



State Fiscal Transfers to Local Governments: Principles and Lessons from the International Practice

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Namaste!

Outline

- Guidelines for grant design
- Revenue Sharing Transfers
- Equalization Transfers
- Results Based Intergovernmental Finance
- A tale of three large countries: Canada, China and India
- Lessons

Guidelines for Intergovernmental Finance

- **Clarity** in objectives, **consistency** of design with objectives and **singular focus**
- **Simplicity**, objectivity and transparency of allocation criteria
- **Incentives** for fiscal prudence and competitive service delivery and results based accountability to citizens
- **Autonomy**: Independence in designing programs and flexibility in use of resources
- **Revenue Adequacy** and responsiveness
- **Predictability**
- **Fairness**: entitlements vary inversely with fiscal capacity and directly with fiscal needs; ***one size does not fit all*** – urban vs. rural, large vs. small
- **Affordability**
- **Review**: Sunset clauses to ensure periodic review and assessment

Not all local services are good candidates for grant financing

Partial Grant financing desirable

- Primary and secondary education and public health
- Welfare assistance
- Arterial roads and regional/metropolitan public transit
- Sports complex for global events. e.g. Olympics
- National Museums
- Courts and prisons. Only those with national and state wide externality
- Agricultural extension and natural resource conservation

Full local self financing desirable

- Local general services and administration
- Parks, recreation and libraries
- Museums, sports facilities and concert halls
- Water, sewer, airports, ports
- Local streets, roads, public transit, street lighting, parking
- Fire protection, ambulance
- Local police
- Garbage and waste disposal,
- Local environmental protection

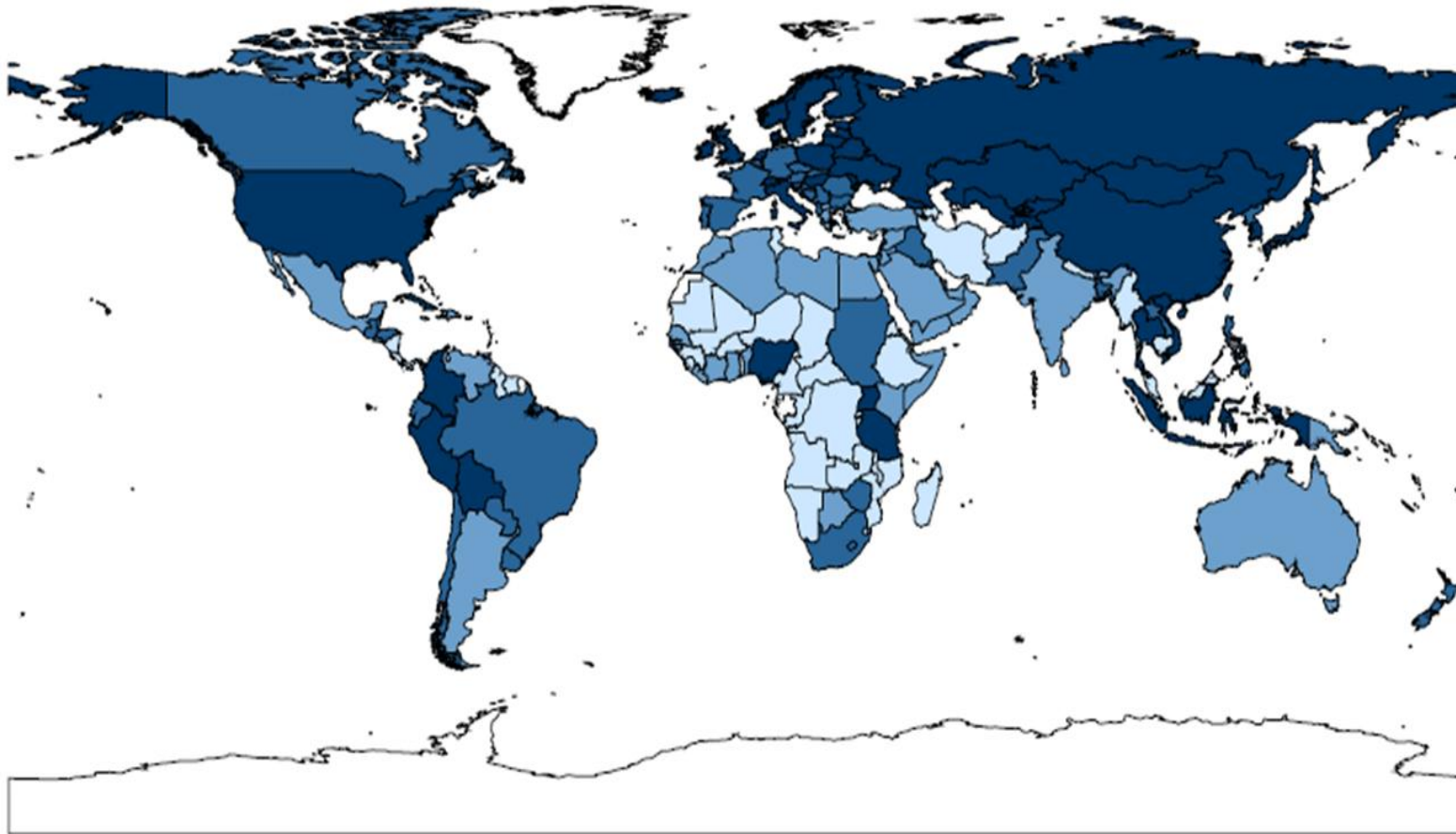
State- Local Transfers: An Overview of Principles and Practices

