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A review of issues

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A review of issues

Odd-Helge Fjeldstad*

ABSTRACT

Fiscal decentralisation - the devolution of taxing and spending powers to lower levels of government - has become an important theme of governance in many developing countries in recent years. Accordingly, restructuring of governmental functions and finances between the national and lower levels of government has entered the core of the development debate. A general conclusion emerging from this review of theoretical and empirical literature on intergovernmental fiscal relations is that sub-national governments need to be given access to adequate resources to do the job with which they are entrusted. At the same time they must also be accountable for what they do with these resources. Moreover, like all public policies, intergovernmental fiscal policies must take into account both the political constraints facing policy makers, such as the strength of different provinces and groups in political decisions, and economic constraints such as the stage of development of financial markets.

1 Introduction

Most countries have several tiers of government. In addition to the national level, many countries have two sub-national levels; i.e. provincial (or regional) and local governments (see table 1). Furthermore, local authorities are often divided into sub-levels such as ward and village councils. In many countries the lower levels of government undertake important fiscal functions, both on the expenditure side and with respect to revenues (Boadway et al., 2000). In such federal systems various forms of fiscal arrangements between the national and lower levels determine the way in which taxes are allocated and shared among the various levels of government, and how funds are transferred from one level to another. Thus, intergovernmental relations, both vertical (between levels of government) and horizontal (within levels) are important for the development and operation of an efficient and effective public sector. According to Bird (1990:281), it is the 'workings of the myriad of intergovernmental relations that constitute the essence of the public sector in all countries'.

The way intergovernmental fiscal systems are organised varies from country to country. These differences partly reflect historical and geographical characteristics of each country, the degree of heterogeneity of the population and the extent of government intervention in the economy. Given this diversity, how questions of inter-governmental structures and functions are resolved in practice will often differ from country to country (Bird, 1990). Although the diversity complicates broad generalisation, reference to the experiences of other countries is often the

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only guide available. Despite its limitations, such experience may provide useful lessons in assessing the potential strengths and weaknesses of intergovernmental fiscal systems in any country (Bird & Vaillancourt 1998).

This paper addresses some of the key issues and concepts that are of general relevance with respect to intergovernmental fiscal relations. Based on the experiences of a number of countries it attempts to derive some basic principles and considerations that should be taken into account when restructuring governmental functions and finances in a federal economy. In doing so, I draw on the growing literature on intergovernmental fiscal relations.[1] Much of this literature refers to the experiences of industrialised countries where federal fiscal arrangements have evolved over a long period of time. However, fiscal decentralisation - the devolution of taxing and spending powers to lower levels of government - has also become an important theme of governance in many developing countries in recent years (Fukasaku and de Mello, 1999; Manor, 1999; Crook and Manor, 1998). Accordingly, restructuring of governmental functions and finances between the national and lower levels of government has entered the core of the development debate.

The article is organised around four questions that must be answered with respect to intergovernmental functions and finances in any country:[2]

(1) Who does what? This question is about assignment of functions between levels of government.
(2) Who levies what taxes? This question is about revenue assignment.
(3) How to resolve the imbalance between the revenues and expenditures of sub-national governments? This question has to do with vertical imbalances between levels of government.
(4) How to adjust for the differences in capacities and needs among different governmental units at the same level of government? This question is about horizontal imbalances or equalisation.

2 Who does what? Assignment of functions between levels of government

A key issue in intergovernmental fiscal relations is the assignment of functions and finances to different levels of government. This can also be described as the allocation of the authority and responsibility for the public sector decisions among different power centres. The traditional theory of fiscal federalism identifies three major functions for the public sector: macroeconomic stabilisation, income distribution and resource allocation (Oates, 1972 and 1999). The theory assigns the stabilisation and redistribution functions to the national government, while it assigns a significant role to sub-national governments in allocating resources. Let us briefly discuss the basic arguments behind this reasoning.

2.1 Macroeconomic stabilisation

The two main instruments of macroeconomic policy are monetary policy and fiscal policy. Fiscal policy, i.e., control over the amount and structure of taxes and expenditures, and the management of the budget deficit or surplus, is a powerful instrument for stabilising the economy. The stabilisation function is usually considered to be inherently national in nature, partly because sub-national authorities have few or no incentives to undertake economic

[1] Classic references include Oates (1972) and Breton & Scott (1978). More recent surveys are Boadway et al., (2000); Oates (1999); Shah (1998); and Tanzi (2000).

