

## CHAPTER 9

# THE DESIGN OF INTERGOVERNMENTAL GRANTS

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### CURRENT SYSTEM OF INTERGOVERNMENTAL GRANTS

The current grant system of Kazakstan is comprised of two components: the tax sharing between the central government and the *oblasts*, and the subventions passed from the central government to the *oblasts*. Because the tax sharing/subvention system has been described in detail in Chapter 7, it need only be summarized here.

Budget targets are set for each *oblast* (and for each local government) as part of the annual budget process described in Chapter 6. Subnational governments receive revenues from minor “local” taxes and shared “regulating” taxes of the central government. The regulating taxes are VAT, excises, enterprise income tax, and individual income tax, and, in a few *oblasts*, taxes on mineral resources. The sharing rates, set in the budget on an annual basis, vary by *oblast* and by *rayon*. Table 7.1 summarizes the sharing rates for each tax, by *oblast*, for 1995 and 1996. Depending on whether revenues from these sources are adequate to finance budgeted expenditures, *oblasts* (*rayons*) do or do not receive subventions from the central (*oblast*) government. Because subnational governments have no control over the amount of revenues they receive from tax sharing, this is best seen as a form of grant, instead of a method of tax assignment. Chapter 8 described the benefits of switching to a system of tax assignment based on subnational surcharges. This chapter discusses a grant policy that would accompany such a shift.

## OBJECTIVES OF GRANT POLICY

It is possible to identify several possible targets of a grant policy. The rest of this section identifies several of these. Note, however, that the currently underdeveloped state of political and fiscal institutions in Kazakhstan makes it inadvisable to implement most of these at this time. Rather, it is suggested that attention should focus on reducing vertical fiscal imbalance and horizontal fiscal disparities and avoiding unintended marginal incentives.

### Vertical Fiscal Imbalance

One objective of grant policy is to redress mismatch between the expenditure responsibilities assigned to a given level of subnational government and the revenue capacity allocated to it, if such exists. Vertical imbalance is quite common throughout the world, as central governments ordinarily have greater fiscal capacity than subnational governments, for reasons specified in the last chapter. Under such circumstances, grants may reasonably be used to overcome vertical imbalance by channeling funds from the central government to lower-level governments.

### Horizontal Fiscal Disparities

A second objective of grants is to reduce horizontal fiscal disparities—differences among *oblasts* in the relationship between the capacity to raise revenues and expenditure needs, by redistributing fiscal resources among *oblasts*. A system with no horizontal fiscal disparities would allow each *oblast* to provide the same level of public services with a given set of tax rates. Horizontal fiscal disparities may exist whether or not there is vertical fiscal imbalance.

While equalization of fiscal capacity is desirable from the viewpoint of short-term equity, it can be questioned on grounds of economic efficiency. Equalization may allow people to remain in locations where the provision of public services is expensive or opportunities for private economic activities are limited. Thus, there may be a conflict between equity and efficiency. From a long-term perspective, failure to equalize fiscal capacity may contribute to migration that enhances productivity and reduces poverty.

## Externalities

Many publicly provided services are characterized by “spillovers,” costs and benefits that are not experienced within the jurisdiction providing the services; these are often called external costs and benefits, or simply “externalities.” Subnational governments generally will not provide an optimal level of public services if significant externalities exist. They will choose the types and levels of services that are best for their local constituencies, ignoring costs and benefits experienced by others. This can lead to underprovision of goods that have regional or national benefits, and overprovision of goods that impose costs on surrounding jurisdictions or on the nation. Many examples can be cited: too little investment in education, inadequate pollution control, underinvestment in regional hospitals, and so on.

