sustainable Development into jeopardy.

2. The positive side of such an adverse environment is that fiscal policy has gained prominence in public debate, academic research and government policy. After a period in which monetary policies, through quantitative easing, supported the real economy, and fiscal policies supported banks through bailouts, fiscal management systems have recovered their main function of promoting inclusive growth and stabilizing the economy, particularly in the context of the implementation of the 2030 Agenda for Sustainable Development. High debt levels, long-term demographic challenges, growing inequalities and increased fiscal risks have led to increased awareness of the need for the adoption of more credible, transparent and accountable medium-term frameworks and the further development of “planning, programming, budgeting and evaluation systems” in support of open budgeting. Those large-scale trends, alongside technological shifts that result in an unequal allocation of benefits, trade integration setbacks and other changes, have further underscored the importance of sound national and subnational budgeting as tools of financing for development.

3. Sound fiscal policy is essential for sustainable and inclusive growth in contexts of high uncertainty and stressed government balance sheets. The Addis Ababa Action Agenda of the Third International Conference on Financing for Development, adopted in July 2015, puts particular emphasis on domestic resource mobilization: “For all countries, public policies and the mobilization and effective use of domestic resources, underscored by the principle of national ownership, are central to [policymakers’] common pursuit of sustainable development, including achieving the Sustainable Development Goals”. It has recognized that “significant additional domestic public resources, supplemented by international assistance as appropriate, will be critical to realizing sustainable development and achieving the Sustainable Development Goals”. The Addis Ababa Action Agenda has committed to “enhancing revenue administration through modernized, progressive tax systems, improved tax policy and more efficient tax collection”, which is a clear engagement in terms of improving the “fairness, transparency, efficiency and effectiveness of [the] tax systems, including by broadening the tax base”. In short, domestic resource mobilization has become one of the main pillars of financing for development, calling for strong fiscal management systems at both the national and subnational level.

II. National and subnational fiscal management systems: the challenge of integration and consolidation

A. Overview

4. Since the adoption of the Sustainable Development Goals, governments have been facing increasing pressure to improve their fiscal management and reporting systems and processes. The gathering, processing and dissemination of timely, accessible and usable information and data has become a game changer in fiscal management and reporting, particularly with regard to: (a) facilitating
macroeconomic, monetary and fiscal policies; (b) ensuring transparency and accountability; and (c) measuring government performance in terms of service delivery.

5. The volume and complexity of fiscal information may pose challenges to national and subnational governments, particularly those that have insufficient technical capacities and inadequate institutional set-ups. However, it is commonly accepted that reliable and readily available fiscal data is a key determinant of public finance reforms and can be helpful in directing resources towards the achievement of particular policy goals, such as poverty reduction, enlarging the coverage of the budget, introducing a medium-term fiscal perspective, producing information on tax expenditure, fiscal risk and contingent liabilities, implementing a programme-based budget framework and improving the quality of cash and debt management.¹

6. The establishment of national and subnational integrated fiscal management systems is still an ongoing work in several countries. A general lack of a geographically and/or sectorally consolidated national budget is all too common. Public transactions, concerning both the expenditure and revenue dimensions, that occur outside fiscal management systems pose significant risks to macroeconomic management and stability as well as to transparency and accountability.

7. The absence of integrated fiscal management systems and consolidated budgets may pose the additional challenge of “duality of systems”, in which national and subnational budgeting processes conflict with each other, leading to inefficient spending and revenue management. Such duality may also generate extrabudgetary flows, making reporting a mere administrative exercise without the proper monitoring and evaluation functions, and leading to inefficient policymaking. Moreover, the duality of the systems may engender contradictory data and asymmetric information, which have a negative impact on revenue and debt management, particularly with regard to contingent liabilities on the part of public enterprises, public-private partnerships and subnational governments. That may ultimately hinder governmental capacity to deliver effective and inclusive public services and goods. Under such conditions, evidenced-based budgeting becomes difficult and might be skewed towards short-sighted and political concerns rather than seeking long-term tangible and impartial objectives.²

B. Roles and responsibilities: involving stakeholders in participatory budgeting

8. In a traditional budgeting system, the sole player in fiscal management is the Ministry of Finance (Treasury) as one of the units within the polycentric centres of government. The role of other stakeholders is rather limited. Until recently, public budgets were drafted and managed by the Ministry of Finance behind “closed doors”. Civil society and other non-governmental actors were shut out of the process, and even legislatures played only an infinitesimal role. However, such practice has been shifting, and fiscal transparency is increasingly becoming the norm in transparent and inclusive budgetary processes and good governance. The concept of a consolidated fiscal management system today goes beyond the Ministry of Finance to fully embrace the principles of partnership, cooperation and collaboration.