[2] Bird & Vaillancourt (1998:15) characterise these as the four 'big questions' with respect to intergovernmental fiscal relations.

stabilisation polices. Furthermore, lower levels of government often lack the necessary macroeconomic instruments to carry out such policies.

Since lower levels of government often are very dependent on the national government for finance, it sometimes makes more sense to think of them as part of the national government rather than as independent actors. However, in some federal countries where a substantial share of national revenues are diverted to lower-levels, the existence of several tiers of government may give rise to difficulties in macro-economic management (Bird, 1990). Thus, Prud'homme (1995) argues that a decentralised fiscal system may make macroeconomic policies more difficult to implement.

Table 1 The structure of sub-national governments in selected countries

Country	Intermediate	Local
Argentina	23 provinces	1617 municipios
Brazil	27 states	4 974 municipios
Colombia	32 departments	1 068 municipalities
Ethiopia	9 regions, plus 2 city adm., 66 zones	550 woredas
France	22 regions, 96 departments	36 772 communes
India	25 states, 7 union territories	3 586 urban local bodies 234 078 rural local bodies
Italy	22 regions 93 provinces	8 100 municipalities
Kenya	39 county councils	52 municipal, town and urban councils
Malaysia	13 states	143 city, municipal and district councils
Mozambique	10 provinces	33 municipalities
Philippines	76 provinces	64 cities 1541 municipalities 41924 barangayas
South Africa	9 provinces	850 local authorities
Tanzania	21 regions (incl. Zanzibar)	92 district councils, 18 municipal and town councils, 1 city council (Dar es Salaam)
Uganda	45 districts, 13 municipalities	950 sub-counties, 39 municipal divisions, 51 town councils
United Kingdom	Counties	540 rural districts, metropolitan districts and London boroughs
United States	50 states	39000 counties and municipalities 44000 special-purpose local authorities

Sources: World Bank (2000) and Fjeldstad & Semboja (2000) based on data from 1997 and 1998.

Argentina during the 1980s illustrates what is sometimes referred to as 'fiscal perversity' of sub-national governments (Prud'homme, 1995). In 1986 provincial expenditures rose rapidly to more than 11.2 % of GDP, while the provincial government revenues dropped to 5 % of GDP. The 6.2 % deficit was either financed by transfers from the central government or by borrowing, which both were inflationary. Furthermore, because the grants were not financed by central government revenues, the practice led to government deficits of a large magnitude. This situation, combined with extensive borrowing by the provincial governments from the Central Bank or from banks controlled by the provincial governments, contributed to unsustainable public sector fiscal deficits that undermined 'national efforts to attain price stability and to promote sustainable economic development' (World Bank, 1990:ii).

In contrast, studies from other countries, including the United States and Western Europe, conclude that decentralisation has not undermined stability (World Bank, 2000). Findings from Canada even suggest that the growth of sub-national budgets has had a stabilising effect on the economy (Sewell, 1996). This is explained by the observation that the major expenditure responsibilities which often are assigned to larger sub-national governments – such as public funding of health and education – act as automatic stabilisers because they are recurrent and not very flexible. Increased reliance on direct taxes, such as personal income taxes in sub-national financing in some countries has also been found to have stabilising effects.

2.2 Income distribution

A substantial share of the public finance literature holds that the redistribution of income is primarily a national government concern. Some scholars even argue that attempts by local governments to redress income differences are likely to be unfair (Prud'homme, 1995). Moreover, it is sometimes argued that decentralised income-distribution is self-defeating. For instance, if a jurisdiction adopts policies to redistribute income by imposing high taxes on the rich and giving high benefits to the poor, the rich will tend to 'vote with their feet' and leave for more lightly taxed areas, and the poor will move in from areas that tend to offer lower benefits.

However, in practice redistributive policies is often carried out at decentralised levels of government, too. For instance, some regulatory policies allocated to local authorities in many countries, such as land use and rent controls, have profound distributional implications. Public health care, primary education, water supply, housing and public transportation which are assigned to sub-national levels in many countries, also have important re-distributional functions (Sewell, 1996). In poorer countries such services are often the only tool for providing in-kind transfers to poorer households. The relatively large size of local governments in the Scandinavian countries is explained in part by their responsibilities for income distribution. In Denmark, for instance, where local authorities account for more than half of total government expenditures and about a third of gross national product, social security and welfare account for more than half of local government budgets.

