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## **Harmonizing Objectives and Outcomes at the National and Sub-National Levels through Citizen Engagement and Capacity Building**

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# *Harmonizing Objectives and Outcomes at the National and Sub-National Levels through Citizen Engagement and Capacity Building*

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## **1. Overview**

In most general terms, this paper explores the idea that good governance – in this case manifested in the active participation and engagement of citizens in the planning and budgetary processes at the national, but mostly at the local levels, together with an accurate determination of the capacities of such levels of government, are the keys to harmonizing the objectives and outcomes of intergovernmental transfers.

This paper is divided into nine sections. The first section discusses the context within which intergovernmental transfers occurs. The second section discusses the framework of the paper that tries to look at the bigger picture suggesting that the system of intergovernmental transfers occurs within the policy framework of decentralization in general, and fiscal decentralization in particular. Additionally, the principles of good governance – accountability, predictability, transparency and participation – impact upon the implementation of intergovernmental transfers. For instance, the predictability of transfers to sub-national levels of government enables rational and realistic planning. The third section of the paper discusses the rationale, objectives and outcomes of intergovernmental transfers. It suggests that, at the end of the day, outcomes – operationalized in terms of the delivery of appropriate basic services – have to be “harmonized” with the objectives of the transfers, which are essentially, to provide

adequate financial resources to fund the functions that are delivered at sub-national levels. Parts six and seven suggest that both citizen engagement and capacity building may be important components in the design of intergovernmental transfers and contribute to the harmonization of objectives and outcomes. More specifically, these sections point out the objectives of the transfers and the general outcomes. The paper also includes some examples of some countries that suggest that citizen participation and capacity building may contribute to the general objective of harmonizing objectives and outcomes.

Referring to a well designed system of intergovernmental transfers, Bahl, Boex and Martinez-Vazquez (2001) point out the critical importance of matching expenditures needs and revenues at the subnational or local government level. This information will then be very critical in determining the amount of the transfers from the national level. According to them, “in order to know how much transfer is necessary, one must estimate the difference between the revenues available to subnational governments as a whole, and the expenditure needs of each level of government (2001:3).

The expenditure needs at each level can only be determined if the responsibilities – and *assigned functions* at the subnational levels – are clearly defined and recognized. This is very much in accordance to the *finance follows function* principle advocated by Bahl which is Rule Two among Bahl’s Rules of Fiscal Decentralization. In finding out what are the appropriate functions that are to be delivered at the subnational levels, it is imperative that the citizen demands and needs be correctly assessed and determined within the context of responsive local governance. This is where active people participation and citizen engagement will play a key role. This however must also be calibrated with the capacities of the subnational levels of government to perform such function.

There is certainly no attempt to romanticize participation. It is recognized that indeed, there are certain goods and services (“merit goods” according to Bahl et al 2001) *such as education, that will be underprovided if the consumption decision is left up to the consumers (or lower level-governments) because the consumer does not recognize the true value or benefit of that good. Indeed there are cases where central government is in a better position to determine the socially optimal level for this good than either individual citizens of local governments* (Bahl et al, 2001:4) This however does not obviate the imperative for seriously considering the participation of citizens, this time at higher levels of government where collective demands upon the politico-administrative system may be better aggregated and articulated and hence factored in the design of the intergovernmental transfer system.

It must be stated though that other equally more important factors such as the imperative to improve both vertical and horizontal fiscal balances should continue to be included in the design of intergovernmental fiscal transfer system.

## **2. Intergovernmental Transfers: Framework for Harmonizing Objectives and Outcomes**

The subject of intergovernmental transfers has been at the center of debates in many countries that have adopted decentralization as a strategy for development and good governance. Financial resources transferred from national to subnational levels of government have been the major sources of revenues for many local governments in developing countries (Litvack 2003; World Bank 2003).

Intergovernmental fiscal transfers refer to the transfer of money from central governments to lower level governments or subnational governments or local government units (states, provinces, cities/ municipalities, etc.). The term ‘transfers’ is often used to refer to a number of different kinds of public financing instruments between central and subnational and local governments, which include, among others, sharing of tax revenues, intergovernmental grants, subsidies, and subventions.” (Bahl, Boex and Vasquez, 2001; Bird and Smart 2001)

Intergovernmental transfers have been adopted as mechanisms for funding national development efforts and public service delivery at the local government level. This is a key feature of decentralized governments, which can be linked with or a response to the overall framework of decentralization. Furthermore, decentralization requires substantial financial imperatives in view of its full operationalization and the achievement of its policy goals and objectives.

Figure One suggests an indicative schematic diagram that may lead to the harmonization of objectives and outcomes of intergovernmental transfers between national and sub-national governments within the context of good governance. It will be recalled that among the elements of good governance are accountability, transparency, participation and predictability. Decentralization provides policy context at the national level. More specifically, fiscal decentralization from the central to sub-national governments provides the policy context for the operationalization of Intergovernmental fiscal transfers. Such transfers enable mechanisms to vertically and horizontally balance fiscal needs and resources in sub-national governments. Sub-national governments, through their own revenue resources and the transfers, deliver basic services as well as pursue local development efforts in their respective jurisdictions. Local development and local services are prioritized through local development planning, budgeting and implementation. However, this requires capacities of local governments to ensure that plans are prepared in accordance with the national goals and needs of the locality. Implementation, monitoring, and review of local plans, altogether, require capabilities of local leaders and staff to ascertain the efficiency, effectiveness, and responsiveness of local policies and programs.