9. Depending on the levels of fiscal and financial management – international, national, subnational and organizational – stakeholders within a consolidated fiscal management system can be diverse. Stakeholder engagement must be adapted to the level of fiscal and financial management and should be based on effective mechanisms of input aggregation. Municipalities and public organizations should engage with individual voices, whereas international organizations may have a harder time engaging at that level, especially because transaction costs can be high.

10. There are also several “activity” subsystems (tasks) within a consolidated fiscal management system, budgeting being only one of them. Again, different stakeholders would be engaged in different tasks. For instance, stakeholders that are engaged in auditing tasks would be different from stakeholders that make expenditure-related structural decisions. Nonetheless, involving all relevant stakeholders in budgeting processes is at the core of consolidated fiscal management and is a necessary condition for success in and across all budgetary phases: the budget preparation phase, including budget structure preparation, consultations, controlling and communication; the budget approval phase; the budget execution phase; and the budget oversight phase.

11. Intensive involvement of stakeholders should be promoted during the preparation phase of the national budget. The recommended (open) list of core stakeholders for that phase should include traditional players such as the Ministry of Finance (Treasury), if established, and other central government bodies, and all actors and entities with legitimate interest in the process. Depending on which agency (within the Ministry of Finance) is the “lead” with regard to preparing and structuring the budget process, meaningful engagement on the part of a wide range of stakeholders may require the consideration of a range of factors, including:

(a) **Timing and frequency.** In what stages of the budget cycle are stakeholders invited to participate? How often and how regularly are they engaged to have an impact?

(b) **Assumptions.** Are stakeholders involved in determining the assumptions (e.g., macroeconomic factors, prices of inputs, fiscal trends)? Are those assumptions transparent?

(c) **Techniques.** What are the techniques used in revenue forecasting and budget allocation (e.g., extrapolation, microsimulation, statistical modelling)? Are stakeholders able to understand them? Are the data accurate and is its quality sufficient to permit forecasting?

(d) **Biases.** Can a government be an honest broker in integrating different perspectives impartially even though it may be biased towards different tendencies?

12. The Ministry of Finance (Treasury), if established, is responsible for estimating revenues and planning public spending. In particular, the Ministry maintains dialogue with spending units (including subnational governments and public enterprises) regarding their expenditure needs and requirements. The knowledge, experience and skills of the Ministry of Finance (Treasury) need to be supported by inputs from additional bodies during the preparation of evidence-based budget proposals. Some of those stakeholders may include national banks, bodies that provide national (and international) data such as national statistical offices, specialized (preferably semi-independent) government bodies such as “value for money” units, institutes of fiscal policy, oversight institutions that are often involved ex ante and in proactive ways through their findings and proposals, independent fiscal discipline oversight bodies such as fiscal councils and, if feasible (or compulsory in some cases), external advisory bodies.
13. Fiscal councils may provide an independent opinion on existing and potential fiscal problems to support prudent fiscal policies, although their mandates, competencies, sizes, analytical capacities and positions among the rest of public institutions may differ. When responding to problems connected with fiscal imbalances during and after the 2007–2008 world financial and economic crisis, many countries established (in the Eurozone, as a semi-compulsory task) independent fiscal councils. Other countries also have special analytical units called value for money units. Such bodies may exist within the Ministry of Finance (Treasury) or in other organizational forms. Their core function is to assess large investment projects in terms of their value for money. They do so by providing opinions about public expenditures. The effective use of that kind of advisory capacity improves evidence-based budget-making and the efficiency of public expenditure systems and processes.

14. Other stakeholders with interest in budgetary processes should also be engaged from the very beginning. People and civil society, the private sector, professional associations and political actors should be provided with a platform to make their voices heard. Once people, and civil society in general, have such a platform, they should use it in a committed and responsible way, with consideration for the intergenerational impact their actions will have in shaping policymaking. In that regard, civic education, which has been neglected in many contexts during the past 30 years or so, should be repositioned and valued in policymaking.

