CHAPTER SIX

Intergovernmental Fiscal Transfers

Nick Devas

Introduction: objectives of intergovernmental transfers

This chapter covers the full range of transfers from central government to sub-national and local governments, including:

- Tax/revenue sharing
- General (block) grants
- Specific (conditional) grants
- Deficit grants
- Capitalisation grants
- Subsidised loans.

Primary objectives for a transfer system

The following are the primary objectives of intergovernmental fiscal transfers:

- To ensure that sub-national governments have the resources to carry out the functions assigned to them, and so to achieve vertical balance between levels of government;
- To distribute resources equitably between sub-national governments according to their relative needs and fiscal capacities, and so to achieve horizontal balance between local governments;
- To compensate for spill-over effects, where the services of one local government (e.g. a secondary school) are used by people outside that local government area;
- To achieve the right balance between national objectives, control and local discretion, and accountability, including influencing the spending patterns of local government.

Other objectives

Transfer systems may also be designed to achieve certain other objectives:

- To control the overall levels of local government expenditure;

- To encourage the mobilisation of local revenues;
- To encourage responsibility and accountability in local decision-making;
- To stimulate local economic development;
- To provide for emergency situations (e.g. natural disasters).

There may, however, be overlaps and conflicts between these objectives.

Tax or revenue sharing

Tax or revenue sharing is the sharing with the sub-national/local government of all or part of the revenue from a particular national tax (e.g. income tax) or revenue source (e.g. royalties on the extraction of natural resources such as minerals, oil or gas). This may be:

- By origin (that is, a proportion of the revenue is shared on the basis of where it was collected) – derivation principle;
- By a formula.

Compared to grants, revenue shares tend to be more secure, since they are usually defined in law and so are not subject to annual decision by central government. They are also usually more buoyant, since they are based on a specified percentage of a national revenue source, which is more likely than local revenue sources to respond automatically to inflation, population growth and economic growth. However, high rates of tax sharing (for example, those specified in constitutions) can undermine the incentive of central government to collect the tax.

Unlike grants, for which allocations are clearly in the hands of central government, revenue sharing suggests a partnership between central and local government, in which the latter may play a significant role in mobilising the revenues – even collecting them.

Tax sharing generally involves local discretion in the use of the revenues but not in the tax rate, and hence in the amount received, unlike a local own revenue source or a system of local surcharging on a national tax (sometimes called tax-base sharing).

Sharing by origin gives local government an incentive to assist in revenue mobilisation. With sharing by formula, that incentive is greatly reduced, since any revenue effort merely increases the size of the pool from which the particular local government receives only a formula share. But inter-regional inequities, and difficulties of assigning shared revenue to the right local government, may necessitate the use of a formula basis, e.g. per capita allocations (as with the business rate in the UK), or allocation based on some other factors to reflect local expenditure needs. In such cases, revenue sharing may be little different from a grant.

General (block) grants

General grants are designed to contribute to the costs of some or all of the services provided by local government. As such, they are intended to address both vertical and horizontal imbalances. General grants allow local governments discretion over the use of money, but there may be limitations/exclusions as to what can be financed and conditions as to use. An important aspect is whether grants can be used to finance debt-servicing on past borrowing (as they can in the UK).

General grants require an allocation formula to distribute grants equitably between local governments, taking account of differences in local expenditure need and relative local fiscal capacity. Block grants are the principal mechanism for achieving equalisation of resources between local governments.

Part (or all) of a block grant can be made conditional on the achievement of particular performance objectives, such as increased local revenue, service delivery performance or financial reporting. An example is the local government transfer fund in Kenya. Such grant elements need an effective system for monitoring on performance. As with any performance target system, there are risks of data manipulation and perverse incentives.

Specific grants

Specific grants are intended to cover some (or all) of the costs of a particular service or activity or development. Grants may be calculated as a share of the agreed costs of a service or project (in the UK, the central government meets 50 per cent of the agreed costs of the police service), or as a fixed amount per unit of the service (e.g. a set sum of money per km of road maintained).

Cost-sharing specific grants may be cash-limited (i.e. a cash amount fixed in advance), or they may be open-ended (i.e. allow for adjustments to reflect increased actual costs during the year or during the life of the project).

