



FISCAL DECENTRALISATION AND SECTOR FUNDING PRINCIPLES AND PRACTICES

ANNEX 4

Introduction to the Principles for Design of Intergovernmental Fiscal Transfer

The views expressed in this paper are those of the author(s) and do not necessarily reflect the view or policies of the Ministry of Foreign Affairs of Denmark.

Jesper Steffensen
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Abbreviations

ADB:	Asian Development Bank
CB:	Capacity Building
CD:	Capacity Development
CG:	Central Government
CGR:	Conditional Grants
FDS:	Fiscal Decentralisation Strategy
EG:	Equalisation Grants
LG:	Local Governments
LGBC:	Local Government Budget Committee
LGDP:	Local Government Development Programme
LGFC:	Local Government Finance Commission
IGFT:	Intergovernmental Fiscal Transfers
IGFTS:	Intergovernmental Fiscal Transfer System
UCG:	Unconditional Grants
UNCDF:	United Nations Capital Development Fund
UNDP:	United Nations Development Programme
WB:	The World Bank

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1. Introduction and Overview¹

The design of systems of intergovernmental fiscal transfer systems² is generally recognized as being one of the most challenging tasks within the field of public finance. The specific manner in which a transfer system is developed is often based on a complex mixture of political choice, economic principles, historical reasons and country contextual factors (including the size and structure of the system of local government).

The design of appropriate *allocation criteria* and formulas, which is the main subject of this paper, is probably one of the most daunting tasks within the field of local government (LG) finance. Nevertheless, it is of great importance for the achievement of the fiscal decentralisation objectives, particularly the efficiency and equity, and the design should be closely realigned with these objectives.

First, this paper reviews the theory and the objectives behind any system of intergovernmental fiscal transfers, provides a theoretical typology/taxonomy of transfers and outlines possible allocation criteria.

Second, the paper presents a brief overview of relevant experiences on development of allocation criteria from various countries, which have already developed mature systems or are in the process of developing new transfers systems.

Recently new innovative systems of grants have been experienced in a number of countries, some of these targeting the performance of the local governments in various areas. The experiences from these initiatives have been encouraging and are summarised in another paper: "*Conceptual Basis for Performance Based Grant Systems and Selected International Experiences*".³

2. Theory – Objectives, Typology of Grants and Allocation Criteria

2.1 Objectives

It is paramount for any system of intergovernmental fiscal transfers that the objectives of the transfer system are clearly spelled out and that the system design reflects these objectives.

The **objectives** of a transfer system can be grouped as follows⁴:

¹ This paper is a revised and refined version of the authors (Jesper Steffensen) input to the Local Government Finance Commission in Uganda, in 2003, published in a Report of the Commission on Allocation Criteria for Grants and the paper with the same title of November 2005. It has been up-dated several times, latest January 2010.

² The words "transfers" and "grants" are used interchangeably.

³ Jesper Steffensen and Henrik Fredborg Larsen, June 2005 and a forthcoming UNCDF publication on Performance-Based Grants by Jesper Steffensen (draft 2009).

⁴ Cf. e.g. Performance Grant Agreement in Improving Local Government Service Delivery, Michael Shaeffer, INFUD, Hirokaiki Suzuki, SAFIN, The World Bank, 2000; and "Intergovernmental Fiscal Transfers: *Some Lessons from International Experiences*" by Richard M. Bird and Michael Smart, University of Toronto, February 2001. As

- *Correcting or adjusting vertical imbalances* – closing the fiscal gap between expenditure assignment and revenue assignments. The transfers may be used to ensure that LGs have adequate revenues to discharge designated functions (expenditure needs), especially as other types of revenues (taxes, user fees, charges etc.) cannot generate adequate revenue for LGs due to various reasons⁵;
- *Compensating* local governments for complying with central government requirements or implementing central government programs that are delegated to the LGs; This may be done through yearly calculations of the impact of new legislation/decisions on transfers of tasks and/or through current adjustments of the size of the grants;
- Correcting or adjusting *horizontal imbalances*⁶ – i.e. equalisation. Transfers can be used to “equalise” the LGs’ conditions for service provision and to bring the LGs closer to a situation where all of them, potentially, have about the same ability to provide basic services to the citizens. Extra resources are transferred to LGs with lower fiscal (tax) capacity and/or higher expenditure needs than the average national level;
- Correcting or adjusting negative or positive *externalities* with public goods provision. Grants may be used to compensate LGs for services they provide, which impact areas beyond their jurisdictions i.e. where there are positive or negative “spill over” effects. For instance grants can be provided to ensure that sufficient educational services are provided, and that the environmental issues are sufficiently addressed. LGs tend to look mainly on their own local needs, ignoring the impact this may have on other LGs. This may often lead to a sub-optimal provision of certain services in a country. However, the provision of education services in a LG may benefit other parts of the country (positive impact) and environmental pollution may affect areas beyond the LG borders (negative impact). Another example is immunisation/vaccinations which may be provided at a level less than warranted from a society perspective, if left entirely to each LG;
- Closely related to the third objective, - coordinating, harmonising and influencing LG spending with central government goals may also be an objective. Various forms of grants may be used to stimulate LG spending within national priority areas/standards⁷. It is important to stress that a transfer system should as much as possible ensure budget autonomy and flexibility at

mentioned by Broadway and Shah (2009) it is important to keep the system simple and pursue to focus on the core objective in each grant scheme.

⁵ Particularly due to the fact that many taxes are most suitable for the central government level.

⁶ Reference is made to: The Reform of Intergovernmental Fiscal Relations in Developing and emerging Market Economies, Anwar Shah, The World Bank, 1994 for a review of the importance of LG equalisation systems, especially in developing countries. Equalisation systems equalise net fiscal benefits across LG (promote equity) and discourage fiscally induced migration, reduce barriers to factor mobility and thereby, if properly designed, facilitate economic efficiency.

⁷ See Broadway and Shah (2009, p. 237) for discussion of this objective.

the LG level and should not lead to a micro control of the LG expenditure priorities;

- *Ensuring efficiency in LG revenue mobilisation, financial management and utilisation of funds.* It is important that transfers do not create negative incentives for LG taxation and expenditure management. Grants may be used to stimulate LG performance, e.g. within the area of tax effort, financial management, good governance and/or other areas⁸;
- Providing central government with adequate *flexibility* to pursue macroeconomic stabilization policy and influence the overall activity level within the LG sector. The CG may wish to ensure that the overall activity level in the national economy can be adjusted, and the size and distribution of the fiscal transfers may be an important element hereof. This objective should be balanced against another objective, which is to ensure that the transfers are predictable, stable and transparent seen from a LG perspective to ensure appropriate local planning and budgeting processes.

In addition to these genuine objectives of transfers, there may be more informal objectives such as CG attempt to control LGs, and/or wish to offload underfunded functions – and push so-called unfunded mandates to LGs with insufficient compensation as part of a strategy to reduce CG budget deficit. The design of the transfer system and the allocation criteria will depend greatly on the main focus and specific priorities of these objectives.⁹

2.2 Typology of Transfers

Typology

In theory and practise there is no uniform classification of transfers, but the typologies below, provide an overview of most applied grants and a taxonomy of: i) the determination of the size of the transfer pool; (ii) the determination of the distribution of the resources between qualifying local government jurisdictions, and (iii) the guidelines and conditionalities imposed for the use of funds at the local level.¹⁰

The first division is whether the grants are specific/conditional, i.e. the grants can only be spent on specific purposes (categorical) or general purpose/unconditional (non-categorical). The grants may be used to finance a broad range of services. Within each of these broad categories¹¹ an additional sub-division can be made in grants

⁸ Please refer to the Paper: *Conceptual Basis for Performance Based Grant Systems and Selected International Experiences*, by Jesper Steffensen and Henrik Fredborg Larsen, 2005 for an overview of the performance based grants and a forthcoming publication on the same subject by UNCDF, Jesper Steffensen (Draft 2009).

⁹ However, there are many international examples of transfer systems, which have created problems in achieving some of the stated objectives and which provide conflicting signals and impacts.

¹⁰ The classification is a further development of the typology made by Stephen J. Bailey, “*Local Government Economics – Principles and Practise*”, Glasgow Caledonian University, Macmillan, 1999. The focus in this paper is on the allocation principles, but the typology may give a brief overview of some of the key types of grants.

¹¹ If grants are defined for use on either specific recurrent costs or capital investments, they may be viewed as specific, but not sector specific. The figure deals with the sector specific – non-sector specific distinction. This means that each of the two strings may actually be divided in recurrent and development grants.

targeting development (sector-specific and non-sectoral grants) and grants for recurrent purposes (sector specific or non-sector specific)¹².

Second, the grants may either be lump-sum, i.e. a fixed amount, or based on a matching principle, implying that the LGs have to cover a given percentage of the expenses, e.g. 5-10 %. In addition, both the lump-sum and matching grants may depend on the LG effort, e.g. the tax effort or financial management efforts (reporting standards, etc.) and/or service output measures. The matching grants can be closed ended, i.e. there is an upper limit for the grant or open ended, i.e. depending on the actual costs and activity efforts by LGs.

In addition to these distinctions, grants can be classified by the way the overall *size of the pool* of resources is determined and the way the *grants are distributed horizontally* across the local governments, see the table below, which is a further adaptation and adjustment of Roy Bahl's and Johannes Linn's (1992) typology¹³, particularly with inclusion of performance-based grants.

Below is a grant typology (see table 1), based on an internationally recognized categorization, adjusted to take into account the new features associated with the PBGS approach¹⁴. Grants can be classified by:

1. The way the overall *size of the pool* of resources is determined, and;
2. The way the *grants are distributed horizontally* across LGs.

Table 1: A Taxonomy of Intergovernmental Transfer Programmes and Examples				
Method of determining the total divisible pool				
Method of allocating the divisible pool among eligible units	Share of national tax revenues	Ad hoc decision or programme specific	Reimbursement of expenditures	Allocation based on estimates/measures of the relative total LG expenditure needs and revenue mobilisation capacity
1) Origin of collection of the tax	A Philippines	--	--	...
2) Formula	B1 Philippines** Indonesia Ghana (DACF) Rwanda (LASBF)	B2 India-BRGF	--	B3 Some of the Nordic Countries Philippines**
3) Total / partial cost reimbursement	C1	C2	C3 Many countries in OECD, e.g. Denmark	---

¹² This is an important distinction in many countries, e.g. Yemen, Ghana, Uganda, Tanzania and Cambodia.

¹³ And inspired by the Fiscal Primer: *Fiscal Decentralisation and Poverty Reduction*, UNDP, April 2005.

¹⁴The table is an adaptation of the typology used in Bahl & Linn (1992) and Bahl (1999), adding the PBGS features.

4) Ad hoc decision	D1	D2 SOI- recurrent grants Zambia (capital grants)	--	D3
5) Performance based (may be combined with 1-4.)	E1 (Ghana-DDF) Tanzania (2009)***	E2 E.g. Uganda (LGD) Tanzania-(LGSP)*** Nepal - (LGCDP) Bangladesh Indonesia Pakistan and many others, see annexes 3.1-3.3	E3 (E.g. Denmark, Japan and Canada)*	E4

Source: Adapted from Bahl (1999) and Bahl & Linn (1992), combined with the features of the PBGS.

* Kind of performance-based funding through the many conditions attached to some of the grants.

** A rough estimation of the expenditure needs of each tier was conducted at the start-up of devolution, but this is currently being up-dated. The adjustment has been in group B1 as it is now a fixed % of the national revenues. The coming PBGS (planned) will be based on a rough estimate of the required size, i.e. (E2)

*** Government of Tanzania has moved from a project specific allocation to an allocation based on a specific % of the public revenues.

Transfers can be distributed to LGs as (conditional or unconditional) formula-based transfers (Type B1, B2 or B3 transfers). Alternatively, transfers can be designed as "ad-hoc" grants where central government has discretionary power (Type D1, D2 or D3), or as full or partial reimbursement of actual local expenditure (Type C1, C2, or C3 transfers). The formula based transfers are sometimes based on detailed calculations of the overall expenditure needs of the local governments (Type B3)¹⁵ Even the size of the overall ad-hoc distributed transfer pool (no clear formula applied) may be based on some overall measures of the total need of all LGs (Type D3), but this model is rare.

Transfers can also be provided in the form of revenue sharing, whereby local governments receive a share of certain revenues collected within their boundaries (Type A). Revenue sharing is considered as a form of transfer when the LG has no control over the tax base, the tax rate, tax collections or the sharing rate (e.g. the Local Development Fee in Nepal or the sharing of wealth taxes in the Philippines).

Finally, and more recently, a number of countries¹⁶ have introduced more performance-based grant (PGBS) allocation systems, where the size of the grants is adjusted against the local governments' performance (type E1, E2, E3 and E4), typically based on calculations of the appropriate expenditure needs to be covered by the system, rough estimates or availability of funding, reviews of absorptive capacity, minimum level required for meaningful investments, etc.

¹⁵ Attempts to make these overall calculations of expenditure needs have been undertaken in a number of countries, e.g. the Philippines, Indonesia, Uganda, Latvia and Estonia. Although it is hard to define detailed needs, these surveys have provided some indication of outcomes of existing revenue sharing arrangements and future directions in the allocations.