2.3 Resource allocation

The fiscal federalist model assigns a significant role to sub-national governments in allocating resources. The classic argument provided by the theory of fiscal federalism (Oates, 1972) is that in a democratic society decentralisation will result in a better match of supply and demand for local public goods. Being closer to the people, it is claimed, local authorities can more easily identify people's needs, and thus supply the appropriate form and level of public services (Enemuo, 2000; Rondinelli *et al*., 1989). Some scholars within the public choice school, also argue that decentralisation tends to increase healthy competition among jurisdictions (Brennan and Buchanan, 1980; Breton, 1989).

However, these theoretical arguments face several practical obstacles. Prud'homme (1995), for instance, questions the relevance of the assumptions of the model of fiscal federalism for developing countries. He puts forward three main arguments to support his critique: Firstly, in most developing countries the problem is not to reveal fine differences in tastes and preferences between jurisdictions, but to satisfy basic needs. Secondly, the model of fiscal federalism assumes that the taxpayers (or voters) of each jurisdiction will express their preferences in their votes. However, in many developing countries where land and labour markets do not function well and democratic tradition is in its infancy, it is not realistic to assume that people can move easily between jurisdictions or make their voices heard through the political process. Thus, according to Prud'homme (p. 208), the menus offered for choice are unlikely to express the electorate's preferences. Finally, even if elected officials wanted to fulfil their mandate from their voters, they can not because of a gross mismatch between available resources and promised expenditures. Therefore, elected officials often lack incentives to keep their promises. And even if they did and had sufficient resources to do so, it is not obvious that they would be able to persuade the local bureaucracy to go along. Local government bureaucrats in many developing countries are, he argues, often unresponsive, poorly motivated and occasionally poorly qualified, and they might have good reasons to pursue their own agenda rather than the agenda of their superiors. This argument is supported by the general observation that central governments bureaucracies are likely to attract more qualified people, partly because they can offer higher salaries, and partly because they can offer better careers, with a greater diversity of tasks, more possibilities for promotion, and a longer view of issues.

To summarise this discussion, assignment of functions between levels of government is complex. In many countries this has opened up for responsibility-sharing between the national government and sub-national jurisdictions. However, without transparency and an appropriate regulatory framework, there can be no accountability. South Africa in the late 1990s provides an illustrative example: The national government and the provinces have joint responsibilities for health and education, but the exact responsibilities of each are not defined (World Bank, 2000). The result is that provinces receive transfers to fund these services but may use them for other purposes, knowing well that the national government will intervene to provide the needed service.

3 Who levies what taxes?

Governments rely on a wide variety of tax instruments for their revenue needs, including direct and indirect taxes, general and specific taxes, business and individual taxes. In this section we address the question on which types of taxes are most suitable for the various levels of government. There is no ideal assignment of taxes between central and lower levels of government. However, a set of 'tax-assignment rules' has been developed in the traditional fiscal federalism theory. These principles relate to the respective responsibilities of central and lower tiers of government in macroeconomic stabilisation, income redistribution and resource allocation (Boadway et al., 2000). Furthermore, in developing countries the administrative capabilities of local governments in tax design (i.e., deciding on revenue bases and setting rates) must be taken into consideration (Bird, 1990). Moreover, in large and diverse countries the issue of tax harmonisation between jurisdictions is important when assigning taxing powers.

The stabilisation objective of the fiscal system calls for central control over the tax instruments that may substantially influence central budget deficits or inflation. Thus, taxes on international transactions (customs duties) and a considerable share of income and general sales taxes (such as VAT) should be assigned to central government. Moreover, the distributive function of government is an argument for centralised corporate income and wealth taxes. If there are wide disparities in income and wealth across provinces, as there are in many developing countries, then local taxing powers may exacerbate these differences. However, since the central government can borrow money to make up for shortfalls, it can live with the more unstable revenue sources. Local governments, by contrast, require relatively stable sources of revenue. Following Musgrave (1983 and 2000), these assignment rules yield the following six general principles of tax assignment in a federation:

1) taxes suitable for economic stabilisation should be levied by the central government; lower-level taxes should be cyclically stable;
2) progressive re-distributional taxes should be assigned to central government;
3) personal taxes with progressive rates should be levied by the jurisdictions most capable of implementing a tax on a global base;
4) lower-level governments should tax revenue bases with low mobility between jurisdictions;
5) tax bases distributed highly unequally between jurisdictions should be centralised; and
6) benefit taxes and user charges may be appropriately used at all levels.

These six principles produce in combination the specific assignment of categories of tax instruments that are presented in table 2.

Table 2 Tax assignments: who should tax what?