Figure one also suggests that citizens can, and may be engaged starting from the design of intergovernmental transfers. It will be recalled that decentralization is a process that enables citizens to participate in the process of governance. It is based on the *“belief that participation of a variety of key local stakeholders, including sub-national*

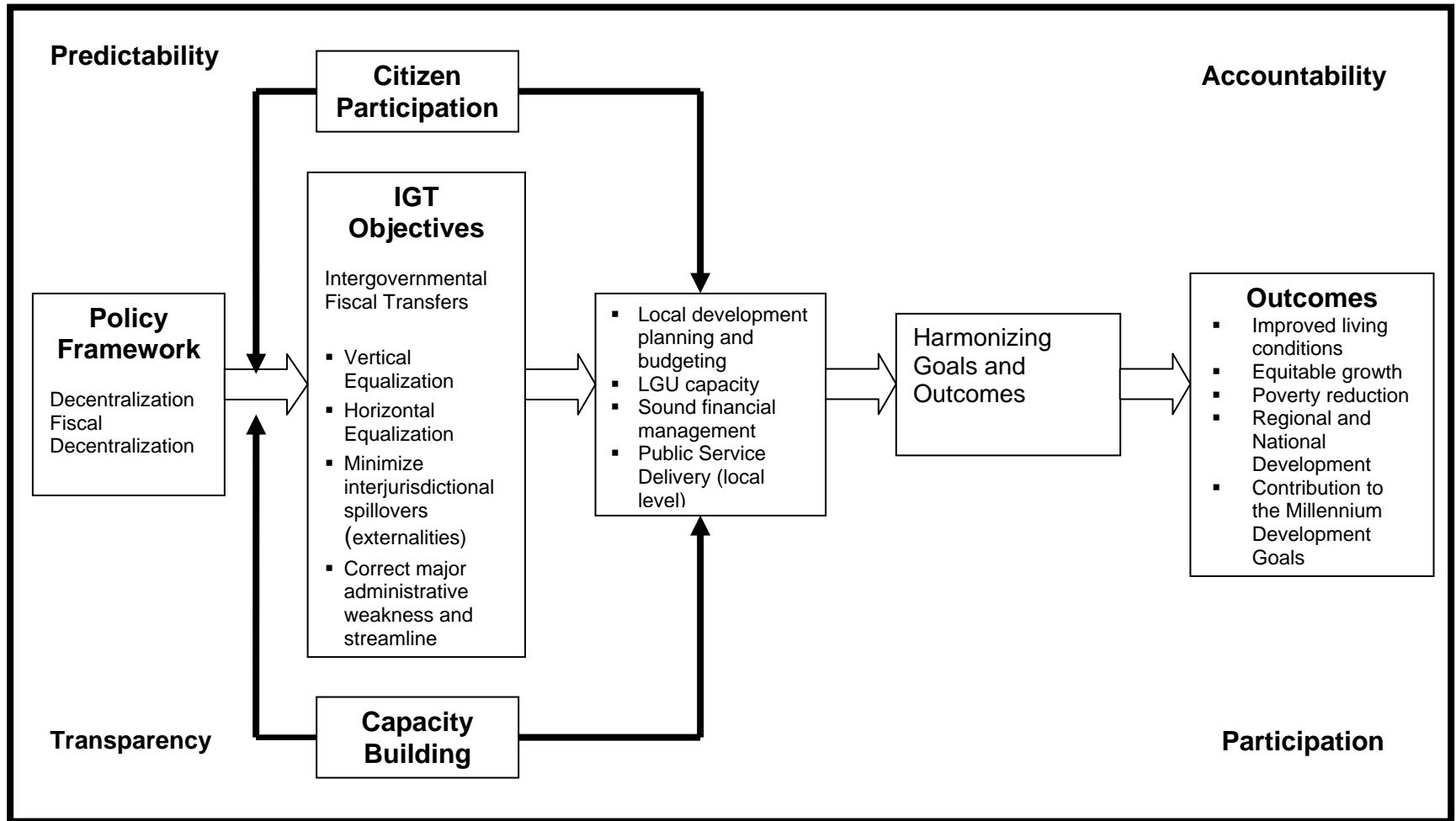
*governments and local communities, is critical to realize development and poverty reduction goals. There has also been a growing recognition of the need for broader partnerships among the various levels of the public sector, the private sector, civil society, and international development agencies in promoting more equitable and sustainable development” (ADB, 2003; TA 5902).*

It is within this context that we are suggesting that intergovernmental transfers could be more predictable and transparent if the participation of citizens, as well as the various subnational governments and other stakeholders, may be incorporated in the design of intergovernmental transfers. Different sub-national governments have varying requirements and objectives from intergovernmental transfers. Hence, their inputs on how to effectively design intergovernmental transfers are important and critical.

It may be mentioned that there is the school of thought, quite rightly, that suggests that citizen participation in sub-national planning and budgeting results in better local governance. It improves prioritization of policies, promotes transparency and accountability in the use of limited financial resources, improves service delivery, and responds to local needs. As such, sub-national governments have better opportunity to reach not only local level goals but also national outcomes.

Policy outcomes – improved service delivery, equitable growth, improvement in socio-economic conditions, better quality of life of local constituents, contribution to regional and national development, and to the attainment of the Millennium Development Goals (MDGs) – are the ultimate goals of decentralization and national policies.

Figure One. Harmonizing Objectives and Outcomes Framework



### 3. Decentralization: The Context for Fiscal Decentralization and Intergovernmental Transfers

This section draws on “Decentralization Imperatives: Lessons from Some Asian Countries” by Brillantes. It discusses the broad context within which intergovernmental transfers occur. It suggests that decentralization – which involves the transfer of functions, powers, authorities and responsibilities from national to local levels. Among the significant transfers are fiscal transfers within the context of intergovernmental transfers.