¹⁶ E.g. Kenya, Uganda, Tanzania, Ghana, Nepal and Bangladesh. Other countries, like the Philippines and Indonesia, are preparing similar schemes.

As most PBGSs have been launched by specific projects or national programmes, they are classified as category E2, as the size of the funds is allocated based on the overall *programme specific* considerations. A formula-based basic allocation formula is used and allocations are then adjusted against the LGs' performance. Some of the countries could potentially move towards types E1 or E4 when further studies of the overall fiscal system are conducted¹⁷ and when the overall LBs' fiscal need versus their revenue potential is further defined. In Ghana the system approximates to type E1 features, as the PBGS is funded partly from the revenue sharing grant (the District Assemblies' Common Fund). Tanzania has also recently moved towards this type of system with GoT's contribution to the overall PBGS funding pool set as a specific percentage (2 %) of the Government's total budget¹⁸ (model E1), although the size has not been based on detailed calculations.

Capital versus Recurrent

The targeting of grants towards capital and/or recurrent expenditures has been a subject for intense discussions in most countries.

Grants can be divided in the following way, reflecting two dimensions:

- 1) Recurrent – capital; and
- 2) Sector – non-sector specific.

Table 2: Recurrent versus Capital and Sector versus Non-Sector Specific

Table 2: Grant – Taxonomy	Sector – Specific*	Non-Sector Specific
Recurrent (operational and maintenance costs)	A.1 E.g. grants for salaries to finance school teachers.	A2. Non-sectoral grants with earmarking for recurrent expenditures, but LG discretion to use the funds across the sectors according to local priorities.
Capital	B1. E.g. grants for the construction of class rooms.	B.2. E.g. capital investment grants for discretionary spending on various sectors (typically various forms of local development funds).
No limits on the type of expenditure to be funded in terms of capital or recurrent costs	C.1. Grants to finance all kinds of expenditure within a specific sector (sector specific conditional grants).	C.2. Unconditional grants with no limitations on utilisation (or a very short "negative list").

(*) In some cases, spending may be further "earmarked" for specific purposes. In some cases modifications of these standard types are practiced, e.g. capital grant schemes may allow a certain percentage for preparation and monitoring of projects (so-called investment servicing costs) or a share for administrative costs.

¹⁷ Indonesia and Uganda (2004-05) have invested considerable effort into analytical work aimed at defining the expenditure needs of various LG functions.

¹⁸ Excluding budget expenditures for debt-servicing and the like.

Most of the performance-based grants are in group B.2¹⁹ as the objective is to promote larger investments in infrastructure and service delivery, but with a maximum percentage set aside to finance investment servicing costs (planning, appraisal, M&E, see Chapter 3). These grants are especially attractive to LGs, as they are largely discretionary in nature and thus allow for a higher level of autonomy on the part of local decision-makers. They are typically targeting capital grants, as they are easier to adjust than recurrent grants (such as those for salaries), which have a high fixed cost element.

A grant may finally be defined along another dimension - as: 1) "development grants", which include some capital investments, but also other types of expenditure (see below)²⁰; and 2) non-development oriented grants

Table 3: Capital versus Development

Capital/Development Distinction	Development expenditures	Non-Development Oriented Expenditures	No distinction between dev. And non-dev.
Capital expenditures	A.1. Capital development investments in development oriented areas, like health centres, schools, roads, agriculture (construction and rehabilitation). Capital grants	A.2. Luxury vehicles and administration buildings (depending on the needs).	A.3: All capital expenditures without limits.
Recurrent expenditures	B.1. Capacity building Awareness raising campaigns. Expenses related to the operations and maintenance of core capital investments, (health, education, water etc.) Capacity building grants.	B.2. Administrative expenses in non-core areas.	B3: All recurrent expenditures without limits.
No distinction between capital and recurrent	C1: Grant to finance all development- oriented expenditures. Development grants.	C2: Grants to finance all non-development oriented expenditures.	C3: All expenditures allowed.

Development transfer schemes are frequently supported (or co-funded) by various donor programmes, and may have a restricted investment menu with a "positive" list

¹⁹ However, there are examples of PBGS with a broad investment menu, including both capital and recurrent costs (e.g. the LATF in Kenya).

²⁰ See Tidemand, Steffensen, Pyndt et al. (December 2003: Volume II) for a discussion of these issues. Some countries therefore categorize certain grants as "capital development grants", mixing the two concepts to enlarge the investment menu (e.g. Tanzania).

(of eligible expenditures) and/or a negative list (of non-eligible expenditures, such as expenditures on religious activities or luxury items).

The PBGSs usually focus on capital expenditures (group A.1.), with incentives to use the funds for development oriented expenditure areas²¹. One of the reasons for this is that it is easier to adjust flexible capital investments, rather than the often more “fixed” recurrent costs.

The capacity building grants to LGs are defined as recurrent (development oriented)²² expenditures in group B.1, and are often part and parcel of many grant systems, particularly the PBGSs.

Factors to determine the type of grant

It is generally accepted that no universal grant model is applicable to all countries around the World and the best model depends, among other factors, on the:

- Objectives of the Government
- Type of local government
- Size of local government
- Type of LG mandatory functions
- Cultural context of the country, historical experiences etc
- The horizontal disparities in fiscal capacity and expenditure needs across LGs
- Administrative capacity and absorption capacity at the local level etc.

Especially the type of *functions* assigned to the LG level is important. Generally, LGs’ functions can be divided into three types:

1. *Agency functions: The LGs perform tasks and services without own influence (or little influence) on the level and quality of the services – the LGs perform the functions on behalf of the central government as agents (e.g. some types of pensions or teacher salaries)*
2. *Partly agency functions: LGs have only partial influence on the level and quality of services they provide e.g. primary schools in many developing countries today, where the LGs perform the tasks but with a number of norms and standards and where the teachers salaries and many other cost items are financed and controlled by central government;*
3. *Discretionary functions: The LGs have a strong control and responsibility over the services and the level and quality of these services themselves (e.g. administration, certain health care functions and local roads).*

The table below illustrates the principles for the relationship between type of functions and the typical transfer schemes and the areas naturally funded by LG own source revenues:

Table 4: Relationship between the type of function and their finance:

²¹ Some countries, like Ghana, Nepal and the Solomon Islands allow LGs to spend a certain percentage of their PBGS allocations on recurrent costs, but exclude other types of expenditure, defined in a negative list.

²² Except in Bhutan where expenditures to training are classified under “capital expenditures”.

Type of Function/Financing	Local government financing	Financed by central government e.g. through grants
Pure Agency functions	(-) Limited own financing	+ Specific grants to encourage the LG to supply service, especially where certain minimum standards are necessary.
Partly Agency functions	+/- Partly funded by own LG revenue sources, partly by grants from centre	+/- (Partly by grants, especially specific "earmarked" grants)
"Own decentralised services" The LGs have full discretion on the level and quality of the services	(+) Funded by LG own source revenues- e.g. through taxes, fees and user charges	Supplementary funding by general grants with the objective to correct horizontal imbalances and fill in the fiscal gap (unconditional or equalisation grants)

2.3 Overall principles for Grant Design

Although the manner in which a transfer program is structured and the method used to divide the funds among eligible LGs should be based on the policy objectives, that the transfer scheme seeks to achieve, international experiences have given rise to a number of universal principles and practices that should be pursued in the design of all intergovernmental fiscal transfer systems. Some of the main principles are listed below, and should be monitored closely when reforms of transfer systems are initiated and implemented²³.

Principles for Grant Design:

1. Keep the objectives clear and transparent and design the system accordingly, and keep the number of objectives behind each grant to the bare minimum;
2. Contribute adequately to the funding of the vertical fiscal imbalance between assigned tasks and own revenue sources,
3. Address the differences in *fiscal capacity* and the *expenditure needs* of the LGs;
4. Preserve budget autonomy: A transfer system should preserve budget autonomy at the local level within the constraints provided by national priorities
3. Support, not undermine, decentralisation and local revenue raising;
4. Ensure a minimum number of different systems of transfers and transfer modalities;
5. Transparent, formula and needs-based allocation across local governments enhancing horizontal equity (pro-poor);
6. Ensure stable, predictable and timely transfers;
7. Enable LG flexibility & initiative within national policy;
8. Involve and strengthen the whole LG structure and consider various types of units;
9. Ensure upward, downward & horizontal accountability. This will include simple, targeted, and consolidated reporting systems;
10. Achieve public participation and transparency;
11. Base the system on the availability of data and keep it as simple as possible;

²³ The principles are largely drawn from the Report: Fiscal Decentralisation in Uganda – The Way Forward, Final Report, January 2001.

12. Ensure proper incentives to improve on administrative performance and service provision, e.g. through rewarding proper initiatives and penalising inefficiency;
13. Link the transfer reforms to other LG reforms and initiatives, especially the LG finance system (taxes, user charges) and the capacity building activities;
14. Keep track on the actual implementation of the system, i.e. the transfer flow;
15. Adjust the system to new LG structures, tasks and responsibilities and ensure proper transitional schemes;
16. Keep the overall system and the criteria for allocation as simple as possible to ensure understanding, support and administrative feasibility.

On the other hand, the transfer system should **not**:

1. Base the size of the transfers on the existing infrastructure and services (service outlets), i.e. should not be a gap filling grant, as this provides disincentives to improve;
2. Bring about sudden and large changes. (the system should consider whether the LGs should be held nearly harmless during the transition);
3. Be subjected to political interference in the allocation of funds during the FY;
4. Cover deficit and financial mal-practice as this will create disincentives to improve on financial management;
5. Be solely based on an equal share approach as this does not consider the different needs in the various LGs;
6. Be based on criteria, which can be influenced and manipulated by the LGs
7. Establish multiple conditional grants, which undermines local autonomy and flexibility.

As mentioned, some of these principles may require significant time to implement in practice, e.g. the wish to improve LG incentives and reward good performance. However it is important in the short term that the formulas for allocation are not penalizing LGs, which have managed to improve own revenue generation and have made an effort to improve on the service provision and coverage of infrastructure. It is also important to note that it may not be possible to achieve all the principles simultaneously, that conflicts may emerge and that certain trade-offs are needed, e.g. a flexible system adjustable to new LG functions may not be fully stable and predictable. Similarly a strong incentive system may, if not properly designed, contradict the equity objective.

2.4 Allocation Criteria

2.4.1 Overall Method and Criteria

The allocation criteria and the weight of each of the criteria determine the horizontal distribution of the grants across the LGs. In practise intergovernmental fiscal transfers may be divided amongst LGs according to four different methods: ²⁴

- 1) Origin of collection, i.e. sharing of the taxes collected within the LG jurisdiction;
- 2) Formula based, with criteria and criteria weights;

²⁴ Intergovernmental Fiscal Transfers – Concepts, International Practice and Policy Issues (Draft, 2002) by Larry Schroeder, Syracuse University and Paul Smoke, New York University.

- 3) Cost reimbursements (partial or total);
- 4) Ad hoc based (based on decisions made by the granting Government²⁵).

In addition, more recently, a number of countries have introduced a *performance-based* element in the horizontal distribution of funds.²⁶

Although decisions are often influenced by political choice and “common sense” considerations, it is generally accepted that the allocation criteria should be based on the **principles** below, and that systems based on clear and objective allocation formulas are desirable.

The **criteria** in grant systems should generally:

Box No. 1 – Principles for Grant Allocation Criteria

- Pursue the *objective(s)* behind each type of grant and try to balance (appropriate trade off) the objectives if some of these are conflicting;
- Be formula based and based on *objective* criteria, (contrary to discretionary criteria where the grantor is free to determine the amount paid on the basis of subjective assessment or expediency²⁷);
- Reflect the variations in *LG revenue raising capacity* (for equalisation grants);
- Reflect the variations in *LG expenditure needs*, i.e. there should be a clear link between each of the criteria and the LG need to spend (especially for equalisation grants). They should respond to the *demand* for, rather than output of public goods such as infrastructure and/or institutions²⁸;
- Accurately reflect the specific characteristics behind each factor;
- Limit the use of equal shares, unless there are good reasons for this;
- Be drawn from sources that cannot be manipulated by the CG or LGs; They should generally be neutral for LG choice on the input side (unless there are strong reasons to pursue a particular method of service provision), e.g. the grants should not force LGs to establish new service institutions if other means to achieve the same objective are more efficient. A LG should not be able to influence the grant it receives by manipulating its expenditure decisions; An exemption from this may be in situations where there are good reasons for establishment of incentives, e.g. to achieve certain service targets or apply certain methods, e.g. participatory approaches;
- Be kept simple, transparent, predictable and stable from one year to another. It is e.g. generally proved that a few criteria can explain the majority of the variations in LG expenditure needs in many countries and few criteria preserve the simplicity and possibilities to achieve a transparent system. The number of criteria depends on the complexity of the LG tasks and the availability of data;
- Avoid *negative incentives* and preferably provide strong incentives for LGs to improve on LG administrative, governance and service provision performance;
- Not display a high degree of interdependence between the criteria and be easy to measure and up-date;
- Designed in a way where the criteria work together in a holistic and mutually strengthening manner to achieve the overall objectives, instead of sending conflicting messages and incentives.