15. Donor countries and institutions that provide critical financial assistance may also play a key role in the budget preparation phase by, inter alia, providing resources and technical assistance. In those cases, countries should have a clear, well-structured and long-term vision, which will serve as a critical ownership tool to provide a unique and consolidated platform in which all donors can anchor their interventions. Otherwise, a donor’s inarticulate intervention may render the process inefficient and have a negative impact on resource mobilization and, consequently, on financing for development.

16. Civil society organizations play an increasingly important role in public budgeting. Not only do they represent the people’s voice, but they also help improve budget policies by providing information on public needs and priorities through their grass-roots connections. By participating in public budgeting, civil society also gets a better sense of budgetary financial constraints, which in turn leads to a better understanding of the trade-offs inherent to the budgeting process, and encourages them to make their requests not as a “shopping list” but rather as an exercise in prioritization. In that context, policymakers should perceive civil society participation not as a threat but as a win-win scenario. When civil society lacks access to budget information or opportunities to engage in budget processes, unpopular or inappropriate programmes that waste money and breed corruption may be chosen. Civil society is also instrumental in drawing more people into the debate by collecting and summarizing data in easily understandable formats, which spreads budget information and trains communities to better understand budgetary processes. Last but not least, civil society can provide technical support and independent opinions on budget proposals and their implementation.

17. The media also plays a significant role in the preparatory phase of budget-making, essentially by keeping the public and other stakeholders informed through updates (e.g., reporting on the release of various budget documents or on significant debates and policy shifts during formulation), covering proposals and reactions from civil society and other parties and creating a venue for the discussion of important policy decisions. The media can be instrumental in exposing relevant issues before the budget is released, thereby contributing to agenda-setting. It is important to ensure that the media provides independent oversight and is not used by stakeholders to cater to private interests and favour the coverage of certain topics over others. With regard
to recognizing possible misuses of fiscal and budgetary processes by politicians and interest groups, social media, although not without its own comparable challenges and issues, has gained significance.

18. During the budget approval phase, the power of the purse lies with parliaments, which often scrutinize and approve budget proposals and authorize the related expenditures. In most cases, the executive branch cannot raise or spend funds without the approval of the parliament. The principle of legislative authorization of all public spending and taxation is also called the “rule of law” in public finance. It gives the parliament a prominent role in ensuring that the available resources are used in ways that maximize benefits for all.

19. Theoretically speaking, such approval by the parliament means approval by the people through representative parliamentarians. However, in many democratic regimes, a considerable gap exists between parliamentarians’ discussion of the budget and the people they represent. An increasing “occasional and incidental citizenship, restricted to the act of voting” and the idea that “the elected, instead of representing, [is] replacing the voter”3 has posed challenges to the role of participatory budgeting in the reinvigoration of representative democracy, which could be realized by enabling the direct participation of citizens in the shaping of public policies. In fact, the widening of that gap has made the budget approval phase into a largely political-legislative phase where political marketing by political parties has gained prominence. Corruption and the misuse of power for personal favouritism have also caused a crisis in political representation, and “it is in this context that the various [participatory budgeting] experiments that have been adopted in many parts of the world gain particular importance, towards a greater citizen involvement in … public policymaking”. Participatory budgets emerge as “one of the most accomplished and consolidated practices of participatory democracy”4.

20. It is widely accepted that participatory budgeting is a game changer in terms of public control over the State and helps create policies that fight inequalities and prevent the private appropriation of public goods. Above all else, participatory budgeting is about civic education. Some experts argue that the educational dimension of participatory budgeting might, in certain circumstances, be more important than the participation in public resource allocation itself. On the one hand, participatory budgeting functions as a “citizenship school” by educating citizens and governments about their respective rights and duties. On the other, participatory budgeting carries some risks, since it can be co-opted by interest groups and make an undemocratic process look democratic.

21. During the budget realization phase, all stakeholders engaged in the budget preparation and approval phases should be involved. The question is how that can be achieved. The budget realization phase involves an intense activity relating to the acquisition of goods and services subject to very complex procurement rules, which requires, in most cases, the intervention of a court of accounts. Participatory budgeting, understood as the mechanism through which residents of a municipality, city district, village or housing estate participate in the planning of local public spending and in decisions on the allocation and usage of available public resources, requires both robust and pragmatic monitoring mechanisms.