Tax type	**Determination of**		**Collection and Administration**	**Comments**
	tax base	**tax rate**		
Customs	N	N	N	International trade taxes
Corporate income	N	N	N	Mobile factor
Personal income	N	N,P,L	N	Redistributive, mobility, stabilisation
Wealth taxes (incl. capital, inheritances)	N	N,P	N	Redistributive
Payroll	N,P	N,P	N,P	Social programme
Value-added tax	N	N	N	Admin.costs, stabilisation
Resource taxes:				
Rent (profit) tax	N	N	N	Unequally distributed
Royalties/fees	P,L	P,L	P,L	Benefit taxes
Conservation charges	P,L	P,L	P,L	Environmental preservation
'Sin' taxes:				
Alcohol, tobacco	N,P	N,P	N,P	Health care shared
Gambling, betting	P,L	P,L	P,L	Province and local responsibility
Lotteries	P,L	P,L	P,L	Province and local responsibility
Taxation of 'bads':				
Carbon	N	N	N	Global/national pollution
Motor fuels	N,P,L	N,P,L	N,P,L	Tolls on road use
Congestion tolls	N,P,L	N,P,L	N,P,L	Tolls on road use
Parking fees	L	L	L	Local congestion
Motor vehicles:				
Registration	P	P	P	Provincial revenue source
Driver's licences	P	P	P	Provincial revenue source
Business taxes	P	P	P	Benefit tax
Excises	P	P	P	Immobile tax base
Property tax	P	L	L	Benefit tax, immobile
Land tax	P	L	L	Benefit tax, immobile
User charges	N,P,L	N,P,L	N,P,L	Payment for services

N=national (or central); P=province (or region); L=local

Source: Boadway et al. (2000)

While the general principles and theoretical discussions of tax assignments are useful, in practice, country-specific factors play a large role (Tanzi, 2000). In many countries local governments raise whatever taxes they are capable of raising, often without worrying excessively about the economic distortions and distribution effects that these taxes may create. For instance, a widely found characteristic of local government revenue systems in Africa is the huge number of revenue instruments in use (Brosio, 2000). Tanzania provides a good case. It is not uncommon that local authorities have more than 50 different taxes and fees, not including the various sub-groups of particular revenue bases. In one council studied by Fjeldstad & Semboja (2000), the by-law on *hawking and street trading* specifies in detail 38 different components (including licences for bicycle repairs, tyre puncture repairs, shoe shiner, car wash, carpenter, firewood, potato chips seller, etc.). Furthermore, there are often large variations on the tax rates imposed by councils on similar revenue bases, for instance on agricultural products. This has led to extensive 'smuggling' of agricultural goods across council boundaries. The complex revenue structure is due to the large tax autonomy of local authorities that may pass by-laws without serious approval by the ministry concerned. Lack of co-ordination between the central and local levels has led to duplication of taxes and inconsistencies between taxes imposed by local authorities and the national government's development policies (e.g., with respect to export promotion). An illustrative example is the cess rate on cashew nuts, a major export crop, which in 1997 represented 20 percent of the price paid to producers in Kibaha district council, creating huge disincentives for export production.

To summarise the discussion in this section, there is no 'ideal' way of dividing taxing responsibility between central and lower tiers of government. The case for centralisation is usually built around macroeconomic considerations and equalisation, and the case for local government taxing powers on efficiency considerations. The 'optimal' way to do things, however, depends on how the government weights these considerations (Bahl & Wallich, 1992). Furthermore, the capacity to administer taxes is always an important constraint to the assignment of taxing powers to lower levels of government in developing countries. If local governments cannot effectively assess and collect the taxes, then the system will tend toward centralisation.

3.1 Cost recovery through user charges

Taxes are not the best mechanism to obtain a better relation between demand and supply of public services. Better links can be achieved through cost-recovery charging systems. Moreover, user charges may contribute to simplifying many of the present intergovernmental problems, partly because user charges are applicable at all levels of government (Bennett, 1990). In some countries, including South Africa, charges on trading services such as electricity, water, sanitation and solid waste, are the major sources of urban and metropolitan revenues.

In principle, user charges tie the amount paid directly to the amount of a service a consumer uses. Thus, responsiveness to customers may be achieved through cost recovery mechanisms. User charges can also reflect differences in ability to pay by incorporating sliding scales for type of user or amount of usage (Rondinelli et al., 1989), although this will require adequate administrative capacity. Accordingly, user charges may have the potential of:[3]

- improving resource allocation;
- controlling the possibility of 'crowding out' by imposing a uniform basis for competition which allows alternative suppliers in the non-governmental area to survive and develop;

[3] Bennett (1990) and Jimenez (1987) provide interesting insights on the potential role of user charges in improving service delivery.