Specific grants allow central government to determine the priorities, the nature of the service to be provided or the project to be developed, in any level of detail. However, detailed central specification may conflict with local needs and priorities, and may lead to an inefficient use of resources unless there is flexibility to adapt to local situations. Also, fungibility of money (that is, the fact that all money is the same) means that specific grants may substitute for, rather than supplement, local resources for a particular sector, and effectively allow a local government to increase spending on an area not intended by central government.

Variations of specific grants

- ***Staff grants:*** To meet the costs of all the staff employed by local government (e.g. the former Subsidi Daerah Otonom (SDO) in Indonesia and grants for staff costs in

Ghana), or of certain staff, e.g. teachers. Such grants are likely to encourage local governments to employ more staff and may lead them to use staff inefficiently.

- ***Matching grants:*** For certain types of activity or project that central governments wish to promote, a matching grant is made on condition that local government makes a matching contribution (not necessarily 50:50 – the matching contribution may be varied according to the fiscal capacity of the local government). Matching grants can be used to encourage local revenue mobilisation, as well as to direct local spending in a particular way favoured by central government. However, richer local governments, which can afford the matching contributions, will be the main beneficiaries, unless matching shares are varied according to local fiscal capacity.
- ***Emergency grants:*** Such grants are usually made to deal with natural disasters. But such allocations should be limited to real emergencies: if they become handouts in response to any unbudgeted need, they undermine local accountability.

Other possible transfers

Deficit grants have been used in some countries to make up the difference between a local government's actual expenditures and its revenues. Such an arrangement might appear attractive, but it tends to discourage both local revenue effort and efficient use of resources by the local government, since local governments know that central government will make up any shortfall. Such grants also tend to shift responsibility for local spending decisions to central government and to undermine local accountability. They are, therefore, a very unsatisfactory way of providing transfers.

Initial capitalisation: Sometimes used for special purpose agencies, such as a development corporation, where investment can generate revenues. This model is not appropriate for local governments in a devolved system.

Central budget allocations: In some cases, local governments may be given authority to draw specified amounts from central budget for particular purposes. This is most likely where the local government is acting as a field agent of central government in relation to a particular activity or delegated function.

Competitive bidding for grants (e.g. the UK's Challenge Funding): This can encourage initiative, quality and performance, but will reward those local governments which have the greatest capacity to respond. Thus, such a system should only be used for modest supplementary grants and not for basic funding.

Subsidised loans: Loans on less than market rates of interest involve a (disguised) subsidy. There are significant risks in this:

- It may lead to inappropriate investments if a local government is not faced with the true costs of the investment (a former subsidised loan scheme for the construction of local markets in Indonesia resulted in markets being in inappropriate locations);

- Rich local governments will be the main beneficiaries, because they can afford to borrow most;
- Such loan subsidies distort the horizontal balance between local governments in the allocation of central transfers.

Evaluating transfer systems

Intergovernmental transfer systems can be evaluated against a number of criteria: adequacy, elasticity and stability; inter-regional equity; economic efficiency and incentives; simplicity, practicality and transparency.

Adequacy, elasticity, stability

- The total level of resources transferred to local government needs matches the responsibilities assigned, in order to ensure vertical balance.
- Transfer amounts need to be adjusted each year to reflect inflation and demographic changes, to ensure that real per capita resources are maintained; where the economy is growing, transfers should also reflect that real growth.
- Revenue sharing may be more elastic than grants, since it is based on buoyant national taxes; however, if the economy declines, tax revenues, and hence revenue shares, may decline.
- Allocation formulae must avoid creating significant fluctuations in transfers from one year to another; frequent changes in allocation formulae can be very destabilising.
- Local governments need to know transfer allocations well in advance to enable them to prepare their budgets.
- Approved transfers must actually be paid, and paid on time.