22. One such mechanism consists of the quarterly reports submitted by national governments to parliament and by subnational governments to their local assemblies.


4 Nelson Dias, “Twenty-five years of Participatory Budgets in the world: a new social and political movement?” in Hope for Democracy – 25 Years of Participatory Budgeting Worldwide.
In fact, while the execution of the budget is in the hands of the executive branch, the legislature continues to play a role. It is not uncommon for funds to be shifted to purposes other than those for which they were initially approved. However, quarterly reporting often fails to reach civil society, as those who are elected tend to crowd out the voters instead of representing them, leading to the aforementioned negative effects on democratic representation and participation. Given its complexity, the budget realization phase may indeed be, among all the other phases, the one where an educated and informed citizenry, duly integrated into social movements and community organization, is crucial in order to guarantee active participation.

23. Following the implementation of the budget, government accounts and financial statements are subject to different types of oversight. All stakeholders can be involved in that phase as well. Parliament and supreme audit institutions are essential. As watchdogs of public finances, supreme audit institutions can be critical to enforcing the accountability of executive agencies to national and state legislatures, and through them, to the public. Furthermore, they play a critical role in combating corruption, supporting good governance and fostering more effective public financial management, provided that they maintain their independence from the executive and have adequate capacity and effective communication tools and strategies.

24. To recap: (a) participatory budgeting represents essentially a bottom-up approach whereby subnational fiscal management systems are duly integrated with national fiscal management systems; (b) there is no strict recipe for participatory budgeting involving all stakeholders; (c) institutional mechanisms are similar across countries even though participatory budgeting is shaped to correspond to particular political, social and economic realities, nationally and subnationally.

C. Transparency and accountability in public finance

25. Transparency is often described as a principle that allows those affected by administrative decisions, business or charitable work to know not only the basic facts and figures but also the mechanisms and processes. Florini defines it as “the degree to which information is available to outsiders that enables them to have an informed voice in decisions and/or to assess the decisions made by insiders”.

26. From a fiscal perspective, transparency can be understood as a government’s obligation to share information with the public, especially regarding the use of taxpayer dollars and the actions of political representatives, as measured by the “access to government information” indicator in the Bertelsmann Stiftung Sustainable Governance Indicators, which rests on the basic “right to know”, making a government accountable to citizens. More broadly, transparency may also include the right and the means to examine public decision-making, including an assessment of its predictability. In that sense, transparency can render governments more efficient, less prone to special interests and corruption and better focused on public value.

27. Being accountable means not only being responsible but also liable for one’s actions. The World Bank’s “Voice and Accountability” calculations indicate that the level of government (fiscal) accountability decreases with national wealth, which raises certain questions, including: How to enforce fiscal accountability, especially in developing countries? How to breach the “closed circle”, in which core actors of the “accountability ecosystem”, including legislators, auditors, citizens, donors and the media, perform less than effectively? The education of taxpayers on their rights and duties can provide some answers, and so can transparency.

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Transparency can be a valuable tool for keeping a government accountable to the people and all stakeholders, although not ipso facto. Having access to information about unlawful or inefficient government actions is one thing; having the legitimate channels to seek change is another. Effective budget transparency, therefore, does not only require responsible government behaviour but also that citizens see and understand the processes and outcomes. In that regard, a dynamic transfer from the source (government) to the recipient (citizen), which some term as “active disclosure”, becomes important.\(^6\)

Heald draws a distinction between “nominal” transparency, which refers to scoring well on indices of fiscal transparency of many international organizations and having freedom of information laws and structures in place, and “effective” transparency, namely, making fiscal information available.\(^7\) As a general rule, therefore, fiscal transparency requires: (a) proper financial reporting and accounting; (b) the timely dissemination of reports to the general public; (c) strong monitoring and oversight to ensure compliance; (d) the alignment of the budgetary, accounting and fiscal reports; and (e) openness of the entire process.

One of the most common measures of budget transparency is the Open Budget Index by the International Budget Partnership. Most recent surveys show limited progress: the average score for the 115 countries sampled in 2017 was 43 out of 100 points, compared with 45 out of 100 in 2015. Declines noted in budget transparency are most dramatic in sub-Saharan Africa, where the average scores fell by 11 points between 2015 and 2017. Other regions show slight increases or declines in their scores, except for Asia, where the average score has risen substantially. At the current rate of improvement, however, it is estimated that it will take over a generation for most countries to reach even moderate levels of budget transparency.