- stimulating a closer response of service producers to customer demands which in turn should raise quality and remove unnecessary production; and
- improving social equity and environmental policy by incorporating the social costs of externalities.

There are obviously a number of constraints on user charges and other means of cost recovery in developing countries. These arise from equity considerations, fluctuations in demand, and the relations between services financed by charges and private sector provision compared to those financed by general tax revenues. For instance, the central government may not have enough information about the structure and effects of most types of user charges across sub-national jurisdictions. Therefore, it is often difficult for the central level to determine if the current structure is appropriate for balancing efficiency and equity objectives. Furthermore, local governments may employ user charges as taxes to fund general expenses, and thereby undermine the relationship between demand and supply of public services. However, governments as well as the public opinion have too readily seen general revenue, particularly tax revenue, as the 'normal' financial source. It has been the easy way out of difficult decisions, illustrated by the large and increasing number of taxes. This suggests that there are reasons and scope for innovation, including greater use of mechanisms of exchange based on realistic pricing and other cost-recovery methods.

4 How to resolve vertical imbalances?

The general nature of intergovernmental fiscal relations is surprisingly similar across a wide range of countries. Almost without exception countries assign more expenditure functions to sub-national governments than can be financed from the revenue sources allocated to those governments. The result of this mismatching of functions and finances – often referred to as 'vertical imbalances' - is that sub-national governments are generally dependent upon transfers from higher levels of government. Thus, Bird (1990) argues that 'money is at the heart of intergovernmental matters'. Table 3 illustrates this point.

Table 3 Vertical imbalances in selected countries

Country	*Vertical imbalances*			
	Share of sub-national government (%)			
	In total public expenditure		*In total tax revenue*	
	1990	*1997*	*1990*	*1997*
Argentina	46.3	43.9	38.2	41.1
Brazil	35.3	36.5	30.9	31.3
Ethiopia	1.5	..	1.6	..
France	18.7	18.6	9.7	10.8
India	51.1	53.3	33.8	36.1
Italy	22.8	25.4	3.6	6.5
Kenya	4.4	3.5	2.2	1.9
Malaysia	20.2	19.1	3.7	2.4
Philippines	6.5	..	4.0	..
South Africa	20.7	49.8	5.5	5.3
United Kingdom	29.0	27.0	5.9	3.6
United States	42.0	46.4	33.8	32.9

Source: World Bank (2000)

Vertical fiscal imbalance exists in all the selected countries because none of their lower level government systems raises sufficient revenue to match expenditure responsibilities. However, table 3 reveals considerable variations between countries with respect to the degree of vertical fiscal imbalances. The sub-national jurisdictions in Argentina, Brazil, the United States and India come closest to achieving fiscal balance. The gap between expenditure and revenue (in 1997) is the greatest for South Africa, Malaysia, Italy and the United Kingdom. Lower levels of government in these countries are therefore especially dependent on transfers from the central government. Furthermore, the table shows that Argentina has the least centralised tax system with respect to share in national tax-raising, while Kenya, Malaysia, the United Kingdom and South Africa are the most centralised.

The basic rationale for a system of transfers is the existence of a fiscal gap at the local government level arising out of own-revenue and own-expenditure assignments. There are a number of methods to close the fiscal imbalances of sub-national governments, some of which also reduce imbalances between jurisdictions (Ahmad, 1997:6). In practice, we may distinguish between systems of *revenue sharing* and *grants*.

4.1 Revenue sharing

The most revenue generating tax bases according to the 'assignment rules' outlined above, belong to the central government. Based on these considerations the central government should keep the major taxes, especially the corporate income tax, multistage taxes such as the VAT, and taxes on foreign trade. Thus, if the sole concern of the central government is simply to fill a vertical fiscal gap one way would be to give lower levels of government a share of major national taxes collected in the area. Sub-national governments may assist in revenue mobilisation by providing information on local taxpayers, and thereby increasing the pool of tax revenues.

Tax revenues can be shared on a tax-by-tax basis or on the entire pool of central government tax revenues. Examples of the first kind are quite common, and exist in Argentina, Brazil, Pakistan, Russia and in other countries (Tanzi, 2000). In Argentina, for instance, the national government collects income tax, VAT, excise taxes, customs duties, energy taxes, social security taxes and some minor taxes. Some of these taxes, including VAT, the income tax and excise taxes, are subject to fairly complicated sharing arrangements with sub-national jurisdictions. In principle, the distribution of shared revenues among sub-national governments are made on a derivation basis, with each jurisdiction getting the same share of the revenue collected in its area.