²⁵ See Schroeder and Smoke, 2002, *ibid*.

²⁶ E.g. Uganda, Tanzania, Kenya, Nepal and Bangladesh (pilot). Please refer to to: Steffensen and Fredborg Larsen, 2005, *op. cit.* for further information about these initiatives.

²⁷ Council of Europe, “Limitations of Local Taxation, financial equalisation and methods for calculating general grants”, Local and Regional Authorities in Europe, No. 65, Edited by Mr. Jørgen Lotz, 1999, Council of Europe Publishing.

²⁸ This does not mean that output related incentives cannot be introduced in certain areas, but that these have to be introduced cautiously.

The transfers should generally avoid funding:

- ❑ Deficits in LG, e.g. caused by malpractices;
- ❑ Gap in the coverage of infrastructure;
- ❑ Systems which provides disincentives to collect LG own source revenues;
- ❑ Systems which distort service provision and provide disincentives for efficiency;
- ❑ Ad hoc arrangements;
- ❑ A large amount of equal shares transfers (each LG receive similar amount) as one size does not fill all.

2.4.2 Allocation Criteria

2.4.2.1 Classification of Criteria

Generally, most grant systems reflect one or several of the following features:

Table 5: Feature of Allocation Criteria

A) LG fiscal capacity (e.g. tax potential/tax base)	B) Expenditure needs (e.g. size of the population, number of people with special expenditure needs, etc.)	C) LG effort within various areas, e.g. tax efforts, financial management performance, etc.	D) Equal shares (lump sum to each LG)
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General purpose grant allocation formulas typically encompass criteria on (B) expenditure needs, but may also incorporate criteria derived from (A) - variations in fiscal capacity (especially if the general grants are also having an equalisation purpose) and C) LG effort and D) Equal shares to all LGs (particularly if there are expenditure needs which are basic for all LGs). These grants may also be formed to address equalisation purposes.

Equalisation grants are often based on criteria from (A) and/ or (B) eventually combined to a lesser extent with criteria (C) and (D), but may also include criteria from all four areas.

Sector specific grants, like grants within Health Care and Education, typically include only certain criteria from (B) expenditure needs and sometimes (D).

In practice most transfer systems pursue various forms of horizontal LG equalisation in order to address fiscal disparities and/or differences in expenditure needs and to enable all LGs in a country attain certain minimum capacities for service provision. This may be done by use of various sector grants, by a more holistic fiscal equalisation system or by a combination of these systems.

2.4.2.2 Grant Objectives – Type of Grants and Criteria

There is a complex relationship between the objectives of the grants, type of grants and the criteria applied in the transfer systems, see the Table below:

Table 6: Links between Objectives of the Grants and the Type of Grants

Purpose of the Grant	Ideal Type of Grant According to Economic Theory	Requirements of the estimation of LG spending needs and revenues	
		For the Calculation of the total size of the grant	For the distribution of the grant among recipient LGs ²⁹
Compensation of "spill over" effects and merit goods (purpose is to influence the LG choice in service provision to provide a better coverage of the entire society needs)	Conditional Open-ended matching grants	Estimate of spending needs in specific areas	Formula measuring activity and output in individual LGs
Equalisation (of spending needs)	Unconditional, closed-ended grant (lump sum)	Estimate depends on LG tasks and the complexity of these Identify "cost drivers", i.e. factors, which have an impact on the LG expenditure levels.	Formula for estimating objective spending needs in LGs based on objective criteria for expenditure needs, e.g. size of population, number of people with special problems, poor people etc. It should be distributed without attached conditions because the aim is to provide the LGs with equal opportunities.
Equalisation (of fiscal capacity) caused by disparities in LG tax base	Unconditional, closed-ended grant (lump sum)	Estimate depends on LG revenue source and the inequality of tax base (fiscal capacity to raise revenues)	Formula for estimating income base in LGs, various methods like representative tax systems (RTS), simple selection of proxy indicators for fiscal capacity, etc.
Economic stabilisation	Unconditional, closed-ended grant (lump sum)	Estimate of cyclical dependency in LG sector	Formula for measuring cyclical dependency in LGs
Support to reduce the fiscal gap between LG expenditure assignment and revenue assignments – fill in the vertical	Unconditional closed-ended grant (lump-sum)	Estimate of general gap between the LG spending needs and LG revenue potential	Formula for distribution of centralised tax base. The formula should be seen in relation to the equalisation grant

²⁹ See also the general principles outlined above, e.g. not to support inefficiency.

Purpose of the Grant	Ideal Type of Grant According to Economic Theory	Requirements of the estimation of LG spending needs and revenues	
		For the Calculation of the total size of the grant	For the distribution of the grant among recipient LGs ²⁹
gap			<p>formula and may be combined with this formula taking into consideration the disparities in expenditure needs and fiscal capacity</p> <p>A performance based component can be included in the distribution formula as well</p>
Grants to use the LGs as agents for CG service provision	Conditional grants	<p>Estimate of general spending needs in specific areas</p> <p>Open or closed ended.</p>	<p>Formula for measuring of minimum service levels in selected areas, reimbursements schemes or criteria reflecting the expenditure needs within specific sector, e.g. number of children in the school going age group</p> <p>This may be combined with various incentive schemes to perform more efficiently in service provision</p>
Related to the above: grants to ensure minimum standards for services across the nation	Conditional non-matching transfers		See above.
Regional development	Capital grants for investments in infrastructure	Estimate of the general need for infrastructure investments, absorption capacity and costs of typical investments	Formula for measuring the need for infrastructure investments in LGs without distorting the incentives to improve the situation. This may be combined with various incentive schemes.

Source: The table is a **further elaboration** of a model outlined in the publication. "Methods for Estimating Local Authorities' Spending Needs and Methods for Estimating Revenue", Council of Europe,

Local and Regional Authorities in Europe, No. 74, Report by the Steering Committee on Local and Regional Democracy (CDLR) prepared with the collaboration of Professor Jens Blom-Hansen, December 2000.

The **objective** behind the grant should always be the point of departure for the design. In practise these objectives, typically based on efficiency considerations, have to be balanced against other values such as LG discretionary power, democracy, accountability, transparency and incentive framework. The various grants should be reviewed holistically. For instance, a gap filling unconditional grants may also be used to pursue the equalisation objectives. The various grants have to work properly together on a mutually strengthening basis. Conflicting and complex multipurpose grants should be avoided.

Most countries³⁰ use a *combination of conditional (categorical) and un-conditional (non-categorical) grants*. The reason is a wish to ensure a proper balance (trade off) between on the one hand the wish of the central government to ensure local adherence to certain national minimum service delivery targets in key sector areas like Education and Health, to ensure that safeguards are put in place, e.g. due to weaknesses in the LG administration (planning, budgeting and financial management capacity) and develop some confidence amongst the funding agencies, that all funds are not diverted e.g. for salary purposes. This is promoted by conditional/earmarked grants. On the other hand, there is the wish to ensure local allocative efficiency, LG discretionary power and autonomy to adjust service delivery to local needs and priorities and to ensure local ownership and participation at the local tiers of governance, some of the main objectives of fiscal decentralisation. These objectives are promoted by unconditional grants with a high degree of local discretion.

2.4.2.3 Expenditure Need Criteria

The use of expenditure needs as criteria for allocation of grants to LGs varies typically from sector specific grants to general grants and/or equalisation grants.

For *sector specific grants*, expenditure needs criteria are often based on objective expenditure needs measures within a particular area, e.g. like school facility grants, where the number of children in the school going age-group may be applied. The criteria should reflect the main impact factor(s) on the size of the expenditure needs without being a subject for LG or central government manipulation (see above). Well-designed sector specific criteria often make it easier to define the general grant criteria (and equalisation grants).

For the *general grants* and the equalisation grants, the LG assignments and the functions, measured as the LG funding responsibilities (after deduction of sector specific grant funding such as user charges) are the point of departure. The keys steps are typically the following:

- a) The main LG mandatory tasks should be defined and their relative weight in terms of expenditures measured,
- b) The factors (and weights of these) impacting on the size of expenditure needs for each service area are defined, and the expenditure need (net expenditure

³⁰ E.g. various countries like Denmark, Uganda and Kenya

- requirements after deduction of sector specific income sources) of each LG calculated,
- c) The expenditure need of the LG is compared with the average expenditure needs for all LGs,
 - d) The equalisation of the expenditure needs may either be carried out by use of the general grant window or by a special system of equalisation grants.

Measurement of service costs (expenditure needs) is far from straightforward and requires clear demarcation of the LG functions, good reliable and up-dated data and knowledge on the costs of the (standard) service provision, experiences and knowledge about the impact of criteria on the expenditure level, well defined criteria for the service standards (e.g. average service level provided, or various types of standard minimum service levels). Ideally a test should be carried out on the reliability of the criteria in terms of impact on the expenditure needs through statistical estimations to find a correlation between possible criteria and expenditure patterns among LGs by use of regression analysis and other statistical methods. Data on promising criteria is then tested against data on expenditures within different functions. This method should be applied with due caution as LGs may not have a discretionary choice to decide on the expenditure pattern, other factors may disrupt the expenditure pattern, and sufficient data is often missing, etc. Therefore many countries opt for a more common sense approach where agreement is reached amongst the major stakeholders on the most feasible criteria (see next section).³¹

Generally, the allocation criteria and the number of these depend on the functions to be financed by the grants, and the complexity of services to be provided³². The allocation of general grants and equalisation grants should typically be based on **criteria** like:

- *Size of the Population*: This is typically the most important criterion in the allocation formulas for general transfers in most countries. The importance of the population-based component in transfer formulas reflects the assumption that a LGs' expenditure needs generally grow proportionally or largely proportional with the number of inhabitants in a LG. The size of the population is used in the general grant system in various countries like Denmark, Norway, Sweden, the Philippines, Nepal, Cambodia, Bangladesh, Solomon Islands, India, Tanzania, Uganda, Kenya, Rwanda and many others.
- *Demographic composition (population age structure)*: Experiences have shown that the demographic composition has a great impact on the costs of the LG mandatory functions, e.g. a high number of children in the school going age groups has a great impact on the LG costs within the education sector, number of elderly people on the costs within the health sector etc.; These criteria are applied in countries such as the Scandinavian countries, Germany, Australia, Uganda (in the equalisation grant scheme) and Tanzania, amongst others.

³¹ E.g. Bangladesh, Ghana, Kenya, Uganda, Tanzania, Nepal, Cambodia and the Philippines.

³² As mentioned by Jørgen Lotz "There is a balance between the degree of simplicity of the system and its ability to smooth out important differences on needs. If your criteria are not the best possible, the whole decentralisation will not work. Inefficiencies and personal inequalities will arise and result in political pressure for recentralisation. If the equalisation system cannot be designed to capture the important differences in expenditure needs, the system becomes politically unacceptable", Council of Europe, 1999.

- *Socio-population structure*: Some sections of the population need more support, e.g. in areas of diseases, areas with high unemployment rate, areas with refugees, etc. (examples of this is the Danish system where unemployment rates is factored in);
- *Costs of the Service Provision*: The costs of the same amount of services may vary from LG to LG due to other reasons than demographic factors, e.g. due to remoteness, lack of accessibility (geographically larger LGs will have to spend more on transportation, infrastructure and less possibilities for economies of scale and or bundling of services, e.g. due to low density of the population. The costs of services may also be higher in certain areas with higher demand on the goods (urban areas), and or less supply of labour, differences in salary costs, and various goods, etc. The impact of this has to be measured/ estimated, if possible by construction of a cost index reflecting the cost differences of various key LG goods and services across LGs;³³ (Nepal as an example has made a rough cost index, which is applied in the general grant system and the size of the territory is applied in many countries, e.g. in Uganda and Tanzania)³⁴;
- *Variety in level of service demands*: Certain areas or type of LGs may have a need for higher standards or additional services, like street lightning or solid waste treatment. The opposite may also be the case, e.g. in areas with a high level of poverty, where there is a need to spend more on water supply, health care and other services. Sometimes, proxies for this can be applied³⁵;
- *Level of Development as the Point of Departure*: Often, the existing distribution of infrastructure varies greatly from the more prosperous to the poorest LGs. This may lead to a wish to equalise the level of services by counting the number of schools, water taps etc. and provide additional sources to the LGs with a low endowment of specific services. Although the objectives behind this initiative may be noble and understandable, this procedure of tying the size of an intergovernmental grant to a particular *level* of infrastructure availability is considered a “bad” practice in design of LG transfers. The reason for this is that it creates disincentives to improve on the service delivery, as improvements will be punished in the following years’ grant allocation. It is therefore better to develop the other indicators, mentioned above, and/or combine these with proxies for poverty, poverty count, (poverty index) like Human Development Index and income/consumption statistics. Examples of countries, which are using poverty figures or proxies for poverty/level of development in the allocation criteria for some of the grants are: Nepal, Uganda and Tanzania;
- In addition, use of physical infrastructure measures should be avoided, e.g. the number of hospital beds or the number school class rooms to allocate grants amongst LGs. Similarly, the number of class rooms in a LG area is a very poor measure of the educational needs of LGs. Wealthier LGs, with greater resources available for education, would likely have more class rooms and thus receive more compensation per capita under such a scheme, while poorer LGs would receive fewer resources. Thus, allocating resources in proportion to *existing capital infrastructure* would perpetuate historical disparities over time.