Depending on one’s paradigms and motivation, decentralization can have different meanings and dimensions. It is a management approach that would deliver public services more efficiently by improving both allocative and *productive efficiency*<sup>i</sup> (Kakhonen 2001). It decongests top management hasten, decision-making processes and minimize unnecessary delays and red-tape. It is a means of “load shedding” wherein central authorities transfer functions and responsibilities to sub-national institutions because of the inability of former to continue funding such functions. It broadens the reach of national government, and enables the “penetration” (Cheema and Rondinelli 1983:15) of national government policies into the remote rural areas of the polity. It can be a means to recognize the special status of certain regions that differ markedly from the rest of the nation due to different ethnic composition and makeup, or availability of resources (Bahl, 2002).

Decentralization suggests democratization by broadening the base of participation and providing a voice to marginalized and non-mainstream sectors of society, such as cultural and ethnic minorities. It contributes to operationalizing democracy at the local level by providing avenues to enable citizens to access structures and processes of governance especially at the local level. Decentralization can mean building the capacities of sub-national institutions to enable them to respond to local needs: it can lead to more autonomous local authorities that would be less dependent upon central institutions. Decentralization can mean more innovations and flexibility at the local level: it allows local governments to design and implement programs customized to the unique needs of the locality. It encourages creativeness and provides the opportunity to depart from standard and formula-based once size fits all approach to development challenges. Indeed, decentralization may mean any or all the above and more.<sup>ii</sup>

Overall, “decentralization entails *the transfer of functions, powers, responsibilities and accountabilities to lower level institutions for better governance*”<sup>iii</sup>. This definition is consistent with the classic definition developed by Cheema and Rondinelli in the early eighties that has somehow become some kind of “industry standard.”<sup>iv</sup> According to them, decentralization is the “transfer of planning, decision-making, or administrative authority from the central government to its field organizations, local administrative units, semi-autonomous and parastatal organizations, local governments or non-governmental organizations” (1983:18). Our definition suggests that, given the recognition in contemporary development analysis about the imperative to reduce poverty, and given that the lack of effective governance was

pinpointed as the “missing link” (UNDP 2000) in failed poverty reduction efforts, the discourse should therefore illustrate that decentralization, when correctly implemented and given the proper policy and capacity mix at the national and sub-national levels, decentralization has the potential to be a very powerful tool to effect good governance.<sup>v</sup>

### **Forms of Decentralization**

Decentralization can manifest itself in various forms.<sup>vi</sup> There are four major types of decentralization, these include:

- Fiscal decentralization;
- Political decentralization;
- Administrative decentralization; and
- Market decentralization

The World Bank Institute points out that fiscal decentralization is the decentralization of fiscal resources and revenue generating powers. Political decentralization occurs when political power and authority are decentralized to sub-national levels. Administrative decentralization aims at transferring decision-making authority, resources and responsibilities for the delivery of a select number of public services from the central government to other lower levels of government, agencies, and field offices of central government line agencies. Market decentralization is allowing functions that had been primarily or exclusively the responsibility of government to be carried out by business, community groups, cooperatives, private voluntary associations, and other non-government organizations.

Fiscal decentralization may take on several forms: self-financing, expansion of local revenues, *inter-governmental transfers* and authorization of municipal borrowing. Administrative decentralization may be further classified into deconcentration, delegation and devolution. Deconcentration “redistributes decision-making authority and financial and management responsibilities among different levels of the *central* government.” Delegation occurs when “central governments transfer responsibility for decision-making and administration of functions to semi-autonomous organizations not wholly controlled by central government.” Devolution involves the transfer of functions and “authority for decision-making, finance, and management to quasi-autonomous units of local government with corporate status.”

Other types of decentralization pointed out by the WBI include *privatization* which involves the cooperation of government and private sector in the provision of services or infrastructure, and *deregulation* which reduces legal constraints on private participation or allows competition among private suppliers for services that in the past were provided by government or regulated monopolies.

Taking off from the above, and building upon the various theoretical constructs in local government and decentralization literature, this paper suggests that decentralization may be classified into the following:

### **Deconcentration; Devolution; and Debureaucratization**

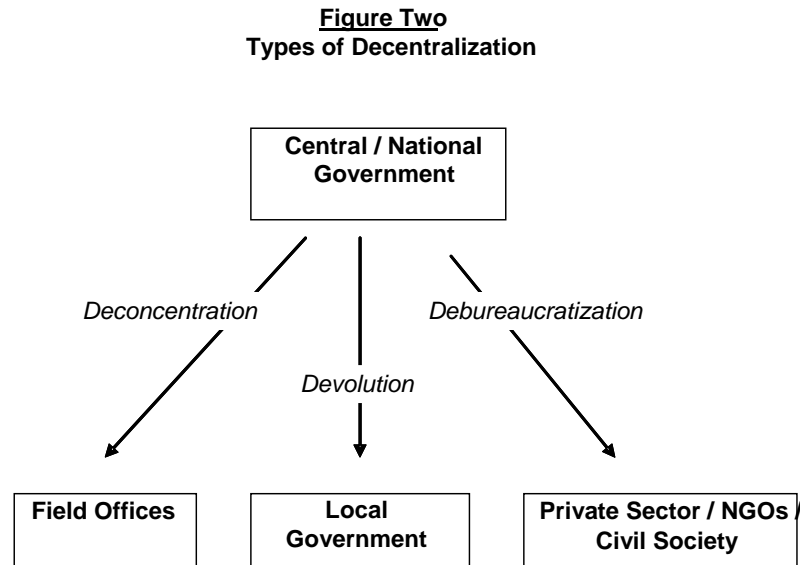
*Deconcentration* may also be referred to as “administrative decentralization.” It entails the transfer of *functions* from central authorities to lower level *administrative* institutions such as field offices. It embraces the notion of “delegation” since central authorities decide and identify what functions can be “delegated” to sub-national institutions. Such institutions, though, still retain their “national character” since they are simply authorized by their principals at the central government to *administratively* act on certain matters including routine matters that need not go to the center and clog operations there. It also includes transfer of authorities over fiscal matters, such as determining up to what amounts the field offices can decide on without having to obtain authority from the central office. To a certain extent, it is referred to as “deconcentration” because it *lessens the concentration* of load in the center. The extent of delegated authority is determined by the center and such delegated authority may be revoked by them. A distinguishing feature of deconcentration is that final authority still rests in the center. It is within this context that deconcentration has been referred to sometimes as “pseudo-devolution.” It is therefore important to always appreciate administrative decentralization within the proper context of the whole decentralization scheme. To a certain extent, it does represent a weak form of decentralization. According to Dalton (2003:9) “administrative decentralization often distracts attention from building towards devolution and in some cases *misses the point entirely*.” In other words, Dalton suggests that we should not lose sight of the ultimate objective of decentralization which is to move towards local democracy – and good governance – one that could be attained through devolution.