Inter-regional equity

- Revenue sharing by origin will reflect and reinforce inter-regional economic differences.
- Block grants can compensate for this if allocations take account of local fiscal capacity; however, there is a major problem of how to measure local fiscal capacity objectively (since actual local revenues reflect both local fiscal capacity and local fiscal effort); also, the scale of block grant resources available is unlikely to fully offset the differences in revenue capacity between the richest and poorest local governments.
- Allocation formulae should also take account of objective differences in expenditure needs, but not of differences in expenditure levels resulting from political choices; again there are problems in measuring needs objectively.
- Formulae may also take account of cost variations due to objective factors, such as

remoteness, transport costs, and geographical and physical conditions, but not cost variations which merely reflect differences in efficiency.

- Recurrent expenditure needs may differ from development expenditure needs: the former may be higher in well-developed regions, which already have a range of facilities to maintain and operate; while the latter will be higher in less developed regions with fewer facilities.

It should be noted that transfer systems are concerned with inter-jurisdictional equity, that is, the distribution of resources between local governments. This is quite different from inter-personal equity. Intergovernmental grants to poor regions may do little for poor people in those regions – that depends on how the local government uses the resources – nor for poor people in the rich regions.

Economic efficiency and incentives

- Grant systems should be designed to encourage efficient use of resources by local governments. This means that, ideally, grants should target outputs, not inputs (i.e. grants should relate to the delivery of a service, rather than be a subsidy for the staff of the local government or capital costs, which might encourage an inefficient use of staff or capital resources).
- Grants should encourage local governments to make their expenditures conform with national development objectives, but should allow the flexibility to adapt to local conditions; otherwise, resources will be wasted on projects which are not needed or which are unsuited to local conditions.
- Grants should avoid discouraging local revenue mobilisation; without an incentive element in the grant system to encourage local revenue collection, grants may simply substitute for local revenues.
- In practice, even specific grants may lead to unintended expenditures, as a result of 'shunting' or 'displacement' (e.g. the availability of grants for schools may mean that a local government can use its own resources for building offices rather than schools). This is because money is fungible.

Simplicity, practicality and transparency

- The grant system and formulae need to be sufficiently simple to be generally understood.
- The system should use only data that are available for every local government, and which are sufficiently reliable and not open to manipulation by the local government.
- Grant allocation formulae need to be transparent, and allocations should be published.

Issues for the design of intergovernmental transfers

a) ***Dependence of local governments on the centre*** erodes local autonomy and accountability. However, the fact that the central government has the main revenue sources means that no system of decentralisation can function without transfers. There are examples where local governments receive a large proportion of their revenues from the centre without its removing their local discretion (e.g. the Netherlands) and others where local governments are highly controlled by the centre, even without receiving significant funds from above (e.g. Kenya). What matters is not the proportion of resources that comes from local revenues, but the discretion over expenditure from overall resources, and particularly 'discretion at the margin'. (Since most local government expenditure is effectively committed, what matters is the marginal choice about spending a bit more in this or a bit less on that.)

b) ***There is an inherent tension between local autonomy and central direction.*** A balance has to be struck between block transfers (including revenue shares) that allow local discretion to reflect local needs, conditions and priorities, and specified or conditional transfers to finance those functions where there is a clear national priority or requirement for uniform national standards. In the early stages of decentralisation, it is generally considered desirable to retain a substantial conditional grant element, to ensure that resources are used for essential services and not diverted into low priority areas like offices and vehicles (but recognising that information asymmetries and fungibility limit the centre's ability to enforce conditions).[1] In the end, that balance has to be arrived at through the negotiation of central-local relations.

c) ***Transfers may substitute for local revenues and thus erode local revenue effort.*** Again, the fact that the main (and most neutral and equitable) taxes are centrally collected in most countries means that transfers are essential. Local governments still have an incentive to collect local revenues, since transfers finance only part of the costs of services demanded by local citizens. Nevertheless, rising grant allocations often do erode local revenue effort, especially where local taxes are difficult to collect (e.g. Uganda). To counteract that, grant systems can incorporate incentive factors to reward revenue performance.

d) ***The intergovernmental transfer system should be designed to achieve balance:*** vertical balance (between levels) and horizontal balance (between local governments at the same level). This requires a proper analysis of the expenditure needs created by the assignment of functions to each local government, and the revenue capacity of each local government (see below). Where there is more than one level of local government, resources need to be allocated fairly between levels to reflect the distribution of responsibilities.

