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Central-Local Fiscal Relations in Developing Countries: A Commentary

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COMMENT

Roy Bahl

In his excellent statement of the effectiveness of alternative central government approaches to financing metropolitan public services, Kenneth Davey reaches a conclusion ("so simple that it seems hardly worth stating") that the advantages of different approaches vary over time, depending on the state of central revenues. Davey's conclusion is quite correct and certainly worth stating but, perhaps, not so simple as he suggests. The purpose of this note is to carry this conclusion one step further by discussing the relationship among the revenue buoyancy of intergovernmental transfers, the type of transfer used, and the financial condition of the central government.

TYPES OF GRANT

As Davey notes, grants may exert many different types of effect on local government financing, depending on the structure of the grant programme. Bahl and Linn have developed a taxonomy, based on both of the relevant dimensions of grant systems in developing countries: The size of the divisible pool and the distribution of this amount among recipients.1/ Some have referred to the former issue as having to do with the vertical fiscal balance between the central and subnational governments and the latter as having to do with horizontal fiscal balance.

Consider first the determination of the size of the total amount to be distributed in any given year, i.e., the divisible pool. The current practice suggests three basic approaches: A specified share of national government revenues, an *ad hoc* decision (such as an annual appropriation voted by Parliament), or cost reimbursement. Once the grant fund is determined, four approaches have typically been followed in making allocations among local governments: On the basis of origin of collection of national taxes, i.e., a derivation principle; by formula; on an *ad hoc* basis; or on a cost reimbursement basis.

This two-way classification suggests a taxonomy of twelve grant "types," of which eight seem to be more or less commonly found in developing countries (see table 1). For example, a type B grant is one where the total national allocation is based on a share of a national tax, but where the distribution among local governments is made on a formula basis. An example of this approach is in the Philippines, where 20 per cent of national internal revenue collections are distributed among local governments on the basis of population and land area. Type C grants differ in that the distribution is on the basis of project costs, e.g., a scheme whereby a fixed per cent of a national tax is distributed among local governments on the basis of the cost of public works projects or teachers' salaries.

Grant types C, G, and K are usually categorical (designated for specific purposes) rather than general-purpose: Most cost reimbursement grants are project-oriented, designated for specified uses, and usually carry a central government approval process. Grants of the K type may be open-ended in that the total grant fund is determined as the sum of all reimbursable expenditures. C and G grants are close-ended which implies that the degree of cost reimbursement and/or the number of projects approved may vary from year to year, according to the total funding available.

Of the remaining five grant types, all are more likely to be general-purpose than specified for some particular use and all will be closed-ended. Grant type A is a shared tax in terms of both the determination of the total grant fund and the (derivation) allocation of the fund among jurisdictions. The use of these funds is infrequently earmarked. Grant types B and D are probably the most common -- the grant fund is determined as a share of a national or state tax and is then allocated among eligible units by formula or on an *ad hoc* basis. Types F, G, and H are programmes whose total amount is determined in an *ad hoc* manner, usually on a political basis, as part of the regular central government budget process. In the case of F grants, the distribution among local governments is by some predetermined formula, while the H case is purely an *ad hoc* distribution.

TABLE 1. ALTERNATIVE FORMS OF INTERGOVERNMENTAL GRANT PROGRAMMES

Methods of Allocating the Divisible Pool among Eligible Units	Methods of Determining the Total Divisible Pool		
	Specified Share of National or State Government Tax	*Ad Hoc* Decision	Reimbursement of Approved Expenditures
Origin of Collection of the Tax	A	--	--
Formula	B	F	--
Total or Partial Cost Reimbursement	C	G	K
Ad Hoc	D	H	--

REVENUE ADEQUACY

Of course, there are many criteria against which we may evaluate these different types of grant, e.g., stimulative effects on local revenues and expenditures, equalization, and the extent to which local autonomy is compromised. In this comment, the emphasis is on what may be the most important purpose of the grant system, the provision of an adequate source of revenue for local governments. "Adequacy" is difficult to define, but one might begin with two propositions: (a) that grants should be large enough to redress the imbalance between the revenue bases and expenditure responsibility assigned to local governments; and (b) that grant revenues should grow at least in proportion to the growth in local population and prices.

The first of these goals might be satisfied by the central government allocation to the divisible pool, and depends almost exclusively on the priority which the central government gives to improving the quality of public services provided by local governments. The issue here is whether the central government attaches enough importance to local government activities to give up control over an important component of its revenue base -- and compromise its ability to carry out stabilization policy and finance its own expenditure programme. An even more important question is whether the central government will resist the temptation to cut grants to local governments in times of stringent budget conditions. As the recent experience in developing countries and the United States shows, the possibility of off-loading a part of the central deficit on to the subnational government sector has proven tempting.

The second proposition, relating to an adequate growth of grant revenues, is more a matter of grant design. Grants should be structured so as to satisfy a target growth relative to income, population, or prices. For example, a target revenue growth could be set to allow local governments to hold real per capita expenditures constant. Whether grant revenues turn out to be population and inflation responsive, however, depends on three features of the grant system: (a) how the growth in the distributable grant pool is determined; (b) how the allocations among local governments are made; and (c) whether the central government actually makes the full monetary distributions called for by the grant system.

A shared tax system of determining the total grant pool, where the "referenced" tax is income elastic, is the best method of ensuring revenue adequacy. The Philippine and Colombian systems are, in theory, based on income-elastic shared national revenue sources. If these shared taxes are distributed on a derivation basis, or even on a formula basis that is weighted heavily towards population, the goal of maintaining real per capita expenditures can likely be realized. If the distribution of the shared tax is by origin of collection, then the grant flow will be more adequate for the larger and higher-income cities than for the smaller and poorer communities.

Grant distributions which are tied to *ad hoc* government decisions are the least likely to produce adequate revenue flows to local governments. The temptation to reduce the local government share to accommodate other national needs is just too great. The experiences in Bangladesh, Jamaica, Kenya, and the Republic of Korea are illustrative. In each case the move from a tax-based to an *ad hoc* determination of the size of the distributive pool foretold a slower rate of local revenue growth.

Sometimes the very nature of a grant system is changed by changing national priorities. Economic and social changes in the Philippines in the 1970s led the central government to actually distribute only about half of the grant entitlements of local governments. A shared tax base system was largely converted to an *ad hoc* system. A similar situation occurred in Colombia.2/

CONCLUSIONS

One cannot come to a firm recommendation about the "best" way to grant assistance to metropolitan local governments. It depends on the government's objectives. For example, if the principal objective is to equalize fiscal capacity across jurisdictions, the goals of stimulating local government tax effort, minimizing administrative costs, and promoting local autonomy are not likely to be well served. If the objective is solely to provide adequate revenues, however, some guidelines might be offered. The shared tax alternatives offer the best possibilities if the national tax chosen for the sharing arrangements is income- or consumption-based. Similarly, cost reimbursement grants can improve the income elasticity of the revenue system because education finance is a prime candidate for such grants. *Ad hoc* determined grant funds lead to the slowest revenue growth because central governments seem to view grants to local governments as one area to cut during times of budget crisis.

NOTES

1/ Roy Bahl and Johannes Linn, *Urban Government Finance in Developing Countries* (Washington, DC: World Bank, forthcoming), chapter 13.

2/ *Ibid.*, chapters 12 and 13.