Policy Paper

Fiscal Transfers: Global Lessons and Best Practices

INTERGOVERNMENTAL FISCAL RELATIONS (IGFR): LESSONS FOR SUDAN FROM INTERNATIONAL, PRINCIPLES, EXPERIENCES, AND PRACTICES

Khartoum, September, 2013
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## Acronyms

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<th>Acronym</th>
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<tr>
<td>COGTA</td>
<td>Cooperative Governance and Traditional Affairs</td>
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<td>CG</td>
<td>Conditional Grants</td>
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<td>CB</td>
<td>Capacity Building</td>
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<td>DBSA</td>
<td>Development Bank of Southern Africa</td>
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<td>DTE</td>
<td>Developing Transition Economies</td>
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<td>DRC</td>
<td>Democratic Republic of the Congo</td>
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<td>ES</td>
<td>Equitable Share</td>
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<td>FFC</td>
<td>Financial and Fiscal Commission</td>
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<td>HDI</td>
<td>Human development Index</td>
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<td>IDP</td>
<td>Integrated Development Plan</td>
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<td>IGFR</td>
<td>Intergovernmental Fiscal relations</td>
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<td>LEA</td>
<td>Local Equitable Allocation</td>
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<td>LES</td>
<td>Local Equitable Share</td>
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<td>MTEF</td>
<td>Medium Term Expenditure Framework</td>
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<td>MDG</td>
<td>Millennium Development Goals</td>
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<td>MIG</td>
<td>Municipal Infrastructure Grant</td>
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<td>NAPEP</td>
<td>National Poverty Eradication Program</td>
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<td>NEA</td>
<td>National Equitable Allocation</td>
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<td>NIE</td>
<td>New Institutional Economics</td>
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<td>PCC</td>
<td>Presidential Coordinating Council</td>
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<td>Provincial Growth and Development Strategies</td>
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<td>SALGA</td>
<td>South African Local Government Association</td>
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<td>SPG</td>
<td>Specific Purpose Grants</td>
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<td>UNDP</td>
<td>United Nations Development Program</td>
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<td>VFG</td>
<td>Vertical Fiscal Gap</td>
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Acknowledgements

Although this paper and associated presentation draws extensively on previous work and research, and was essentially a desktop exercise, its final version is substantially enriched by comments from the respondent and participants at the Round Table. In particular, I would like to thank the discussant Professor Atta Al Batahani, Department of Political Science (University of Khartoum), His Excellency Mr Ali Mahmoud Abdul-Rasool, Minister of Finance and National Economy and Mrs Amna Abbaker, Secretary General of the Financial and Fiscal Allocation and Monitoring Commission, whose insightful questions, contributions and comments were significant. In addition, I would like to thank the UNDP Sudan office for inviting me to the Round Table. In this regard, the support and advice provided by Mr. Getachew Adem Tahir, Economic Advisor for UNDP Sudan, and his staff in the course of preparation of the paper were invaluable.

Dr. Jaya Josie
3 December, 2013
Executive Summary

The purpose and objective of this paper is to consider the extent to which internationally accepted practices of intergovernmental fiscal relations (IGFR) principles may provide important lessons for Sudan. However, it is important to note that the diverse nature of IGFR and fiscal decentralization has given rise to an equally diverse and extensive body of international literature. For this reason, the paper can only present a brief and selective general review of the issues. In particular, the paper reviews and discusses lessons for Sudan with specific reference to fiscal decentralization principles and practices to address pro-poor and poverty reduction policy objectives for Sudan. Thus, the paper reviews the international IGFR literature on principles and best practices from which policymakers may draw lessons for application in Sudan. Using concrete examples the paper discusses the essential background features and challenges in IGFR systems and the tensions that exist, and compromises that must be made in order to resolve these tensions.

Structure of the Paper

Including the introduction, the paper is divided into six sections. The introduction discusses the objectives of the paper and the framework used for highlighting a number of general features and best practices that characterize successful intergovernmental systems and sets them apart from less successful ones. Using a framework for assessing the IGFR system in South Africa, the paper presents a context and background for a general discussion on lessons that may be learned from developed and developing transition economies (DTE). Section two considers optimal IGFR principles and practices for addressing pro-poor and poverty reduction policy objectives in DTEs. The next part, Section three, reviews theoretical and conceptual frameworks for fiscal decentralization for pro-poor and poverty reduction policies in DTEs. Section four considers fiscal decentralization designs for such policies. Section five discusses the notion of harmonization and equalization of transfer mechanisms, taking account of sub-regional socio-economic disparities, and section six presents some examples of equalization transfer mechanisms that account for sub-regional socio-economic disparities. Section seven summarizes the key principles and recommendations that may be relevant for Sudan.

Aim of IGFR in Developing Transition Economies (DTEs)

In DTEs, the main aim of IGFR policies is to ensure provision of basic public services for achieving national equity goals in general, and pro-poor and poverty reduction policy objectives in particular. These, explicitly stated or not, include the aim that citizens ought to have equal access to food, educational opportunities, health care, water and sanitation, housing, job opportunities and socio-economic security regardless of where they reside. The role of the fiscal transfer system is to facilitate the decentralization of fiscal responsibilities in a way that leads to efficient and responsible sub-regional decision-making, while at the same time respecting developmental and macroeconomic policy objectives. An effective equitable sharing system must be able to effectively balance the competing demands for macroeconomic stability against the need for equity and redistribution in developing nations with high levels of socio-economic and spatial disparities. Figure 1 in the paper illustrates this virtuous cycle to show how a DTE attempts
to resolve the balance between developmental and macroeconomic policy objectives. The efficient application of IGFR principles will contribute to an effective IGFR system.

**IGFR Principles for Best Practice (Shah: 1994)**

In the literature Shah (1994) presents a set of IGFR principles against which policies for the equitable sharing on nationally-collected revenues may be assessed. These principles include: fiscal autonomy of sub-regional governments; revenue sharing for fiscal equity; formula-driven, rather than discretionary, grants; transparent processes for determining grants; unconditional major grants; sub-regional accountability for expenditures; avoidance of bailouts; norms and costs as elements of the grant formula; macroeconomic management; sub-regional revenue raising powers and, sub-regional government financial management. The equitable sharing of national revenue is implemented through an equalization mechanism that, in practice, should satisfy the IGFR principles.

Application of IGFR principles for equitable sharing of revenue
Almost all decentralized states have an equalization mechanism for the fair sharing of resources among provinces/states and local governments. Sharing entails affording sub-national government sufficient resources, such that each can provide comparable levels of public services using similar revenue-raising effort. This is what is referred to as fiscal equity. It is an explicit objective of the Australian federal system and is built into the Canadian constitution as a requirement of the equalization system (Petchey, 2011; Boadway, 2003; Dahlby, 2004; Freebairn, 2011). Equitable shares are unconditional grants and discretionary to the extent that sub-national governments choose the exact mix of services preferred by their constituents, provided they meet the basic national norms and standards set nationally for health, education, water and sanitation and welfare. Stability, certainty and avoidance of budget shocks of allocations are ensured by the use of formulae over a medium term planning cycle.

Principles, Design and Practices for Effective Allocations
Grant allocations are determined by a well-specified formula and have a number of advantages over those that are determined on an ad hoc discretionary basis by national government. Formula-driven grants are more transparent, reliable and predictable, and are less subject to short-term fiscal constraints and day-to-day political considerations. Formula driven grants are designed to be in place for intervals of several years. They are also designed so that risks of unexpected changes in revenue are borne by national government, which may be especially important where provincial governments have little revenue-raising ability, and where they cannot use debt as a method of insuring themselves against revenue fluctuations.

In South Africa and Australia major grants, especially those that play an equalizing role, tend to be largely unconditional and non-matching. This ensures that sub-regions are able to exercise the utmost discretion. Of course, there may be some requirement to ensure that when sub-regions use these grants to deliver important social programs, they adhere to national norms and standards. Formula-driven, unconditional grants have one further benefit because provinces bear responsibility for the consequences of their expenditure. The grants help to avoid the potentially-serious problem faced by many
federations with large vertical fiscal imbalances – the problem of bailouts of irresponsible (or over-zealous) sub-regional governments.

There are two elements that can facilitate the design of equalization grants. One is a component that compensates for differences in the ability of provinces to raise their own revenues. This is relatively straightforward to implement, and equalization systems in established federations tend to do so (for example, Canada and Australia). The other involves differences in the resources required to achieve comparable service levels. These differences arise due to variations in demography and geography among provinces and municipalities. Historically inherited inequality in levels of development, including critical capital backlogs, is a major determinant of sub-regional

**Challenges in implementing Grant Formulae**

DTEs do not have access to reliable data for implementing complicated grant formulae. In such cases the grant pool may have to be estimated macro-economically, and the allocations determined via consensus achieved through a process of cooperative governance, and negotiations within intergovernmental fora.

The ability to raise their own revenues offers sub-regional governments freedom to implement programs of their own choice and size. However, the fact that many sub-regions do not have an adequate tax base is a significant discouraging factor. Therefore, the case for decentralizing expenditure functions is much stronger than for decentralizing taxation functions. Although sub-regions can impose certain taxes, most of them choose not to although they may by simply “piggy-backing” onto the national system at their own chosen rates. This results in a system characterized by vertical fiscal imbalances where expenditure responsibilities are decentralized to sub-regional governments, but tax revenues sources are centralized in favor of the national government (Martinez-Vazquez & Searle: 2007).

**IGFR Institutional Assignment of Powers and Functions in Practice**

National Parliaments or legislatures normally determine, through legislation, the nationally-accepted norms and standards of constitutionally- mandated public services. By setting out clearly, through legislation; the policy objectives, targets (primary, intermediary and secondary), policy instruments (legislative, administrative, institutional), and budget requirement and monitoring mechanisms. In some countries, National Parliament can prescribe how the public service norms and standards may be implemented.

Conventionally, the national, central or federal government has over-riding responsibility for the macroeconomic management, management of the country’s political, security and foreign affairs, and shares responsibility with sub-national or regional governments for the provision of public services and the collection of revenues. In addition, central government may also mandate appropriate, essential or minimum levels, norms and standards of services. Sub-regional governments are responsible for delivering most of the range of public social services which fall in the areas of education, welfare, and health, transport, and sometimes, housing. Local governments carry responsibility for provision of local infrastructure, housing, public transport and basic services such as sanitation and
water reticulation among others. The framework in Table 1 in the paper illustrates how constitutional and legal obligations may be balanced and coordinated with institutional arrangements for the delivery of service mandates against prescribed constraints.