*Devolution* is also referred to as “political decentralization.” This entails the transfer of powers to lower level *political institutions* specifically the local governments. Local governments partake of a *political* nature when they fulfill the following criteria<sup>vii</sup>: (a) They have a set of *elected* officials, e.g., elected local chief executive such as the mayor and / or the local legislative body; (b) The local governments have jurisdiction over a specifically defined *geographical area*; (c) They have clear responsibility for the performance of certain functions and delivery – and financing<sup>viii</sup> - of basic services, and are held accountable for such; and (d) They have the power to generate revenues and levy *taxes*. Local governments are clothed with a certain amount of autonomy that enables them to decide on local matters without interference by the center. The imposition of taxes should be authorized by the local legislative assembly.<sup>ix</sup>

*Debureaucratization* refers to the process of transferring public functions, powers and authorities to the private sector, business organizations, voluntary and non-governmental organizations, people’s organizations, and to civil society in general. It is essentially enabling non-government and extra-governmental structures to deliver of services and perform functions that traditionally belonged to government.

Debureaucratization (“getting out of the bureaucracy”) is recognition of the limitations of government’s inability to deliver some services due to some limitations (such as lack of resources and even graft and corruption). More important, it recognizes that there are some services and functions that may be more efficiently delivered and performed by the private sector. There may be various modalities of debureaucratization. These may range from government-non-government partnerships, to joint ventures, co-financing between government and private sector, to contracting out and even outright privatization.

Figure Two represents the various modalities of decentralization – deconcentration, devolution and debureaucratization



As suggested earlier, the linkage between intergovernmental transfers and decentralization may be explained within the context of “*fiscal decentralization*.” It will be pointed out that one of the primary concerns of intergovernmental transfers is to be able to achieve the desired results and outcomes (e.g., improved quality of life) based on objectives that have been set by the sub-national government, in particular, and by the national government in general. It concerns the overall impact of local development initiatives through local governments in view of equitable growth and poverty reduction.

It must be realized though, that subnational governments confront two challenges of budgeting in view of realizing their respective policy goals, thrusts, and programs as prescribed in their local development plans. These are in the area of revenue mobilization and revenue utilization. Revenue mobilization refers to the generation of local revenues such as (i) collection of local taxes, e.g. fees and charges, business permits; (ii) proceeds from government services and business operations; (iii) income from assets; and, (iv) funds from grants and aids. Revenue utilization concerns the expenditure management and involves the allocation of local in the provision of goods and services for the fulfillment of the function of government (Tomas, 1999).

In the Philippines, for instance, most local government units have inadequate resources to finance local development and the implementation of national policies due to the imbalance allocation between levels of governments, unequal sharing of the Internal Revenue Allotment (IRA), undefined tax base, and low local tax collection.

#### **4. Intergovernmental Fiscal Transfers: Rationale, Objectives and Outcomes**

As pointed at the outset, there are three principal reasons why intergovernmental fiscal transfers are important between central government and sub-national governments in decentralized states in both industrialized and developing countries (Bahl, Boex and Vasquez, 2001; ADB, 2002)

First, central governments have advantages over sub-national governments in raising revenue from many types of particularly productive sources, while sub-national governments have advantages in providing many types of public services directly to their constituents.

Second, there are often substantial disparities in revenue-raising capacity across decentralized levels of government. Some sub-national governments are inherently more capable in raising revenues than others; this is primarily the case because of their jurisdictional characteristics, i.e., natural resources, population, tax base, geographical location, availability of infrastructure, and quality of political leadership and attitude of people, among others.

Third, resources from the central government can be used to ensure that basic national priorities will be met in all sub-national government jurisdictions. As discussed above, devolution transfers the delivery of basic services from the national level to subnational level to ensure that such needs are directly delivered to the people.

In addition, the central government exhibit better administrative efficiency and distributive function than sub-national governments.

Sub-national governments' fiscal condition concerns the available local revenue resources and their expenditure requirements in local public service delivery, public infrastructure development; promotion of economic sustainability; and contribution to national development and economic growth and stability. More often than not, there is an imbalance between the expenditure and the revenue raising capacity of sub-national governments. Moreover, revenue raising capacity across sub-national governments differs; some are able to generate enough or high revenue, others cannot.