The level of budget transparency is determined not only by the transparency and inclusiveness of the budgetary process (e.g., who participates in the preparation of budgets and setting of fiscal priorities, the frequency of audits, the reliability, clarity and integrity of financial materials), but also by the gaps and shortfalls in fiscal practices, including extrabudgetary funds, tax expenditures, quasi-fiscal activities and contingent and future liabilities. Those instruments should be used sparingly.

Extrabudgetary funds are perhaps the most widely used tool to mobilize earmarked revenues and undertake expenditures without the proper control of audit entities and the parliament. Usually those funds are set up in a such way as to allow for the discretionary allocation of resources by the higher levels of decision-makers in public administration, which often promotes clientelism and corruption. Most proposals for such funds are presented by sectoral ministries in an attempt to escape the control of the Ministry of Finance (financial controllers) during the expenditure cycle of the budget execution. However, there are policy areas where the existence of such dedicated funds is essential. One example is environmental funds, where earmarked revenues, collected through environmental taxes, are supposed to be spent exclusively on environmental protection, and not to help manage shortfalls on current expenditures.

Two specific tools that can increase budget transparency and openness are participatory budgeting, described above, and performance-based budgeting. Performance-based budgeting is the linking of the funding of public sector organizations to the results they deliver, while making systematic use of performance information and analysis. When applied in an effective and inclusive manner,

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\(^7\) David Heald, “Fiscal transparency: concepts, measurement and UK practice”, *Public Administration*, vol. 81, No. 4 (November 2003).
participatory budgeting can boost trust in public institutions and customer (citizen) satisfaction. It also has the potential to make governments more responsive to the needs and preferences of citizens and more accountable to the public with regard to performance in resource allocation and service delivery. It can give public bodies the opportunity to gain useful knowledge about stakeholder needs so they can make informed decisions and identify urgent spending needs, allowing people to make their own proposals to control public spending and vote for proposed alternatives.

34. If the alternatives proposed are limited, the results of voting may not adequately represent the real public interest, however.

Participatory budgeting represents a direct-democracy approach to budgeting. It offers citizens at large an opportunity to learn about government operations and to deliberate, debate and influence the allocation of public resources. It is a tool for educating, engaging and empowering citizens and strengthening demand for good governance. The enhanced transparency and accountability that participatory budgeting creates can help reduce government inefficiency and curb clientelism, patronage and corruption.\(^8\)

35. The switch to performance-based budgeting as a transparent method of allocation of public resources is recommended because traditional budgeting shows only where the money is spent; it does not disclose the results of spending. Performance budgeting is expected to fill that gap by informing all stakeholders on the spending objectives of public bodies. It asks: What is to be achieved from allocated resources? What are citizens receiving in exchange for their money? It is expected to shift the focus from inputs to outputs and/or outcomes, and from “how much money do I get?” to “what should I achieve to obtain this money?”

36. Most developed countries have learned from the successes and failures of planning, programming and budgeting systems since they were first introduced more than 50 years ago. Many developing countries, however, may be implementing them as a “must”, often to comply with standards set by international donors. Sometimes, due to limited implementation capacity, the introduction of performance budgeting may end up being a bureaucratic exercise of “form-filling” devoid of effective outcomes.

D. Fiscal decentralization

37. Fiscal decentralization is generally defined as the designation of the authority to raise revenues and make spending and borrowing decisions to the subnational level. The authority of subnational governments to make such decisions is typically broad in systems where decision-making powers have been devolved or transferred, though in different degrees, to elected subnational governments. Those powers are rather limited in those deconcentrated systems in which subnational governments are upwardly accountable to the central government and local officials are often appointed by the central government, not elected by the people.

38. Decentralization (the assignment of decision-making powers to subnational levels of government) and fiscal decentralization (the assignment of expenditure functions and revenue sources to subnational levels of government) are usually, but not always, associated with better governance in terms of the rule of law, anticorruption, transparency and accountability. Some believe that the devolution of expenditure and revenue mobilization prerogatives to subnational levels may lead to accountability, strengthen social capital and reinvigorate political participation. In addition, there is evidence that fiscal decentralization affects macroeconomic

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stability, particularly the financing structure of subnational expenditures. Fiscal decentralization involving subnational revenue mobilization, as opposed to relying on transfers from central governments, for instance, has been associated with lower public deficits and lower expenditures to gross domestic product (GDP) ratios.