The successful implementation of IGFR and fiscal decentralization policies require a sound institutional framework. In principle, IGFR institutions are there to support and ensure cooperative governance, monitoring and functioning of intergovernmental fiscal relations. In South Africa, for example, these institutions formalized in legislation include the Budget Council, the Budget Forum, the Financial and Fiscal Commission (FFC) and the South African Local Government Association (SALGA). In addition, the Presidential Coordinating Council (PCC) that includes the Office of the President, Members of the Cabinet and the Premiers of the provinces, are important in guiding intergovernmental fiscal relations. All these institutions play a vital role in balancing the priorities of the three spheres of government in South Africa. In Australia and India, independent grant commissions are charged with the responsibility of making recommendations for the equitable allocation of grants (Shah: 1994).

Pro Poor IGFR Policies and Practices in DTEs

In general, pro-poor policies for poverty reduction in developing transition economies could fall under the broad intergovernmental relations principle and practice of fiscal equalization. In some countries such as South Africa, Nigeria, Ethiopia and the Democratic Republic of the Congo (DRC) pro-poor IGFR objectives are mandated in the Constitution with respect to enshrining the rights of citizens to basic services, and are the fundamental responsibility of government. In principle, to ensure pro-poor and poverty reduction strategies, equitable shares should be based on the costs of delivering services, and should take account of disparities in demography, geography and other socio-economic conditions (for example disparities in health, income inequality, unemployment, infrastructure backlogs and inaccessible regions) that affect the costs of delivering the services (Shah: 1994).

Legislation often gives specific mandates for provision of free or subsidized basic services to disadvantaged communities to address pro-poor and poverty reduction across sub-regional governments. In addition, conditional grants may be used to direct national resources to achieve particular objectives that national government may identify such as infrastructure and the development of institutional capacity. Such grants are used to avoid committing sub-regional governments to finance unfunded mandates not included in their budgets.
Fiscal Decentralization: Equalization and Harmonization

Countries tend to compensate for socio-economic and fiscal disparities by using intergovernmental equalization grant transfers (Bahl: 1999). The effectiveness of the equalization policy instrument depends on what taxes support the transfers, what sub-regional services are to be financed and what distribution formulae are to be used to allocate resources among sub-regional governments. Fiscal disparities emerge when sub-regional governments are granted greater revenue raising powers and those sub-regions with larger tax capacities and stronger administrative infrastructures are advantaged at the expense of the poorer regions with lower fiscal capacities. The role of equalization is to ensure that regions with lower fiscal capacities can provide the same levels of public goods and services as those regions with higher fiscal capacities and abilities (Boadway: 2003).

Redistribution is the basis of equalization, especially where decentralization tends to create disparities in regions that limit their capacity to provide a nationally-accepted level of services. The impact of equalization will depend on the extent to which sub-regional own revenue raising capacity can be balanced against sub-regional expenditures for the provision of services. This balance is measured by the extent of the vertical fiscal gap (VFG). If the VFG is bigger, the reliance on transfers is also greater and vice-versa. Boadway (2003: 3) presents three criteria that must be met to determine an optimal equalization instrument.

- Policy should show that sub-regional expenditure and revenue-raising decisions are optimal and as such that they are in the national interests as well as the sub-regional interests.
- Equalization should have benefits for correcting and compensating for non-optimal regional decision-making that results in non-optimal decentralized outcomes, such as inter-jurisdictional fiscal externalities on expenditures and/or own revenues decisions.
- Equalization instruments, such as grant formulae based on clear outcomes, must limit the extent to which they may introduce perverse incentives that allow sub-regional governments to manipulate and influence the outcomes.

To summarize, equalization can be used as a policy instrument to:

- Achieve horizontal equity among residents of different regions
- Ensure regional government stability against negative shocks
- Ensure predictability of regional budget allocations
- Ensure that different regional governments have comparable fiscal capacities to provide standard levels of services across the country
- Correct for distorting regional government decisions.

Evaluating Institutional Arrangements for Pro Poor Equalization

A study by Shah: 2005, using a new institutional economic framework, considered four models of institutional arrangements across several countries that include developed and DTEs. The evaluation was conducted using criteria to compare overall transaction
costs and outcomes when each of these two models is used. The rating for overall transaction costs criteria ranges from high, medium to low, and the criteria for outcomes are assessed as to whether they are positive (yes), negative (no), not applicable (N/A) and unsure (maybe). The institutions studied included the following models: central/national government agencies, national legislatures, intergovernmental forums, and independent agencies such as grants commissions. The study (Shah: 2005: 11) found that:

- The independent role of so-called independent institutions is overrated because norms and standards for equalization should not be separated from political decision-making.
- Independent institutions generate agency problems in an attempt to find and maintain their relevance. Among others the agency problems include:
  - Mission creep to extend and enlarge its role and influence,
  - Incentive for complexity to solve simple questions in order to create a market demand for high levels of technical expertise, and public oversight becomes too difficult, costly and impractical as the agency’s output becomes more complex.

For his conclusions, and the lessons that may be extremely useful for DTEs, Shah (2005: 11) concludes that:

- Compared to an intergovernmental forum model an independent agency model will generate higher overall transactions costs and less desirable potential outcomes because:
  - The independent nature of grants commissions and their pursuit of ideal complex systems undermine the role of public participation, oversight, transparency and accountability in the formulation of recommendations.
  - Participation and monitoring costs will also rise without any assurance that the higher transaction costs will generate better outcomes.
  - The usefulness and impact of the independent agency model is limited because of its high transaction costs, and its predilection for ideal and optimal solutions as opposed to feasible and practical reforms.
- By comparison intergovernmental fora tend to engage in political bargaining in search of simpler and feasible solutions to reduce transaction costs for the country.

Thus, the author (Shah: 2005: 12) proposes that to achieve simpler, equitable and durable outcomes each institutional arrangement must be informed by an analysis of the incentive regime in place and the related agency costs.

**Designing Pro Poor Fiscal Decentralization Policy**

Designing a pro poor equalization grant system must follow general principles and rules for transfers to achieve these policy objectives. Fundamentally a grant system is about the equitable, efficient and effective allocation of nationally-collected revenues and resources to meet national redistributive policy objectives. The allocation rule, together with stabilization and redistribution rules, is the key policy principle for management of intergovernmental fiscal relations systems. In IGFR, practice allocations must be consistent with the general equitability principles of parity, proportionality, and priority (Young: 1994:
8-9). Parity means that all claimants should be treated equally; Proportionality recognizes that goods and services must be divided according to the established differences amongst claimants; and, Priority affirms that the person with the greatest need is entitled to a first claim on the goods or services.

Recommendations for a Revenue Sharing System:

For a developing transition economy such as Sudan there are certain basic principles that may be relevant. Among others these include the following:

- National revenue must be divided equitably between national and sub-regional governments to provide the mandated national basic levels of public services. In addition, conditional grants may be used to direct national resources to achieve particular objectives that national government may identify from time to time, such as poverty reduction, public infrastructure and the development of institutional capacity.
- The equitable share component of the equalization grant should be based on an objective measure of the norms and costs of delivering the mandated services in each sphere. Objective criteria may be translated into a transfer formula that allocates the amount of money that would be required for the sub-regional government to deliver an optimal standard level of services in an efficient way.
- The transfer amount should take account of disparities in demography, geography and other socio-economic conditions (for example poverty levels, health, income inequality, unemployment and infrastructure backlogs) that affect the costs of delivering the services. Such grants could have the following characteristics:
  1) Be unconditional in the sense that government spheres would be free to choose the exact mix of services most preferred by their constituents, provided they met the basic norms and standards set nationally for poverty reduction, health, education and welfare. This would encourage responsibility and would not distort the incentives for spending and raising revenues.
  2) The amounts provided to each sphere of government should be stable over the medium term to ensure the planning of expenditures and not be subject to uncertainty or budget shocks.
  3) A formula, rather than administrative discretion, should drive the amounts provided so that the process is transparent and as objective as possible.
  4) The size of the equitable share should be affordable given the fiscal realities facing national government.
  5) Sub-regional equitable shares relative to the national equitable share should take account of own source sub-regional revenues.
  6) The division of equitable shares should provide support through conditional grants, to specific elements of basic services that have spillover effects (such as teaching hospitals, and public infrastructure such as roads).

- The use of the equitable shares is subject to important constraints and expectations. Sub-regional governments must, therefore, provide basic services according to the nationally-agreed mandates and must be held accountable to the national and sub-national legislatures, and to the public in the relevant jurisdiction.
• The level (norms and standards) of services provided by all spheres must be sustainable, and be raised as the economy develops and generates the resources to meet social pressures for higher standards.

• The equitable shares must continually be balanced against the requirement to maintain viable national economic and fiscal policies in the face of a great demand for services.

• As the ability of sub-regional governments to raise their own revenues is enhanced, they should become more responsible and accountable to their electorates.

• Sub-regional restructuring must equalize and extend benefits to areas that have been historically disadvantaged and under-serviced in the past.

• The relationships among the three spheres of government – national, provincial/state and local – must nurture co-operative intergovernmental relations through negotiation and consensus for establishing norms and standards for basic services.

Thus, in balancing the need to provide basic services against current fiscal realities, the long-run payoff of investment in services such as poverty reduction, education and health, is that it creates the conditions for stronger economic growth and generates a healthier fiscal environment for further sustainable savings and investment.
Introduction

It is an essential feature of all IGFR systems, federal and non-federal, that tensions exist and compromises must be made. The experience of decentralized states, especially the more established federal states, highlights a number of general features and best practices that characterize successful intergovernmental systems and set them apart from less successful ones (Shah, 1994). By success, it is meant that the decentralization of public service provision achieves two objectives. First, it gives sub-national governments’ responsible legislative authority to meet their own constituents’ particular needs effectively. Second, it ensures that citizens are provided with comparable access to basic social services regardless of their residence. Specifically, in the case of Sudan, the IGFR system may be effectively used to implement pro-poor and poverty reduction policy objectives.

The best practice IGFR principles listed by Shah (1994) include fiscal autonomy of sub-regional governments; revenue sharing for fiscal equity; formula driven rather than discretionary grants; transparent processes for determining grants; unconditional major grants; sub-regional accountability for expenditures; avoidance of bailouts; norms and costs as elements of the grant formula; macroeconomic management; sub-regional revenue raising powers and, sub-regional government financial management.

Although decentralizing basic public service provision to sub-regional spheres of government can enhance efficiency, these basic public services are at the same time among the most important policy instruments for achieving national equity goals in general, and pro-poor and poverty reduction policy objectives in particular. These, explicitly stated or not, include the aim that citizens ought to have equal access to food, educational opportunities, health care, water and sanitation, housing, job opportunities and socio-economic security regardless of where they reside.