There will always be competing demands for scarce resources from central ministries and national programmes, and these may often carry more weight than the needs of local government. In some countries (e.g. Nigeria), there are constitutional provisions for resource distribution between levels of government; while these may protect essential resources for local government, they can lead to inflexibility, and to circumvention by central government.

e) ***Distribution between types of transfer:*** Within the overall system of transfers, a key decision is what proportions should go via the different forms of transfer:[2]

- Tax sharing: for buoyancy, partnership, local discretion
- Specific grants: for specific national programmes or objectives
- Block grants: for local discretion and fiscal equalisation.

f) ***Allocations of grants and transfers to local governments should be based on clear and technically sound formulae.*** In the end, though, allocations are politically determined. At one extreme, allocations may be based on ad hoc negotiations, so that those regions which have the greatest political bargaining power receive the largest amounts. Even where there are clear allocation formulae, these may be manipulated to favour particular regions or politically favoured jurisdictions. Allocations may be further manipulated after they have been approved, through top-slicing by ministries or by intermediate levels of government, or they may be paid late, or not at all. All of those things undermine the credibility of the intergovernmental transfer system and the viability of local governments.

g) ***Allocation formulae need to strike a balance between fairness and simplicity.*** In order to achieve horizontal and vertical balance, it is desirable to take into account all the factors that affect local governments' abilities to finance their expenditure requirements. However, the data required for such comprehensive formulae are unlikely to be available, and much of the data that are available may be unreliable, out of date or subject to manipulation (and the formulae can only work if reliable data are available for *all* local governments). In addition, the more complex the formula, the less it is likely to be understood and the more scope there is for political manipulation. There is a good case for keeping the formulae simple and understandable, even if they does not achieve complete equity.

A study by de Mello (2000) of published data on 30 developed and developing countries sought to identify whether intergovernmental transfers resulted in a 'deficit bias' in decentralised decision-making, as a result of co-ordination failures, common-pool problems, free-riding and moral hazard, resulting in worsened national fiscal deficits. This concern comes particularly out of Latin America, where substantial tax sharing, not always matched by devolution of functions, together with wide borrowing powers by sub-national governments, has undermined the fiscal position of some central gov-

ernments. However, de Mello found that in most OECD countries, well-established and effective rules have generally prevented that problem. Nevertheless, these are significant potential pitfalls for fiscal decentralisation in developing and transitional countries if the system is not well designed.

Intergovernmental grant formulae

Allocation of block grants (and revenue shares allocated by formula) should be based on a transparent formula using objective factors. Formulae should include the following elements.

a) ***Expenditure needs factors***

A local government's need for resources to meet its expenditure responsibilities will be determined by various factors. For example, for primary education, the main driving factor will be the number of pupils, but there will be other factors that influence costs, such as remoteness, relative poverty of the population and the condition of school buildings. There will also be differences between recurrent expenditure needs (based on the number of pupils in school) and capital expenditure needs (dependent on the number of school-age children not yet in school). However, accurate data on such factors may not be available.

In practice, for most local government services, population is likely to be the main driver of expenditure needs. But this may not adequately reflect the needs of sparsely populated regions or small local government units (with relatively high overhead costs for democratic decision-making and basic administration). Thus, an area factor and a lump sum element are often included in the formula. However, the lump sum element should be small, to avoid creating an incentive for fragmentation of local government units.

More complex formulae may include a variety of factors related to the costs of each of the services for which local government is responsible, e.g. length of roads and distribution of poor people. (The UK government's revenue support grant formula includes more than 100 factors.) However, accurate and up-to-date data may not exist for all local governments, and there are risks if the local government can manipulate the data to its advantage. Also, the more factors there are in the formula, the more difficult it is to establish the correct weighting for each factor.

b) ***Unit cost factors***

Unit costs for the same service may vary significantly across the country, depending on remoteness or geographical factors (mountain areas, islands, etc.). It may, therefore, be appropriate to include factors to reflect these differences. However, accurate cost data may be difficult to obtain, so that once again the accuracy and equity of the formula has to be balanced against practicality. There is a risk that the application of crude cost factors may simply introduce new inequities.