³³ These criteria are typically applied at a rather advanced stage.

³⁴ Yemen uses the criteria in the opposite manner, where the population density is a contributing factor in the allocation system.

³⁵ Norway is an example of a country, which is supporting defined remote areas in the Northern part of the country and Denmark provides special support to the islands.

2.4.2.4 Expenditure Need Criteria in Equalisation Grant Systems – the Weights³⁶

Generally, there are three overall methods for the development of the weights of the various criteria in the equalisation of expenditure needs:

- 1) The expenditure **norm** principle;
- 2) Expenditure, which actually appear in the LGs budgets and accounts, based on standard/ **average** costs and
- 3) Common sense estimates

Ad 1: Expenditure norm principle³⁷

The principle behind this system is that the central government defines the service level for various LG services, the expenditure norms are fixed, defined according to what is expected to be the feasible service level, i.e. the so-called minimum standard service level. A total expenditure norm is calculated as a sum of all the expenditure norms in the various sector areas. This model implies that the central government has formulated fixed standards and detailed costs calculations for all service areas, and types of LGs, or that such standards can be estimated during the course of the work on the allocation criteria. International literature and experiences normally suggest that this model is very challenging and often not feasible or appropriate. It should also be stressed that the model can lead to a rather centralistic model, where the LGs are forced to spend the standard amount on various services despite local variations in wishes/needs. This will be against the basic ideas behind fiscal decentralisation, and lead to wastefulness and inefficiency in resource allocation.

Indicative minimum service standards and costs calculations, might be useful in other areas, e.g. in the development of compensation schemes when tasks are transferred vertically, between levels of governments, in the calculation of the revenue sharing schemes between levels of government and in the current central government-LG dialogue on service targets. A more consultative approach where LGs and CG, in common, agree on some standard costs for key mandatory services and apply these standards in the criteria allocation systems with defined weights, may be applied. However it is important that these standards and criteria are not be applied as rigid demands to spent exactly the minimum amount (e.g. X amount of US\$ per child on health care) of funds on a particular service area.

Ad 2) Calculations based on actual average expenditure

The actual average expenditure model is applied in a number of countries. The level of sophistication may vary from common sense calculations to very detailed regression analysis, based on more or less detailed data sets. The principle is to review the present or historical LG composition of expenditure across the key sector areas, i.e.

³⁶ As mentioned by Anwar Shah: “Expenditure needs should – as point of departure - be defined as the cost of supplying average performance level for the existing mix of state-LG programmes, without applying subjective standards such as “minimum service levels” or “reasonable service levels”, Shah, 1994.

³⁷ This system has typically been applied in the Federation of Russia and in a number of the Russian republics.

education, roads, services for elderly people, social welfare, administration, utilities etc. for the most recent finance years, and review the percentages of the budget transferred to these areas, e.g. 20 % on Education, 10 % on Water and 15 % on Health.

The second step is to decide on the standard costs (typically average costs) of these services, e.g. expenditure per child in the primary school for the average LG.

The third step is then to find the factor, which has important impact on the level of expenditure for the specific group of expenditure (the "cost drivers"). An example could be in Education, where the number of children in the school going age group may be a good criterion, or reviews may show that there are other factors, which might have a major impact on the expenditure level, e.g. the poverty level. Regression analysis may be applied to identify the exact criteria for expenditure needs and the exact weight of this criterion (to identify links between the criteria and the expenditure levels). Alternatively, assumptions on this can be made from the beginning of the calculations, e.g. it may be assumed that the number of children between 7-18 years old is the most important factor to determine the expenditure level. Many countries use a combination, where common sense considerations play a significant role. Regression analyses are often not feasible due to lack of sufficient data, or equally important, if the LGs have limited autonomy to decide on the mix of services. In this case the existing composition of the budget expenditures is out of tune with the local needs and the calculations would not reflect the real needs.

Ad 3) Common Sense

In practise the development of expenditure need criteria is not an easy task. The mandatory tasks have to be defined and the expenditure needs of these tasks should be calculated, using a detailed breakdown of the expenditures according to a standard account plan/coding system of LG expenditures. Certain compromises and rough estimates have to be made and often rough estimates of the relative importance of various criteria are used, and further defined through dialogue with various stakeholders (e.g. Bangladesh, India, Tanzania, Nepal, Rwanda).

In the **development of the criteria for expenditure needs** it is important to consider the following:

- The criteria should be *closely related to the tasks* that the LGs are expected to perform. If various types of LGs have various types of mandatory tasks (e.g. rural and urban authorities), the criteria should be different as well (both the numbers of criteria and their weights).³⁸ In general, only the mandatory tasks should be included in the transfer system.
- The criteria should be discussed in a close *dialogue* between the central and LGs and decided by an official body, preferably ultimately by the Parliament with a broad democratic mandate. A second option is that decisions are made by a key ministry/intergovernmental fiscal body after careful deliberations with the LG stakeholders. It may not be possible to agree with the LG

³⁸ E.g. in Denmark the expenditure needs criteria are not the same for the counties and the municipalities, as their tasks are different, e.g. the municipalities have no hospitals.

representatives as equalisation implies that some of the LGs will be “winners” and other “losers”, but it is important to involve the expertise from that level in the dialogue and listen to their voice.³⁹

- The criteria should be “*objective*” meaning that they cannot be manipulated by the LGs. It should not be possible for the LGs to receive extra funds, just because the LGs choose e.g. to establish artificial places in the kindergartens, seats in the classrooms and construct roads where they are not needed. Support to specific services or specific service provision methods (e.g. investment in institutions) may distort (bias) the local priorities away from the most efficient mix of service provision at the local level;
- There should be a *close relationship between the criteria*, e.g. number of pupils in school going age group for the primary school, and the *expenditure needs* (causality link). The exact relationship can sometimes be calculated by use of statistical analysis or assumed by common sense considerations and/or pilot tests in various LGs;
- The *demographic criteria* (size of the population, size of the population across various age groups, children, people in the working age, elderly people etc.) are often the key criteria and may explain most of the variations in the expenditure needs across LGs. Other criteria, such as Km of roads, and population density (less density, often drives the costs upwards) might also be included. It is often appropriate to use the “number of inhabitants to explain the residual expenditure (general administration costs, general public service etc.), areas which cannot be explained by more specific factors;
- A *gradual development* of the criteria is often a feasible way. The available information/statistic has to be considered in the selection of criteria. As the information, e.g. on the LG service level and needs is developed, the criteria can be further specified.⁴⁰
- There is always a tradeoff between the wish to develop a 100 % fair and “ideally correct” system, achieving all its objectives (which can never be fully achieved) with many criteria and the wish to keep it *transparent*, simple and political feasible. It is generally better to explain 90 % of the variation in expenditure needs by use of 5-6 criteria than to explain 97 % with 30 criteria. An appropriate balance/trade off should be established between these conflicting objectives. The experiences from many countries have shown that 7-10 criteria can explain most of the variations in expenditure needs. The system does not have to be as complicated as some of the experiences in e.g. European countries. Few key criteria, based on number of inhabitants, key demographic criteria and the size of the units, will often be able to explain most of the variations in expenditure needs.

³⁹ E.g. in Uganda, the Constitution, 1995 states that the LGs have to be consulted in the design of the criteria for the conditional grants.

⁴⁰ E.g. the unconditional grants in Uganda have been distributed according to two main criteria: 1) number of inhabitants (75 % weight) and 2) size of the LG in terms of Km² (25 % weight). Other criteria for equalisation grants have been adopted from 1999.

- The criteria should reflect the *net costs* of service provision, i.e. after deduction of the revenues from various *specific* grants and user charges/fees. Otherwise, there is a risk that the system will lead to double counting;
- If indexes for expenditure needs are applied, e.g. HDI or cost index, they should be weighted, e.g. the HDI figures should be multiplied with the number of people in the local area and not just imputed in the model without a weight;
- LGs with special characteristics should be considered. These issues may often be most appropriately addressed by use of special grant schemes, e.g. special grants to islands, and depressed areas.

2.4.2.5 Criteria to be Avoided

In practise, the selection of criteria varies greatly from country to country. Nevertheless, there is a common agreement about certain criteria, which should be avoided in all cases.

First, criteria, which create bad incentives (called perverse incentives), should be *avoided*. Examples of these are criteria, which have a negative impact on the LG tax effort or financial management efforts, e.g. CG financing of a LG with fiscal problems caused by malpractice (“bail out”) or problems with the financial management procedures and reduction of grants if and when the LGs increase the collected taxes.

Second, the availability of infrastructure should not be used a direct criterion for allocation. If for instance a higher concentration of schools, classrooms or water facilities causes a reduction in the grants, the LGs will have no incentive to improve service provision as they will be “punished” by a reduction in their grant allocation in the subsequent years. On the contrary, if grant allocation is based on a specific factor like the number of classroom constructed (specific service outputs) the LGs may have an incentive to focus exclusively on this factor (specific part of the services) neglecting other important areas such as schoolbooks, hiring of teachers etc., i.e. leading to a severe distortion of local preferences and allocation efficiency. This may impinge on the whole idea behind decentralisation.

Finally, grant allocation criteria should avoid creating systems which provide disincentives for LGs collect own source revenues; systems which distort service provision and provide disincentives for efficiency; systems which are based on ad hoc arrangements and systems, where a large amount of equal shares transfers⁴¹ (each LG receive similar amount) as one size does not fill all.

2.4.2.6 Transfer Criteria on Fiscal Capacity (Revenue Potential)

The revenue raising ability of LGs is important especially when it comes to general grants and equalisation systems. There are a variety of methods being used to measure LG ability to mobilise own source revenues and to incorporate this in the transfer systems. If the central government wish to equalise the LG revenue raising

⁴¹ A high amount of equal share may also introduce strong incentives for proliferation of LGs.

capacity and to provide more resource to LG with lower potential to generate revenues, various options exist. There are basically two approaches⁴²:

- 1) The macro-economic approach
- 2) Representative tax system (RTS) approach

The first approach, the macro-economic approach, focuses on identifying a single proxy for the revenue raising capacity, like the regional/local GDP or the regional/local personal income. The advantage of this is that it is simple. But the disadvantages are that: i) It fails to account for the ability to tax citizens outside of the boundaries of the LGs, ii) it assumes that LGs make an equal effort to collect taxes, iii) it does not consider the variations in types and potential of taxes/revenues across the LGs and finally iv) these figures may not be available for all LGs.

The second approach, applied in different forms in various countries⁴³, is to focus on the tax potential for each of chief LG taxes, also called the representative tax system (RTS) where all major revenue sources of LGs are included. The representative tax system (RTS) consists of national average tax rates applied to all commonly used tax or revenue bases. The tax potential is measured for all key LG taxes and the differences from the particular LG to the average is measured and equalised by grants. The steps are the following: a) Determine the tax sources to be included in the RTS, b) define and estimate the tax bases, c) calculate the representative (average) tax rate and d) estimate the tax potential for each LG e) aggregate the results for all major LG taxes and f) compare the individual LGs with the average tax potential. It is important that the *tax potential* is applied, as application of the *actual* collected LG taxes will create disincentives to improve on LG tax administration.

In practice, there are often great problems in getting sufficient statistics and data to apply one of the two approaches and more pragmatic solutions are therefore applied in many countries, like incorporation of some poverty indexes on the expenditure side of the equalisation system or other transfer schemes⁴⁴, see the comparison in the table below in international experiences.

2.4.2.7 LG Effort – Tax and other Areas of Performance Criteria

It is well known that grants systems, if not properly designed, may induce poor incentives for LGs to raise own source revenues, especially when the local taxes constitute such a very small proportion of the total income that a large proportionate increase in local taxes will only lead to a very small proportionate increase in LG total funds for spending/services.⁴⁵

There are no clear theoretical economic reasons for inclusion of LG tax effort in the transfer schemes. Nevertheless there may be various political and administrative

⁴² See: “Equalisation Across Sub-National Governments, Fiscal Capacity”, by Serdar Yilmaz, Public Sector Specialist, World Bank Institute.

⁴³ E.g. in the present Ugandan EG system uses this in a simple form (GT tax estimated proxy) and Denmark (income and property tax).

⁴⁴ E.g. in Uganda, Tanzania and Nepal.