Where externalities would be pervasive if a service were to be provided by subnational governments, provision by the central government is appropriate; see Chapter 5 on expenditure assignment. In less extreme cases, the central government may provide grants intended to induce subnational governments to provide more of the services characterized by external benefits, for example, by paying a fraction of the cost of certain projects. Provision of services characterized by external benefits is sometimes mandated by higher levels of government. As noted earlier, it is not appropriate to mandate the provision of services without providing the required funding. In developed countries, such grants are often aimed at environmental protection and the provision of health services and education for the poor. In transitional and developing countries, the focus is more general, but particularly on health, education, transportation, and infrastructure. Unfortunately, externalities are notoriously difficult to measure. As a consequence, it is difficult to design such grants, and grants that are targeted very specifically but inaccurately may yield unintended and undesirable consequences. Because of these difficulties, this book does not propose the use of grants for this purpose now.

## Minimum Standards

Grants are often made to guarantee the provision of minimum levels of certain services such as education and nutrition for children and for lactating mothers. These can be explained as necessary to overcome particular forms of externalities (for example, concern

for the well-being of children living elsewhere, for humanitarian reasons, or perhaps because of fear that an uneducated child will grow to be an adult who is a burden on society). Alternatively, grants can be seen as a form of redistribution in-kind (provision of food or education directly to the child, instead of money to the parents, who may not spend it on the child). In any event, use of funds provided to finance the satisfaction of minimum standards is commonly restricted to provision of the services in question.

## **Tax Effort**

Some countries use grants to encourage revenue mobilization, by providing rewards for increased tax effort and penalties for low tax effort, for example, by including tax effort in grant formulas. Such incentive programs presuppose that subnational governments have independent revenue-raising powers, and thus can respond to the incentive by adjusting tax rates, tax bases, and the efficiency of collection. In developing countries, including those in transition, this is often not the case; subnational governments are more likely to be constrained by lack of adequate tax instruments than by lack of willingness to exert tax effort. It is difficult to justify including tax effort in grant formulas. It runs counter to the purpose of decentralization, which is to allow subnational governments to decide how much tax effort to put forth. This book does not support the use of grants to encourage tax effort. Nonetheless, it should be noted that subnational governments may increase tax effort if they are given greater control over fiscal affairs, as is proposed here.

## **Avoiding Unintended Marginal Incentives**

Grants intended to reflect external benefits of public services or to encourage tax effort should affect the “tax cost” of subnational public expenditures. Suppose that one fourth of the benefits of a particular form of expenditure are realized by nonresidents of the *oblast* providing the service. It is appropriate that a grant be designed to reduce the tax cost paid by residents of the *oblast* by one fourth to induce them to provide more of the service than if they considered only the local benefits. For example, the grant might be 25 tenge for each 75 tenge spent from local tax revenue to provide the service, or 25 percent of total *oblast* spending on the service. It may, however, be preferable to rely more heavily on charges for the use of roads and highways. This deserves further attention. Or, to encourage tax effort, the central government might

provide a grant that matched, not necessarily on a one-for-one basis, *oblast* revenues from own-sources, perhaps subject to an upper limit.

Because this book does not advocate the use of grants to overcome externalities or to encourage tax effort, another objective is offered as a guide to grant policy: grants should be designed in a way that does not affect the “tax cost” of *oblast* (*rayon*) spending. To accomplish this, it is necessary that the size of grants not be affected by the amount of revenue an *oblast* raises from own-sources. In particular, grants should not be reduced if local taxes are increased. If this is achieved, grants will not affect marginal decisions on the level of public spending.<sup>1</sup>

## RELEVANCE FOR KAZAKSTAN

Most of the objectives of grant policy discussed in the previous section are largely irrelevant under the current system, or, at least, are commingled in such a way that it is difficult to identify them.

### Vertical Fiscal Imbalance

Under the current system in Kazakhstan, the potential for vertical fiscal imbalance seems to be recognized and addressed, as subventions are paid to 11 of 20 *oblasts* (plus Leninsk). On the other hand, it can be argued that vertical fiscal imbalance is a meaningless concept in the current system, which simultaneously decides subnational budget targets and allocates enough revenues from shared taxes and subventions to finance them.