One problem with the tax-by-tax sharing arrangement is that it may give the central government an incentive to concentrate its collection and enforcement efforts on the taxes that are either not shared or shared to a lesser degree (Ahmad, 1997). Furthermore, the central government may have an incentive to concentrate increases in rates (for instance for stabilisation purposes) on the shared taxes, something that may distort the tax system. Therefore, revenue sharing based on the entire pool of government revenues may be preferable. Revenue sharing, which transfers a portion of the national proceeds of a tax according to a predetermined formula, is much like a general-purpose unconditional block grant. However, this does not address the problem of horizontal imbalances, i.e., between jurisdictions within the same level. Sub-national governments' autonomy over revenue bases and rate structures are also sacrificed.

Furthermore, revenue sharing arrangements may have both pro- and contra-cyclical effects. For instance, if the central government tries to tighten fiscal policy by raising shared taxes, this move will also give the provincial or local governments more resources for spending. This outcome may be avoided if the portion of revenue going to the sub-national governments is levied at a constant rate on the shared tax base. Fixed revenue-sharing arrangements may also have pro-cyclical effects as tax revenue automatically rises during a boom, and thereby increases the spending capacity of the sub-national governments, while declining revenue during economic downturns forces them to cut back spending. To address this problem, some element of flexibility could be introduced in these sharing arrangements. For instance, this can be done by relating the transfers to a moving average of central government revenues or by requiring provincial or local governments to build up revenue stabilisation funds to even out cyclical fluctuations in shared taxes.

4.2 Grants

Besides revenue sharing, the main mechanism for intergovernmental transfers is grants from central to local governments. In principle, there are three broad categories of grants:[4]

- *Unconditional grants:* These are general-purpose transfers aimed at addressing vertical imbalances.
- *Conditional grants:* These grants carry conditions regarding the use of the funds. Sometimes the conditions are tied to the performance to be achieved in the programmes financed through them.
- *Equalisation grants:* These are used to address horizontal imbalances between local authorities. The purpose of horizontal equalisation is to equalise the capacity of local governments to provide a 'national standard' level of public goods and services. The grants also have the effect of closing the vertical fiscal gap.

A variety of *unconditional* (or general) grant systems are in use to determine the total amount to be distributed among sub-national governments. Brosio (2000) discusses various grant systems in use in Africa: Ghana, for instance, uses a system where no less than 5 % of total central government revenues are to be allocated to a 'Common Fund' for the disposal of sub-national governments. In Uganda, unconditional grants are determined annually with reference to the reassignment of tasks between the national and sub-national governments. According to the Ugandan Constitution, the total amount is calculated on the basis of a formula that includes the unconditional grant of the previous year, corrected by the increase in the general price level, plus the net change in the budgeted costs of running newly devolved or subtracted services. Thus, the Ugandan formula takes into account the actual devolution of functions and its budgetary implications. Ethiopia, in contrast, follows a less transparent system. When determining the size of the grant one starts with estimates of total resources available from tax and non-tax revenue and counterpart funds. However, direct foreign assistance, which is extensive in some jurisdictions, is not included. After negotiations with the regions, the national government allocates the total pool between itself and the regional governments. In 1995/96 a formula based system was introduced in Ethiopia. However, according to Brosio (2000) the formula has changed every year since its introduction.

A key element in many ongoing decentralisation reforms in developing countries is the provision of *conditional* block grants from the centre to sub-national governments. The conditionality refers to earmarking the financing to certain broad-based services, such as primary education, primary health, water supply, agricultural extension and roads. The grants are often based on minimum standards of service to be defined by the sector ministries in negotiation with representatives of sub-national governments. These grants usually relate to recurrent costs only. Such earmarking of grants will of course limit the autonomy of sub-national jurisdictions, and thereby partly negating the arguments for decentralisation (Wolman,

[4] Ahmad (1997) provides a thorough and readable 'state-of-the-art' study on grants.

1990). However, imposing conditions may be justified by distributional considerations, such as the need to ensure minimum nation-wide standards for the provision of services of national concern. Thus, to even out income among jurisdictions, a formula could be based on redistribute criteria which may combine population, income per capita, indicators of backwardness, etc..