⁴⁵ Bailey, 1999, p. 205, Yilmaz, p. 38 and Bird, 2001, p. 4 (although the last author is sceptical towards introduction of the tax effort as an criteria due to lack of data and information).

reasons, founded in the way the LG political system functions in a specific country context and the LG politicians' incentive system. In countries like Uganda and Tanzania where the own source revenues constitute less than 15 %, there may be less incentives to focus on these smaller parts of the revenues, combined with political interests in keeping the taxes low. Therefore, fiscal effort may be included as one of the criteria in the allocation system in order to encourage LGs to exploit their tax potential and generate funding for better public services. However, this may generally only be appropriate under certain strict conditions and assumptions⁴⁶, among which the most important are: a) The basic data on the LG revenue statistics is available (preferably data detailing the LG utilisation of their tax potential) or at least good statistics on the development in revenues over the years, b) a clear knowledge that all LGs have a great non-utilised tax potential, c) a strong political wish to "boost" LG taxation in cases where the level (public sector) may generally be sub-optimal and provide a sub-optimal level of LG services and d) where there is a lack of strong local accountability, i.e. certain country specific conditions deriving from the features of the relationship between the politicians and the constituencies and/or a clear indication that the transfer systems create problems with the tax incentives.⁴⁷

Other performance related criteria, designed in a way where LGs receive a higher share of resources if they perform well within certain areas, may also be explored. There are typically related to administrative performance, public financial management and good governance, and have been piloted in a number of countries with encouraging results. The Ugandan Local Government Development Programme (LGDP)⁴⁸ is one of the good examples (models) of this. Good performance within areas such as planning, budgeting, accounting, accountability and transparency is rewarded and poor performance sanctioned through adjustment of the size of the capital grants. In Tanzania similar systems have been rolled out and other countries are currently developing the criteria⁴⁹. Typically these criteria are based on certain minimum access criteria such as the existence of development plans, approved budgets and accounts and compliance with certain functional capacity requirements and more qualitative performance measures, which are put in place to reward good performance and sanction poor performance. The lessons from these initiatives show that it is important to⁵⁰:

⁴⁶ In some of the literature on grants the usefulness of the tax effort as criteria is disputed, cf. e.g. Richard M. Bird and Michael Smart: "Intergovernmental Fiscal Transfers: Some Lessons from International Experience, University of Toronto, January 2001 and Anwar Shah: "*The Reform of Intergovernmental Fiscal Relations in Developing Countries and Emerging Market Economies*", The World Bank, 1994. It should only be used with caution and under certain conditions.

⁴⁷ This was the case in Uganda, and non-sectoral development grants under the LGDP II introduced tax effort incentives in the capital grant component. This is also being tested in countries like Ghana, Nicaragua and considered in other countries like Nepal.

⁴⁸ The Programme Midterm Review of the LGDP in Uganda found a lot of evidence to show the mutual and reinforcing relationship between the development grants, capacity building grant and the performance incentive system: "*Programme Review of LGDP*", February 2002, Jesper Steffensen, Emmanuel Ssewankambo and Gerhard Van't Land and Analytical and Preparation Report of LGDP II, September 2002. Other countries like Kenya, Tanzania, Senegal, Nicaragua, Punjab in India, have also introduced performance measures for some of the development grants.

⁴⁹ E.g. Sudan and Nepal.

⁵⁰ Please also refer to the Report: Incentive Based Allocation of Local Development Funds to Local Authorities: Experiences and Lessons, UNDP/UNCDF SDP Mwanza Region, October – November 2002, by Emmanuel Ssewankambo and Steffensen and Larsen, 2005 op. cit.

- Develop the Minimum Conditions (MC) and Performance Measures (PM) in full cooperation with the LGs – both the technical and political level of the authorities to ensure full understanding and support to the selection;
- Keep the MC and PM simple to understand, transparent, realistic and achievable;
- Ensure that the areas reflected can be influenced by LGs (endogenous factors), i.e. not dependant on exogenous factors, like legal changes, draught, etc.;
- Ensure that the MCs and PMs are closely related to the legal framework and supports the compliance;
- Ensure an appropriate link between the various indicators, avoid overlaps and contradictions;
- Technically possible to apply (i.e. objective, measurable and information is available);
- Politically durable – endorsed by councillors as fair and credible to be applied;
- Easy to interpret in a standardised manner;
- Ensure that the system is well known to the citizens and ensure that the system facilitates dialogue and accountability;
- Ensure that the LGs are supported to improve on the MCs and PMs, particularly through a strong capacity building support from the central government.⁵¹
- Neutral, independent and fair assessment of the performance.

The *management of these indicators*/the assessment of the performance is a great challenge and good organisation, information dissemination, feedback and quality assurance is critical for the success of the system. LGs should be well aware about the criteria and perceive the system as credible and fair. Systems based on performance criteria have typically been introduced on a project specific basis, related to generic performance and targeted to development grants, but some countries have rolled the systems out to cover the entire country, and others are planning to do so. Among the forerunners has been Uganda, which is considering to extend the principles to other national grants and to allow the LGs, which have proved to have better performance within key defined areas, more autonomy over the allocated sources, and within certain grant schemes, a higher per capita allocation.⁵²

2.4.2.8 Equal Shares Criteria

Equal shares are sometimes applied for general purpose transfers and equalisation systems, in order to ensure a minimum funding of certain key functions, e.g. like administration buildings, certain key functions (executive officers), etc. based on the assumptions that certain functions are necessary for all LGs. Most often these criteria are combined with criteria on expenditure needs and will seldom stand-alone (e.g. Denmark, Uganda, Cambodia and the Philippines)⁵³.

⁵¹ One of the strengths of the Ugandan LGDP has been the linkages between the development grants, the incentive framework and the capacity building grant (and support).

⁵² Refer to Fiscal Decentralisation in Uganda- Draft Strategy Paper, March 2002, prepared by Fiscal Decentralisation Working Group, p.12-13. This Strategy says that: “*a gradual reduction of central government control will be linked to improvements in capacity and performance of individual local governments*”.

⁵³ Equal shares are one amongst other criteria in transfer systems in various countries like Denmark (part of criteria in the general grants), Uganda (has been part of the unconditional grants), Ghana and Solomon Islands (part of the criteria in the main grants).

An exaggerated use of equal shares (high criteria weight) may lead to bad incentives and inefficiency in allocation (as various LGs do not have the same expenditure need). It can also lead to pressure to create a sub-optimal number of LG units. Secondly, and more importantly, the use of equal shares as a factor in the allocation formula raises a question of basic fairness. If the equal share system is used as an allocation principle, regions with fewer residents would receive much larger transfers per capita. This violates a basic principle of fairness in a democratic system of LG governance and may lead to a strong pressure to establish new and non-viable LG units.

2.4.2.9 Capital and Recurrent Allocation Criteria

Most of the general principles for the design of recurrent transfers also apply for the *development* (or more defined capital) grants. For development grants, additional criteria or rather conditions may be applied such as requirements that LGs have prepared adequate investment development plans and maintenance plans, involved constituencies in the priority making, proved that they are economically viable (co-funding requirements may be one way of indicating this), measures to ensure ownership and sustainability of the investments are in place, e.g. by use of matching grants formulas. The system needs strong systems, procedures and incentives to cater for the maintenance and recurrent costs implications of the investments.

In addition, it is important that there is a certain link between the size of and distribution of the transfers for investments and the size and distribution of the funds for recurrent costs. It will not be viable and sustainable to transfer large amounts of development transfers to LGs without ensuring sufficient funding of the recurrent costs for maintenance and operations. This means that the linkages between the recurrent and development transfer formulas should be considered and built into the design. Hence, the various formulae are mutually interrelated and should be reviewed in a holistic way, in order to ensure the right balance between equity, efficiency (sustainability), objectivity, and simplicity in the allocation system. If the grant formulae are not reviewed holistically, it will be nearly impossible to ensure a proper balance between the various objectives of the transfer system, outlined in Section 1.

2.4.2.10 Poverty Sensitive Criteria versus Criteria Reflecting Financial Sustainability

The various objectives need to be balanced in the design of every transfer system. For instance a highly poverty sensitive formula may in the short term contradict certain objectives on financial sustainability, if large resources are transferred quickly to areas, which do not have the capacity to absorb the funds and/or future potential for economic growth. On the contrary, systems entirely focusing on short term financial efficiency may contradict the medium and long-term objectives of balanced, sustainable growth and building up of sustainable systems and procedures in the medium to longer term. Table 7, overleaf, describes some of these issues.

Table 7: Poverty sensitive Criteria in the Allocation System

Poverty Criteria	Advantages	Disadvantages	Comments
Poverty sensitive allocation criteria	<p>Is typically in line with the government's development principles and announcements.</p> <p>Provide more resources to the weaker and poorest areas for development and thereby (at least in the short term) supports the objective of a balanced national development and country-wide reduction in poverty.</p> <p>A single LG fiscal equalisation system cannot cope with the large regional inequalities. Therefore the entire transfer system (each grant) has to be geared towards this aim.</p> <p>May attract more donor support from other programmes, and thereby pave the way for better coordination and mainstreaming of the various programmes</p>	<p>Put pressure on the absorption capacity in the weaker areas.</p> <p>The investments will not be provided in the high growth areas, which may lead to a negative impact on the efficiency.</p> <p>The challenges with the operational and maintenance costs will increase.</p> <p>Increase the demand for LG co-funding (if this is required) from own sources, which may not be readily available, unless this transfer system is designed in a very well balanced manner.</p> <p>May lead to a more complicated and non-transparent grant system.</p> <p>Limited data availability can cause problems in the calculations, e.g. in the identification of proxies for poverty indicators. It is often hard to agree on a definition of "poverty".</p> <p>Transfer systems cannot alone equalise the economic development, other factors such as growth potential, business</p>	<p>The design of transfer system needs to take a holistic review to ensure that the various criteria and schemes play appropriately together.</p> <p>Transfer systems should not be a stand-alone activity to boost economic development in the poorest areas, but should be linked to other poverty alleviation activities.</p> <p>As mentioned, there is a limit for the degree to which a system can suddenly make significant changes in criteria towards a more equitable allocation (if it is non-balanced), as the capacity to absorb has to be gradually developed.</p>

Poverty Criteria	Advantages	Disadvantages	Comments
		development policy, tax policy, natural resource endowments etc. should also be considered, and may be more important for a balanced growth.	

Table 8, overleaf, shows that the design of the allocation criteria varies greatly across the countries and depends on the specific country contexts in which the transfers are functioning.

3. Overview of Some Experiences from Design of Transfer Systems

The challenge to identify appropriate grant allocation criteria is enormous and recognized in the theoretical literature on transfer systems. It is also reflected in the international experiences where the search for the "best possible" allocation criteria is often guided by a mix of common sense, scientific calculations and political choice as a single "right" means is simply not present or data is not available to approach this. As all countries have several objectives behind their transfer systems, the general picture is very complex and in reality, a variety of transfer schemes co-exist in most countries. Priorities (tradeoffs) have to be made on the strengths and relationship between the various objectives. Table 8, overleaf, provides a brief introduction to some of the country specific allocation formulas to provide ideas for the future design in other countries⁵⁴.

The allocation criteria varies from transfer systems with more than 50 criteria in Japan, about 20 in Denmark, to less than 10 in some of the Central and Eastern European countries and 1-2 criteria in some developing countries, e.g. in Asia.⁵⁵ As mentioned in Section 2, these criteria tend to be gradually developed and fine tuned, and it is often appropriate to start with a very few simple, fair and objective criteria. Therefore, compromises have been made in most countries, where the theory has been combined with feasible common sense considerations and more practical studies and analysis. Finally, there has been a continued improvement in the systems and in the data applied in most countries, especially over the last 20-30 years.

A clear classification of the countries in the above-mentioned typology of grants and allocation formulas is not possible as nearly all countries apply more than one type of grant allocation formulae.

⁵⁴ Most of the data is collected in 2003. Some system may have changed since then, but the overview is aimed for generation of ideas, not an up-to-date international comparison of the existing systems. When new data is applied the most recent year is shown in bracket.

It is also important to emphasize that the list should not be seen as an overview of best practices, as some of the allocation formulas need to be reviewed and adjusted significantly to achieve their objectives.

Table 8: Overview of some Grants and Equalisation Schemes in Selected Countries⁵⁶

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
Examples from Africa				
Ghana⁵⁷ (2009)	<p>1) Many of the funding flows are routed directly to deconcentrated departments for personnel emoluments and administrative costs based on the payroll (i.e. not genuine transfers to LGs)</p> <p>2) Common Fund for capital investments</p> <p>3) District Development Facility</p>	<p>Ad 1: Based on number on the payroll – centrally administered</p> <p>Ad 2: The transfers cannot be less than 5 % of total public tax revenues. Formula approved by Parliament, includes criteria such as: Equal shares, status of the development, tax effort compared to the projected revenue, expenditure needs and contingency (floods, droughts etc.)</p> <p>Ad 3: The Facility (grant) which is a performance-based development grant is divided in 3 parts: 40 % for basic development grants, 40 % allocated based on performance and 20 % for CB. The basic grant is allocated using 3 criteria 40 % equal share, 50 % based on size of population and 10 % based on size of the LG territory. The performance is allocated in a system where each LG gets between 0-100 points in the annual performance assessment.</p>	<p>Finance the staff</p> <p>The Common fund should ensure equitable development of infrastructure and boost capital investments</p> <p>To support local development and LGs' incentive and capacity to improve performance in core functional areas such as financial management, governance and organisational management</p>	<p>The system is a subject for reform and the plans are at an advanced stage, which will significantly increase the funding for district development investments (2007). A new formula is being discussed.</p> <p>Decentralisation has taken root on the development side but not the recurrent transfer side</p> <p>The performance incentive is strongest for the smaller LGs, as the scoring index is not weighted.</p>
Kenya⁵⁸ (2006)	<p>1) Local Authority Transfer Fund (The size of the LATF is linked to the national income tax and constitutes at present 5% of the revenue from this tax. The long-term objective is gradually to increase the percentage of transfers to 20% of the income tax)</p>	<p>The allocation criteria for the LATF funds are based on the principles in the LATF regulations (transparent and predictable) and consist of three criteria:</p> <ol style="list-style-type: none"> 1) A basic lump sum of 1.5 Million Ksh to each LA; 2) Criteria weight on the population of each LA; 3) Criteria weight on urban population – resources allocated according to the relative size of the urban population (urban bias). <p>The weight of the criteria is adjusted every year. There are access conditions to the grants, which concern submission of budget, dept clearance letters etc. Compliance with these ensures that the LGs receive 60 % of their allocations. In addition, fulfilment of</p>	<p>1) The LATF was established through and Act of Parliament in 1998 to provide <i>resources</i> and <i>incentives</i> to enable LAs to improve on service delivery, strengthen financial management and accountability and eliminate outstanding current local debts.</p>	<p>LATF has piloted a performance based system and generated results in areas such as planning, financial management and debt reducing initiatives.</p> <p>Most funds to the local areas “by-passes” the local authorities, and the CDF funds is increasing fast, creating parallel funding systems.</p>

⁵⁶ As per the year in bracket for each country. Only selected examples of grants in each country are shown. The intension is not to cover the full range of intergovernmental fiscal transfers, but rather to provide some relevant examples.