### Horizontal Fiscal Disparities among *Oblasts*

Chapter 7 showed that potentially significant fiscal disparities exist among the *oblasts*, and also among the *rayons* within *oblasts*. Revenue collections per capita demonstrate a high degree of variation among *oblasts* (Tables 8.1 and 9.1). Taldykorgan has the smallest revenue collection per capita (T980 per person),<sup>2</sup> while

<sup>1</sup> In the terms of standard microeconomic theory, the objective is to provide grant funds in a way that increases the amount available for *oblast* spending (the income effect), without changing the terms on which private command over economic resources can be traded for public services, via the political process (the substitution effect).

<sup>2</sup> The revenue retained per capita refers to all local revenues as well as *oblast* shares of revenues from VAT, excises, enterprise income taxes, and individual income taxes.

Mangystau has the highest (T8,621 per person). It appears that existing policies are intended to counteract these disparities.

**Table 9.1. Retentions Per Capita and Collections Per Capita - Current Law and Uniform Sharing Rates**  
(Hypothetical uniform sharing rates: individual income tax 100%, enterprise income tax 90%, VAT 50%, excise tax 100%)  
(tenge)

<i>Oblast</i>	Total Tax Collections	Total Retentions Current Law	Total Retentions Uniform Sharing
Akmola	5,882	4,445	4,445
Aktubinsk	6,762	4,524	5,366
Almaty	1,548	1,548	1,309
Atyrau	9,809	3,807	8,325
East Kazakhstan	4,461	4,461	3,754
Jambyl	1,759	1,759	1,484
Jezkazgan	4,559	4,559	3,881
West Kazakhstan	3,407	3,407	2,846
Karaganda	5,944	4,111	4,629
Kzyl-Orda	1,851	1,851	1,524
Kokshetau	2,872	2,872	2,273
Kostanai	5,949	3,269	4,947
Mangystau	8,621	4,546	7,250
Pavlodar	6,408	3,265	5,374
North Kazakhstan	2,769	2,769	2,293
Semipalatinsk	2,633	2,633	1,963
Taldykorgan	980	980	817
Torgai	1,947	1,947	1,574
South Kazakhstan	2,776	2,776	2,305
Almaty City	13,487	4,227	10,408

*Note:* Collections and retentions for individual and enterprise income taxes, VAT, and excises.

*Sources:* 1995 Amended Budget of Kazakhstan (Ministry of Finance) and authors' calculations.

The system of differential sharing rates and subventions prevailing in 1995 reduced horizontal disparities somewhat. Sharing rates were somewhat equalizing, if collections per capita are compared with retention rates, by *oblast*. In *oblasts* where collections per capita are relatively high, the corresponding sharing rates were relatively low, and vice versa. This was especially true for VAT and the enterprise income tax.

Disparities would have been far greater if all tax-sharing rates had been uniform across *oblasts*. Table 9.1 shows collections per capita and retentions under the 1995 sharing system and under one system of uniform sharing rates. (Hypothetical *oblast* shares are 100 percent for individual income tax and excises, 90 percent for enterprise income tax, and 50 percent for VAT.) Under the

**Table 9. 2. Revenue Per Capita and Expenditure Per Capita, 1995**  
(by *oblast*, tenge)

<i>Oblast</i>	Revenue Per Capita Retained Excluding Subventions	Subventions Per Capita	Expenditures Per Capita
Akmola	5,301	0	5,301
Aktubinsk	6,048	0	6,048
Almaty	2,591	2,905	5,496
Atyrau	6,144	0	6,144
East Kazakstan	6,048	773	6,821
Jambyl	2,487	1,987	4,474
Jezkazgan	6,052	0	6,052
West Kazakstan	4,538	1,556	6,094
Karaganda	5,798	0	5,798
Kzyl-Orda	2,519	5,869	8,388
Kokshetau	3,734	1,889	5,623
Kostanai	5,052	0	5,052
Mangystau	6,941	0	6,941
Pavlodar	5,405	0	5,405
North Kazakstan	3,813	1,830	5,642
Semipalatinsk	3,659	3,664	7,323
Taldykorgan	1,561	3,452	5,013
Torgai	2,743	3,267	6,010
South Kazakstan	3,446	1,397	4,843
Almaty City	6,713	0	6,713
Leninsk	23	5,604	5,627
Mean	4,315	1,628	5,943
Coefficient of variation	0.422	1.125	0.149