Other public services than the major nationally defined ones discussed above, are often funded by unconditional block grants. These services may include district culture, community development, natural resources. As unconditional grants there are no minimum standards of service defined nor any performance indicators. Therefore, these grants may be used at the discretion of sub-national level of government to provide services in line with the objectives of the area, and will be accounted for through the individual jurisdiction's accounting system.

Two factors seem to be critical to ensuring the effectiveness of the block grant system. These are (1) accountability, and (2) predictability. Regarding accountability, financial management and control of the recurrent grants suffer from several weaknesses in many developing countries. These often relate to the absence of internal audit sections, poor reporting systems and non-compliance with established financial regulation. Semboja (1999) reports from Tanzania that some local authorities divert large shares of the grants disbursed for the education and health sectors to other issues. Regarding predictability, sub-national governments often experience delays and irregularities in the receipt of grants. According to Semboja (1999), local councils in Tanzania, in general, receive less than the budgeted charges approved by the Parliament. For instance, during the five months period October 1998 to February 1999, Kisarawe district council received only 45 % of the approved budget. The corresponding figure for Dar es Salaam city council was 66 %. Predictability is further weakened since there is no objective criterion for determining the level of charges disbursed to the various councils.

Thus, experiences indicate that it may be problematic in practice to design and enforce appropriate conditions for grants. Without substantial capacity building in financial management and monitoring, controls may end up being more formal than substantive, opening up for mismanagement and corruption. It may even become more difficult to specify and enforce conditionality on the performance of the sectors supported by the block grants.

4.3 Macroeconomic aspects of fiscal decentralisation

Promoting fiscal responsibility at sub-national levels calls for implementation of a stable and transparent system of transfers, geared to filling any gap between the assigned spending and revenue-raising responsibilities of lower level governments (Ter-Minassian, 1999). The definition of such a system is far from easy, especially given the need to preserve adequate incentives for tax effort and cost effectiveness in spending by the sub-national governments. However, in the process of fiscal decentralisation it is important to be aware of the risks for macroeconomic management and fiscal discipline. Mechanisms of fiscal transfers may impose considerably rigidity to the central government budget. Therefore, substantial devolution of revenues and spending responsibilities to sub-national jurisdictions can affect the central government's ability to carry out stabilisation and macroeconomic adjustment through the budget.

The destabilising potential of sub-national governments' is greatest when they face no hard budget constraint (Ter-Minassian, 1999; World Bank, 2000). Expectations of bail-out in case of financial trouble weaken the incentives to economise on costs, and may generate resource waste and rigidity within local authorities. These inefficiencies, in turn, may spill over into macro-economic imbalances. In particular, concern for macro economic imbalance lies behind the common recommendation that strict limits should be imposed on the borrowing ability of sub-national jurisdictions (Bird & Vaillancourt, 1998). It is feared that sub-national governments that are highly dependent on national transfers, may increase their current expenditures above their capacity to fund them out of current revenues and then close the gap through borrowing. For instance, in Mexico provincial borrowing contributed in the mid-1990s to a situation where some states were defined as 'bankrupt' (Tanzi, 2000).

Short-run macro-economic management considerations call for effective limits on sub-national governments' deficits, consistent with national objectives for growth, inflation and balance of payments. To ensure a regular and frequent dialogue between the central government and provincial and local authorities on budget trends, institutional forums, such as the South African 'Financial and Fiscal Commission', may play an important role.

Stability and transparency considerations call for formula-based revenue-sharing and other transfer systems. Thus, many developing countries are currently shifting from totally discretionary methods to formula-base systems of allocation from the centre to sub-national governments. For example, South Africa introduced in 1998/99 a formula-based system of allocation was introduced which also includes an equalisation component. However, according to Brosio (2000), the main problems in many African countries at present appear to be: (i) frequent changes in the allocation formula; (ii) use of variables reflecting discretionary policy choices made by the recipient sub-national governments; (iii) little attention paid to equalisation; and (iv) few incentives to increase own revenue generation by lower level governments. Therefore, the South African system deserves further attention since it has made important improvements in terms of transparency and efficiency in the allocation of resources from the centre to the provincial level.

5 How to resolve horizontal imbalances?

The problem of 'horizontal balance' has to do with the fact that geographical areas usually differ with respect to resource capacity and needs. For instance, the taxbase per capita often differ substantially between urban municipalities and district councils. Furthermore, the needs for public services may differ because some areas, for example, have a higher percentage of school children and/or elderly people than others (Wolman, 1990). Designing fiscal institutions to cope with this complex reality is often problematic, and may be further exacerbated by political imperatives of treating even the most unequal jurisdictions uniformly, and by historically rooted conflicts and rivalries between regions and population groups (Bird, 1990).