c) ***Local fiscal capacity***

The capacity of local governments to finance expenditures from their own resources will vary widely. Capital cities may be able to finance all of their expenditure needs from their own revenue sources, while remote rural local governments may be able to generate little by way of local revenues. Inter-regional equity requires that allocation formulae incorporate a factor to reflect local revenue capacity. However, this is often the most difficult aspect to include, because of the absence of objective data on revenue potential. It is not appropriate to use actual revenues since these reflect revenue effort as well as revenue potential, and so would reward local governments that have low revenue effort as well as those with low revenue potential.

Where the main local revenue source is property tax, and where the central government is responsible for property valuation (as in the UK), the property tax roll can be used as the measure of local revenue capacity. In the absence of this, it may be possible to use data on regional income per capita or gross regional domestic product (GRDP) as a proxy for local fiscal capacity. However, it is rare for such data to exist for every local government, and in any case GRDP may not accurately reflect local governments' tax base (since local taxes may impinge on some economic sectors and not others).

d) ***Poverty***

Given the concern with poverty reduction, it is often advocated that a poverty factor should be included within the formula. There are a number of problems with this: firstly, the choice of a definition of poverty and how that definition should be applied as a factor; secondly, whether data exist on poverty for all local governments, which is unlikely; thirdly, allocating resources to local governments based on a poverty factor does not mean the money will be spent on the poor. If the aim is to fund services for the poor, then a specific grant allocated on the basis of a poverty factor may be more appropriate than incorporating a poverty factor in a block grant formula. If there is a revenue capacity factor in the formula, that should already reflect poverty to some extent.

e) ***Revenue incentive***

If there is concern about the grant system undermining local revenue performance, then it may be appropriate to include a factor in the grant formula to reflect improvements in revenue collection. This could be based on the percentage increase in revenue collection. Again, there will be problems in obtaining accurate and timely data, which need to be verified to avoid manipulation by local governments. Improved (or worsened) revenue performance could also be due to circumstances beyond the control of the local government.

f) ***Performance factors***

Other performance factors can be built into the formula. In Kenya, for example, 40 per

cent of the local authority transfer fund grant is allocated according to performance elements, such as submission of accounts, progress on debt reduction and preparation of a service delivery plan using citizen participation. Such incentive elements can be effective in achieving improved performance (as has been the case in Kenya), although they require effective and uncorrupt mechanisms for checking on actual performance.

In summary, of the above elements, expenditure needs should probably be the dominant one. Within that, population is likely to be the dominant factor (and the one on which reliable data are most likely to exist). There will rarely be sufficient resources to achieve complete equalisation of fiscal capacity between local governments, but where inter-regional inequalities are large, a substantial proportion of the block grant should be allocated for equalisation, so long as objective data are available to reflect local revenue potential. Performance factors, including revenue mobilisation, can be added, providing there are mechanisms for monitoring actual performance. Other factors, including poverty weighting, raise problems about data availability and possible perverse incentives.

In the end, there needs to be a balance between the fairness of the grant allocation, as reflected in the above factors, and simplicity. If the formula is too complex, it becomes impractical to apply and cannot be readily understood and accepted by those who receive the grant. Complexity also opens up the opportunity for manipulation.

There will need to be central controls (e.g. through external audit) to ensure that grant money is not misused. However, controls should not necessarily be more stringent than controls over the use of local revenues: grant monies do not 'belong' to central government – all money belongs to the taxpayer, and there should therefore be proper systems of control over the use of all money used by local (and central) government.

Finally, the impact of the transfer system on local governments should be monitored regularly, so that undesirable results can be corrected. However, the system also requires stability – frequent changes to the formula are destabilising for decentralised service provision.

Notes

1. A positive example here is the LGDP grant in Uganda, which allows local governments at various levels to select local development projects from a menu. This allows quite wide scope for local choice about the type, design and location of projects, but ensures that resources are used broadly for national priority sectors.
2. In addition, there may be flows of funds from the centre to the locality through sector expenditures of sectoral ministries and special purpose agencies that by-pass local government.

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