Objective	Grant Design	Better Practices	Practices to Avoid
Bridging vertical fiscal gaps	Reassign, tax decentralization, tax abatement, tax base sharing	Tax base sharing in Thailand, Denmark, Finland, Sweden	Deficit grants, wage grants, tax by tax sharing (China, Indonesia, most developing countries)
Reducing inter-local fiscal disparities (equalization)	<p>Fiscal capacity equalization (FCE) to a defined standard with the standard determining the total pool and individual allocation</p> <p>Fiscal need equalization through Demand for Public Services approach</p>	<p>Local inter-municipal fiscal capacity equalization with an explicit standard using Robin Hood approach as in Denmark, Finland and Sweden or provincial programs of local fiscal cap equalization in Canada</p> <p>-----</p>	<p>General revenue sharing with multiple factors, (states in Brazil, India)</p> <p>Comprehensive fiscal equalization with a fixed pool as in Ethiopian and Australian states</p> <p>Econometric or cost based approaches to fiscal need compensation as by the Australian states, Netherlands and Ethiopia</p>

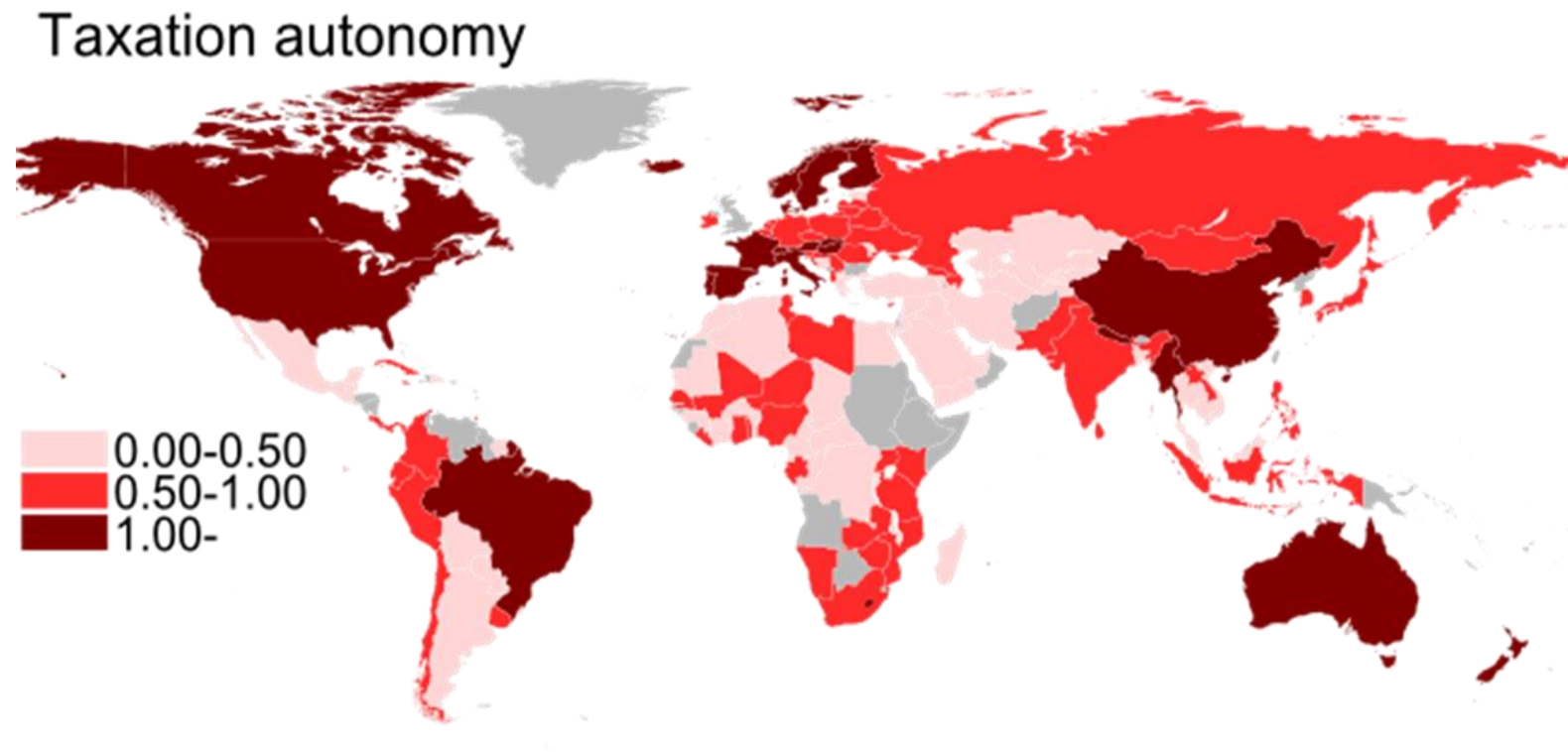
Objective	Grant Design	Better Practices	Practices to Avoid
Setting state minimum standards in merit public services	Output based transfers, conditions on service standards	Roads and primary education (ex-Indonesia, Canada), Education (Australia, Canada, Chile, Brazil, Colombia); Health (Brazil, Canada)	Conditions on spending (most countries)
	Planning view of infrastructure deficiencies from a state standard. Conditional capital grants –matching rate inverse with fiscal capacity; facilitate capital market access to credit worthy local governments	School construction grant to ensure primary school within 5KM of a child’s residence. (Indonesia, pre-2000)	Formula based or ad hoc capital grants with no matching and no future upkeep requirements (Ethiopian states, Indonesia, Bhutan)
Compensation for spill-outs of benefits	Open-ended matching with matching rate based on spill-outs rate	Inter-municipal agreements in Finland	Arbitrary grant as in Ethiopia
Influencing local priorities	Open-ended matching	Matching grants for transportation and public transit (Alberta, Canada)	Ad hoc grants
Promoting competition among local governments	Project or Output based grants using Certification or Tournament approaches	Albania and Russian Oblasts	Ad hoc grants

Vertical Fiscal Gap: Why?