It is the role of the fiscal transfer system, and fiscal decentralization policies more generally, to facilitate the decentralization of fiscal responsibilities in a way that leads to efficient and responsible provincial or sub-regional decision-making, while at the same time respecting developmental and macroeconomic policy objectives. An effective equitable sharing system must be able to effectively balance the competing demands for macroeconomic stability against the need for equity and redistribution in developing nations with high levels of socio-economic and spatial disparities. Figure 1 illustrates this virtuous cycle to show how a country like South Africa, emerging from centuries of colonial and apartheid oppression, attempts to resolve the balance between developmental and macroeconomic policy objectives.

Almost all decentralized states have some mechanism for the fair sharing of resources among provinces/states and local governments. Sharing entails affording sub-national government sufficient resources, such that each can provide comparable levels of public services using similar revenue-raising effort. This is what is referred to as fiscal equity. It is an explicit objective of the Australian federal system, and is built into the Canadian constitution as a requirement of the equalization system (Petchey, 2011; Boadway, 2003; Dahlby, 2004; Freebairn, 2011).
In South Africa, for example, grant allocations are determined by a well-specified formula and have a number of advantages over those that are determined on an *ad hoc* discretionary basis by national government. Formula-driven grants are more transparent, reliable and predictable, and are less subject to short-term fiscal constraints and day-to-day political considerations. This aspect of grants cannot be over-emphasized, especially in decentralized systems, such as South Africa, where provincial governments have relatively limited revenue-raising power. Formula driven grants are designed to be in place for intervals of several years. They are also designed so that risks of unexpected changes in revenue are borne by national government, which may be especially important where provincial governments have little revenue-raising ability, and where they cannot use debt as a method of insuring themselves against revenue fluctuations.

**Figure 1: A Structural View for the Equitable Sharing of Transfers to Regions with high levels of Disparities**

Source: Adapted from Petchey, MacDonald, Josie, Mabugu, Kallis: 2007

In South Africa and Australia, major grants, especially those that play an equalizing role, tend to be largely unconditional and non-matching. This ensures that sub-regions are able to exercise the utmost discretion. Of course, there may be some requirement to ensure that when sub-regions use these grants to deliver important social programs, they adhere to national norms and standards. In South Africa, for example, national government and the provinces bear joint responsibility for ensuring that public services in areas like education, welfare, and health satisfy national equity criteria. Formula-driven, unconditional grants have one further benefit because provinces bear responsibility for the consequences of their expenditure. The grants help to avoid the potentially serious
problem faced by many federations with large vertical fiscal imbalances – the problem of bailouts of irresponsible (or over-zealous) sub-regional governments.

National grants that are intended to equalize the ability to provide comparable levels of public services are inherently difficult to design (Reschovsky, A., 2007). There are two elements that can facilitate this design. One is a component that compensates for differences in the ability of provinces to raise their own revenues. This is relatively straightforward to implement and equalization systems in established federations tend to do so (for example, Canada and Australia). The other component involves differences in the resources required to achieve comparable service levels. These differences arise due to variations in demography and geography among provinces and municipalities. Historically-inherited inequality in levels of development, including critical capital backlogs, is another major determinant of sub-regional disparities. These are much more difficult to measure and very few countries attempt to do so in a detailed way. An exception is Australia, where the equalization system incorporates needs in a sophisticated approach to determine the horizontal allocation of grants among states (Petchey, 2011, Freebain, 2011).

There is widespread agreement that, in principle, cost differences in fiscal requirements ought to be included in equalization grants. Costing services using a production or cost function approach is extremely complicated and data intensive and requires long run time series data. Not many developing countries have access to such data. For these and other reasons, in South Africa, the nationally collected revenue is macro-economically estimated and the pool of funds available for equitable shares is determined via consensus achieved through a process of cooperative governance as stipulated in Section 41 Chapter 3 of the Constitution. The consensus is achieved through negotiations within intergovernmental fora, such as the Budget Council and the Budget Forum and their respective administrative committees made up of officials from national and provincial government departments. The decisions made are supported by extensive technical research.

In the South African context, the requirements that the norms and costs of providing basic services inform are not only the horizontal division of funds across provinces and municipalities, but also the vertical division of the equitable share. Although it is the prerogative of national government to determine the vertical division of national revenue, it must nonetheless be done in a way that satisfies the requirements set out in the Constitution. These involve ensuring that the provinces and municipalities can provide basic services up to the national norms and standards. National government is ultimately responsible for macro-economic management and hence the implementation of fiscal and monetary policies that will facilitate its employment, price stability and growth objectives.

The case for decentralizing expenditure functions in countries such as South Africa is much stronger than for decentralizing taxation functions. Although provinces in South Africa can impose certain taxes, most of them choose not to exercise this prerogative. Provincial governments can have taxing responsibility without disrupting a harmonized national tax system by simply “piggy-backing” onto the national system at their own chosen rates. The ability to raise their own revenues offers provincial governments a valuable degree of freedom that allows them to implement programs of their own choice and size. This is an important aspect of sub-regional autonomy. However, the fact that
many provinces in South Africa do not have an adequate tax base is a significant, discouraging factor.

South Africa’s IGFR system has important functions decentralized to the local government level. Principles that are relevant for provinces also apply to financing local government. For example, the importance of decentralizing local decision and fostering independence of local decision-making, the need for oversight to ensure that local governments’ program design satisfies national norms, and the relevance of equity and efficiency considerations in the design of grants. One additional consideration arises in the local government context, and that concerns the relationship of local governments to national and provincial governments.

In most countries, the relationship among governments is strictly hierarchical. National governments deal with the provinces, while provinces alone deal with their municipalities. The situation in South Africa is complex, where there are three spheres of government that are treated equally and are required under the Constitution to govern cooperatively. In practice, however, the local government sphere operates within the policy and funding parameters and regulations set primarily by national government.

Given this brief background of the current developments in IGFR principles as applied to South Africa, the purpose and objective of this paper is to consider the extent to which such principles and practices may provide important lessons for Sudan. However, it is important to note that the diverse nature of intergovernmental fiscal relations and fiscal decentralization has given rise to an equally diverse and extensive body of international literature. Therefore, a short general review of the issues will have to be selective. In particular the paper will review and discuss such lessons for Sudan with specific reference to fiscal decentralization principles and practices to address pro-poor and poverty reduction policy objectives for Sudan.

In the literature on fiscal decentralization (Bahl, et al: 2004; Fox: 2007) in developing transition countries, Sudan is often discussed as a post-conflict developing economy. In fact fiscal decentralization policies in Sudan have a long history (Suleiman: 2008). The history of fiscal decentralization predating the conflict between North and South Sudan and subsequent developments, will be addressed in another paper to be presented at this Round Table. As with many other international experiences from its inception, fiscal decentralization in Sudan included allocations of transfers, grants and subsidies to local councils and state governments. In keeping with international experiences Sudan’s system was also characterized by vertical fiscal imbalances that are typical of fiscally decentralized states where expenditure responsibilities are decentralized to sub-regional governments, but tax revenues sources are centralized in favor of the national government (Martinez-Vazquez & Searle: 2007).

Many of the problems associated with the earliest experiences of fiscal decentralization and intergovernmental fiscal relations in Sudan highlighted by Suleiman (2008) and Norris (1981) are typical of post-colonial developing transition economies (Shah: 2004, Shah & Badoway: 1994, Bahl: 1999). In fact, given its history, and for the purpose of this paper review of global lessons for a well functioning fiscal transfer system for pro-poor growth and poverty reduction, it would be appropriate to designate Sudan as a developing
transition economy (Badawi: 2008: 2) rather than a post-conflict economy. A developing transition economy designation highlights indicators for fiscal decentralization policies that go to the heart of a well functioning fiscal transfer system for pro-poor growth and poverty reduction under all conditions – including post-conflict situations. On the other hand, a post-conflict designation assumes that conflicts are transitory and further conflicts are unlikely, and therefore immediate fiscal policy attention should be given to the consequences of post-conflict conditions.

The possibility of conflicts exists in developed, developing and under-developed economies. Well-functioning intergovernmental fiscal transfer systems in developing transition economies targeting pro-poor and poverty reduction policy objectives have to go beyond the transitory objectives of post-conflict consequences and conditions. In many developing transition economies high levels of poverty, inequality, socio-economic and spatial disparities, and community struggles for scarce natural resources give rise to, and exacerbate inter- and intra-regional conflict. If these socio-economic and spatial disparities are adequately addressed through a well-functioning fiscal transfer system, the risks of future internal conflicts are more likely to be reduced.

In many respects, Sudan exhibits high levels of poverty, inequality, socio-economic and spatial disparities, and community struggles for scarce natural resources. In addition, Sudan is also a vast country in terms of size, populations and sub-regional diversity and disparities, and therefore the devolution and decentralization of political and fiscal power and governance is a potent challenge (El Mahdi: 2008, Ministry of Finance, Sudan: 2010). Sub-regional disparities in economic development and political power represent the possibility for tensions between central and sub-regional governments and may hinder the country from reaching its full economic and social potential, and undermine attempts to address poverty and inequality through the provision of basic services to the most disadvantaged in society. Can Sudan’s current status as a low income and developing transition economy (Brixiova, et al: 2003), be transformed by a well functioning fiscal transfer system that includes policies for pro-poor growth and poverty reduction?

Following the peace protocols signed in Kenya between North and South Sudan in 2004, the country put in place a Power Sharing Protocol to guide the development of Sudan’s emerging federal system, and to address the socio-economic and spatial disparities that differentiate and disadvantage sub-regional populations from each other (Bell & Ahmed: 2005: 1). Included in the 2004 agreement was a Wealth Sharing Protocol that established a set of fiscal decentralization principles for the equitable sharing of national revenue to ensure a commitment for the distribution of the common wealth through decentralized decision-making for development, service delivery and governance. In addition, the protocol proposed that a set comprehensive equalization criteria be developed and used for the allocation of intergovernmental grants. Given the background discussed above the aim of this paper is to highlight and review, some of the most relevant and appropriate international experiences from which Sudan may draw lessons.

Subsequent developments eventually led to the granting of full independence to Southern Sudan, and today the Republic of Sudan is in the process of reforming and refining its intergovernmental structure to specifically develop a fiscal decentralization
policy with a well-functioning fiscal transfer system that targets pro-poor growth and poverty reduction. In this regard, the aim of this paper is to provide a review from the literature of some international IGFR principles and best practices from which policymakers may draw lessons for application in Sudan. *Section two* considers fiscal policy principles and practices for an optimal IGFR system that may be effective in meeting pro-poor and poverty reduction policy objectives in DTEs. Thus *section three* reviews some pro-poor and poverty reduction theoretical and conceptual fiscal decentralization frameworks applicable to DTEs such as Sudan.

