MUNICIPAL FINANCE

2

BACKGROUND SERIES

Intergovernmental Transfers in Developing and Transition Countries: Principles and Practice

Roy Bahl

APRIL 2000

LOCAL GOVERNMENT FINANCE

The World Bank

INTRODUCTION

Intergovernmental transfers are the cornerstone of sub-national government financing in most developing and transition countries. Transfers are a compromise in that they allow the central government to hold control over the public financing system while they offer a way to channel money into the budgets of provincial and local government. However, the general term "transfers" refers to a number of different kinds of public financing instruments: Grants, shared taxes, subsidies, and subventions are but a few. Some of these transfers may be designed to be very centralizing in nature while others are decentralizing. They may be intended to address a wide variety of different issues. Some are in constitutions while others are presidential decrees or even annually legislated.

This paper is about the design of intergovernmental transfers. The objective is to make two points. The first is that there are many different forms of intergovernmental transfers, and the right choice for a country depends on the objectives to be achieved. The second is that most countries adopt several forms of transfer, and these have to be viewed as a system with the important evaluation issue being their overall impact.

OBJECTIVES OF INTERGOVERNMENTAL TRANSFERS

Governments introduce intergovernmental transfers for one of four good reasons, and for a number of not-so-good reasons. In this section we review the reasons for transfers, and we stress the point that the design of the system should be driven by the objectives to be accomplished. The principles of fiscal federalism, as they have come to be known, have been taught to a couple of generations of students of public finance. While these principles provide good guidance in most cases, there are variations related to the specifics of public finances in developing and transition countries.

Vertical Balance

There is an imbalance between the expenditure responsibilities of subnational governments and their revenue raising powers. At the early stages of development, the priority public sector responsibilities are infrastructure development and the provision of basic living necessities, and the protection of economic stability. This dictates fiscal centralization. But with economic growth and urbanization, public expenditure needs shift more toward services provided by local governments, e.g., social services, water supply, etc. The result is an inability of local governments to provide adequate levels of public service. The gap must be filled in one of two ways: by giving local governments more revenue

raising powers or by revenue transfers from the central government to the subnational governments.

Local Taxes or Local Transfers?

In developing and transition countries, there are limited choices for the delegation of taxing autonomy to local governments. The alternative is to leave the bulk of revenue raising power at the central level, and to provide a subsidy to local government revenues to accommodate the mismatch. The result is that transfers comprise a major component of subnational government revenues. As local governments grow into the ability to use modern instruments of local taxation, the importance of transfers diminishes. In the U.S., for example, transfers finance less than one-fourth of all state and local government expenditures and subnational governments have access to a wide variety of consumption and income taxes.

But the story is very different in developing and transition countries. In Table 1, we outline the major tax sources. By process of elimination, we can conclude that relatively few of these are suitable as sub-national government revenue sources.

We live in a value-added tax world. Cnossen (1998) points out the widespread use and revenue dependence on the VAT, and its growing importance. But as much as the VAT is a boon for national government finances, it is not suitable as a subnational government tax. It raises problems as regards the taxation of imports (will one allow certain port cities to tax all incoming imports?) And the taxation of exports (will one allow certain port cities to pay all of the tax credits due to exporters?) Moreover, local taxation of value-added will encourage protectionist type activities by subnational governments. Most important of all, subnational governments could compromise the administrative integrity of the value-added tax. Bird and Gedron (1997) have pointed out that subnational governments could carry off an effective value-added tax provided that the local government and the national government used the same base and provided that the central VAT were well administered. In most developing and transition countries, these conditions are not likely to be met.

Issues Related to Vertical Balance

Those who design transfer systems and are driven by the vertical balance objective must face up to two major issues. The first is how does one measure vertical fiscal balance. In order to know how much transfer is necessary, one must estimate the difference between the revenues available to subnational governments, and the expenditure needs of those governments. This is quite a subjective matter, because expenditure needs are almost limitless. Most countries who use the vertical balance approach determine a "minimum service level", and fill the gap with transfers. In some cases, the amount of transfers is determined by a central budget constraint rather than by a "minimum requirements" approach.