Higher Degree of Expenditure Decentralization



But Much Lower Degree of Tax Decentralization



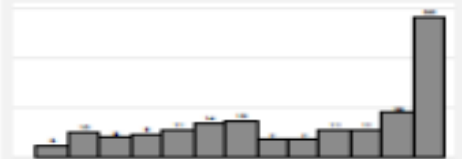
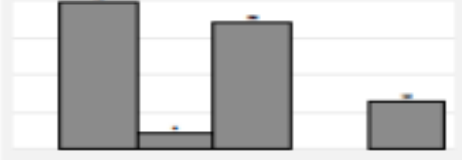

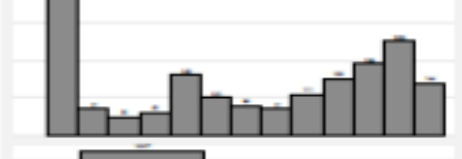
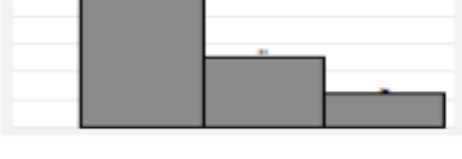
Large vertical gaps exist mostly in developing countries

LG Vertical Gap



Fiscal Decentralization: A Worldwide View of Local Fiscal Gaps and Transfers

Table 6: Fiscal Decentralization: Frequency Distribution of Countries

Name	N	Min	Max	Distribution	Countries, low values	Countries, high values
LG vert. gap	123	0	100		Niger(0) Togo(0) Iran (5.9) Ice-land(9.2) Roma- nia(9.5)	Syria(100) Uganda(90) Bu- rundi(90) India(90) Burkina Faso(90)
LG tax. auton-omy	158	0	1		0 - 71 country	1 - 25 countries
LG un-cond. transfers	159	0	1		0 - 56 countries	1 - 45 countries
LG exp. auton-omy	182	0.25	1		0.25 - 39 countries	Togo(1), Niger(1), Hong Kong(1), Singapore(1), Iceland(0.98)
LG borr. freedom	160	0	1		0 - 89 countries	1 - 22 countries

Transfers to Deal with Vertical Fiscal Gaps

- **Fiscal Gap:** Structural imbalance as a result of a mismatch between revenue means and expenditure needs.

Sources of Fiscal Gap and Possible Solutions:

- Inappropriate assign: Reassign taxing and spending powers
- Limited tax bases: Allow joint occupancy or tax decentralization.
- Tax room lacking: Tax abatement and tax base sharing (Denmark, Sweden, Thailand).
- Tax competition: Provincial collection and general (not on a tax-by-tax basis) revenue sharing.
- Practices to avoid: deficit grants; tax by tax sharing.

Tax competition not a significant issue but revenue sharing predominates solutions to VFG in developing countries

- Most developing countries follow revenue sharing with multiple factors to deal with VFG
- Some use sophisticated gap filling approaches as done in Indonesia and Ethiopia
- Both the approaches have important limitations but sophisticated gap filling does significantly worse as they often result in opaque, complex and unfair allocations.

Revenue Sharing Practices

- Determination of total pool: Arbitrary (universal practice)
- Allocation criteria:
 - Basic allocation (equal per jurisdiction component)
 - Population
 - Population density
 - Area, Total, mountainous, arable
 - Incidence of poverty
 - Backwardness index
 - Fiscal capacity indicators
 - Tax effort indicators
 - Other need indicators
- Factor Weights: Rationale? How determined?

Revenue Sharing

Merits

- Efficiency gains of centralized tax administration
- Simple and transparent division of fiscal pie
- State and local expenditure autonomy preserved
- Possible to incorporate factors to accomplish grantor objectives

Drawbacks

- Lack of political and fiscal accountability if little discretion of revenue raising at the margin
- States and local government have no discretion over the total amount
- Growth in state and local funding dependent on growth in federal revenues and not on own expenditure needs
- States and locals exposed to risks with changes in federal tax base or collection
- Specific revenue sharing for individual taxes on narrow bases such as income and payroll taxes, not desirable due to perverse incentives
- Revenue sharing with multiple factors that work at cross purposes introduces complexity and lack of clarity in impact
- Tax effort provisions can introduce inequity
- Equal per jurisdiction component, if significant, can create incentives for breakup of existing jurisdictions

