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Challenges in Designing and Implementing Intergovernmental Fiscal Transfers in Asia

Intergovernmental fiscal transfers are an important tool of public sector finance in industrialized and developing countries for three main reasons.

First, central governments have advantages over subnational governments in raising revenue from many types of productive sources, while subnational governments have an edge in providing many types of public services. This reality invariably results in a mismatch between the expenditures that subnational governments are expected to make and the resources locally available to them.

Second, substantial disparities in revenue-raising capacity exist across decentralized levels of government. If subnational governments relied exclusively on their own resources, wealthier jurisdictions could spend substantially more on public services than lower-income areas. This would have not only equity implications but also efficiency implications. If decentralized governments are responsible for infrastructure and services essential to production, areas with fewer resources may be unable to support local economic development.

Third, resources from the central level can be used to ensure that basic national priorities will be met in all subnational jurisdictions. Typical priority sectors are health and education, and often also roads, water, and other services. Providing these services may promote efficiency (if externalities are involved) and equity, and also support poverty reduction efforts.

The Asian Development Bank (ADB), like other international development agencies, has been focusing more attention on supporting the reform of intergovernmental fiscal transfers in recent years. This is part of a broader paradigm shift in which subnational governments have growing resource needs as the public sector is decentralized. Decentralization is based on a belief that key local stakeholders, including subnational governments and local communities, must work together in meeting development and poverty reduction goals. The need for broader partnerships among the various levels of the public and private sectors, civil society, and international development agencies is also increasingly recognized as promoting more equitable and sustainable development.

This article briefly examines the achievements and challenges of intergovernmental fiscal transfers in Asia. Key issues that emerge from theory and international practice are highlighted and recent experiences in Cambodia, India, Indonesia, Pakistan, and Philippines are reviewed. Transfers generally have multiple objectives, are often controversial, and can be challenging to design and implement effectively, particularly in developing countries. Several important issues have to be considered.

Aggregate Size of Transfers and Macroeconomic Concerns

Concerns have been raised in many countries that guaranteeing a large percentage of central resources each year to subnational governments can create macroeconomic problems. These fears are not unfounded. Fixed transfer arrangements reduce central control over the disposition of public resources, and a substantial proportion of subnational governments in many developing countries have weak capacity to use the resources efficiently. The potential dangers of guaranteed allocations, however, must be balanced against the value of providing subnational governments with a reasonably stable revenue base and the potential (eventual) local gains of decentralized services delivery.

Despite concerns about undermining central government fiscal flexibility and local government performance, most of the countries under consideration have elected to institutionalize a fixed percentage of a major tax, group of taxes, or total domestic revenues as the pool of resources for allocation to subnational governments through intergovernmental transfers.

- In Cambodia, the allocation is small, growing from less than 2% of domestic revenue in fiscal year (FY)2002 to 5% in FY2006, but the local government (commune) system is in the early stages of development.

- The Indian Government shares nearly 35% of its domestic revenues with the state governments, partly under the mandate of a constitutional amendment and partly on the recommendation of a periodic Finance Commission.
- The legally mandated Dana Alokasi Umum (DAU) in Indonesia represents at least 25% of the Indonesian Government's national budget and accounts for nearly 75% of local revenues.
- In Pakistan, the pool of resources for the main intergovernmental transfer program to the provinces as determined by a periodic Finance Commission makes up 37.5% of most national revenues, with a few sources sharing 100% on the basis of origin. It accounts for more than 60% of transfers to subnational governments.
- The Internal Revenue Allotment (IRA) of the Philippines shares by law 40% of gross national internal revenues (in the third year before the allocation year) and accounts for 94% of all transfers.

While institutionalizing significant transfers increases the legitimacy, stability, and financial viability of subnational governments, structural deficiencies in the transfer systems can create problems. The contribution of state governments in India to the overall public sector deficit, for example, has been steadily growing in recent years due partly to incentives embedded in the national transfer programs. Transfers in the Philippines have given subnational governments greater access to revenues, although they have increased fiscal imbalances among local governments. Disbursement problems, and in some cases continued shortfalls in revenue, have induced provinces in Pakistan to borrow. In Indonesia, some local governments receive more central resources than they need or can manage responsibly, causing increasing concern.

The experiences of these countries highlight the need to improve the overall fiscal performance of the public sector by getting the levels of transfer funding right and directing these to subnational governments through programs that create appropriate incentives for responsible behavior.

Variety and Structure of Transfer Programs

Most countries have multiple goals for subnational governments, as is often reflected in the variety and structure of transfer programs. Unconditional grants, for example, are best for promoting autonomy and interjurisdictional redistribution, while conditional grants are more efficient in encouraging expenditures on particular types of target services. Sometimes the various transfer programs do not fit together well, increasing complexity and creating serious administrative problems.