*Sources:* Level of budget revenue by oblast, USAID Barents Group; 1993 Population, *Statistical Yearbook* (1994).

uniform sharing rates, the disparities among *oblasts* are larger than under the 1995 sharing system.

The data in Table 9.2 show that, in most cases, those *oblasts* receiving subventions are the *oblasts* for which per capita retained revenues are relatively low. A simple regression tests whether the subventions are actually equalizing. Subventions per capita were regressed on per capita revenue collected as a measure of relative fiscal capacity of an *oblast*.

The simple correlation between subventions per capita and tax collections per capita was -0.30, suggesting that subventions go to *oblasts* with lower tax collections. The correlation between subventions per capita and retentions per capita was -0.87. The simple correlation between subventions per capita and GDP per

capita was -0.65. All of these figures attest to the equalizing nature of the current system of subventions; grants go to *oblasts* where current fiscal capacity is relatively low.<sup>3</sup>

Expenditures per capita show less variation among *oblasts* than do tax collections, in part due to the system of expenditure planning based on norms that still exist at the central and subnational levels of government. Because subventions help to fill expenditure gaps, the capacity of subnational governments to meet expenditure needs is partially equalized. Still, there is some variation in *oblast* expenditures per capita. Kzyl-Orda Oblast has the highest level of expenditures per capita, at T8,388 per person. Jambyl Oblast spends only about 54 percent of that amount per person.

### Combating Disparities within *Oblasts*

Significant revenue disparities can exist within *oblasts*. Chapter 7 reported that within Almaty Oblast, the *rayon* of Kapchagai collects over 15 times as much tax revenue per capita as Rajinbek. Once revenues are shared, however, the variation is reduced. After sharing, Kapchagai retains T2,914 per person (from the four major taxes), ten times that of Rajinbek's T297 per person.

Adding subventions reduces disparities even more. Once subventions are added, revenues per capita in Almaty Oblast range from T8,414 per person in Kengen to a low of T1,761 per person in Kaskaleu. Evidence is, however, by no means conclusive of whether or not the current behavior of *oblast* governments is equalizing, on average.<sup>4</sup> The regression coefficient of subventions per capita on total output was negative but not significant.

Yet it would be difficult to believe that *oblasts* do not try to equalize revenue somewhat, given that subventions from the central governments are equalizing. As further evidence of equalizing behavior, in Taldykorgan Oblast, subventions are not given to the City of Taldykorgan, which is the only district that does not receive 100 percent of all regulating taxes.

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<sup>3</sup> This is different from the situation in Russia and Ukraine before 1993. In those countries, subventions did not appear to be equalizing (Bahl and Wallace 1994; Martinez-Vazquez et al. 1995).

<sup>4</sup> It appears that the subvention system in Almaty Oblast is neither equalizing nor disequalizing. A simple regression of per capita subventions on per capita collections shows that subventions are somewhat equalizing. However, the regression coefficient on per capita collections (-0.53), is only marginally significant.

## Externalities

It is impossible to know the extent to which the current system takes account of externalities. Under the Soviet system, externalities might have been considered in the development and application of expenditure norms; in fact, this seems unlikely for current expenditures, given that norms do not seem to depend on the likelihood and degree of externalities. Externalities might have played some part in the determination of capital spending. For example, relatively more funds might have been allocated to a project expected to provide benefits to residents of other *rayons*. Again, this is unknowable, without considerable historical research. In any event, this is largely irrelevant, because, with few exceptions, under current practice, funds from shared taxes and subventions can be spent as subnational governments wish. Certainly, there are no provisions for matching funds, as would be expected in a system intended to induce subnational governments to expand expenditures on services characterized by externalities.