*Section four* will review appropriate fiscal decentralization designs for the implementation of pro-poor and poverty reduction policy objectives. In this regard the review will consider general principles and rules for allocations and transfer of grants, the institutional arrangements, typology of allocations, transfers and grants for IGFR systems, revenue collection and equitable sharing principles, a comparative review of practices against generally accepted principles and guidelines.

*Section five* will review and discuss how the harmonization and equalization of transfer mechanisms may take account of sub-regional socio-economic disparities when targeting pro-poor and poverty reduction policy objectives. The section will provide a brief overview of the economic, Constitutional and institutional for addressing disparities, identifying and defining disparities that differentiate regions, and setting country-specific norms and standards for achieving the MDGs. *Section six*, summarizes the key recommendations that may be relevant for Sudan and concludes.
Fiscal Decentralization Principles and Practices for an Optimal IGFR System

In most developing and developed countries that have adopted federal or intergovernmental fiscal relations systems the assignment of powers, responsibilities and functions to the different tiers or spheres of governments is formalized and institutionalized in the Constitution and/or other legislation. However, in developing transition economies the constitutional formalization of the assignment of powers, responsibilities and functions specifically includes addressing socio-economic disparities and inequalities as part of pro-poor policies for poverty reduction (South Africa, Ethiopia and Nigeria).

Conventionally, the national, central or federal government has over-riding responsibility for the macroeconomic management, and management of the country’s political, security and foreign affairs, and shares responsibility with sub-national or regional governments for the provision of public services and the collection of revenues. Macroeconomic management is a key ingredient in fiscal decentralization, and Figure 1 presents a framework for balancing macroeconomic objectives against policies for targeting pro-poor and poverty reduction objectives. National, federal or central government may also mandate appropriate essential or minimum levels, norms and standards of services. State or provincial governments are responsible for delivering most of the range of public social services, which fall in the areas of education, welfare, and health, transport, and sometimes, housing. Local governments carry responsibility for provision of local infrastructure, housing, public transport, and basic services such as sanitation and water reticulation among others. Drawing on the example of South Africa, Table 1 presents an adapted framework illustrating how constitutional and legal obligations may be balanced and coordinated with institutional IGFR arrangements for the delivery of service mandates against prescribed constraints.
### Table 1: Stylized View of IGFR Institutional Arrangements in South Africa

<table>
<thead>
<tr>
<th>Expenditure shares in terms of Bill of Rights &amp; Section 214 (1 &amp; 2) of Constitution for:</th>
<th>Governance &amp; institutional responsibility of:</th>
<th>Constraints in terms of Bill of Rights &amp; Section 214 (2) clauses (a to j) of Constitution</th>
</tr>
</thead>
<tbody>
<tr>
<td>National Interests (e.g. Defense &amp; foreign)</td>
<td>Sole</td>
<td>No</td>
</tr>
<tr>
<td>National Debt</td>
<td>Debt service &amp; Deficit limits</td>
<td>Limited borrowing</td>
</tr>
<tr>
<td>Needs &amp; interests of national government</td>
<td>Public service personnel, capital &amp; operational, other</td>
<td>Agency role</td>
</tr>
<tr>
<td>Education</td>
<td>Higher, adult &amp; technical; science &amp; technology</td>
<td>Basic &amp; early &amp; childhood</td>
</tr>
<tr>
<td>Health</td>
<td>Teaching hospitals &amp; medical research</td>
<td>Basic &amp; primary health care</td>
</tr>
<tr>
<td>Welfare services</td>
<td>Support for non-governmental agencies</td>
<td>Full</td>
</tr>
<tr>
<td>Social Security</td>
<td>Full</td>
<td>Agency role</td>
</tr>
<tr>
<td>Housing</td>
<td>Subsidies to province &amp; municipalities</td>
<td>Concurrent with national and local</td>
</tr>
<tr>
<td>Water &amp; Sanitation</td>
<td>Infrastructure grants to municipalities</td>
<td>No</td>
</tr>
<tr>
<td>Transport &amp; Roads</td>
<td>Funding of transport parastatal, network &amp; national roads</td>
<td>Concurrent with national &amp; local, for provincial roads</td>
</tr>
<tr>
<td>Electricity</td>
<td>Generation through parastatal (Escom)</td>
<td>No</td>
</tr>
<tr>
<td>Safety &amp; Security</td>
<td>Full</td>
<td>No</td>
</tr>
<tr>
<td>Emergencies</td>
<td>Concurrent</td>
<td>Concurrent</td>
</tr>
<tr>
<td>Contingency Reserve</td>
<td>Sole</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: Adapted from Petchey, MacDonald, Josie, Mabugu, Kallis: 2007
The objective of intergovernmental fiscal arrangements is to ensure that these inter-governmental responsibilities are carried out in the spirit of co-operation, fairness, and efficiency (Smoke: 2000, Shah: 2004, Josie et al: 2008). In the end, it is the welfare of individual citizens, wherever they reside, that should be the ultimate objective guiding the decisions around fiscal responsibilities.

This implies that sub-national governments are almost exclusively reliant on the equitable sharing of national revenue to deliver basic public social services to the levels stipulated by national norms and standards. This challenging task is made more difficult given that capacity to deliver effective services varies considerably across and within sub-regions.

The situation may be quite different for the local government sphere, which may be able to generate some of its own revenue through property rates and user charges. While this revenue may well be insufficient for providing some basic municipal services, this may not be the case with provincial or state governments which have to provide social services such as education, health, social welfare, housing and transport.

A system of intergovernmental fiscal arrangements should achieve continuous improvement in the level of basic services across the nation to address poverty, deprivation and inequality as resources permit. It must finance services in an equitable manner across sub-regions in general and disadvantaged communities in particular. At the same time, the system must allow sub-regions to develop the capacity to assume full responsibility for providing basic social services in their own jurisdictions.

The long-term vision of fiscal decentralization to address pro-poor and poverty reduction objectives is one where national government, in consultation and co-operation with sub-national spheres, sets norms and standards for basic public services (Shah: 1994 and 2004). Ideally, these standards should be transparent and should be in national legislation. Sub-national spheres have the responsibility to design and deliver programs within their jurisdictions that satisfy these national standards, utilizing the resources available to them.

In developing countries such as South Africa, Nigeria and Ethiopia, the Constitution and/or legislation provides that national revenue be divided equitably across sub-regional governments and should ideally be sufficient to allow spheres to provide the mandated national basic levels of education, welfare, health, water and sanitation services. Within this context, legislation in South Africa gives specific mandates for provision of free basic services to disadvantaged communities to address pro-poor and poverty reduction across sub-regional governments. In addition, conditional grants may be used to direct national resources to achieve particular objectives that national government may identify such as infrastructure and the development of institutional capacity. This principle is used to avoid committing sub-regional governments to finance unfunded mandates not included in their budgets.

Conceptually and in principle equitable shares should be based on the costs of delivering services in each sphere and should take account of disparities in demography, geography and other socio-economic conditions (for example disparities in health, income
inequality, unemployment, infrastructure backlogs and inaccessible regions) that affect the costs of delivering the services. This approach will ensure that pro-poor and poverty reduction strategies form an integral part of the fiscal decentralization framework (Shah: 1994).

Equitable shares are unconditional grants and are discretionary to the extent that sub-national governments choose the exact mix of services preferred by their constituents, provided they meet the basic national norms and standards set nationally for health, education, water and sanitation and welfare. Stability, certainty and avoidance of budget shocks of allocations are ensured by the use of formulae over a medium term planning cycle. National Parliaments or legislatures normally determine, through legislation, the nationally-accepted norms and standards of constitutionally mandated public services by setting out clearly, through legislation, the policy objectives, targets (primary, intermediary and secondary), policy instruments (legislative, administrative, institutional), budget requirement and monitoring mechanisms. In some countries, the National Parliament can prescribe how the public service norms and standards are implemented.

The successful implementation of IGFR and fiscal decentralization policies require a sound institutional framework. In principle, IGFR institutions are there to support and ensure cooperative governance, monitoring and functioning of intergovernmental fiscal relations. In South Africa, for example, these institutions formalized in legislation include the Budget Council, the Budget Forum, the Financial and Fiscal Commission (FFC) and the South African Local Government Association (SALGA). In addition the Presidential Coordinating Council (PCC), that includes the Office of the President, Members of the Cabinet and the Premiers of the provinces are important in guiding intergovernmental fiscal relations. All these institutions play a vital role in balancing the priorities of the three spheres of government in South Africa. In Australia and India, independent grant commissions are charged with the responsibility of making recommendations for the equitable allocation of grants (Shah: 1994).

In general, pro-poor policies for poverty reduction in developing transition economies could fall under the broad intergovernmental relations principle and practice of fiscal equalization. For developed economies, the standard literature on equalization in fiscal decentralization focuses essentially on equalization as an instrument for the efficient allocation of labor across regions, achieving fiscal equity and redistribution for correcting sub-regional distortions (Boadway: 2003, Petchey: 2011).
Pro-poor and Poverty Reduction Theoretical and Conceptual Fiscal Decentralization Frameworks

A fundamental redistributive priority of all governments is to provide basic services to address disparities associated with poverty, deprivation and inequality within the constraint of available resources. Despite the importance of this policy objective for developing economies the link between fiscal decentralization and pro-poor policies for poverty reduction has only recently received special attention in the literature (UNDP: 2005; Bjornestad: 2009, Boex: 2006; Steiner: 2005; Braun et al: 2000; Afridi: 2005). In general, analyses on pro-poor policies for poverty reduction in the literature tended to focus on national strategies (Ravallion: 2009; Kakwani et al: 2006; Scott: 2009; Gunatilaka: 2001).

The theoretical and conceptual relationship between poverty reduction policies and fiscal decentralization is discussed at length by Boex (2006) and provides an overview of the literature on the subject. The article systematically defines poverty and fiscal decentralization and draws attention to the intersection between these two concepts. The article traces the evolution of the definition of poverty from its description of poverty as a condition of low income (less than US$1 a day) and the failure to satisfy basic needs and minimum levels of subsistence, and to the failure to maintain minimum standards of a given society – often referred to as ‘relative deprivation’. Recent debates have further extended the definition to include notions of the Human Development Index (HDI) (UNDP: 1990) ‘capabilities’ (Sen: 2000): vulnerability, dignity, inequality, autonomy, voice, inclusion, empowerment and participation. Some of these concepts will be discussed later on in this paper. The inclusion of the HDI implies that poverty measurement goes beyond income and also evaluates life expectancy, levels of education and health, and per capita GDP.