The countries under consideration generally have more than one type of transfer program but are clearly moving toward consolidation. Most of the case studies on which this review is based focus primarily on one or two major transfer programs, so that definitive comparative conclusions cannot be drawn about the overall systems. Two observations can, however, be made.

First, all of the countries are developing a substantial revenue-sharing system that imposes relatively limited conditions on the use of transferred recurrent resources, highlighting the importance these Asian decentralization programs place on subnational autonomy. Examples include the Finance Commission's transfer of resources to states' recurrent accounts in India, the DAU targeted primarily to local governments in Indonesia, the shared tax transfer to provinces in Pakistan, and the IRA shared by all subnational governments in the Philippines. Cambodia, which has only recently started to decentralize, allocates resources through a single unconditional transfer system with both administrative and development components.

Second, intergovernmental transfer programs on the capital side are typically smaller than recurrent transfers in these countries and are structured in different ways. India has a major development-oriented transfer under the National Planning Commission, but many resources apparently get used for recurrent expenditures and problems arise in distributing development funds as a standardized grant/loan package. The Philippines has only a few capital transfers, but capital investment is somewhat stimulated by regulations requiring that 20% of the IRA be used for development and by the availability of loans from the central Municipal Development Fund. Pakistan has one transfer program for general development expenditures, while the rest are for specific purposes. Indonesia presently has only very minor development transfers, largely because of the recent dismantling of a long-standing problematic and substantial system of conditional development transfers, which is only gradually being restructured. Cambodia's transfer program is intended primarily for development expenditures, but aggregate transfers are, as noted above, quite small.

Resource Allocation

Defining the criteria for allocating transfer program resources can be challenging in two respects: identifying the main objective and defining how best to allocate resources. A redistributive unconditional transfer program, like most of the major recurrent transfer programs in the case countries, might be simply targeted for poor areas, or it might be more ambitiously designed to fill a fiscal gap between defined expenditure needs and fiscal capacity. Thus, transfer designers must decide what they want to achieve and how it can best be measured.

The case countries have approached the problem of transfer allocation in very different ways. All have developed some type of formula-based allocation, ranging

from very simple to relatively complex. For example, the shared tax transfer pool in Pakistan is allocated to provinces entirely on the basis of population, although two backward provinces also receive a special grant. Cambodia also includes a poverty index in its formula, and the Philippine IRA considers land area and "equal sharing." The Indonesian DAU and the Indian state recurrent account transfer go the greatest lengths. They are both designed to measure, in different and not entirely adequate ways, both expenditure needs and fiscal capacity.

These variations in approach illustrate some of the important tradeoffs in the design of transfer formulas. Allocation in Pakistan based on a single variable is simple and transparent, but is at best a crude measure of expenditure need. The use of land area and an equal share by the Philippine IRA attempts to broaden the measures of need beyond population, although one may question the choice of these particular variables and their effects. The Cambodian attempt to incorporate a poverty index specifically targets a portion of resources to the most needy local governments.

All of these simple measures, however, focus only on expenditure needs. In contrast, the Indian and Indonesian models attempt to consider both expenditure needs in greater detail and the revenue capacity of subnational governments. These more complex formulas, however, can pose problems. The Indian formula is based on filling a fiscal gap defined largely by existing patterns of subnational expenditures and revenues. Public finance economists prefer an approach based on defined expenditure and revenue norms. The Indonesian formula is closer to this approach, but problems remain.

A serious problem with allocation formulas is that some desirable variables are difficult to measure correctly. Equal expenditures, for example, do not always lead to equal results, and even if relevant interjurisdictional differences could be accounted for, decisions must be made about how to weigh each component of an expenditure index. In addition, even if allocation variables are defined properly and assigned reasonable weights, data may not be available or reliable in some countries, including those under consideration.

A common critique of transfer formulas is their tendency to undermine subnational revenue generation by using transfers to substitute for local tax effort. Most of the cases, like many other countries around the world, do not deal with this issue very well. India and Indonesia try to take subnational revenue generation into account, but not satisfactorily. No tax effort variable is used in the Philippines, although limited evidence suggests that the IRA may have modestly stimulated local revenue mobilization in the aggregate. Pakistan has a small matching grant for provincial resource mobilization that rewards (up to a certain limit) provincial revenue efforts above their historical average growth rate, but provincial revenue yields remain rather low and appear to be shrinking. Cambodia does not use an explicit tax effort variable, but requires minimum local contributions before disbursing transfer allocations.

Political and Bureaucratic Interference

Many transfer systems worldwide—by design or by manipulation—have historically allocated resources with a degree of subjectivity that undermines basic economic objectives. Although some countries, including India, Pakistan, and Philippines, have small transfer programs with unclearly specified allocation mechanisms, all of the countries under consideration have made great efforts to move toward more objective, formula-driven transfers, at least with major programs.