Local Fiscal Equalization Transfers: *Why and Why Not?*

- **Why?**
 - **Political:** Overcoming threat of secession and creating a sense of political unity
 - **Fiscal Efficiency and Fiscal Equity:** Advances social justice (fiscal equity) and efficiency in market resource allocation (fiscal efficiency) (Boadway, 1982,2007).
 - **Securing a Common Economic Union:** Integration of fiscally disadvantaged communities regions in the State economy.
- **Why not?**
 - **Capitalization** of taxes and expenditures, higher prices for public services but lower prices for private goods and services in poorer jurisdictions. Factor mobility more important.
 - **Disincentive for local economic development.**
 - **Weakens Fiscal Discipline:** Weakens hard budget constraint.
 - **Endangers long term growth prospect:**
 - **For paternal (vertical) programs - constrains fiscal space for the state government.** May limit state action due to inflexibility of expenditures.

Local Fiscal Equalization Transfers: How?

- **Paternal (Provincial)Programs**
 - **Fiscal capacity equalization:** Canadian Provinces
 - **Fiscal Need Equalization:**
 - **Econometric, imputation based or ad hoc expenditure need or cost equalization** (Australia, Sweden, Ethiopia, China)
 - **Demand for Public Services Approach (Partial: for a few individual services by Canadian Provinces; Full : none))**
 - **Comprehensive capacity + need equalization:** Australian and Ethiopian states and Chinese provinces
- **Fraternal or Robin Hood Programs:** Denmark, Finland
- **Mixed programs:** Sweden, Switzerland

Pros and Cons of Alternate Equalization Programs

Program	PROS	CONS
Paternal (Vertical)	<ul style="list-style-type: none"> • Easier to finance and administer • Supports national/state objectives in creating a common economic and social union • Glue for holding the country together 	<ul style="list-style-type: none"> • Undermines local accountability to residents; • Strategic behavior by recipients; complexity; • Incentives for lobbying, inefficiencies and disincentive for improving tax base and amalgamation; • Non-transparent; • Central/state discretion; and • Lack of explicit national compact on equalization
Solidarity/ Fraternal (Horizontal)	<ul style="list-style-type: none"> • Ideal system. Simple and transparent • Pool subject to discipline of an explicit compact and potential for right balance in equalization 	<ul style="list-style-type: none"> • Political bargain possible only in relatively homogeneous societies • Compact problematic for cost/need equalization
Robin Hood (Horizontal)	<ul style="list-style-type: none"> • Transparent • But forced compact 	<ul style="list-style-type: none"> • Excessive marginal tax rates; false prices for public goods • Disincentive for local economic development

Demand for Public Services Approach: Operating Expenditure Needs for Urban LGs (U1...U4): An Illustration for large urban government U1 A

Local Service	Service population	Total expenditure by ULG class U1 (Rp)	ULG A's Share of Need factor	Expenditure need in ULG A (Rp)
Education	School age population	1,000,000	0.01	10,000
Health	Weighted population with higher weights for ages 0-4 (2.0) and 65+ (1.5)			
Transportation - roads	Paved Road Lane Kms			
Public Transit	population			
Water & Sewer	Assessed value of residential , commercial and industrial properties			
Solid Waste	population			
Police/Security	Population (50%) ,Property values (50%)			
Street lighting/ cleaning	Street Lane Kms			
Parks and recreation	Park area			
Public housing	Population below poverty line			
General Administration	Population			
Misc.	Population			
ALL SERVICES		Sum		Sum

District Operating Expenditure Needs for Rural LGs(R1...R5): An Illustration for District Local Government R1 A