The extension of the definition of poverty beyond income pre-supposes the provision of and accessibility to basic services such as education, health, social security and welfare services to the most deprived and disadvantaged in society. The provision of these basic services is the responsibility of all three tiers or spheres of government. Despite the wealth of literature on the subject, a little caution is required in making an automatic connection between decentralization and pro-poor policies for poverty reduction in Africa. The reason for this caution is that some authors (Brosio: 2000) argue that there is very little evidence to suggest a direct causality between fiscal decentralization and poverty reduction, as the latter may be the result of other political and economic factors.

In some countries such as South Africa, Nigeria, Ethiopia and the DRC, this objective is mandated in the Constitution with respect to enshrining the rights of citizens to basic services, and is the fundamental responsibility of government. Rights to which all citizens are entitled are in areas such as housing, health, social security, and education. Addressing these rights is an integral part of pro-poor and poverty reduction fiscal decentralization strategies. Responsibility for the delivery of such services are shared amongst different spheres or tiers of government, with each level of government mandated with certain powers and charged with fulfilling its assigned functions.
In India, for example, grant transfers programs are used for improving the welfare of individuals in households. One such program is the supplementary school-feeding scheme. The effectiveness of the scheme in India has been researched (Afridi: 2005) and the findings indicate that for a minimum allocation per child per school day, the feeding scheme reduced the daily calorie deficiency of the average primary school pupil in the survey region by almost 35%, iron deficiency by 25% and met their entire protein deficiency needs. Overall the study found that the increase in daily nutrient intake of scheme participants ranged from 49% to 100%.

Nigeria’s experience in using fiscal decentralization for poverty reduction is implied in the Constitutional prescripts that mandate all three tiers of government to provide core public services. In 2007 (Freinkman: 2007) Nigeria introduced a new conditional grant transfer program targeted at primary health care, rural electrification, rural water supply and sanitation, and specific purpose grants for poverty reduction through the National Poverty Eradication Program (NAPEP). It remains to be seen whether these equalization type programs address the fundamental institutional weaknesses identified by Freinkman (2007).

In Ethiopia, a DTE that has adopted fiscal decentralization, Moges (2008: 15) notes that sub-regional governments have responsibilities for the provision of public services that contribute towards poverty reduction and the improvement of living standards in sub-regions. These services include health, education, regional infrastructure and the promotion of investment and growth in sub-regional economies. However, the author argues that leaving the provision of these vital services to sub-regional governments may not have the desired effect because many sub-regions are financially dependent on central government. In order for all citizens to have equal access to basic public services, the federal government should consider directly providing such services to all households irrespective of their residence across regions (Moges: 2008: 17) because unacceptable poverty levels can be found even in sub-regions considered relatively richer than others.

In the developing and transitional economies characterized by wide fiscal disparities among regions such as those discussed above, the use of equalization transfers is a justifiable policy instrument for pro-poor and poverty reduction programs within an intergovernmental fiscal relations system (Bahl: 1999). The conceptual framework and practices of using equalization transfers in general, and for pro-poor policy objectives in particular, will be discussed in the next section of this paper.
Fiscal Decentralization: Equalization and Harmonization

In DTEs, very often, average income in the richest regions can be twenty times more than in the poorest regions. Such extreme socio-economic disparities translate into extreme fiscal disparities among regions. These fiscal disparities manifest themselves when sub-regional governments are granted greater revenue-raising powers and those sub-regions with larger tax capacities and stronger administrative infrastructures are advantaged at the expense of the poorer regions with lower fiscal capacities. Countries tend to compensate for such socio-economic and fiscal disparities by using intergovernmental equalization grant transfers (Bahl: 1999). The effectiveness of the equalization policy instrument, Bahl (1999) argues, depends on what taxes support the transfers, what sub-regional services are to be financed, and what distribution formulae are to be used to allocate resources among sub-regional governments.

Thus, the role of equalization is to ensure that regions with lower fiscal capacities can provide the same levels of public goods and services as those regions with higher fiscal capacities and abilities (Boadway: 2003). It is clear that redistribution is the basis of equalization especially where decentralization tends to create disparities in regions that limit their capacity to provide nationally-accepted level of services. Although the trade off between efficiency and equity has dominated much of the debate, fiscal decentralization and equalization in developed economies (Oates: 1999, Boadway: 2003, Petchey: 2011), this has been tempered by a recognition that in employing equalization as a policy instrument, equity and efficiency should be complementary and supplementary rather than contradictory. To support this contention Boadway (2003) presents a set of equalization principles and practices derived from a survey of the literature.

According to Boadway (2003: 1), equalization is presented as a necessary component of fiscal decentralization because it counterbalances the tendency for fiscal decentralization to generate disparities that differentiates regions from each other in the provision public goods and services. In their quest for vertical national equity, and horizontal equity across regions, developed and developing transition economies have adopted equalization policies because of an aversion to vertical and horizontal inequality, and in the interests of promoting generally-accepted social welfare norms and standards for society in general. Following this review, Boadway (2003: 1) highlights the principle features of equalization.

Primarily, equalization is made up of unconditional redistributive transfers from national to sub-regional governments financed from nationally collected tax revenue. For this form of equalization to be effective it requires a larger share of tax room at the national level, in other words a larger VFG. The VFG is an important economic efficiency inducing policy instrument. In this regard the VFG assists in harmonizing taxes and internalizing fiscal externalities. It also provides an incentive for national government to institute a redistributive interpersonal tax-transfer system (Boadway: 2003: 2).

In the literature (Boadway: 2003: 2), the roles and objectives of equalization are many and varied. To summarize equalization can be used as a policy instrument to: achieve horizontal equity among residents of different regions; ensure regional government stability against negative shocks; ensure predictability of regional budget allocations;
ensure that different regional governments have comparable fiscal capacities to provide standard levels of services across the country, and sometimes conditional equalization transfers can be used to correct distorting regional government decisions. However, ultimately the impact of equalization will depend on the extent to which sub-regional own revenue raising capacity can be balanced against sub-regional expenditures for the provision of services. This balance is measured by the extent of the VFG. Boadway (2003: 3), citing the examples of Australia, Canada and Germany, suggests that a VFG indicates the level of reliance on national government transfers to sub-regional governments. If the VFG is bigger, the reliance on transfers is also greater and vice-versa. Based on his Boadway (2003: 3), presents three criteria that must be met to determine an optimal equalization instrument.

Firstly, equalization policy should show that sub-regional expenditure and revenue-raising decisions are optimal such that they are in the national interests, as well as the sub-regional interests. Secondly, an equalization instrument may be considered optimal if it can have benefits for correcting and compensating for non-optimal regional decision-making that results in non-optimal decentralized outcomes such as inter-jurisdictional fiscal externalities on expenditures and/or own revenues decisions. Thirdly, an optimal equalization instrument, such as grant formulae based on clear outcomes, must limit the extent to which it may introduce perverse incentives that allow sub-regional governments to manipulate and influence the outcomes. Having considered the main policy objectives and principles for equalization as a redistributive instrument, the next question is what are the most appropriate institutional policy instruments that will make equalization an effective mechanism for intergovernmental fiscal decentralization policy?

Many DTEs have adopted equalization as a fiscal decentralization instrument for redistribution of resources to address regional disparities and target poverty and inequality reduction. In countries such as Nigeria, Ethiopia and South Africa, specific institutional arrangements are in place for the effective implementation of equalization policies. However, institutional arrangements across DTEs vary, and according to the literature, their effectiveness has shown mixed results especially if effective and efficient service delivery is predicated on policy coordination among national, state and local government institutions. In Nigeria for example, Freinkman (2007) argues that institutional arrangements for policy coordination among all three levels of government in the delivery of constitutionally-mandated basic public health and education services are weak. Policy coordination at sub-regional level is ineffective because it is not taken beyond the level of plans to actual implementation of programs and projects.

The institutional weakness in Nigeria’s coordination of IGFR arrangements is characterized by the absence of any formal administrative basis for producing national consolidated performance reports with basic expenditure information, outcomes and outputs for assigned service delivery functions such as education and health. According to Freinkman, (2007), the absence of a systematic report that consolidates information related to the evaluation of monitoring expenditures and performance undermines the principle of planning and coordination for predictable and stable IGFR budget allocations over medium term expenditure frameworks (MTEF). Consequently, the absence or limited vertical and horizontal information sharing across the three levels of government introduces an additional weakness in the IGFR system and compromises the attainment of MDG sector
goals that could negatively impact on pro-poor and poverty reduction policy objectives.

In South Africa, a 2009 report by the National Department of Cooperative Governance and Traditional Affairs (COGTA) concluded, among others, that the disjuncture in policy coordination among the three spheres of government resulted in poor local government service delivery (COGTA: 2009). In this case, local government Integrated Development Plans (IDPs) elaborated in conjunction with provincial governments is very seldom implemented because of poor policy coordination among the three spheres of government. For example, the report implies that there is the lack of planning and coordination between municipalities and provinces where these two government spheres have concurrent funding responsibilities for the delivery of housing, health and public transport services.

The COGTA evaluation pointed to a fundamental contradiction in the requirement for infrastructure funds to be spent according to municipal IDPs and according to the proportions attributed to the socio-demographic indicator weights in the Municipal Infrastructure Grant (MIG) formula. The evaluation made the point that while IDPs reflect local priorities that could vary across time and space, provincial and national plans reflect their own policy objectives and targets. A classic example is housing programs that are prioritized and funded from the national government through the provinces and where municipalities are expected to provide land and infrastructure services not envisaged in their IDPs, very often in conflict in situations where a municipality may have already spent most of its MIG allocation on other priorities (Josie: 2008).

In examining the legislative and institutional policy instruments that govern the way service delivery and infrastructure are implemented the Study Report (COGTA: 2009) concludes that a major obstacle to service delivery is the lack of effective alignment of integrated planning and coordination among different government departments. For example, some provincial infrastructure and regional planning policy objectives captured in the Provincial Growth and Development Strategies (PGDS) are not implemented, and are even more difficult to monitor and sanction, because they are not supported by legislative and institutional policy instruments. On the other hand local government integrated development plans (IDP) are legally binding on municipalities through the Municipal Systems Act and the Municipal Finance Management Act.