39. In parallel with globalization, the past two decades have witnessed a proliferation of fiscal decentralization efforts by subnational governments seeking more control over revenues and/or expenditures. Those efforts may also originate from the central government, in an attempt to outsource some of the responsibility for raising revenues. Regardless, the main issue is that the same resources that a central government allocates to subnational governments are both an expenditure (for the central government) and revenue (for the local recipient government). Thus, there is little consensus on how to optimize the allocation of resources (e.g., the formula applied for the allocation of money), even when it is agreed that the central government will perform that function.

40. In fiscal decentralization, the efficient allocation of resources between the national and subnational governments typically depends on factors such as the capacity of the subnational government to collect revenues and execute spending plans, local governance structures and the extent to which the central and subnational governments agree on the overall fiscal framework.

41. A related but distinct issue is subnational borrowing. When subnational governments gain more authority over revenues and expenditures, they also gain opportunities to borrow resources on their own. If central governments fail to establish regulations and monitor subnational borrowing, serious fiscal problems can ensue. In some countries, for example, subnational governments have borrowed far beyond established guidelines, forcing the central government to step in to bail them out.

42. The social, economic and political benefits notwithstanding, fiscal decentralization may, under certain circumstances, lead to the inefficient allocation of resources and poor accountability and governance, such as when expenditures and revenue mobilization functions are not clearly assigned across the different levels of government. In some cases, fiscal decentralization may even lead to an increase in corruption. Caution is therefore advised when assessing and generalizing about the benefits of decentralization, particularly in a context of limited accountability and transparency and poor institutional capacity.

43. Fiscal decentralization presents some trade-offs. Often, transition economies are in a situation where they need to implement fiscal consolidation, usually as a result of robust public investment programmes, while they are simultaneously devolving fiscal authority to subnational governments. That raises the problem of reconciling the need to determine the level and allocation of expenditures and revenues under a fiscal consolidation programme at the national level with fiscal autonomy at the subnational level.

44. Achieving equilibrium in the medium to long term without compromising the benefits of fiscal decentralization is possible. Fiscal decentralization can be calibrated to fit different levels of institutional readiness. The question is not about whether to adopt fiscal decentralization but rather how to do it (i.e., at which pace and through which modalities). Empirical evidence from Europe shows that decentralization is associated with better fiscal outcomes for middle-income countries with good governance. There is also some evidence that high- and middle-income countries have maintained fiscal control, despite a high degree of fiscal devolution, through the use of various incentives, rules and coordination mechanisms among distinct levels of government while also ensuring appropriate planning and monitoring.
45. The adoption of a set of principles of fiscal decentralization might help in that regard. Some of the principles may include: (a) navigating between the benefits and challenges; (b) assessing institutional readiness together with calibrating the level of fiscal decentralization; (c) managing trade-offs; (d) ensuring fiscal responsibility/equivalence regarding the need to make expenditure decisions at the level of administration responsible for financing that expenditure; (e) considering subsidiarity, meaning that a higher level of government will take up a government function only if a lower level of government cannot fulfil that function efficiently; (f) emphasizing equality/equalization, which would entail the need for fiscal policy to address (regional) disparities caused by different tax bases and expenditure needs; and (g) stressing fiscal autonomy, implying that lower levels of government would be autonomous in their decision-making and the exercise of their executive powers.

46. Among the most ambitious attempts to promote fiscal decentralization is the European Charter of Local Self-Government signed by 47 countries. Article 9 of the charter defines the core standards of fiscal decentralization as follows:

1. Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.

2. Local authorities’ financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.

3. Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.

4. The financial systems on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.

5. The protection of financially weaker local authorities calls for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility.

6. Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them.

7. As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction.

8. For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law.

E. Illicit financial flows and domestic resource mobilization: strengthening fiscal management systems

47. By adopting the Sustainable Development Goals, the global community has agreed that corruption and the illicit transfer of funds out of developing countries can undermine sustainable development by reducing the resources available for essential public services, undermining a country’s capacity to attract investors and fuel the
economy and weakening the trust between citizen and State. Corruption, bribery, theft and tax evasion cost developing countries some $1.26 trillion a year, money which could be used to lift those who are living on less than $1.25 a day out of such poverty for at least six years. Sustainable Development Goal target 16.4 aims to significantly reduce illicit financial flows by 2030, linking the reduction of illicit financial flows with sustainable development.