Revenue and expenditure assignments in sub-national national governments give rise to vertical and horizontal fiscal imbalances within a nation's intergovernmental finances (Yilmaz and Bindebir, 2003). Vertical fiscal imbalance means the disparity between revenue sources and expenditure needs at different levels of sub-national

governments. A vertical imbalance occurs when the expenditure responsibilities of sub-national governments do not match with their revenue raising power. Meanwhile, horizontal imbalance occurs when own fiscal capacities to carry out the same functions differ across or within a level of sub-national governments. To a large extent, intergovernmental fiscal transfers are instruments to correct the vertical or horizontal imbalances in the fiscal capacities of different sub-national governments.<sup>1</sup>

Intergovernmental fiscal transfers have four principal objectives: (i) to equalize vertically (improve revenue adequacy); (ii) to equalize horizontally (interjurisdictional redistribution); (iii) to minimize interjurisdictional spillovers (externalities); and (iv) correct major administrative weakness and streamline bureaucracy (ADB, 2003). Table 1 presents the four objectives, needs, and key dimensions in intergovernmental fiscal transfers.

**Table 1. Objectives and Key Dimensions of Intergovernmental Fiscal Transfers**

Objectives	Fiscal Gap, Fiscal Need, and Fiscal Performance Areas	Key Dimensions
<ul style="list-style-type: none"> <li>▪ To equalize vertically (improve revenue adequacy)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Vertical imbalance refers to insufficiency of local revenue resources to meet the costs in providing public services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Fiscal gap between expenditure and capacity to raise revenue from local sources</li> </ul>
<ul style="list-style-type: none"> <li>▪ To equalize horizontally (interjurisdictional redistribution) refers</li> </ul>	<ul style="list-style-type: none"> <li>▪ Horizontal imbalance relates to the disparities across subnational governments' fiscal capacity to raise revenue from local sources</li> </ul>	<ul style="list-style-type: none"> <li>▪ Unequal revenue or tax bases, natural resources/wealth across subnational governmental</li> <li>▪ Variation in socio-economic characteristics of population</li> <li>▪ Differences in geographical location and climate conditions</li> </ul>
<ul style="list-style-type: none"> <li>▪ To minimize interjurisdictional spillovers (externalities),</li> </ul>	<ul style="list-style-type: none"> <li>▪ There is need to maximize the use of central fiscal transfers in better performing subnational governments</li> <li>▪ There is need to address negatives externalities from nearby subnational governments</li> </ul>	<ul style="list-style-type: none"> <li>▪ Benefits from well performing subnational governments spillover to nearby local government jurisdictions</li> <li>▪ Costs of poor performing subnational governments extend to neighbouring local governments</li> </ul>

<sup>1</sup> ADB. Managing Local Government Expenditure and Fiscal Decentralization

Objectives	Fiscal Gap, Fiscal Need, and Fiscal Performance Areas	Key Dimensions
<ul style="list-style-type: none"> <li>▪ To correct major administrative weakness and streamline bureaucracy</li> </ul>	<ul style="list-style-type: none"> <li>▪ Need for administrative efficiency in tax collection and revenue management</li> <li>▪ Central governments have better capacities to manage revenue collection than subnational governments</li> <li>▪ Equitable redistribution of income from central government to subnational governments</li> </ul>	<ul style="list-style-type: none"> <li>▪ Weak administrative processes and redistributive function of national resources</li> </ul>

This fiscal gap between revenue and expenditure and the disparities to earn enough revenue among sub-national governments must therefore be filled by either giving them more revenue raising powers or by revenue transfers from the central government. The latter is relatively ideal since sub-national governments have different characteristics, thus not all of them are able to generate enough revenue to finance local needs.

### Box 1. Experience of IGT in Some Asian Countries

**Cambodia** heavily targets resources to poorer provinces through its revenue-sharing formula, but the formula is being phased in as part of a decentralization process that is beginning with some of the better-endowed areas.

**Pakistan's** main provincial revenue-sharing formula (population-based) by special allocations to backward provinces has led to higher per capita expenditures in the backward provinces, but they still have enormous backlogs in access and higher costs of service provision.

In the **Philippines**, the IRA is found to substantially increase the aggregate resources at the local level and possibly has a modest effect on development status. But it apparently worsens the fiscal imbalance across the various sub-national levels of government.

**India** and **Indonesia** make more sophisticated attempts to deal with fiscal imbalances by considering expenditure needs relative to revenue capacity. But imbalances remain significant, partly because of deficiencies in the design and management of transfer programs and partly due to the offsetting effects of other activities.

Source: ADB, Intergovernmental Fiscal Transfers in Asia.

Vertical and horizontal balance could be achieved by matching taxing powers (capacity to earn) and fiscal transfers; then equalize resources with expenditure requirements. In the Philippines, for instance, the present Internal Revenue Allotment (IRA) formula (based on population, size, and sharing) fails the equitable redistribution function of fiscal decentralization because most of the LGUs that perform better – in terms of service delivery, economic growth, and poverty reduction – have greater tax base, more people, and still get equal share from the fiscal transfers. This further aggravates the imbalance between richer LGUs and poorer ones. In effect, LGUs with greater capacity to earn end up getting more from the IRA; while those that are less capable but have greater level of expenditure needs to push for growth and poverty reduction, receive the smaller share of the transfers. Hence, the gap continues to widen between subnational governments.

Table 2 presents the linkage between the rationale, objectives, and outcomes of intergovernmental fiscal transfers.