As is the case with South Africa and Nigeria, a study by Moges (2008) indicates that high levels of vertical and horizontal imbalances also characterize Ethiopia’s experience of fiscal decentralization. The study further found that the imbalances gave rise to a disjuncture between the priorities of local populations as expressed in regional government decisions, and the priorities of the center. Ethiopia’s IGFR system includes fiscal decentralization policies to address socio-economic and regional disparities. This general principle is enshrined in Article 90 of the Ethiopian Constitution and prescribes that the State, taking into account resource constraints, must provide all Ethiopians with access to health, education, clean water, housing, food and social security.

In practice, however, the allocation of funds by the federal government has been made in an ad hoc manner based on requests from sub-regional governments, and priorities and preferences of the federal government.
The *ad hoc* nature of such allocations in Ethiopia introduces a degree of uncertainty and unpredictability of the pool of funds available for sub-regional government budget programs targeted at fulfilling constitutional mandates in the provision of public services (Moges: 2008). In rejecting the *ad hoc* allocations to sub-regional governments Moges (2008: 17) proposes the use of a formula in which weightings are attached to regional contributions towards the nationally-collected tax revenues, and/or relative weights in favor of poverty indicators in the allocation of federal grants to sub-regions.

Once the pool of funds has been determined, federal government can then allocate according to the formula an unconditional block grant to sub-regional governments to be used at their discretion. Moges (2008: 19) noted that in recent years these allocations constituted 36 percent of consolidated national revenues, and is the most important source of sub-regional government revenues.

Moges (2008: 26-27) argues that the current policy of a highly centralized decision-making process of fiscal decentralization in Ethiopia at the central and sub-regional level has failed to improve the efficiency of the public sector to diversify output to reflect the preferences of the local population. This failure is likely to result in the IGFR system, not taking into account the institutional and other transactional costs of expenditure decisions by federal and sub-regional governments. Consequently, the costs are passed on to taxpayers and encourage fiscal indiscipline at the expense of achieving economic, political and social policy objectives.

In contrast to, and perhaps complementing, the arguments proposed by Moges (2008), a study by Araya (2011) evaluating the effects of a massive shift of resources from the Ethiopian federal government to sub-regions to support access to social services, suggests that there have been some net benefits to citizens. Despite the emergence of vertical and horizontal fiscal imbalances, equalization policies between 1994 and 2002, targeted at greater access to social services in regions and districts has had positive impacts on rates of primary school enrollment, childhood immunization and infant mortality. The study further found that in reducing disparities in access to social services, targeted equalization policies also created equality of opportunity and inter-regional equity between previously disadvantaged and richer regions. The study concludes by recommending that a systematic fiscal equalization approach be used to close the existing fiscal gaps, and to provide better social service access to communities.

From the preceding discussion, it is obvious that institutional arrangements for fiscal equalization transfers in DTEs need to be reviewed and assessed to ensure that they are harmonized with national fiscal decentralization policy objectives. Such an evaluation is particularly necessary where fiscal equalization is used as an instrument targeting pro poor and poverty reduction policy objectives. In this regard Anwar Shah (2005) presents and discusses a possible new institutional economic framework for evaluating alternate institutional arrangements for equalization transfers. This paper by Shah follows his comprehensive discussion (2004) on the progress, problems and promises of fiscal decentralization in DTEs. In the latter, in addition to a broad analytical perspective on fiscal decentralization in DTEs, Shah raises the specter of the failure of institutional arrangements for effective equalization transfers to meet policy objectives. He proposes
that DTEs need to rethink fiscal arrangements as a function of their own specific conditions especially if these conditions were the result of historical legacies, internal regional conflicts, and past economic failures (Shah: 2004: 2).

Re-thinking institutional arrangements for equalization transfers requires an evaluation of existing equalization systems. To show why it is important to re-think arrangements rather than to adopt systems without considering specific national conditions and environments, Shah (2005) applies a new institutional economic framework to evaluate the equalization of institutional arrangements. The author empirically tests the framework in a more detailed manner for Canada, Germany, Australia and India. The study considers four models of institutional arrangements across several countries that include developed and DTEs. The institutions studied included the following models: central/national government agencies, national legislatures, intergovernmental forums, and independent agencies such as grants commissions.

Table 3 presents a selection of developed, emerging and DTEs according to the type of model used in each country. Some countries like Australia and South Africa use both independent grant commissions and official intergovernmental fora. In his study Shah (2005) provides a comprehensive list of the countries and analyses the type of model used in each system.

Table 2: Institutional Models for Equalization Transfers Selected Countries

<table>
<thead>
<tr>
<th>Institutions for Equalization Transfers</th>
<th>Developed &amp; Emerging Economies</th>
<th>Developing Transitional Economies (DTEs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central/national government</td>
<td>China, Italy, Japan, Netherlands, Poland, Switzerland, Ukraine, South Korea, India</td>
<td>Kyrgyz Republic, Tanzania, Kazakhstan, Philippines, Ghana, Zambia, Brazil</td>
</tr>
<tr>
<td>National legislatures</td>
<td>All except China</td>
<td>Brazil</td>
</tr>
<tr>
<td>Intergovernmental forums</td>
<td>Australia, Canada, Germany</td>
<td>South Africa, Indonesia, Nigeria, Pakistan</td>
</tr>
<tr>
<td>Independent agencies (Grants commissions)</td>
<td>Australia, India</td>
<td>South Africa, Uganda</td>
</tr>
</tbody>
</table>

Source: Adapted from Shah: 2005:2

1) “all countries with the single exception of China, national legislature must enact legislation to provide a legal basis for central-state-local transfers“ (Shah: 2005:2).
2) In Brazil for “...the broad criteria for revenue sharing transfers... the upper house of the national parliament (the Senate) serves as the primary decision making body for specifics of the formula as well as monitoring compliance.“ (Shah: 2005:2).

In a central or national government agency model, decision-making is the prerogative of the executive, while in the legislative model some executive IGFR decision-making and legislation are the prerogative of parliament. Outside of these two options are the intergovernmental fora and the independent agencies. An intergovernmental forum is set up through legislation and provides a formal institutional framework for negotiation and political bargaining. In South Africa, there are two such institutions, and the Minister of Finance convenes both. One is called the Budget Council and includes provincial finance.
executives (ministers), and the other is called the Budget Forum that includes provincial and local government executives. Other IGFR institutions are also represented in these fora. In addition to peer pressure to find consensus, intergovernmental fora in South Africa are established in response to a constitutional requirement for cooperative governance. Thus bargaining is defined and limited by a legal framework making it easier to find common ground.

The independent agency or grants commission model is a formal independent IGFR institution set up by the constitution and/or legislation. It is normally made up of independent experts and technocrats with expertise in IGFR and fiscal decentralization-related matters. The main function of these commissions is to provide independent, professional, transparent, and rigorously-researched recommendations and advisories on the determination of the available revenue pool, the allocation criteria and formulae for the distribution of funds among recipient sub-national governments.

Shah (2005: 11) believes that the independent role of such institutions is overrated because norms and standards for equalization should not be separated from political decision-making. Secondly, he argues that such independent institutions generate agency problems in an attempt to find and maintain their relevance. Among others the agency problems include mission creep to extend and enlarge the agency’s role and influence, incentive for complexity to solve simple questions to create a market demand for high levels of technical expertise, and public oversight becomes too difficult, costly and impractical as the agency’s output becomes more complex.

However, for his conclusions, and the lessons that may be extremely useful for DTEs, Shah (2005: 11) compares and evaluates these two models using a new institutional economic (NIE) framework. The author notes that both models may co-exist although not necessarily adding the same value. The evaluation is conducted using, respectively, a set of criteria to compare overall transaction costs and outcomes when each of these two models is used. The rating for overall transaction costs criteria ranges from high, medium to low, and the criteria for outcomes are assessed as to whether they are positive (yes), negative (no), not applicable (N/A) and unsure (maybe).

Drawing from his study Shah (2005) makes several conclusions and recommendations that will have significant implications for transitional economies such as Sudan. Thus, the author (Shah: 2005: 12) proposes that to achieve simpler, equitable and durable outcomes, each institutional arrangement must be informed by an analysis of the incentive regime in place and the related agency costs. From the findings of his comparative NIE evaluation (Table 4) Shah concludes that, compared to an intergovernmental forum model, an independent agency model will generate higher overall transactions costs and less desirable potential outcomes. The reason for this is because the independent nature of grants commissions and their pursuit of ideal complex systems undermine the role of public participation, oversight, transparency and accountability in the formulation of recommendations. In addition to increased agency costs, participation and monitoring costs will also rise without any assurance that the higher transaction costs will generate better outcomes. By comparison, intergovernmental fora tend to engage in political bargaining in search of simpler and feasible solutions to reduce transaction costs for country. For example, the Budget Council and Budget Forum in South Africa use the
constitutional principle of cooperative governance to arrive at practicable solutions for the equitable sharing of national revenue.

By contrast the independent Financial and Fiscal Commission (FFC) recommendations, while well researched, are extremely complex, and have had a low to medium impact on the IGFR system in South Africa in general. In the same vein Shah goes on to argue that grants commission processes tend to ignore consensus building, and IGFR recommendations are determined independently of the equalization standard. In addition, in the desire for perfection, independent agency research may lead to changes in methodology, thus compromising stability and predictability of equalization allocations. Therefore, Shah (2005: 12) concludes, that the usefulness and impact of the independent agency model is limited because of its high transaction costs, and its predilection for ideal and optimal solutions as opposed to feasible and practical reforms. Following from the above discussion, the next section of this paper will consider the design for practical fiscal equalization designs for pro-poor and poverty reduction policies.

<table>
<thead>
<tr>
<th>Table 3: Comparative NIE Evaluation of Intergovernmental Forum Independent Agency (Grant Commission)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Criteria for:</strong></td>
</tr>
<tr>
<td><strong>Overall Transaction costs</strong></td>
</tr>
<tr>
<td>Participation and monitoring costs</td>
</tr>
<tr>
<td>Legislative/executive decision making costs</td>
</tr>
<tr>
<td>Agency costs</td>
</tr>
<tr>
<td>Uncertainty costs</td>
</tr>
</tbody>
</table>

**Potential outcomes**

| **Political compact on equalization standard**               | Yes           | No          |
| **Durability of political compact**                         | Yes           | N/A         |
| **Pool determined by equalization standard**                | Yes/No        | No          |
| **Allocation determined by equalization standard.**         | Yes           | No          |
| **Stability of allocation criteria**                        | Yes           | May be      |

Source: Shah: 2005: 18
Fiscal Decentralization Designs for Implementation of pro-poor and poverty reduction policy objectives

The preceding section of this review discussed various institutional arrangements for equalization transfers to address poverty reduction and socio-economic disparities. This section of the paper reviews and considers general principles and rules for the design of equalization transfers to achieve these policy objectives. The section also discusses a typology of allocations, transfers and grants for IGFR systems, revenue collection and equitable sharing principles. For this review, the South African experience will be used as a point of reference because, according to the literature (Bahl: 1999; Shah: 1994) reviewed thus far, South Africa’s IGFR system has borrowed principles and practices from both developed and developing countries.