48. In addition, the global community has recognized, through the Sustainable Development Goals, that urgent action is needed to mobilize, redirect and unlock the transformative power of a substantial amount of private resources to deliver on sustainable development. The fight against illicit financial flows (target 16.4) requires, among other things, strong institutions (target 16.a) at the national level, powered by committed leadership. The public sector needs to set a clear direction, review and monitor frameworks, regulations and the incentive structures that enable attracting investments and reinforce sustainable development. National oversight mechanisms, including the supreme audit institutions and the oversight functions of legislatures, should be strengthened. The fight against illicit financial flows also requires strong international partnerships among governments, the private sector and civil society, built upon principles and values, a shared vision and shared goals that place people and the planet at the centre, with emphasis on the importance of domestic resource mobilization and capacity for tax and other revenue collection (targets 17.17 and 17.1).

49. A core challenge to the implementation of the Sustainable Development Goals today consists of the need to reboot development financing where domestic resource mobilization is a critical element. Fiscal management is an important part of the overall effort to strengthen resource mobilization and development financing. Strengthening the tax bases of developing countries requires reducing illicit financial flows. Reports by Global Financial Integrity, a non-governmental research institute, show that illicit financial flows have grown on average between 8.5 and 10.1 per cent per year between 2005 and 2014, and their volume reached $2 trillion to $3.5 trillion in 2014 from developing countries, presenting an upward trend thereafter until 2016. Trade misinvoicing is the primary measurable means for shifting funds in and out of developing countries illicitly; in fact, an average of 87 per cent of illicit financial outflows were due to the fraudulent misinvoicing of trade.

50. In absolute terms, some countries might not display excessive amounts of illicit financial flows compared with other countries. In relative terms, however, the impact deserves action. For instance, for the period 2008–2012, the annual average outflow of Ethiopia was $3.55 billion, which represented 1.355 per cent of the foreign direct investment flowing into the country; illicit financial flows from Nicaragua were equal to 20.4 per cent of the country’s GDP, while its average annual volume was $1.9 billion; flows from Zambia were equal to 24.1 per cent of its total trade and the volume of the outflows was $3.1 billion on average; and illicit financial flows from Rwanda were 51.7 per cent of its total tax revenue, while its annual outflows were $402 million.

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51. The International Monetary Fund recognizes that illicit financial flows can have a substantial impact on the economic stability of a country and the broader global financial system by draining foreign exchange reserves, lowering tax receipts and reducing government revenue. They divert resources from public spending and can reduce the capital available for private investment. They may also encourage criminal activity, undermining the rule of law and political stability of a country. Finally, destabilizing flows can have a negative impact on the broader economy.

52. The available data do not allow for the measurement of illicit financial flows in a rigorous manner. That challenge should not prevent action, however. The few existing sources highlight that trade mispricing and transfer pricing abuse account for a majority of illicit financial flows. Identifying and addressing the specific incentives and regulatory dynamics that influence trade-related illicit financial flows is thus critical to addressing tax base erosion, which is also a precondition for generating additional domestic resources to finance the Sustainable Development Goals.\(^\text{13}\)

53. Curbing illicit financial flows requires strong international cooperation and concerted action by developed and developing countries in partnership with the private sector and civil society. In October 2015, the Economic and Financial Committee (Second Committee) of the General Assembly held a joint meeting with the Economic and Social Council on “Illicit financial flows and development financing in Africa”. The meeting identified illicit financial flows as a priority area for policy coherence for sustainable development.

54. The cross-cutting nature of illicit financial flows requires policymakers and other stakeholders to act strategically, assessing the potential trade-offs and synergies in an interdisciplinary manner. That can allow governments to make informed decisions and take effective action to:

(a) Identify and raise awareness of the types, magnitudes and risks of illicit financial flows;

(b) Consider the contextual factors that allow the flows to thrive;

(c) Support coherence within and between national and international normative frameworks (vertical coherence);

(d) Examine critical interactions across economic, social and environmental areas to address illicit financial flows (horizontal coherence).