⁵⁷ Ghana Fiscal Decentralisation Project, Design Report, CIDA project 400/1878, September 2002 and Central Government Transfers and Local Government Revenue, SNV, 2002 papers on transfer systems.

⁵⁸ Steffensen, Tidemand and Natoire, 2003.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
	<p>2) Smaller transfer schemes such as the road maintenance fund</p> <p>3) A number of competing transfers flows, e.g. the constituency development fund in increasing in importance</p>	<p>specific defined performance criteria (such as financial management and planning performance), provides additional (40 %) of the funds to the good-performing LGs.</p> <p>2) The road fund is allocated according to a complex system with several criteria, some on the km of roads, traffic volume, and rural – urban distinctions</p>	<p>2) Support the national targets within the Road Sector /Conditional grant for road maintenance).</p>	
Tanzania (2005) ⁵⁹	<p>1) Conditional grants with little flexibility</p> <p>2) Various basket funds and road maintenance funds</p> <p>3) Non-sectoral capital development grants (from 2004) and capacity building grants</p>	<p>1) Typically one grant with formulae per sector. A reform is ongoing to establish clear transparent allocation criteria based on expenditure needs instead of available infrastructure. An example of this is <u>health sector grants</u>, which uses the following criteria: 1) Population (70 %), 2) Poverty count (10 %), 3) Vehicle route mileage/distance (10%) and 4) infant mortality rate (10%).</p> <p>2) Earmarked to boost service delivery in these sectors (Education, Health and Roads). Formula based formulas.</p> <p>3) Clear formula-based: Criteria: a) Population (70%), b) Land /size of the LG territory (10%) and c) poverty count (20 %), d) adjustment (+/- 20%) for LG <u>performance</u> in key generic areas like financial management and good governance (upwards and downwards).</p> <p>The Capacity Building Grant is based on a transparent allocation formula reflecting the needs of various districts.</p>	<p>The conditional grants are the most important source for funding of local. They fill in the fiscal gap in the expenditure and revenue assignments.</p> <p>Support service delivery in specific sectors.</p> <p>3) Support development projects and minor capital investments + provide good incentives to improve performance in planning, budgeting, financial management, procurement and good governance.</p>	<p>A comprehensive reform is ongoing to improve the allocation criteria for all recurrent grants, establish <u>needs and formula based</u> criteria for allocation, starting with Health and Education. The reform will be introduced gradually. Abolition of certain local taxes have been compensated through new grants.</p> <p>A new performance based capital development grant scheme has being rolled out to all districts in the country to promote capital investments and to ensure LG planning processes and performance.</p>
Uganda (2009)	<p>1) Unconditional grants</p> <p>2) Conditional recurrent</p>	<p>Ad 1. The formulae has originally been designed with three criteria: 1) equal share (150 Mill UGSH), Size of the population (85 %) and 3) size of the local government territory/land (15 %). However, due to problems in the funding of the basic salaries, certain changes have been made in practice to ensure certain coverage of the salary expenditures (staff on payroll, size of population and size of the area), for the salary part of the allocation. The non-salary recurrent component is still using the 3 criteria.</p>	<p>1. To ensure that the basic administrative and political functions are covered by funding.</p> <p>2. To ensure funding for the sector specific objectives. The</p>	<p>The grants to LGs have more than tripled over the past 7 years. There is an ongoing reform to improve and simplify the transfer schemes, to merge some of the grants and to improve on the horizontal allocation.</p>

⁵⁹ President's Office- Regional Administration and Local Government – Key Documents on Fiscal Decentralisation in the Mainland Tanzania, April 2004 and Tidemand, Steffensen, Pyndt et al, PWC: Development of a Capital Grant System and Capacity Building Grant system, Final Report, Volumes 1,2 and 3, December 2003.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
Uganda (cont.)	grants and conditional capital grants (more than 20 of these) (10 % flexibility across some of the grants)	Ad 2. Formula based related to the expenditure needs within various areas. There are several grants within each sector Health, Education etc. each with their own allocation formulae, some based on existing infrastructure, staffing positions etc. other on objective expenditure needs. E.g. the school capitation grant is greatly influenced by the current enrollment rate in the primary schools There is a great need to reform some of these criteria as they are typically based on the existing availability of infrastructure and not seen to be sufficient poverty sensitive.	conditionalities are introduced to ensure that funds are spent within the sector to achieve the national poverty alleviations objectives.	The criteria for the various grants have been reviewed and new formulas suggested by a team of consultants/and the Local Government Finance Commission. The future system will be based more on the objective expenditure needs and outputs rather than on the existing stock of infrastructure and input.
	3) Equalisation grants (very small amounts)	Ad 3. Proxy for fiscal capacity (tax base) and a number of criteria for expenditure needs such as number of citizens in various age groups (5-14 years, 15-19 years etc.) km of roads, district area, livestock population etc. (rather complicated formula)	3. To equalize the revenue potential and the expenditures needs of the local authorities (districts and urban authorities)	The proposed criteria are based on objective criteria for expenditure needs within the various areas and poverty sensitive proxy indicators. However, the formulas are designed to avoid great changes in the short term in the existing size of transfers to each local authority.
	4) Capital development sectoral and non-sectoral discretionary grants	Ad 4) There are three criteria: 1) Size of the population, 2) size of the local government territory /land (15 %) and a poverty index. The grants are allocated only to LGs which pass certain minimum conditions, and LG which has a better performance in annual assessments are reward by 20 % or sanctioned by 20 % of the basic allocation	4. To support capital investments in infrastructure and service delivery and to promote good local government incentives in key generic administrative areas.	The sector specific formulas are regularly reviewed by the local government finance commission.
				The non-sectoral capital grant scheme has attracted a lot of attention due to its innovative features and various evaluations have proved its value.
Rwanda (2007)	1) Block grants for recurrent administrative expenditures	1) A new allocation formulas was adopted in 2006 with the following criteria : Size of the population (20 %), Poverty measured by inverse of revenue collected (20%), size of the area (10%), bonus for tax effort (10%), and finance gap between administration cost and collected revenues (40%).	Fiscal gap between expenditure needs and revenue collected	The criteria are transparent but tend to move in opposite directions.
	2) Various sector grants	2) Allocation criteria varies greatly, some using equal shares, other based on clients, other on estimated expenditure needs.	Fiscal gap and to promote specific decentralization sector reforms	The criteria are being reviewed as part of the sector dialogue. There is a need for a strong guidance of the sectors.
	3) Various programmes,	3) Allocation formula with population, coverage of water/sanitation		

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
	particularly the Common Development Fund (CDF) for capital investments	infrastructure, and other factors	Promote small scale infrastructure	The formulae for CDF may create disincentives to improve. The capital grant system is project specific and all investments have to be improved beforehand. There are multiple smaller grants and on and off-budget funding schemes, each with their own modalities.
South Africa⁶⁰ (2003/04)	Equitable share grant Specific purpose grants	Fiscal capacity and expenditure criteria : Number of poor households and the relative difference between the number of poor individuals and number of non-poor individuals, the costs of an estimated basket of basic services per households , population size, historical distribution in no. Of staff, household with services backlogs) E.g. grants for capacity building Infrastructure grants	Fiscal gap and equalization Specific services and purposes	Ongoing reform to streamline and consolidate (reduce the number of grants) the system and criteria.
Zambia (2010)	Recurrent grants Retrenchment grants Capital grants	Population factor in with a depreciation index of 5 factors with equal weight : 1) number of poor people, % of population lacking access to water, % of population lacking access to sanitation facility, % of households lacking access to input market and % of households lacking access to public transport Based on the relative level of debt within core areas such as pensions and salaries No clear formula yet, but from 2011 it is expected that the recurrent grant formula will be applied.	To contribute to the funding of core services and closure of the gap between expenditure and revenue assignments Restructure and reform the overall funding system, including targeting the problems with financially stressed LGs Boost the investments in infrastructure and service delivery	The formula may create disincentives to improve coverage of infrastructure, but formula-based allocation is seen as a major step forward towards higher level of transparency and predictability. The deficit grant has in-built problems in terms of incentives to improve performance. The capital grants have so far only been allocated to a few LGs.

⁶⁰ A. Shah: Chris Heymans in Local Governance in Developing Countries, World Bank, 2006.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
Examples from Australia				
Australia⁶¹ (2003)	1) Equalisation Grants (in brief in the following columns) 2) Special Purpose grants	<p>1) The grant applies both fiscal capacity and expenditure needs (for recurrent expenditure).</p> <p>The standard for any expenditure function is the average per capita spending by all states and the standard in any revenue (income) category is the average per capita revenue (income) raised by all states.</p> <p>The next stage involves reflecting those influences beyond a state's control (not a state's relative efficiency), which require the state to spend more than the national average per head of population, or alternatively make greater effort to raise the national average amount of revenue per head of population. These influences are termed <i>disabilities</i> and derive mainly from the examination of average State practices. For example - if it was the case that it is general practice across the States to subsidise electricity services to pensioners, it would be appropriate to use the proportion of pensioners in each State's population as a basis for a disability.</p> <p>There are currently some twenty criteria for disabilities used in this process, examples of the more important ones are set out below: <u>Socio-Demographic Composition</u> - which takes account of the differences in the characteristics of State populations such as age, sex, aboriginality, and income, and their impact on the demand for, and unit costs of State services. <u>Input Costs</u> - which allow for differences between States in the price of labour, office accommodation and electricity. <u>Administrative Scale</u> - which allows for the differences in the extent to which states can achieve economies of scale in their central office functions and "whole of state" services. <u>Urbanisation</u> - which allows for differences in demand for or cost of services arising from the concentration of population in urban centres. <u>Dispersion</u> - which reflects the effects of the geographic distribution of populations within each state upon the cost of services. <u>Economic environment</u> - allows for the effects on the demand for State services arising from the size or complexity of State economies, or because it is uneconomic for the private sector to provide services.</p>	<p>The Commission's assessments are based on the principle that the grant to which is State is entitled should enable them to provide the national average standard of state-provided public services assuming an average level of operational efficiency and average effort to raise revenue</p> <p>The grant distribution system is intended to be "policy neutral", i.e. unaffected by the policies of individual States, which should not be able to directly influence grant distribution results by their own actions and policies.</p> <p>Equalisation has played a significant, overt and explicit role within the Australian grant distribution system since 1981. The Australian system aims to adjust for the imbalance between States and Territories' revenue raising capacities, compared against their expenditure commitments. Equalisation takes account of both differences in the capabilities of the States to raise revenues and differences in the amounts required to be spent by the States in providing a standard of service.</p> <p>The general equalisation grant</p>	<p>The system is reformed every 5 years based on recommendations from the Fiscal Commission (information in this table is from 2003)</p> <p>In some areas where data is not fully available the Commission makes its recommendations based on qualified value judgements, a procedure, which has caused some controversies.</p>
Australia (cont.)				