## Minimum Standards

The Soviet system appears to have been driven largely by a desire to provide comparable levels of public services in all parts of the Soviet Union; thus, minimum standards were taken for granted (even if they were not always achieved in practice). Because money is so tight and there are now few restrictions on the expenditure of funds by subnational governments, it is unlikely that minimum standards are being maintained, even where they ostensibly underlie expenditure norms.

## Marginal Incentives

In the present system, reference to marginal incentives has relatively little meaning, as *oblasts* (and *rayons*) have neither the ability nor the incentive to raise additional funds, except by using extrabudgetary funds. An important objective is to create a system that provides both the ability and incentive to raise marginal funds.

## Tax Effort

Similarly, the current system does not encourage—nor even allow—tax effort *ex ante*; indeed, by filling the projected revenue-

expenditure gaps of subnational government budgets, the system encourages subnational governments *not* to increase their tax effort. Tax effort can occur *ex post* only to the extent that dual subordination gives subnational officials control over local tax officials.

## A Practical Compromise

In principle, it would be possible to use a combination of grants to achieve a multitude of objectives. (In theory, one needs as many policy instruments as objectives to accomplish multiple objectives.) Alternatively, one might construct a formula intended to recognize multiple objectives. In fact, it would probably be a mistake to attempt to introduce a complicated grant system under present conditions. Rather, it is suggested that Kazakhstan should adopt a relatively simple general grant system designed to reduce vertical and horizontal fiscal imbalances. Such a system would facilitate provision of minimum levels of important services, though it would not guarantee it; subnational governments may decide to spend the funds under their control on other services. Also, it would not deal with externalities. Where these are deemed important, they should be addressed through matching grants targeted to specific projects and programs.

## PROPOSED SYSTEM

Efforts by the central government to overcome horizontal fiscal disparities should not be based on equalization of *actual tax collections*. In the extreme case, such efforts deteriorate to the present system, in which the central government fills in revenue gaps and takes away extra revenues, leaving subnational governments no control over fiscal effort, and rendering the *ex ante* division of tax revenues between jurisdictions essentially meaningless. Rather, equalization should be based on *fiscal capacity*, as indicated by the *oblast* revenues that would be forthcoming if the *oblast* were to apply a typical system of tax rates.<sup>5</sup> Because equalization grants would be divorced from actual tax collections, the *oblast* would have control over total revenues (and tax assignment would matter). Box 9.1 describes the system

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<sup>5</sup> In Western literature, this is commonly called a “representative tax system” or RTS. In the US, the states have access to a wide variety of tax bases. Thus, RTS includes choices of taxes, as well as rates.

of this type that was proposed by the new Financial and Fiscal Commission in South Africa.

Table 9.3 illustrates how such a system might work. In the top portion of the table the three columns represent *oblasts* or *rayons* with high, average, and low tax capacity, as indicated by their tax base, shown in the first line. The third line shows how much revenue each jurisdiction would receive if it were to levy the typical tax rate, shown in the second line. This typical tax rate is the rate that would finance a target level of spending if levied on the average tax base; it is discussed further below. Line 4 indicates positive and negative deviations from the target level of revenues that result from imposition of the typical tax rate. Line 5 shows that the jurisdiction with low fiscal capacity would receive a grant to provide it with the same fiscal resources the average jurisdiction would obtain if both levied the typical rate of tax. The jurisdictions with high and average fiscal capacity would receive no grant, because their fiscal capacity is not below the average.