**Table 2. Rationale, Objectives, and Outcomes of Intergovernmental Fiscal Transfers**

<b>Rationale</b>	<b>Objectives</b>	<b>Outcomes</b>
1. Central governments have natural advantages over subnational governments in raising revenues from certain types of particularly productive sources, while subnational governments have natural advantages in providing many types of public services.	<ul style="list-style-type: none"> <li>▪ To equalize vertically (improve revenue adequacy)</li> </ul>	<ul style="list-style-type: none"> <li>• Match cost of expenditure and available resources at the subnational governments</li> <li>• Deliver public services, infrastructure development needs at the subnational governments</li> <li>▪ Promote regional development and local economic stability</li> <li>▪ Contribute to national economic growth, sustainability, and development</li> <li>▪ Improved living conditions and quality of life of people</li> </ul>
2. Substantial disparities in revenue-raising capacity across decentralized levels of government	<ul style="list-style-type: none"> <li>▪ To equalize horizontally (interjurisdictional redistribution) refers</li> </ul>	<ul style="list-style-type: none"> <li>▪ Raise standard of public service delivery in lower-income subnational jurisdictions</li> <li>▪ Promote equitable redistribution and allocation efficiency</li> <li>▪ Meet requirements to support local economic development, e.g., provision of key infrastructure and services</li> </ul>

Rationale	Objectives	Outcomes
3. Use national resources to meet basic national priorities at the subnational jurisdictions	<ul style="list-style-type: none"> <li>▪ To minimize interjurisdictional spillovers (externalities),</li> </ul>	<ul style="list-style-type: none"> <li>▪ Subnational constituents enjoy national priority goals by providing basic services such as health, education, water, sanitation, among others</li> <li>▪ Constituents of poor performing subnational governments enjoy services from better performing local governments nearby (spillover/ externalities)</li> </ul>
4. Administrative inefficiency of some local governments	<ul style="list-style-type: none"> <li>▪ To correct major administrative weakness and streamline bureaucracy</li> </ul>	<ul style="list-style-type: none"> <li>▪ Better administrative efficiency in the redistributive function of national resources</li> </ul>

Source: ADB, 2003; TA 5902

## 5. Capacity Building For Effective Utilization of Transfers, Resource Mobilization, and Sustainability

The experiences of decentralization of some Asian countries suggest that local governments everywhere face similar problems and challenges. For instance, the lack of capacities - *financial and human* resources – continues to be a concern. Additionally, the so-called “absorptive capacities” of local governments under a decentralized set-up have to be carefully studied. Capacity building in its various forms should always be a priority and is a continuing process. It must be emphasized though that the “lack of capacities” problem is not the exclusive domain of subnational institutions. Even central government agencies and civil society organizations confront the lack of capacity problem as they are all trying to adjust to a decentralized set-up. What is the “proper” role of each level under such a set up? Among other things, there is the imperative to clearly delineate levels of authority and functional responsibilities between and among the various sectors, government and non-government alike, and between the different levels.

**Box 2. Capacity Building for Local Financial Sustainability in Cambodia**

The Cambodia local councils heavily rely on fiscal transfers to cover both their administration and development expenditures. Indeed, transfers are an important feature of local development administration and governance.

The Commune/Sangkat Funds (CSF) – design of fiscal transfers in Cambodia – recognizes local capacity building as its primary objective. It recognizes that transfers play a critical role in developing and sustaining an autonomous local-level development planning, budgeting and implementation process.

Moreover, the objectives of intergovernmental fiscal transfers are not limited to correcting the vertical and horizontal imbalances; there has to a linkage to develop a system and incentives for local mobilization and management of local public resources. There has to be efforts to put in place mechanism whereby the local councils would have the power and capacity to raise their own revenue source, which would provide the long term solution to financial constraints and would foster local accountability.

Source: ADB, Intergovernmental Transfers in Asia: Cambodia, 2003.

As mentioned earlier, lack of financial capacities continues to serve as a challenge for effective local governance. The concern is how to mobilize resources and generate revenues for effective local governance. Various strategies have been tried, ranging from fiscal transfers from the central government to generating revenues through taxes to harnessing the energies and potentials of the private sector. Decentralizing countries continue to face the challenge of refining the formulas and conditions for transfers. For instance, how should performance, and even extent of poverty and underdevelopment, be incorporated in determining central government transfers to sub-national governments. Add to this the inertia of central government to attach conditionalities to grants and transfers (Brillantes, 2004).

## **6. Intergovernmental Fiscal Transfers: Citizen Participation in Local Planning and Budgeting**

This section draws on “Civic Participation in Subnational Planning and Budgeting.” *Participatory planning and budgeting refer to the involvement of citizens in identifying local priorities, policies, programs, and projects that require allocation of resources.* The idea of participatory planning and budgeting builds upon the opportunity for people participation in the allocation of resources to priority social policies, and for them to monitor public spending and policy performance. The citizens’ involvement in

this innovative policy making processes puts forth the opportunity for people's voice to be heard; and thus become empowered. As such, local constituents gain ownership of these policies/programs/projects for local development. Hence, their desired commitment to support social policies and the LGU development initiatives could be expected.

**Box 3. Participatory Planning and Budgeting: Successful Redistribution Resulting in Better Outcomes**

Studies show that the successful redistribution and utilization of resources in decentralizing states result in better outcomes. A case in point would be Porto Alegre, Brazil, where it was able to balance expenditures and earnings, and equitable redistribution of resources to regions by instituting participatory budgeting. The redistribution of resources to lagging regions is an important function of intergovernmental transfers.

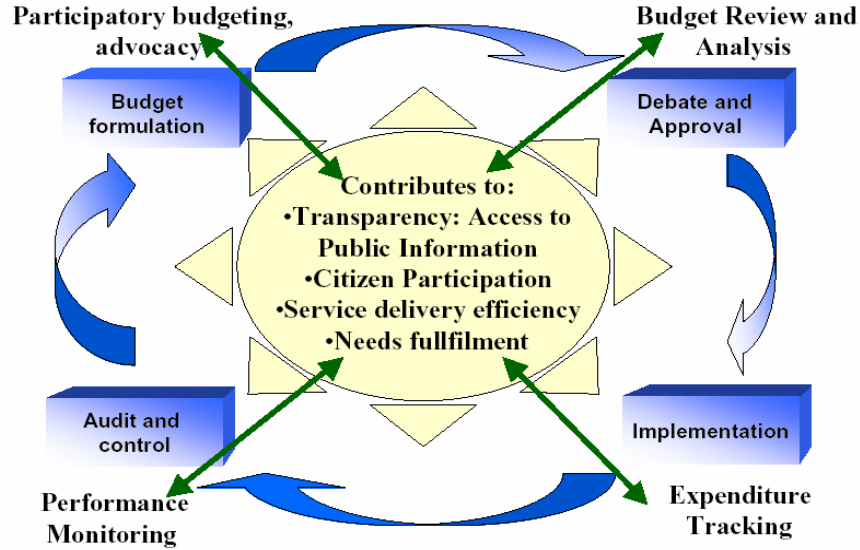
This is not to say that transfers are not important; rather, there has to be an inter-phase between intergovernmental transfers and other stages of financial management and resource utilization at the subnational governments.