III. Conclusions and recommendations

55. The Addis Ababa Action Agenda stresses that sound, effective and efficient national and subnational integrated fiscal management systems are preconditions for the mobilization of resources towards achieving the Sustainable Development Goals. Fiscal policy and fiscal management systems are at the core of sustainable and inclusive growth, particularly in the context of high uncertainty and stressed government balance sheets. The absence of integrated fiscal management systems and consolidated budgets may also pose the additional challenge of “duality of systems”, where national and subnational budgeting processes conflict with each other, thus leading to inefficient spending and revenue management, contradictory data and asymmetric information, which has a negative impact on revenue and debt management.

56. Mobilizing budgetary resources and improving the performance of national fiscal management depends on the engagement of all relevant stakeholders in budgetary processes. Preparing, approving, executing and controlling budgets should not be a matter pertaining to the Ministry of Finance (Treasury) only. Coordinated and collaborative stakeholder engagement must define budget-making.

57. Other than the Ministry of Finance (Treasury), governmental players such as value for money units, institutes of fiscal policy, fiscal councils and oversight bodies should participate in fiscal management and budgetary processes in proactive ways. Other major non-governmental stakeholders, including businesses and civil society organizations, should be included. The media should play a significant role by keeping public and other stakeholders informed in objective and impartial ways. All those stakeholders, once they are given a voice, should use that voice in a committed and responsible way, taking into account the intergenerational impact of their actions on shaping policymaking. For that to happen, civic education should be put high on the policymaking agenda.

58. The transparency of public budgets should be incrementally improved. Transparency is a precursor to accountability of fiscal management bodies, but it does not deliver accountability automatically. Increasing government accountability, particularly in developing countries, is pressing, yet complicated. Increasing people’s financial literacy can be a first step forward towards that aim.

59. Access to information about government actions and financial figures may also help, but only if people have proper access to channels to fight corruption and the mismanagement of public funds. Fiscal transparency is still in its infancy in many developing countries, and fiscal instruments such as extrabudgetary funds, tax expenditures, quasi-fiscal activities and contingent and future liabilities may hamper it. The use of those instruments should be limited as much as possible.

60. Extrabudgetary funds are perhaps the most used tool to mobilize earmarked revenues and undertake expenditures without the proper control of audit entities and the legislature. Usually those funds are set up in a such way as to allow the discretionary allocation of resources by the higher decision-making entities in public administration, thus feeding clientelism and corruption.

61. It is widely accepted that participatory budgeting is a game changer in terms of public control over the State, and consequently helps policymaking by fighting inequalities and preventing the private appropriation of public affairs. It should be used more frequently, especially at the subnational level. Programme- and performance-based budgeting have the potential to inform taxpayers about how public money is used to achieve results. Mechanical and overly dense compilations of performance budgets may not help, but visible linkages between priorities and results at feasible scales can be vital. By participating in public budgeting, civil society can get a better sense of budgetary and financial constraints, and consequently better understand the trade-offs inherent to the budgeting process. Policymakers should perceive civil society participation not as a threat but as a win-win scenario.

62. Decentralization and fiscal decentralization should continue, given their potential benefits. Fiscal decentralization principles are defined by international organizations, but their implementation should be calibrated to fit diverse levels of institutional (and general) readiness, including the pace and paths of fiscal decentralization.

63. Illicit financial flows can undermine the fiscal capacity of any country and can have a negative impact on governance. Countries should identify the sources of such flows, raise awareness about the types, magnitudes and risks of illicit financial flows, consider the contextual factors that allow them to thrive, create coherent national and
international normative frameworks (vertical coherence) and consider critical interactions across economic, social and environmental areas to address illicit financial flows (horizontal coherence).

64. Well-conceived and well-structured fiscal management systems at the national and subnational levels can be a driving force behind transparency and accountability by: (a) strengthening civil society organizations and implementing open and transparent budgeting processes; (b) promoting institutional reforms, such as the independence of the judiciary, audit courts, customs authorities and the central bank; (c) creating commissions dedicated to fighting corruption and illicit financial flows; (d) strengthening the capacity of financial institutions and of revenue collection mechanisms and enhancing the capacity of government institutions in charge of natural resource extraction; (e) undertaking tax reform to widen the tax base and reform customs procedures to curtail trade mispricing; and (f) enhancing activities and enforcement aimed at combating money-laundering.