The second issue to be faced by grant designers is that there is a mismatch between the reliance dictated by vertical balance considerations on the one hand, and efficiency considerations on the other. For example, vertical balance considerations might dictate that subnational governments receive $X in transfers. But this amount may result in some services that should be tax-financed being covered by grants. (See Box 1). This could lead to overspending by the subnational governments because certain services that should be financed with local taxes and user charges would be financed with external grants.

Equalization

Equalization is another justification for intergovernmental transfers. Developing and transition countries are characterized by wide fiscal disparities among regions. It is not unusual for the average income in the richest places to be 20 times greater than that in the poorest places. To the extent that subnational governments are given more revenue raising powers, these disparities will widen because the more urbanized local governments have the greatest taxable capacities and the strongest administrative infrastructures.

If countries are to equalize inter-regional differences in financial capacities, it must be done with intergovernmental transfers. As will be underlined below, the potential to equalize does not necessarily mean that equalization will occur, nor does it mean that equalization is necessarily a good policy for a country. In order to assess equalization as a justification for intergovernmental transfers, we must consider three questions: How are intergovernmental transfers financed (i.e., what taxes support the transfers), what services do subnational governments deliver, and what distribution formulae are used to allocate resources among the local governments?

Externalities

Another justification for the use of intergovernmental transfers is to offset externalities. That is, left to make their own decisions, local governments may underspend on services where there are substantial external benefits. For example, subnational governments may underspend on education and health services relative to that desired by the nation as a whole. In this case, theory tells us that a grant conditional on spending for the service in question could stimulate spending on that service.

The design of an intergovernmental transfer system to address externalities raises two important issues that must be addressed by policy makers. The first is the size of the grant required. That is, how much of a subsidy is required, and how much expenditure response will be required by the local government? This is a subjective question that must be answered by the central government. In fact, this issue is very often ignored by fiscal planners.

The second issue has to do with three-level fiscal federalism. If the grant is made to the provincial or state government, it may not reach the government that is responsible for the underspending. Related to this is the issue of how the intermediate level government will allocate its resources to the local level government.

Administrative Justifications

A final justification for intergovernmental transfers is that part of the public financing system is administrative. The argument goes that the central government has a capacity to assess and collect taxes that is much greater than that of subnational governments. It is less costly, therefore, for the central government to collect the taxes and then to allocate the revenues to local government in the form of transfers.

There are two issues to raise about this justification. One is that it may not be true that all taxes are more efficiently administered at the central level. In fact, some taxes are known to be more cheaply administered, and with higher collection rates at the local level. The property tax, user charges and local licences are better administered at the local level and certain types of taxes related to the ownership and use of automobiles can be more efficiently administered at the local level. The second issue is that the charge of local government tax administrative inefficiency can become a self-fulfilling prophesy.

Bad Justifications for Intergovernmental Transfers

The above are the proper justifications for intergovernmental transfers. But governments in transition and developing countries often do not use these justifications. Rather, they adopt intergovernmental transfers for other, less justifiable reasons. These "bad" reasons fall into four categories. The first is to discourage local government autonomy. That is, the central government is resistant to give up control over governance that would come with giving revenue raising powers to local governments. As an alternative, intergovernmental transfers are given as a local government revenue source.

The second reason might be an attempt to maintain or enforce uniformity. The goal of the central government might be to resist diversity on the part of local governments, in terms of expenditure mix or revenue structure.

A third reason could be a belief that local governments are more corrupt than the center, and therefore that a shift of responsibility to subnational governments would lead to a waste of revenues. There is some reason to argue that local government officials are more susceptible to influence by local citizens, because they are closer to the local electorate.

Fourth, a transfer system may be put in place as part of a strategy to offload the budget deficit on to local governments. For example, a grant system