Source: World Bank. Thindwa, Jeff. Entry Points for Civil Society to Influence Budget Processes

Budgeting means drawing a plan – periodic/annual budget based on local development plan in the case of local government units – in monetary terms. Participatory budgeting could be viewed in two ways. First, it uses a tool for participatory governance wherein program/project interventions are needs-based; thus, programs/projects financed by the local government have direct and significant impact on the lives of local constituents.

Second, it could be viewed as a mechanism whereby the citizens are directly involved in the actual budgeting processes – budget formulation, review and approval, execution, and review – thereby ensuring transparency and accountability of the expenditure management of local funds. “Participatory approaches to expenditure management refer to the range of methods, tools and choices that introduce/involve ordinary citizens and civil society in general into the process of allocation, tracking disbursement, and monitoring use of public resource (See Figure Three) (World Bank, : Thandwa).” At the end of the day, participatory planning and budgeting contribute to transparency, where people have access to public information; citizen participation; service delivery efficiency; and, needs fulfillment.

**Figure Three. Framework for Citizen Participation in Subnational Budgeting**



Source: World Bank Thindwa, Jeff. Entry Points for Civil Society to Influence Budget Processes

## 7. Intergovernmental Fiscal Transfers: Harmonizing Objectives, Goals and Outcomes

The delivery of local services at the subnational governments requires financial resources. However, most subnational governments suffer from financial constraints to fund the provision of basic services such as health, education, water, sanitation; and local infrastructure development. As such, fiscal transfers have been the mechanisms to fill the gap between expenditure needs and local revenue resources. Intergovernmental transfers “support significant increases in local service delivery because they transfer significant amount of funds from national government to subnational governments.”<sup>2</sup>

The intergovernmental fiscal transfers design has to be able to meet the critical linkage of national and subnational governments in harmonizing objectives and outcomes. “As such, a well-designed intergovernmental fiscal transfers can play a critical role in promoting regional development, developing local infrastructures, delivering essential services and reducing poverty in a more efficient and equitable manner.”<sup>3</sup>

Harmonizing the objectives and outcomes of intergovernmental fiscal transfers is not as simple as many would think – transferring money from the national government to subnational governments. It does not only refer to achieving vertical or horizontal

<sup>2</sup> ADB, TA 5902. Study on Intergovernmental Fiscal Transfers for Equitable In-Country Growth. Intergovernmental Fiscal Transfers in Asia: Current Practice and Challenges for the Future, 2003.

<sup>3</sup> *ibid*

objectives or equalization but more importantly, achieving desired results and outcomes at the subnational levels, i.e. delivering the services to the people, especially to the poor; improving the living conditions of the local constituents; reducing poverty; and contributing to regional and national economic development, sustainability and growth.

**Box 4. Challenges in Designing and Implementing Intergovernmental Transfers**

Based on the studies of 5 Asian countries that practice intergovernmental fiscal transfers, ADB has enumerated several challenges in designing and implementing them, among others:

- National government officials recognize the importance of stable sources of revenue for subnational government to meet their increasing functions and responsibilities; however, they are worried about the macroeconomic implications of institutionalizing major intergovernmental transfers
- Intergovernmental transfers are often intended to meet a variety of difficult, and sometimes conflicting objectives. Hence, programs have to be prioritized to meet different objectives.
- Devising mechanisms to allocate intergovernmental transfers can be very challenging. Selecting the appropriate criteria and measuring performance are much more difficult and problematic.
- The objectives of intergovernmental fiscal transfers are often compromised by political and institutional interference
- The overall effect of intergovernmental fiscal transfers and other national policies related to subnational governments on broader development goals is difficult to determine.

Source: ADB, Intergovernmental Fiscal Transfers in Asia.

## 8. Summary Notes

The various concepts, rationale, justifications, and objectives of intergovernmental fiscal transfers boil down to how subnational governments can finance the delivery of public goods and services at the local levels in a decentralized set-up of government. Intergovernmental fiscal transfers should be viewed as a part of fiscal decentralization and the larger system of decentralization.

The intergovernmental fiscal transfers do not guarantee achievement of objectives and outcomes. The case studies on “Intergovernmental Fiscal Transfers in Asia” (ADB) covering 5 countries – Cambodia, Philippines, Pakistan, India and Indonesia – offer a very valid observation that intergovernmental transfers are not the only factors that influences better outcomes to subnational governments. Indeed, intergovernmental

transfers should not be situated outside the overall framework of fiscal decentralization, and decentralization for that matter. Rather, it should be viewed as part of the system and its design should be tailored fit to work within the system of local governance.

The design of transfers has to be placed within the overall context of systems and processes of subnational governance, i.e. legal and regulatory framework, local development planning, budgeting process, financial management, implementation, revenue mobilization, and own revenue source generation, among others.