Local Service	Service population	Total expenditure by RLG class R1 (Rp)	RLG A's Share of Need factor	Expenditure need in RLG A (Rp)
Education	School age population	1,000,000	0.01	10,000
Health	Weighted population with higher weights for ages 0-4 (2.0) and 65+ (1.5)			
Transportation – paved roads	Paved Road Lane Kms			
Graveled roads	Graveled roads Lane Kms			
Water	No. of Households			
Agricultural extension	No. of Farm Households			
Veterinary services	No. of livestock			
General Administration	Area			
Misc.	Area			
ALL SERVICES		Sum		Sum

Local Fiscal Equalization in Nordic Countries: A Summary View

	Fiscal capacity equalization	Expenditure need equalization
Denmark	Mixed central plus Robin Hood program with 85% tax rate if PCFC>115%. Subsidy rates (SR):85% if PCFC<90% otherwise 45%	Solidarity Program
Finland	Solidarity RTS program with 37% tax rate for above national average per capita fiscal capacity (PCFC); SR 100% if PCFC<92%	Central program of cost equalization for health, welfare and education and rural/urban cost differences above 65% of national average.
Norway	Robin Hood Program covering major taxes except PT with 60% tax rate for above average PCFC. SR 95% for PCFC<90% otherwise 60%	Solidarity Program plus special central grants to smaller LGs, northern counties and fast growing LGs
Sweden	Same as in Denmark but SR 95% if PCFC<115%	Solidarity program of cost equalization for 9 services

Denmark: Equalization models and standards

Equalization Type	Metropolitan areas	Small cities	Rural LGs
Fiscal capacity	85% Robin Hood	90% Robin Hood	50% central grant
Fiscal Needs	85% Robin Hood	60% Robin Hood	35% Robin Hood

Fiscal Equalization Grants: Some Lessons from International Experiences

- Equalization formula must determine both the pool and allocations.
- Local fiscal capacity equalization with an explicit standard is desirable but may be difficult in developing countries with scarce data on tax bases.
- Local fiscal need equalization is doable if one uses simpler “Demand for Public Services Approach” .
- Output based transfers offers a promising alternative for fiscal need compensation. Enhance results based accountability.
- Equalization transfers must not be looked at in isolation of the broader fiscal system especially conditional transfers.
- For local equalization – one size does not fit all.
- Important to have societal consensus on the standard of equalization
- Must have a sunset clause and provision for a review and renewal
- Institutional arrangements for a continuous review and periodic revision require serious thoughts as such an agency must embody representative of donor and recipient governments to reach a compact on the equalization standard.

A NEW VISION OF SPECIFIC PURPOSE
TRANSFERS - RESULTS BASED
INTERGOVERNMENTAL FINANCE:
Output Based Operating Grants
And
Planning Based Capital Grants

Traditional conditional grants vs. Output-based grants

Criterion	Traditional Conditional Grant	Output-based Grant
Objective	Spending levels	Quality and access to public services
Design	Complex	Simple and transparent
Eligibility	Government	Service providers (govt. and beyond government)
Conditions	Inputs	Outputs
Allocation	Project proposal	Service population
Compliance	Inspections and audits	Client feedback. Comparison with base year.
Penalties	Audit observations	Public censure, voice and exit
Managerial flexibility	None	Absolute
LG Autonomy	Little	High
Transparency	Little	High
Focus	Internal	External
Accountability	Top down input based	Bottom up, results based

An example: An Output based (performance oriented) education grant to set national minimum standards and encourage competition and innovation and citizen empowerment

- **Allocation basis among local governments:** school age children (ages 6-17)
- **Distribution to providers:** equal per pupil to both government and private schools
- **Conditions:** Universal access to all, private school admissions on merit regardless of parents' income, improvements in school achievement scores, graduation and drop out rates, no condition on spending
- **Penalties:** public censure, reduction of grant funds
- **Incentives for cost efficiency:** retention of savings
- **Built-in bottom up results based accountability:** competition with voice and exit options as parental choice of school determines school grant.