South Africa’s system of (IGFR did not evolve organically as is the case with other federal nations that came into existence as part of a political agreement between relatively independent and economically self-sufficient regional states. In South Africa, none of the provinces existed as self-sufficient entities before 1994. The current fiscal decentralization and the intergovernmental system was the outcome of protracted national negotiations in the Constituent Assembly that led to the demise of white minority rule, the end of apartheid and the emergence of a democratic state in which the constitution is the supreme law of the land.

The constitution (1996) defines South Africa as “one sovereign, democratic state” with three spheres of government with relative degrees of autonomy - national, provincial and local government. There are nine provinces, each with its own legislature, premier and executive councils and 283 local governments divided into three municipal categories. The categories are the metropolitan (category A), the local municipalities (category B) and, the district municipalities (category C).

The constitution includes a Bill of Rights (Chapter 2) that sets out the human and socio-economic rights to which South African citizens are entitled. The Constitution also (in Chapter 3) makes provision for intergovernmental relations to be mediated by prescribed principles of cooperative governance and legislation. The objective of South Africa’s intergovernmental fiscal arrangements is to ensure that these inter-governmental responsibilities are carried out in the spirit of co-operation, fairness, and efficiency.

A central priority of the South African government is to provide basic services to all citizens within the constraint of available resources. In South Africa this objective is mandated in the Constitution and is a fundamental responsibility of government. Rights to which all citizens are entitled are in areas such as housing, health, social security and education. Responsibility for the delivery of such services are shared amongst different spheres of government, with each level of government mandated with certain powers and charged with fulfilling its assigned functions.

Under the Constitution and other legislation, the national government has over-riding responsibility for the management of the country’s affairs and shares responsibility with sub-national or regional governments for the provision of public services and the
collection of certain revenues. National government prescribes appropriate essential or minimum levels, norms and standards of services. Provincial governments are responsible for delivering most of the range of public social services, which fall in the areas of education, welfare, and health, transport and housing. Local governments carry responsibility for provision or local infrastructure and basic services such as sanitation and water reticulation.

South Africa’s intergovernmental fiscal relations system is an eclectic mix of several international experiences. This is not surprising as many of the authors discussed in this review played a significant role in shaping and influencing the country’s current system. Among others these authors include Robert Inman, Roy Bahl, Jeff Petchey, Robin Boadway, Andrew Reschovsky, Paul Smoke and Giorgio Brosio.

In principle, it is the role of the grant structure and fiscal arrangements more generally, to facilitate the decentralization of fiscal responsibilities and equalization transfers in a way that leads to efficient and responsible provincial or regional decision-making, while at the same time respecting national goals and objectives (Bahl: 1999). This virtuous cycle is illustrated in Figure 1. Fundamentally, a grant system is about the equitable, efficient and effective allocation of nationally collected revenues and resources to meet national redistributive policy objectives. The allocation rule, together with stabilization and redistribution rules, is the key policy principle for management of intergovernmental fiscal relations systems. “In general an allocation rule is a method, process, or formula that allocates any given supply of goods among any potential group of claimants according to the salient characteristics of those claimants” (Young: 1994: 8). In IGFR practice this definition must be consistent with the general equitability principles of parity, proportionality, and priority (Young: 1994: 8-9). Parity means that all claimants should be treated equally; Proportionality recognizes that goods and services must be divided according to the established differences amongst claimants; and, Priority affirms that the person with the greatest need is entitled to a first claim on the goods or services.

The content of an allocation rule according to Young (1994: 9) requires normative principles that emerge from empirical rules based on institutional choices, judgments and compromises between competing principles. The reason for this is because an allocation problem emerges when a set of resources, rights, burdens or costs are temporarily and collectively controlled by a group of individuals (government or legislatures) who also have individual entitlements to the resources, rights, burdens or costs. Therefore, an allocation is the decision made by a group or institution acting on behalf of the group about who gets the good or who bears the burden. A decision may be about allocating a good, a service or a burden.

Goods, services or burdens may be classified into different types. They may be homogeneous and divisible such as money or water, or they may be inhomogeneous and divisible like land. A good, service or burden can also be homogeneous and indivisible like seats in parliament or exemptions from obligations. Others may be heterogeneous and indivisible such as in allocating kidneys for transplant, or places in universities, or jobs for designated groups. Whatever they are, the goods, services or burdens may be fixed (by law), or variable in the sense that the required resources may not be readily available at a given time (Young: 1994: 7-8)
**Perspectives on IGFR Grant Design:**

The benefits of well-designed formula-driven grants arise from the fact that sub-regions may bear responsibility for the consequences of their expenditure. The grants help to avoid the potentially serious problem faced by many federations with large vertical fiscal imbalances – the problem of bailouts of irresponsible (or over-zealous) provincial governments. This is the so-called “soft budget constraint problem”.

Another challenge for estimating unit costs is that the microeconomic demands of sub-regions may conflict with the macroeconomic constraints determining the available pool of funds from the nationally collected tax revenue and other sources. If each sub-region has to take account of its real unit costs (including backlogs, inequality and other disparity factors) for the provision of basic services and economic development, and these amounts are aggregated across all regions, then the total sum may be greater than the national expenditure budget pool available for equitable allocation funds. Thus, in public finance parlance, if this *hard budget constraint* limits the actual amount of funds available, why would it be necessary to estimate unit costs in any case?

Finally, costing services using a production or cost function approach is extremely complicated and data intensive and requires long run time series data. Not many developing countries have access to such data. For these and other reasons, in South Africa, the nationally collected revenue is macro-economically estimated and the pool of funds available for equitable shares is determined via consensus achieved through a process of cooperative governance (stipulated in Section 41 Chapter 3 of the Constitution). The consensus is achieved through negotiations within intergovernmental for a, such as the Budget Council and the Budget Forum. The decisions made are supported by extensive technical research. The Shah (2005) study discussed above supports this consensus building approach.

Another issue to highlight when designing formulae is how to include norms and cost differences in a grant formula. In this regard it is important that the inclusion of norms and costs are done in such a way that sub-regional spending does not directly influence the amounts transferred. Otherwise, sub-regional authorities are likely to distort their spending priorities in order to influence the amount of grants they are to receive. Grants could be designed so that norms are able to reflect the objective features of the regions that affect the amount of money needed to provide standard levels of public services.

In the South Africa context, designing grants is complex because the norms and costs of providing basic services inform not only the horizontal division of funds across provinces, but also the vertical division of the equitable share. Although it is the prerogative of national government to determine the vertical division of national revenue, it must nonetheless be done in a way that satisfies the requirements set out in the Constitution. These involve ensuring that the provinces and local governments can provide basic services up to national norms and standards.

In many DTEs the case for decentralizing expenditure functions is much stronger than for decentralizing taxation functions. Nonetheless, the advantages of sub-regional levels of government having reasonable revenue-raising responsibilities are compelling.
This need not imply a separate taxing authority. Sub-regional governments can have taxing responsibility without disrupting a harmonized national tax system by simply “piggy-backing” onto the national system at their own chosen rates. The ability to raise their own revenues offers sub-regional governments a valuable degree of freedom that allows them to implement programs of their own choice and size. This is an important aspect of sub-regional autonomy.

South Africa is an example of fiscal imbalance where much of the national tax revenue available for equitable sharing is raised by national government through various tax regimes. This imbalance is illustrated in Table 5 below. Table 5 presents the tax revenues that are allowed by legislation for national, provincial and local governments.

Table 4: Revenues Allowed for National, Provincial and Local Governments

<table>
<thead>
<tr>
<th>Categories</th>
<th>National</th>
<th>Provincial</th>
<th>Local Govt.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes</td>
<td>Personal Income; Value Added Tax (VAT); Corporate tax; Tariffs</td>
<td>Some surcharges on existing taxes; Tourism levies; Fuel levies; Gambling.</td>
<td>Property rates; Motor vehicle license; other</td>
</tr>
<tr>
<td>User Charges</td>
<td>Electricity generation; Airport &amp; harbour fees; Rail transport; National toll roads; other.</td>
<td>Hospital fees; School fees; Provincial toll roads; other.</td>
<td>Water &amp; sanitation; electricity distribution; other.</td>
</tr>
<tr>
<td>Borrowing</td>
<td>Treasury bond issue; national &amp; international financial markets and institutions.</td>
<td>As per legislation &amp; approval of national minister of finance.</td>
<td>Municipal bond issue; national financial markets; Development Bank of Southern Africa (DBSA); other.</td>
</tr>
</tbody>
</table>

Source: Adapted from Petchey, MacDonald, Josie, Mabugu, Kallis: 2007
Table 5 below presents a view of how the tax revenues collected are shared amongst the three spheres of government in South Africa, according to the types of allocations (unconditional or discretionary, conditional, specific purpose).

Table 5: View of Revenue Shares for National, Provincial and Local Governments

<table>
<thead>
<tr>
<th>Types of Allocation</th>
<th>National Share</th>
<th>Provincial Share</th>
<th>Local Govt. Shares</th>
<th>Total Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unconditional</td>
<td>NEA</td>
<td>PEA</td>
<td>LEA</td>
<td>ES</td>
</tr>
<tr>
<td>Conditional Grants</td>
<td>-PCG-LCG</td>
<td>PCG</td>
<td>LCG</td>
<td>CG=PCG+LCG</td>
</tr>
<tr>
<td>Specific Purpose Grants</td>
<td>-PSP-LSP</td>
<td>PSP</td>
<td>LSP</td>
<td>SP=PSP+LSP</td>
</tr>
<tr>
<td>Total</td>
<td>NEA-(PCG+LCG+PSP+LSP)</td>
<td>PEA+PCG+PSP</td>
<td>LEA+LCG+LSP</td>
<td>TNCR</td>
</tr>
</tbody>
</table>

(Source: Adapted from Petchey, MacDonald, Josie, Mabugu, Kallis: 2007)

Where:

TNCR = NEA - (PCG + LCG + PSP + LSP) + PEA + LEA

NEA = National equitable allocation

PEA = Provincial equitable allocation

ES = Equitable shares

CG = Conditional grants

SP = Specific purpose grants

PSP = Provincial specific purpose grants

LSP = Local government specific purpose grants

PCG = Provincial conditional grants

LCG = Local government conditional grants

TNCR = Total nationally collected revenues
Equalization Transfer Mechanisms Accounting for Sub-regional Socio-economic Disparities

Following from the equity principles discussed by Young (1994), an important component in the design of grant systems is accounting for cost differences in the resources required to achieve comparable service levels. These differences arise due to variations in demography, geography and socio-economic disparities among sub-regions. However, determining normative principles of parity, proportionality and priority to account for cost disparities in grant formulae from institutional choices remains the biggest challenge. As discussed earlier, structural inequality in levels of development is a major determinant of regional disparities.