An effective intergovernmental fiscal transfer design has therefore to emphasize the allocative efficiency and equitable redistribution of funds to subnational governments; thereby addressing the issues of vertical and horizontal imbalances. More importantly, a good fiscal transfer design has to support (i) improvement of service delivery; (ii) equitable growth; (iii) poverty reduction; (iv) regional and national development; and (v) contribute to the attainment of the Millennium Development Goals.

## **9. Indicative Action Points**

This paper recognizes that the impact of intergovernmental transfers on the outcomes has not yet been well-studied, at least in Asia. Most of the few studies focus on fiscal decentralization and the larger context of decentralization that link objectives and outcomes of national and subnational policies.

Hence, researches should be pursued focusing on effect/impact of resources through intergovernmental transfers towards the attainment of outcomes. An empirical study would show that the resources provided through fiscal equalization efforts were spent on improving the critical local services generally presumed to improve economic growth and income distribution. Furthermore, such endeavor could also focus on establishing the linkage between intergovernmental transfers and improved service delivery by the subnational government impacting on the improved service delivery, economic growth, and poverty reduction.

Attempts to present the idea of harmonizing objectives and outcomes of national and subnational governments through intergovernmental transfers would require a methodological and thorough research. Ideally, it should look into the direct relationship or linkage of resources from intergovernmental transfers and outcomes at the local level, and ultimately, national policy goals. Comparative researches should be conducted which would lead to a critical analysis on how to effectively harmonize objectives and outcomes of intergovernmental transfers.

This could be among the next steps that could be taken within the context of defining a sharper research agenda.

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## End Notes

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<sup>i</sup> Kakhonem (2001) writes that *allocative efficiency* may be attained through better matching of public services to local preference; *productive efficiency* may be attained through increased accountability of local governments to citizens, fewer levels of bureaucracy, and better knowledge of local costs.

<sup>ii</sup> Cheema and Rondinelli, in their classic and authoritative work *Decentralization and Development. Policy Implementation in Developing Countries* (1983) list as many as fourteen reasons behind the adoption of decentralized development planning and administration in developing countries. These include the following: overcome the limitations of centrally controlled national planning; cut through red tape; increase the sensitivity and knowledge of central government officials to local problems; allow political and administrative “penetration” of national government policies into remote areas; allow greater representation for various political, ethnic and religious groups; develop greater administrative capability among local governments; increase efficiency of central government by relieving top management officials of routine tasks; provide a coordination structure for national agencies operating at the local level; institutionalize participation of citizens; create alternative means of decision-making; lead to flexible and innovative administration; allow leaders to locate services and facilities among local communities; increase political stability and national unity by recognizing diversity; and reduce diseconomies of scale inherent in over-concentration of decision-making in the national capital.

<sup>iii</sup> Good governance has been referred to as the “missing link” between anti-poverty efforts and poverty reduction. According to the UNDP (2000:54) “even when a country tries to implement economic policies to foster pro-poor growth and mount targeted poverty programmes, inept or unresponsive governance institutions can nullify the impact.” It is within this context that decentralization, *properly implemented and supported*, may be an effective instrument that may bring about effective governance. We are definitely cognizant of the possibility that the decentralization strategy, if badly planned and implemented, can even worsen inequalities (UNDP 2000:60). Decentralization may therefore be a two-edged sword.

<sup>iv</sup> We use the term “industry standard” to suggest that many multilateral development institutions – have used as reference, or taken off from, the Cheema and Rondinelli construction.

<sup>v</sup> This is certainly not an attempt to romanticize the notion of decentralization. As stated elsewhere in the paper, decentralization is a double bladed sword: not used properly, it can exacerbate inequalities among regions and even lead to fragmentation of the state; but when used correctly, can indeed be a potent poverty reduction strategy.

<sup>vi</sup> <http://www.decentralization.org>; see also [www.ciesin.org/decentralization](http://www.ciesin.org/decentralization). Another relatively new site is <http://www.decentralization.ws> of the Asian Resource Center for Decentralization.

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vii These criteria are essentially in accordance with the classic elements of the state as described in political science literature, i.e., people, territory, sovereignty

viii It is within this context that one cardinal rule that must be followed in implementing decentralization is Roy Bahl's (1999) Rule No. 2: "*Finance follows Function.*" In other words, Bahl argues that the functions and responsibilities of local authorities should be clearly defined first, vis-à-vis national authorities. After a clear delineation of responsibilities, then the funding of such services – whether by transfers from the central government, or by locally generated taxes, or users fees, etc – should then be addressed. One reason for failed decentralization strategy is the continuing practice on the part of central authorities to mandate sub-national governments to perform functions without providing the necessary funds, hence "unfunded mandates." Some refer to this practice as "dumping" – referred to elsewhere in this paper as "load shedding" - of responsibilities to the local governments on the part of central authorities because of the inability of the latter to continue funding them. The complete and highly authoritative *Implementing Rules for Fiscal Decentralization* as developed by Roy Bahl which is rapidly becoming a classic in the decentralization discourse are as follows:

- Rule one: Fiscal decentralization should be viewed as a comprehensive system
- Rule two: Finance follows function
- Rule three: There must be a strong central ability to monitor and evaluate decentralization
- Rule four: One intergovernmental system does not fit the urban and rural sector
- Rule five: Fiscal decentralization requires significant local government taxing powers
- Rule six: Central governments must keep the fiscal decentralization rules that they make
- Rule seven: Keep it simple
- Rule eight: The design of the intergovernmental transfer system should match the objectives of the decentralization reform
- Rule nine: fiscal decentralization should consider all three levels of government
- Rule ten: Impose a hard budget constraint
- Rule eleven: Recognize that intergovernmental systems are always in transition and plan for this
- Rule twelve: There must be a champion for fiscal decentralization

ix This would be in accordance with the time honored dictum that there can only be taxation when there is representation of the people, in this case through the local legislative body.