The second portion of the table subdivides each column into three, depending on the fiscal effort made by the jurisdiction, as indicated by their actual tax rates shown in line 6. It shows actual tax rates, tax revenues, equalizing grants (which exist only in the case of the jurisdictions with below-average fiscal capacity), and total fiscal resources (the sum of tax revenues and grants). Attention should focus first on the sets of columns for jurisdictions with average and below-average fiscal capacity. Each type of jurisdiction has the target level of total fiscal resources, provided it levies the typical tax rate; but it gets more or less than that, if it levies a higher or lower rate.

This system combines equalization with fiscal autonomy by leaving both subvention and nonsubvention *oblasts* with the capacity to adjust their tax rates to gain more or less revenue than would be provided by typical rates, without affecting the amount of equalization grants.

It may be worthwhile to contrast the result of this proposal with what happens under current practice. First, there is no way subnational jurisdictions can exert more or less tax effort, *ex ante*, except through the “backdoor” methods described earlier; they have no control over tax rates. Second, tax rates are the same in all jurisdictions. Revenue targets are met by imposing sharing rates below 100 percent for nonsubvention jurisdictions and making grants to subvention jurisdictions. For this reason, jurisdictions would not want to exert more tax effort, even if allowed the option. Thus, *oblast* budgetary control is sacrificed to achieve satisfaction of norms and equalization.

Table 9.3. Illustration of Equalization Grants Based on Representative Tax System

Calculation of Equalizing Grants	Fiscal Capacity of <i>Oblast</i> or <i>Rayon</i>								
	Average			Average			Low		
1. Tax base per capita	100			100			75		
2. Typical tax rate	20 %			20 %			20 %		
3. Revenue from RTS	20			20			15		
4. Deviation from RTS	0			0			-5		
5. Equalizing grant	0			0			5		

  

<i>Tax Collections and Grants:</i>	Fiscal Effort								
	High	Ave	Low	High	Ave	Low	High	Ave	Low
<b>Complete Equalization for <i>Oblasts</i> with Low Fiscal Capacity</b>									
6. Actual tax rate	24	20	16	24	20	16	24	20	16
7. Tax revenue	36	30	24	24	20	16	18	15	12
8. Equalizing grant	0	0	0	0	0	0	5	5	5
9. Total resources	36	30	24	24	20	16	23	20	17
<b>Partial (60 percent) Equalization for <i>Oblasts</i> with Low Fiscal Capacity</b>									
10. Actual tax rate	24	20	16	24	20	16	24	20	16
11. Tax revenue	36	30	24	24	20	16	18	15	12
12. Equalizing grant	0	0	0	0	0	0	3	3	3
13. Total resources	36	30	24	24	20	16	21	18	15
<b>60 percent Equalization for all <i>Oblasts</i></b>									
14. Actual tax rate	24	20	16	24	20	16	24	20	16
15. Tax revenue	36	30	24	24	20	16	18	15	12
16. Equalizing grant	-6	-6	-6	0	0	0	3	3	3
17. Total resources	30	24	18	24	20	16	21	18	15

Note: RTS = Representative tax system.

Several points need to be added to this exposition. First, equalization need not be complete. The third portion of the table shows grants of only 60 percent of the amount needed to achieve target revenues.

Second, jurisdictions with above-average fiscal capacity obtain more revenues from application of typical tax rates than needed to meet the budget target. The top three parts of the table are constructed on the assumption that such excess revenues would not be taken away—that equalization “levels up” the position of the poorer *oblasts*, but does not “level down” the position of the richer ones. If it were thought appropriate to take resources from jurisdictions with above-average fiscal capacity, it is important that “negative grants” be based on the same reasoning as the positive grants discussed above. (Note that the proposed South African system described in Box 9.1 envisions negative equalization grants.) The bottom portion of Table 9.3 is based on the alternative assumption that 60 percent of both positive and negative deviations from the target are eliminated.

Target revenues were defined above by application of a typical tax rate to the tax base of the average subnational jurisdiction. In principle, one might want to equalize the capacity of subnational jurisdictions to satisfy expenditure needs, instead of fiscal capacity. But this is not easily done. “Need” is a difficult concept to define and to measure, in part because the costs of providing public services vary widely within a country. Given the need for simplicity, it seems appropriate, at least in the short run, to focus on fiscal capacity, without attempting to consider expenditure needs.