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In some instances, however, institutional and political issues arise even with these major programs. For example, coordination is lacking in India between the recurrent transfers managed by the Finance Commission and the (intended) development transfers managed by the Planning Commission. In addition, not all resources in some transfer programs are distributed in a carefully considered way. About 30% of the Planning Commission transfers in India, for example, are allocated to a few "special category" states that account for only about 5% of the population and have weak absorptive capacity. This heavy concentration of development expenditures generates greater claims from the "special category" states for recurrent transfers from the Finance Commission.

Various concerns arise in other countries as well. Although the formula and schedules are clear, provinces in Pakistan often get only 75% of their allocation and with significant delay. This is partly due to national revenue shortfalls, but the fact that some provinces receive more or less than the average disbursement suggests that political and institutional concerns are contributing factors. In addition, some smaller transfer programs in Pakistan allocate resources primarily on the basis of political criteria, and the Philippine case cites several examples of "pork barrel" funds. Intergovernmental transfers are inherently political, but those who design and implement transfer programs are expected to keep the politicization of the

process from seriously undermining the basic fiscal and economic goals of transfers.

Overall Effects of Intergovernmental Transfer Programs

Do major transfer programs meet key development objectives? Clearly, in all of the present cases, intergovernmental transfers support increases in local expenditures simply because they transfer substantial volumes of resources to subnational governments. How systematic this is, however, is more difficult to say, and the effects on services delivery coverage and quality in the region have not been well studied. Different transfer programs have varying objectives and measurements of achievement. If a transfer program is, for example, intended to be redistributive, does it simply target poorer areas or take a more complex fiscal equalization approach based on normative measures of expenditure needs and fiscal capacity?

All of the case studies fall short of considering fiscal capacity, and other factors influence the final outcome. Cambodia targets resources to poorer local governments, but the formula is being phased in as part of a decentralization process that first focused more resources on more capable areas. Special allocations to backward provinces in Pakistan to supplement the main provincial revenue-sharing formula (population-based) have led to higher per capita expenditures, but enormous service backlogs still exist. In the Philippines, the IRA substantially increases local resources and possibly has a modest effect on development, but it apparently worsens fiscal imbalances across subnational levels of government.

India and Indonesia make more sophisticated attempts to deal with fiscal imbalances by considering expenditure needs relative to revenue capacity, as noted above. Imbalances remain significant, however, because of deficiencies in the design and management of transfer programs and the offsetting effects of other activities. The major role in capital outlays that the national government still plays in some countries, for example, substantially affects the pattern of distribution of regional public resources, at times giving it an apparent bias toward better-endowed areas. In all cases, international aid channeled from the central to subnational governments is a significant factor in resource allocation, sometimes worsening and at other times offsetting the effects of national government behavior. Finally, little is known in the countries under consideration about intrajurisdictional redistribution, which is important in reducing inequality and poverty.

Even if intergovernmental transfers meet basic redistribution and services delivery goals, they may not stimulate balanced regional growth. Most of the case studies on which this review is based do not pay much attention to the broader issue of regional growth. The ones that do have not found substantial reductions in disparities; rather, in some cases, disparities have increased. A few cases, however, suggest that even where transfers have resulted in some genuine redistribution, the resources are not well spent or substantial leakages from the regions occur. India's case, for example, puts into question the value of channeling large volumes of resources to regions that have limited absorptive capacity and growth potential. Finally, regional growth is influenced by too many factors and policies that are just as or more important than the distribution of public resources. Thus, policymakers should not depend too much on the ability of transfers to improve interregional growth disparities.

Moving Forward

Various proposals can be made to improve intergovernmental transfer systems in all countries under consideration. A few issues particularly stand out. First, greater understanding is needed regarding how the full set of transfer programs in a particular country relate to each other and to broader national policies and goals. Second, all of the allocation mechanisms require appropriate improvements in the form of better formulas and more standardized data, but this must be accomplished without unduly complicating the transfer systems. Third, direct national agency expenditures and international donor programs, which channel resources to subnational governments primarily on the development side of the budget, are significant in most of the countries under consideration. Such programs can have both positive and negative effects. Their role relative to the fiscal decentralization objectives of a particular country, therefore, requires careful consideration.

This review is based on *Intergovernmental Transfers in Asia: Current Practice and Challenges for the Future* by P. Smoke and Y. H. Kim (Manila: Asian Development Bank, 2003). This book provides an overview of relevant theory and international practice, presents case studies of selected major transfer programs in five Asian countries, and contains an extensive bibliography on intergovernmental transfers. Note that the Pakistan case focuses on provincial transfers because it was researched and written before recent attempts to decentralize to the municipal level.

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