Whether fiscal decentralisation aggravates income differences among sub-national jurisdictions or becomes a positive force in efforts to alleviate poverty depends on two factors (World Bank, 2000:110): The first *is horizontal equity*, which is the extent to which sub-national governments have the fiscal capacity to deliver an equivalent level of services to their population. The second can be described as *within-state equity*, which is the ability or willingness of sub-national governments to improve income distribution within their borders.

Horizontal equity is connected to the question of *equalisation grants*. Tax bases usually vary substantially between provinces and between different local authorities. A jurisdiction with a relatively small tax base cannot compensate by imposing much higher tax rates without losing businesses and residents to jurisdictions with lower taxes. The costs of providing public services may also vary due to, for instance, population density and geographic location. To correct for such variations many countries have introduced *equalisation grants*. The purpose of these grants is to channel funds from relatively wealthy jurisdictions to poorer ones. Such transfers are often based on an equalisation formula that measures the 'fiscal need' and 'fiscal capacity' of each province or local authority (Oates, 1999). The formula results in a disproportionate share of transfers going to the jurisdictions with the greatest fiscal need and the least fiscal capacity. One problem with equalisation grants, however, is that sub-national governments may differ in their willingness to raise taxes. Thus, the grants may create an incentive for sub-national authorities to understate their tax bases or relative wealth in order to maximise transfers from the national government.

In many countries, however, income inequality is due to differences among individuals *within* a local authority or province rather than to differences among the local governments or provinces themselves. Therefore, by providing poorer provinces with additional resources will affect only one aspect of the equity problem. Ravallion (1999) reports that evidence from India and Indonesia shows that even dramatic redistribution across regions will have limited results unless targeting is improved within regions themselves. This, in turn, depends on the ability and willingness of the sub-national jurisdictions to engage in redistribution.

A recent review of a social programme in Argentine, found that when reforms were introduced to improve the programme's reach to the very poor, most of the improvements were due to reforms in intra-provincial targeting and better national monitoring of provincial performance (World Bank, 2000). Similarly, in Bolivia it was found that only when decentralisation gave communities more power to influence their local governments, the composition of local public expenditures shifted in favour of the poor.

Success in targeting the poor requires therefore a combination of national and sub-national efforts. In general, the main responsibility for poverty alleviation and income distribution should remain at the central government level, partly to secure national standard level of public goods and services. However, provinces and local authorities can play important roles through the delivery and management of social services. Nonetheless, the central government needs to retain a monitoring role to ensure that redistribute goals are satisfied (World Bank, 2000:111).

6 Concluding remarks

A general conclusion emerging from this review of theoretical and empirical literature on inter-governmental fiscal relations is that sub-national governments need to be given access to adequate resources to do the job with which they are entrusted. At the same time they must also be accountable for what they do with these resources.

Another conclusion is that questions on how to organise intergovernmental fiscal systems should be approached in the specific circumstances of each country in a manner that is consistent with achieving the relevant policy objectives. These objectives include efficient allocation of resources, income distribution and macroeconomic stabilisation. Furthermore, they may include objectives such as achieving 'regional balance' in the country. Often, there will be conflicts not only between these objectives, but also between local and central perceptions on the weights to be attached to them. Moreover, like all public policies, intergovernmental fiscal policies must take into account both the political constraints facing policy makers, such as the strength of different provinces and groups in political decisions, and economic constraints such as the stage of development of financial markets (Bird & Vaillancourt 1998). Finally, all policy changes proposed must start from the given set of initial conditions: every country has a history, and the current state of its fiscal institutions in large part reflects the product of an evolutionary process of policy change over time.

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Summary

Fiscal decentralisation - the devolution of taxing and spending powers to lower levels of government - has become an important theme of governance in many developing countries in recent years. Accordingly, restructuring of governmental functions and finances between the national and lower levels of government has entered the core of the development debate. A general conclusion emerging from this review of theoretical and empirical literature on intergovernmental fiscal relations is that sub-national governments need to be given access to adequate resources to do the job with which they are entrusted. At the same time they must also be accountable for what they do with these resources. Moreover, like all public policies, intergovernmental fiscal policies must take into account both the political constraints facing policy makers, such as the strength of different provinces and groups in political decisions, and economic constraints such as the stage of development of financial markets.

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