⁶¹ Source: Report on "An Independent Commission? A perspective from down under Report", Annex 3 – A Document made available by the long term adviser of the LGFC, Uganda, Mr. Kevin Curnow, 2003.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
		<p><i>Physical Environment</i> - which measures mainly the effects of climate on maintenance costs & depreciation.</p> <p><i>Isolation</i> - allows for the higher costs in some States arising from their economic and geographical isolation from the main interstate sources of supply in South East Australia.</p> <p><i>Cross-border</i> - reflects the services that each State provides to residents of other States.</p> <p>As disabilities are measured against States' and Territories' positions relative to each other, they give rise to positive or negative needs when expressed as a ratio to the national average. If disabilities are shown to exist the Commission will normally seek to apply the equalisation process to remedy this, but it is important to note that it may choose not to if: A disability is insignificant; no community service objective can be identified; if the activity is of an economic development character; differential needs are met by specific payments from the national Government.</p> <p>The process involves first the Commission considering the expenditure and income activities of the 8 State and Territory governments against a standard framework of expenditure and income <i>categories</i>. The framework consists of 41 expenditure categories and 18 revenue sources, examples of which are detailed in the table below. Standards are developed, derived from the States budgets, against which the revenue raising capacities and expenditures of each State can be compared. The standard for any expenditure function is the average per capita spending by all States, and the standard for any revenue income category is the average per capita revenue raised by all States. Examples are shown below:</p> <p><i>Expenditure Categories</i> Pre-School Education, Secondary Education, Hospitals, Nursing Homes, Mental Health, Police, Administration of Justice, and Family & Child Welfare.</p> <p><i>Income Categories</i> Vocational Education & Training, Property Titles, Road User Charges, Hospital Patient Fees Public Safety User Charges, Fees & Fines.</p>	<p>to support the provision of a standard service is not tied to meeting particular social needs or policy aims. The States have the power to decide how to allocate their resources between both regions and functions, and the distribution of general revenue grants cannot overcome any perceived deficiencies in that direction.</p> <p>Direct influence by the national Government in support of national objectives is done through the special purpose payments.</p>	
Examples from Europe				
Denmark ⁶²	1) Unconditional block grants	1) Distributed according to the LG tax base (i.e. no equalisation impact)	1) Fill up the fiscal gap, compensate when new tasks	1) Are adjusted every year based on calculations of the

⁶² Source: Municipalities and Counties in Denmark – Tasks and Finance, Danish Ministry of the Interior, January 1999. The systems in Norway and Sweden are based on many of the same basic criteria, cf. Council of Europe, 2001.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
<p>(2004) (The system contains a vast number of transfer schemes and the schemes vary across types of LGs. Only the main national systems are mentioned here)</p> <p>The system will be reformed as part of the overall LG reform, which reduces the number of LGs.</p>	<p>2) Conditional grants (reimbursements)</p> <p>3) Equalisation grants (various schemes for various types of LGs, counties, municipalities, municipalities in the Metropolitan area), The table only provides information on the national municipal system.</p> <p>4) Grants to specific LGs with special features and needs</p>	<p>2) Reimbursements of costs within specific areas with specific percentages, e.g. 100 % on pension schemes for elderly people (open ended)</p> <p>3) Formula based. Tax base (from income tax and land values) – Percentage of the difference between the tax base of the LG and the average tax base is equalised (45 % of the difference) + national support to the weaker LGs, i.e. a total of about 80 % of the differences in the LG fiscal capacity is equalized.</p> <p>Expenditure needs (45 % of the difference between the average needs and the LG' s expenditure needs is equalised). The factors measured are:</p> <p>a) Basic equal share grant to each LG (approx. 1 mill. USD)</p> <p>b) 11 Age derived criteria (total 80 weight), i.e. criteria which has been identified as having an impact on the expenditure needs using the budget and accounting classification system</p> <p>c) 5 social criteria, e.g. i) number of children with single parents, ii) number of people in the age group of 20 – 59 without employment in excess of 5 %, iii) number of foreigners from developing countries.</p> <p>4) Specific grants to smaller islands and Specific grants to LGs with special social problems</p>	<p>are transferred vertically.</p> <p>2) Reimburse/co-finance expenditure within areas where the LG acts as agent or has limited control on the level of expenditure, contribute to the financing of areas where the LG discretion is limited</p> <p>3) Ensure more equal opportunities to provide services by bringing an more uniform relationship between tax capacity and services</p> <p>LGs with low tax base and /or high expenditure needs compared to the national average are compensated (the two EG systems are combined). LGs finance this basic system themselves (the so-called “Robin Hood approach”). In addition, the CG finances a special support scheme to the LGs with the weakest tax base (less than 80 % of the average level).</p> <p>4) To support LGs which cannot be fully captured by the equalisation system</p>	<p>costs and negotiations between CG and the associations of LGs.</p> <p>2) The percentage of each reimbursement scheme is carefully designed to ensure neutrality between various activities, and proper incentives</p> <p>3)There are various schemes for counties, municipalities and counties in the Metropolitan area. Equalisation is higher in the Metropolitan area (about 90 %).</p> <p>The system has been revised several times and is always a subject for discussion and improvement.</p> <p>4) These grants constitute less than 5 % of the total transfers from CG.</p>
<p>Germany⁶³ (2003) Various</p>	<p>Lander (larger regions): Targeted on differences in resources not expenditure</p>	<p>The Landers are Guaranteed a minimum of 95 % of the average financial strength (revenue potential)</p>	<p>Objective: To fill up the fiscal gap between expenditure and revenue assignments, and</p>	<p>There is a discussion on the criteria to be applied to assist the financial weaker Lander</p>

⁶³ As per 2000. Source: Regional and Local Governments in the European Union, Responsibilities and Resources, Committee of Regions, European Communities, 2001.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
systems at regional level (between Lander and vertically between Bund authorities and Lander and horizontally on the local level grants from the Land authorities to the municipalities)	needs Grants to Lander with special needs in special geographical areas Equalisation of the LGs (municipalities) at the lower tier of Government	Based on criteria such as emergency areas, costs of political leadership (small areas), and certain transitional grants. Expenditure needs and fiscal capacity (the system differs from Lander to Lander), but typically criteria such as the size of the population, unemployment rate and the number of pupils are applied. The expenditure needs are compared with the estimated fiscal capacity (potential) and the grants cover a part of the difference. The percentage of the coverage of the gap varies from Lander to Lander.	support the weaker areas. The basic objective is that every unit should have financial capacity which can be compared with its expenditure needs Each Lander decide on the grant and equalisation system and the revenue sharing model for the relationship between the Lander and the municipalities in the Lander	(information from 2003)
Russia, The City of St. Petersburg⁶⁴ (2000) (a Region with 111 LGs)	Grants to fill up the fiscal gap between LG own revenues and the expenditure needs and provide a minimum level of service standards	Minimum standards (norms) based on cost of various services calculated for each sector area, which are mandatory for the LGs to cover. LGs have to ensure that the minimum standards of spending are adhered to in the City of St. Petersburg and that the LGs have sufficient revenue to provide the minimum standards. LGs are divided into 7 groups (not transparent) according to certain historical reasons and the various tasks they perform. Approx. 60 out of 111 LGs receive grants to bring them up to the minimum standard guaranteed service level (the own tax revenues and the grants are added up and compared to the cost of delivering services to the required minimum standards). Among the 7-10 standards or what can be seen as criteria in the allocation system are: (it varies from group to group of LGs): *Cemeteries: X rubbles per M2 *Memory parks: X rubbles pe M2 *Orphans: X Rubbles per child *Environment: X Rubles per inhabitant Social services to school children from families with many children: X rubbles per child per year Green areas: X rubbles per inhabitants.	Objective: To support the LGs with a low tax potential and high expenditure needs. The standard norm system has a number of flaws, among these: unclear criteria, disincentives for some of the LGs to improve on the tax system, and problems with the grouping of LGs.	The minimum standards are very low and some LGs have several times more funding available than others, and can keep this amount of funds for own discretion. The poorest LGs can only spend the funds on the specific minimum standards and have no flexibility and autonomy.

⁶⁴ Source: “Annex on Local Government Finance – Key findings and Recommendation” (Jesper Steffensen) to the Report from NALAD, 2000 on the System of Local Government in St. Petersburg, cooperation programme under the Danish Ministry of the Interior and the City of St. Petersburg.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
France (1999) ⁶⁵	1) General operating grant 2) Revenue compensation grant 3) Investment subsidy 4) A general decentralisation grant	The distribution is based on a complex calculation, and based on historical data.	Ad 1: Fund the general expenditure assignments Ad 2: Compensate in areas with low fiscal capacity Ad 3: To boost investments Ad 4: To compensate for new tasks.	
Portugal (1999) ⁶⁶	Transfer to the Financial Compensation Fund (FEF)	15 % allocated equally between 305 municipalities, 40 % allocated according to the number of inhabitants in the units and the average number of nights spent in hotels and campsites, 5 % according to the number of inhabitants under the age of 15 year, 15 % based on the area, 5 % based on a fiscal compensation index, 10 % length of road network, 5 % number of parishes and 5 % geographical accessibility.	Fill the gap between revenue and expenditure assignments and provide a degree of equalisation by evening out the spending requirements 60 % of the transfer has to be used on capital investments Minimum 10 % has to be transferred to the parishes	The system was changed in 1999 to provide direct funds to each level of government (municipalities and parishes)
UK (2000) ⁶⁷	General grants (revenue support grants) and specific grants for agent functions	1) General Purpose Grant: Based on a calculation of the relative LG need for spending (standard spending assessment). Criteria included are: size of the population, number of pupils, number of elderly people, density of population, length of the roads, indicators of deprivation, and variations in labour costs. The detailed formulae is largely based on statistical analysis of past composition of expenditures (regressions analysis). 2) Specific grants are related to each sectors and based on expenditures.	1) To achieve an equalisation outcome, which enable all local authorities to provide a standard level of services with a certain tax rate. The system takes into account the differences in expenditure needs and fiscal capacity of the units and pursues to ensure that sufficient funding is available for a standard range of services. 2) Specific grants to ensure that sufficient resources are allocated towards national targets (agent functions where reimbursement is given).	The system is currently adjusted.

⁶⁵ PWC, 2000.

⁶⁶ Committee of Regions 2001.

⁶⁷ PWC, 2000.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
Examples from Asia and Pacific				
Cambodia (2007)	One general purpose grant for the commune/ sangkats- the so-called C/S Fund, which is divided in an administration and a local development component	<p>The Commune Sangkat Fund (CSF) is the mechanism set up by the Government (Sub-Decree No 16 dated 25/02/2002) to channel fiscal transfers to the CS councils. The Fund has been so far capitalized by an annual appropriation from the national budget (a percent of the Government's total domestic revenues), and a contribution from external development partners.</p> <p>The CSF resources are channeled to the CS Councils following two streams:</p> <ul style="list-style-type: none"> • The General Administration stream (not more than 1/3 of total CSF resources): to be allocated to individual CSC in proportion to the number of councilors; • The Local Development stream (not less than 2/3 of total CSF resources), is allocated by a formula. <p>During the period 2002-07, the allocation criteria and weights of each of the three criteria in the formula remained unchanged, notably: equal share (35%), council population (35%), and poverty score (30%). Source: UNCDF / Mohamed El Mensi, 2007.</p>	<p>The objective is to support small -scale investments in infrastructure, service delivery and cover the costs of general administrative functions.</p> <p>The scheme is also put in place to enhance the legitimacy of the local authorities and support learning processes in planning, budgeting and financial management (new innovative and decentralised service delivery).</p>	<p>The size of the funds is set by a certain percentage, approximately 2.5-3.0 % of the total domestic revenues.</p> <p>Most of the funds have been spent on roads and smaller infrastructure projects like bridges.</p>
Philippines (as of 2005)	<p>One major scheme, the Internal Revenue Allotment (IRA)</p> <p>The size of this is set as a fixed percentage, which is 40 % of the national internal revenues three years prior to the current Fiscal Year.</p> <p>Small number of capital transfers (typical project specific)</p>	The allocation is distributed among the different tiers of local governments as follows: Provinces (23%), Cities (23%), Municipalities (34%), Barangays (20%). The resulting amount is further divided among the LG at each level with the use of the following formula: 1) Population (50%), 2) land area (25%), and 3) equal sharing (25%).	Fill the fiscal gap between expenditure and revenue assignments, particularly after the devolution of task from 1991.	<p>The equal share component has been questioned and there are various proposals (2005) to improve on the formulae.</p> <p>There is an ongoing review of the system and it is considered to introduce a more performance based allocation system, which should provide better incentives for the LGs to improve the performance.</p>

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
Pakistan (2002) ⁶⁸	<p>The size is based on recommendations from the Finance Commission (grant constitutes a significant part of the LG resources)</p> <p>In addition there is a number of smaller support schemes</p>	<p>Entirely on basis of population, although with a special grant targeted to the two backward provinces.</p> <p>A number of the smaller schemes have no clear criteria and seem to be impacted by political considerations.</p> <p>Small matching grant for provincial resource mobilisation that rewards (to a certain limit) provincial revenue effort in excess of their historical average growth rate.</p>	<p>Fill up the gap between revenues and expenditures (generally no equalisation impact)</p>	<p>In reality the provinces often get only 75 % of the supposed grants and they are often delayed</p>
Indonesia ⁶⁹ (2005)	<p>The support from CG (DAU) represents minimum 25 % of the National Budget and accounts for about 60 % of the LG revenues</p> <p>No explicit system for development transfers (but grants may be partly used on development).</p> <p>DAK: Earmarked grants with various criteria</p>	<p>DAU: Both fiscal capacity (measured as variation in the local gross domestic product) and expenditure needs criteria (population, area, inverse HDI, relative per capita GDP, and price differentials) are including in formula The costs of the existing salary structures are deducted from the pool of equalisation prior to the calculations.</p> <p>DAK: Various allocation criteria (general, special and technical criteria).</p>	<p>Fiscal gap and equalisation (mixed)</p> <p>Special objectives.</p>	<p>Despite the attempt to deal with fiscal imbalances, these remain very significant.</p> <p>There has been an attempt to streamline the vast number of different grants.</p>
Bangladesh (2007)	<p>1) Development block grant from government to be integrated with a donor basket fund arrangement- "topping up" of funds: a) a system for the entire country gradually phased in and b) additional funds for 6 districts</p>	<p>Previously: Fixed amount, population and land, but not fully clear in practice.</p> <p>Programme (UNCDF): Fixed amount, population and land.</p> <p>Future system: Minimum allocation per unit and then additional funds allocated using the size of LG population, finally adjusted against the LGs' performance</p> <p>Some districts will get additional supplementary performance based grants.</p>	<p>Finance gap and support development of investments in infrastructure and basic service provision</p> <p>Promote performance in core areas, such as revenue mobilisation, procurement and planning/budgeting.</p>	<p>The reform will roll out useful pilot experiences with performance based funding, and will particularly target financial management performance of the LGs.</p> <p>The reform will be combined with strong capacity building support of CG and LGs.</p>
India (2009)	<p>State Finance Commission grants</p>	<p>State Finance Commission grants varies greatly across the states, and may include numerous criteria such as population, land size, number of disadvantaged people, etc.</p>	<p>Support the service delivery of the LGs in each state</p>	

Paul Smoke 2002.