Examples of Provincial-Local Output Based Grants

- **School finance** by Canadian provinces, Brazilian states, Finland and Chile
- **Health Finance** by Canadian provinces and Brazilian states and Finland
- **Road Finance** by Canadian Provinces

Output Based Grants (OBGs)

- OBGs empower citizens as governors
- Weakens opportunism and pork barrel politics
- Exposes corruption, inefficiency and waste
- Opens public sector to competitive pressures within and beyond
- An important direction of reform for both industrial and developing countries.

From Dividing the Pie to Creating An Enabling Environment for Responsive and Accountable Local Governance

- **Tax Decentralization and Tax Base Sharing**
- ***Output based operating fiscal transfers to set state minimum standards***
- ***Planning based capital transfers to overcome infrastructure deficiency from a defined standard over the planning horizon***
- ***Fiscal equalization transfers***
- **Responsible borrowing**

State-Local Fiscal Transfers: A Tale of Three Countries - Canada, China and India

State-Local Fiscal Transfers – A comparative perspective

Indicator	Canada	China	India
LG Status	Provincial legislation	Executive order	Constitution and State legislation
LG Role – percent of GDP	7%	11%	<2%
LG Role – percent of total govt. expenditures	19%	66%	6%
Local Government Autonomy: Political/Fiscal/Administrative	strong/strong/strong	moderate/moderate/ weak	Strong/weak/weak
Self financing – Urban/rural	90%/75%	60%/47%	52%/7%
Vertical fiscal gap at the local level	15%	47%	75% (?)
Tax yield sharing and tax rebates	-	50% of operating grants	-
General revenue sharing (multiple factors)	-	-	Predominant source of financing local operating expenditures
Equalization transfers	20%	15% of operating grants	Not practiced. General revenue sharing has some equalization impact.
Specific purpose transfers	80%	35% of operating grants	Both central and state programs
Borrowing	Yes, assisted by Provincial Municipal Finance Corporations	Prohibited until 2014 but extensive through local investment finance corporations. Now regulated by MOF and PBOF	Yes, state regulated
Institution of decision making on state transfers	Treasury/Municipal Affairs	Central Ministry of Finance (MOF) and Provincial Bureau of Finance (PBOF)	State Finance Commissions

State-Local Fiscal Transfers: Lessons and Conclusions

Fiscal Transfers: Negative Lessons or Practices to Avoid

- Grants with vaguely specified objectives
- General revenue sharing with multiple factors (complex formula)
- Tax by tax sharing for taxes with narrow bases
- Deficit grants
- Fiscal effort provisions in unconditional transfers
- Input or process based or ad hoc grants
- Formula based capital grants
- Capital grants without assurance for upkeep
- Negotiated or discretionary transfers
- One size fits all grants to local governments
- Grants involving abrupt changes in total pool and its allocation

Fiscal Transfers: Positive Lessons or Practices to Strive For

- Consider tax decentralization or tax base sharing first.
- K.I.S.S. (keep it simple, sir)
- Focus on single objective
- Introduce ceilings and floors
- Introduce sunset clause
- Output based conditional transfers with citizens' evaluations
- Fiscal capacity equalization to a defined standard
- Separate formulae for population size class, area, urban/rural nature of local governments.
- Hold harmless and grandfathering provisions
- Political consensus on the standard of equalization
- Institutional arrangements for broad based consultation

Conclusions

- Simplicity, transparency and predictability critical for consensus building and for local planning and budgeting.
- Complexity and rigor does not necessarily enhance fairness.
- “One size fits all” grants or single formula general revenue sharing for all LGs lead to unfairness for all.
- Grants must not provide perverse incentives for local development and must encourage competition and innovation.
- Capital grant – formula based determination and combining with operating grant not desirable. Must embody a planning view of overcoming infrastructure deficiencies.
- Autonomy must be accompanied by accountability to local residents. Need for grant system to preserve local autonomy while encouraging citizen-based accountability.

Thank you!