### **Box 9.1. Financing Provinces in South Africa**

*Constitutional Foundations.* Like Kazakstan, South Africa has a unitary government. The post-apartheid constitution of South Africa contains provisions dealing with various aspects of intergovernmental fiscal relations, including the assignment of expenditure functions and tax assignment. In addition, it provides that a nonpartisan Financial and Fiscal Commission (FFC) should advise the Parliament and provincial governments on a variety of issues in intergovernmental fiscal relations. These include the taxing powers of the provinces, the allocation of revenues collected by the central government between tiers of government, grants from the central government to the provinces, and borrowing by subnational governments. It is hoped that institution of FFC will help base decisions on intergovernmental

fiscal relations on objective technical grounds, and not on purely political considerations.

*Taxing Powers.* The constitution of South Africa allows the provinces to levy taxes (presumably via independent legislation and administration), other than income tax, VAT, general sales tax, and customs duties. If allowed by enabling national legislation, provinces can levy flat-rate surcharges (presumably implemented by the tax authorities of the central government) on the base of taxes imposed by the national government, except for the company income tax, VAT, and customs duties. The above limitations were motivated, in part, by recognition of administrative problems inherent in provincial surcharges on VAT and fear of exporting of provincial taxes on company income. Due to the administrative difficulties of imposing destination-based provincial surcharges on excises, these two provisions imply that surcharges on the individual income tax are likely to be the most important source of provincial revenues from own-sources.

*Taxation and Equalization.* FFC has recommended that the provinces be allowed to exercise their constitutional prerogative to impose surcharges on the individual income tax. To make "room" for such surcharges, while holding aggregate tax revenues of the central and provincial governments roughly constant as a percentage of GDP, FFC proposes that the central government reduce its individual income tax rates by a certain number of percentage points (set provisionally at 7 percentage points). A zero-sum system of tax equalization grants, which can be either positive or negative for a given province, has been proposed to compensate partially for horizontal fiscal disparities, as reflected in differences in the taxable capacity of the provinces, as reflected in revenues from the income tax surcharge. This grant would not, however, be dependent on the provincial tax rate actually chosen (or on other grants it receives). Thus, by levying a tax rate higher or lower than 7 percent, a particular province could have a higher or lower level of public services.

*Conditional Grants.* FFC has also recommended that the central government provide two important types of grants to the provinces: conditional grants for basic health and education, motivated by the desire to guarantee the capacity to finance minimum services; and an unconditional grant intended to overcome vertical fiscal imbalance and ensure the fiscal capacity of the provinces. It has also recommended conditional grants for the training of doctors in provincial hospitals, justified by the national interest in such training. The minimum service grants for health and education, intended in part to help provinces overcome regional disparities in the availability of services, can be spent only for the purposes intended. They are based on the qualifying population in each province (for example, the number of children aged 5-17, in the case of the education grant). To avoid disrupting provincial budgets, FFC proposes that these grants be phased in over a period of seven to ten years.

*Overcoming Vertical Imbalance.* The unconditional grants are based on population, but with each member of the rural population given a weight of 1.25 times that of the urban population, to reflect the relative deprivation of rural areas. Being intended to offset vertical fiscal imbalance, the aggregate amount of these grants would be set to achieve a given split of government spending between the provinces and the central government, taking account of other grants and the reduction of the individual income tax rate of the central government (and the desire to reduce the budget deficit).

*Summary of Advantages.* The system described combines several advantages: tax surcharges to provide fiscal autonomy; tax equalization to compensate for horizontal fiscal disparities; unconditional grants based largely on population to overcome vertical fiscal imbalance and differences in need; and conditional grants to ensure minimum levels of certain services. It is essentially a textbook example of how to structure intergovernmental fiscal relations.