⁶⁹ A. Shah: Local Governance in Developing Countries, 2006.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
	The Backward Regions Grant Fund (BRGF)	The states are using various formulas for allocations of funds to the districts and gram panchayats and urban authorities, but most of the states are just using one criteria – the size of the population. However, a few states are using poverty sensitive criteria such as number of people from special tribes/special castes, or people living in the slum areas.	Support service delivery in the disadvantaged /backward regions, through targeting of the development grants to these areas.	The grant scheme has just been reviewed in July 2009 and a number of reforms, including new allocation criteria are expected. There are also plans to test performance-based allocations in some states, e.g. West Bengal.
Bhutan (2009)	Annual Block grants to the Gewogs	The allocation criteria are: 1) 70 % size of the population, 2) 5 % size of the LG territory and 23) poverty count: 25 %. There are certain minimum access conditions which have to be complied with prior to the allocation	General discretionary grant for development and service delivery, with certain conditions for grant access.	There are plans to move into a more performance-based allocations where the size of the grants is adjusted against the performance of the Gewogst.
Nepal⁷⁰ (2007 and 2008/2009)	About 75 % of LG revenue derives from grants from CG. There are two main types of grant components for districts: 1) administrative grant/recurrent grants and 2) capital development. ⁷¹ There are different grants to various types of local governments, see next column. A pilot of performance-based grants, previously supported by UNCDF and DFID is in a process of being rolled out to all LGs. It is supported by a group of development partners under the Local Governance and Community Development Programme. In the first	<u>Districts</u> Administrative grant is based on the salaries and allowances from the centrally posted staff and supplementary staff hired by the LGs, based on standard administrative norms (number of staff positions based on categories of districts, pay scale, allowance rate, welfare contribution etc.) Block Grant: This is an unconditional development grant, which has recently been transformed into a performance-based development grant. <u>Districts (FY 2008/09) - the system is under reform</u> In FY 2008/09, the horizontal allocation of the Government funded development grants was based on the following criteria: 1) 50 % population, 20% human development index (none weighted), 10 % size of the LG territory, and 20 % cost index. A grant funded by the development partners (grants will be merged from FY 2010/11) was allocated based on: 40 % population, 25 % HDI (weighted with the size of the population, 10 % size of the LG territory and 25 % weighted cost index. <u>Villages: (FY 2008/09)</u> The development grant was allocated using 3 criteria: 1) 60 %	Cover the costs of the basic administration. Fill up the gap between assigned revenues and expenditures. Support capital investments and introduce performance incentives to improve capacity and performance in core areas such as financial management and governance. Investments in service delivery and performance incentives (future).	The governments' transfers have been rather unpredictable and there have been a lack of objective and transparent criteria. Adm. grants: There are no incentives to save funds on administration as they cannot be transferred to other places. The two streams of funds – the one funded by the GoN and the other by a group of development partners will be merged and aligned from FY 2010/11. Considerations on improvements of the formula are ongoing. The testing of the performance based grants has been successful and the

⁷⁰ Source: An Overview of the Intergovernmental Fiscal Relations in Nepal, Working Paper 02-05, April 2002 by Mr. Manoj Shrestha.

⁷¹ There were previously grants for district roads and one for suspension bridges, but these have not been merged with the general block (development) grant. The entire system is under reform.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
	years, the support from DPs were routed through a parallel grant, but from FY 2010/11 the two schemes will be merged into one consolidated performance based development grant system – one for districts, one for municipalities and one for the villages.	population, 2) cost index 30 % and size of the territory: 10 %. There was certain maximum and minimum levels as well as certain ceilings figures were “rounded”. <u>Municipalities: (FY 2007/08)</u> In the case of municipalities, grants are provided to those local bodies having less than NPR 10 million as internal resources. The criteria for distribution of these funds are not fully transparent and Local Development Fee to compensate for the abolition of the Octroi, and which is allocated based on previous revenue figures. A reform is ongoing of the allocation formulas.	Supplement own funding and compensate for tax change. To provide capital grants for smaller infrastructure and rehabilitation and introduce innovative measures, such as performance based allocations to Incentivise good performance (areas of performance are planning, budgeting, financial management and good governance/transparency)	
Solomon Islands (2009)	Provincial Government Capacity Development Funds	The allocation criteria are 80 % based on two criteria (80% based on size of the population and 20 % equal share) and then 20 % based on the relative performance of each province (weighted). Funds are only allocated provided that a range of minimum access conditions are complied with.	Discretionary grant for local development (capital investment is the focus). The grant is also put in place to incentivise good performance and enhance capacity of the provincial governments.	The performance-based grant system was introduced in 2007 and has been gradually refined since then.
Example from Central America				
Nicaragua⁷² (2001)	Development grants	Matching grant. The collected tax revenue is matched by a Stimulus Development Fund on a dollar to dollar basis (since 2001)	Contribute to the general sources for development and support incentives to collect taxes (tax effort)	Previously (1997-2000) the system was based on the LGs’ utilisation of the tax potential, and LGs with a high utilisation rate received more grants. This system was rejected as it was seen by everybody to be too complicated).
Examples from the Middle East				
Egypt⁷³ (2005)	Recurrent transfers are sent directly to the deconcentrated sector	Fiscal gap filling transfer system. However, the central government controls the expenditure side through sets of standards that determine the limitations of expenditure on different services.	Financing the vertical gap at the local level. It is also equalizing in a sense, because the	Local administration system is very centralized. It deals with all local units as administrative

⁷² Information received from Phillip Bøttern, LG-DK, 2003.

⁷³ Information for Jordan and Egypt is provided by Dr. Khaled Zakaria Amin, Assistant Professor, Cairo University.

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
	<p>departments at the local level.</p> <p>Investment transfers are decided according to the needs of local units.</p>	<p>Two criteria are used to decide on investment transfers. One is the size of population and the other is the Human Development Index, which is available at the governorate level. The index has indicators of education level, GDP per capita, and life expectancy. The percentage assigned to each indicator is decided by the Ministry of Planning. However, the criteria of the assignment process are not transparent.</p>	<p>expenditure at the local level is determined by national standards.</p> <p>This transfer seeks to finance development and capital projects at the local level. Regional projects are not financed by this transfer, rather directly by transfers from concerned line ministries.</p>	<p>agents without authority. Government is in the process to draft a new law of local administration that may change the foundations of these transfers. Econometric literature in the field highlights that the transfer system is not equalizing. It benefits rich and well-developed local units.</p>
Jordan (2005)	<p>The system of transfers depends on fuel tax as the main source of the transfer pool. The system distributes the pool on specific number of quotas that are assigned to the municipalities.</p>	<p>The assignment of quotas to different municipalities is based on the following criteria:</p> <ul style="list-style-type: none"> ○ The special nature of the municipality (tourism, commercial, boarder, administrative center....etc.) ○ Population Size ○ Minimum limit of quotas that each municipality should receive. <p>The decisions on the number of quotas assigned to each come as shared decisions between the Ministry of Municipalities Affairs and the Ministry of Planning, while the Ministry of Finance plays a major role in deciding the quota's monetary amount.</p>	<p>The transfers cover almost 60% of local expenditures. During the 1990s, the transfer pool experienced stagnation, while the local autonomous revenue shrank.</p> <p>The system is not transparent and not equalizing.</p>	<p>A national committee is constituted to review the current transfer system. The committee is in the process of replacing the current system by a formula-based one. The committee is thinking of different factors to shape the formula including: the current transfer, per capita, population size, salary and wages expenditures, dept service, property tax revenues, and other autonomous local revenues.</p>
Yemen (2005)	<p>One capital transfer scheme –the transfers can only be used for capital development costs</p>	<p>The Law on Local Authorities, 2000, specifies 6 criteria: 1) population density, 2) Abundance or scarcity of resources, 3) level of social and economic development and level of deprivation, 4) local authority performance, 5) performance in collection of financial resources and sound spending and 6) any other criteria determined by the Council of Ministers.</p> <p>According to recent studies, the 2005 grants were distributed according to the following criteria, considering the lack of data on some of the parameters: 1) 20 % for population density, 2) 25 % for abundance/scarcity of local revenues, 3) 45 % of the level of economic and social growth and poverty rate and 4) 10 % for performance efficiency in local resource collection and the expenditure.</p> <p>A new Draft Law suggests the following future six criteria: 1) Size of the population in the district, 2) level of growth of local resources</p>	<p>Support the fiscal gap between expenditure and revenue assignments and funding for infrastructure/capital investments, i.e. not recurrent (operational and maintenance) costs.</p>	<p>The transfers can only be used for capital investments and there is a lack of linkage with the funding for operational and maintenance. This is expected to create allocative inefficiencies.</p> <p>The criteria need a thorough review as some of these seem to move in opposite directions and provide disincentives to improve on service delivery.</p> <p>The data availability has been a great constraint for development of targeted</p>

Country	Main Transfer Schemes	Allocation Criteria	Objectives and other features	Comments and coming reforms
		(income) and infrastructure, 3) level of implementation of the annual development plan, 4) efficiency in resource collection, 5) abundance of financial resources and 6) any parameters of standards that the Cabinet may approves ⁷⁴		criteria.

⁷⁴ Based on a Study of the Policy Options for Finances and Financial Management System of the Local Authorities, Yemen, LGDK, August 2005.

The review of the international experiences on allocation criteria for intergovernmental fiscal transfers shows that most of the countries are using measures of expenditure needs, and that most countries are using the size of the local government's population as the main, if not only, criterion for horizontal allocation across the LGs.

Several countries are using various proxies for costs of the service provision, like the density of the population/land area - low density is often compensated as it is calculated or assumed that it causes higher costs of service provision - (e.g. Uganda, Tanzania, Ghana the Philippines, and Nepal which are examples of countries using the land factor) or various cost indexes (like Nepal). Equal share is also used in some countries, although with a minor factor, such as Solomon Islands and Ghana.

Some countries are also using various poverty indices and measures for the backwardness of certain areas (e.g. Uganda, Tanzania, Cambodia, Bhutan, Nepal, some states in India and many OECD countries). Finally, an increasing number of countries have introduced performance related measures in the allocation of capital development grants, e.g. Uganda, Tanzania, Bangladesh, Nepal and Solomon Islands. As an example Tanzania has elaborated a capital development grant system where the LG performance in key generic areas like planning, budgeting, financial management and good governance has an impact on allocation of the grants. Some countries, like Ghana, Pakistan, Rwanda and Nicaragua have included tax effort as a criterion in the allocation of grants (Uganda and Tanzania also make use of some incentives on the LG tax efforts in the allocation of capital grants as well). Other countries are planning to introduce a link between the size of the transfers and the administrative/financial performance of the LGs in order to provide stronger incentives to improve on administration and service provision (e.g. Sudan and the Philippines).

Most developing countries make use of relatively few criteria (often 1-4 criteria for the major grants) due to lack of data and administrative capacity and a wish to keep the system transparent and simple.

Allocation criteria have been reformed and /or are being reformed in a great number of countries, typically after a period of testing and gathering of experiences, and there is a positive move towards more transparent, formula-based systems in many countries.

4. Concluding Comments

The review of the theory and the practice on design and implementation of systems of intergovernmental fiscal transfers have shown a great variety, particularly when it comes to the horizontal allocation criteria.

However, there are some common recognised principles, which can guide the design of future systems, and the experiences have shown some common trends in the reform process across the countries, even across the continents.

An example of this is the development in many countries towards more transparent, formula-based systems and, more recently, a trend towards more performance-based grant allocation systems promoting good LG performance in beforehand defined functional areas.

The review has also shown that there is some way to go in several countries, not only in terms of adjusting the system to recognised international principles for grant allocation, but also in the extent to which the allocation criteria actually applied can achieve their objectives. There is also a strong need to develop better data and statistics to support a better targeting of the formulas.

Some of the existing systems seem to provide disincentives to improved local government service provision and other important elements of local government performance, and the current reform processes in many countries are therefore welcomed, important and urgent.

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