Even though a country’s constitutional and legislative framework may provide a firm foundation for making rules-based institutional choices, regional disparities are difficult to prioritize and measure and very few countries attempt to do so in a detailed way. Reschovsky (2007) makes the point that estimating the differences in sub-regional input costs that should be incorporated in a grant model can be controversial and highly political because parochial considerations play a crucial role in determining what sub-regional features, characteristics and indicators are prioritized and taken into account. In the absence of clear normative principles based on institutional choices, any judgments and compromises between competing principles will be perceived as less than objective. Explanations as to how the parameters in grant allocations were estimated would most likely raise suspicions that the weights were chosen on the basis of political and/or parochial considerations.

There is agreement amongst some economists (Petchey et al 2000) that socio-economic disparities and inequalities impact on the material, physical and psychological quality of life and capabilities of individuals and the communities in which they live. In many DTEs the legacy of the structural inequalities inherited from the past inhibits the ability governments to deliver the concomitant public services. Among the key challenges facing sub-regional governments are disparities in the quality, availability and adequacy of public services across sub-regions. Associated with this challenge is the requirement for government to allocate adequate and equitable levels of grants to sub-regions to eradicate and eliminate the socio-economic disparities that limit their capacity to promote growth and development in the quest to eradicate inequality and poverty.

The inadequate provision of basic services and the lack of physical access to these services seriously handicap disadvantaged communities. In this regard national government has a responsibility and an obligation to ensure that sub-regional governments provide the necessary public services for their citizens in general and, more specifically, for those communities that still suffer the consequences of a legacy of past structural economic disparity.

To more effectively take account of disparities in an equalization grant, several composite cost disparity indices for disadvantage and socio-economic inequality may be constructed from sets of sub-indicators. International best practice shows how other countries have captured the disparity costs in formulae for delivering services to regions.
with varying degrees of disparities. In Switzerland, for example (Dafflon and Toth: 2005, Petchey et al, 2004; Reschovsky: 2007), residential location in remote and inaccessible geographical areas is used as a factor to calculate grant subsidies to these sub-regions. The first such sub-indicator may be population dispersion.

Consider, for example, a geographically-large sub-region with a dispersed population. The cost of providing a school or hospital in such remote regions is higher than the cost of providing the same school or hospital in an urban metropolitan area with a predominately city-based population. This is so because, to provide a school or hospital in a remote location, it is also necessary to incur the cost of providing access roads, extending electricity and water systems and other infrastructure. As a result of such ‘population dispersion disparity’ the per capita unit cost of the flow of capital services in such a region may be relatively high. However, Reschovsky (2007) argues that that the key problem in estimating the costs of such inputs in the provision of public services is “identifying which factors are likely to play a role in influencing the costs of services and then determining the quantitative importance of those factors.” (Reschovsky, 2007: 404).

A second example of a composite cost disparity measure that may be relevant in some DTEs, such as South Africa, relates to debilitating diseases. If a sub-region has a relatively high incidence of debilitating diseases such as HIV/Aids or TB in its population, then the cost of each unit of health service may be high compared to a sub-region with a relatively lower incidence of such diseases. This is because HIV/Aids and TB require more social infrastructure resources to manage services.

Although there is no conclusive evidence (Lienhardt, 2001) to suggest a causal link between debilitating diseases such as TB and HIV/AIDS and environmental or socio-economic conditions, some studies (David et al, 2007) suggest that socio-economic and environmental conditions such as overcrowding and informal slum settlements are closely associated with a higher incidence of TB and HIV/AIDS. From this observation one can assume that the cost of providing a given unit of public service output may be higher in sub-regions with structural disadvantages resulting from past policies.

For example, the cost of achieving given educational and health outcomes for people from poor families may be higher than the cost of achieving the same educational or health outcomes for people from richer backgrounds. Sub-regions with more poor people (unemployed, lower incomes) and victims of past socio-economic discrimination might, therefore, be expected to incur higher costs in achieving given health and educational outcomes. Thus, some aggregated measure of socio-economic inequality and debilitating disease sub-indicators may be included in a composite cost disparity index.

Australia is an example of where the equalization grants formula attempts to incorporate needs and disparity factors (called disabilities) in a sophisticated way to determine the horizontal allocation of grants among states. Petchey, Shapiro, MacDonald and Koshy (2000) developed a model demonstrating how to capture differences within fiscal equalization formulae in capital costs across Australian states.

Despite the challenges and difficulties of doing so, there is general agreement amongst public finance practitioners that, in principle, differences in fiscal requirements ought to be included in equalization grants targeting disadvantaged communities. This is especially true in systems where sub-regions have little revenue-raising capacity of their
own. More particularly taking account of disparity cost indicators would ensure compliance with the equity rules of parity, proportionality and priority in allocation formulae.

Some perspectives on the inclusion of disparity cost indicators for ensuring parity, proportionality and priority in grant allocations are illustrated in the IGFR formulae used in South Africa. Particular attention is focused on how disparity indicators can be used for prioritizing the persons with the greatest need because such claimants have been the victims of established structural disparities, and are therefore entitled to a first claim on the goods or services provided by the state.
Accounting for disparities in South Africa’s IGFR system:

In Table 1 above, and listed in column five, macroeconomic issues and other considerations are taken into account in the South African government’s IGFR formula for equitable allocations to provincial and local governments. Among these considerations, prominence is given to provincial and municipal fiscal capacity, efficiency and economic disparities. The provincial equitable allocation (PEA) is made up of the unconditional equitable share (ES) and any other conditional grants and specific purpose grants (SPG) from the national equitable allocation (NEA). The local government equitable allocation (LEA) consists of the unconditional local government equitable share (LES) for operational functions; the municipal infrastructure grant (MIG) for municipal infrastructure and, a capacity building (CB) grant for institutional support. Table 6 illustrates the manner in which the national, provincial and local government allocations are made from total nationally-collected revenues.

The provincial equitable share (PES) is an unconditional allocation to provinces in keeping with the principle of relative autonomy. Provinces receive the largest budget equitable shares because they are responsible for implementing the major national social service functions such as education, health and housing. The PES for every province is determined on the basis of a formula with six components (National Treasury, Budget Review, 2000). Each component is given a policy weight between zero and one depending on the degree of importance attached to the component by policy-makers. Allocations in the formula are driven by a policy-weighted series of different population components and other factors and can be written as:

\[
PES = 0.5E_p \text{(school age, enrolment ratio)} + 0.26H_p \text{(proportion without medical aid)} + 0.14B_p \text{(share of national population)} + Pov_p \text{(provinces share of poor)} + 0.01EO \text{(share of total employee remuneration)} + 0.05 Ins
\]

Where:
- \( E \) is the equitable share.
- \( p \) represents population.
- \( E \) is the education component determined by the population of school age (6-17 years) and the enrollment ratio.
- \( H \) is the health component determined by the proportion of population without medical aid.
- \( B \) is a basic allocation for all provinces based on each province’s share of the national population.
- \( Pov \) represents each province’s share of the national poor population defined as those who have incomes in quintiles 1 and 2 in the Income and Expenditure Surveys (IES).

\footnote{The details of the principles, guidelines and, rules for implementing the IGFR in South Africa were published by the Department of Provincial & Local Government (DPLG) in the Practitioners Guide to the IGR System in South Africa, 2007. In 2002 National Treasury published details of the IGFR allocation formulae in Budget Guidelines (2002).}
- **EO** represents a province’s economic output given as its share of total employee remuneration.
- **Ins** is the institutional component and is weighted equally for all provinces.

The policy weights for each component is assigned following consultation between national and provincial government policy-makers in various IGFR fora [See Department of Provincial and Local Government (DPLG), Practitioner’s Guide to the IGR System in South Africa: 2007].

The local government equitable allocation (LEA) is determined on the basis of a formula (DPLG: 2007) and can be written as:

\[
\text{LEA} = \text{LES} + \text{MIG} + \text{CB}
\]

Where
- **LEA** is the local government equitable allocation.
- **LES** is the local government equitable share grant to fund municipal operations.
- **MIG** is a municipal infrastructure grant
- **CB** is capacity building grant for supporting institutional development in municipalities with little or no revenue raising capacity to fund institutional development.

The **LES** is defined as:

\[
\text{LES} = \text{BS} + \text{D} + \text{I} + \text{R} \pm \text{C}
\]

Where:
- **BS** is a component for the provision of basic services such as water, refuse removal, sanitation, electricity and environmental health care and, free basic services to poor households earning less than R800 per month (in 2007),
- **D** represents a component for the development needs of municipalities and was set at zero on the recommendation of the FFC (2007/08) to avoid the risk of perverse incentives,
- **I** is an institutional support component to assist poor municipalities without revenue raising capacity to fund administration,
- **R** is a correction component for revenue raising capacity and measures the fiscal capacity of municipalities to raise own revenues from taxes, surcharges and user fees and,
- **C** is a general correction and stabilization factor.

Of all the factors in the LEA, the MIG is the most significant. It is a conditional grant and allocations to municipalities are formula driven. The formula consists of percentage allocations for five different components representing different municipal infrastructure needs.

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2 The DPLG was subsequently renamed Cooperative Governance and Traditional Affairs (COGTA).
Summary of the Municipal Infrastructure Grant (MIG) Formula

The formula can be written as:

$$MIG = B + P + E + N + M$$

Where:
- $B$ represents the allocation for basic residential infrastructure such as water, sanitation, roads, electricity, street lighting and solid waste removal.
- $P$ denotes funds for new and rehabilitated municipal service infrastructure.
- $E$ is the allocation for the construction of social service institutions and micro-enterprises.
- $N$ is the allocation for nodal development and renewal programmes in targeted urban and rural municipalities and;
- $M$ is a performance related adjustment to the total MIG allocation for a municipality.

In addition, each component is weighted by an identified socio-demographic disparity parameter that reflects differences among metropolitan and local municipalities. The disparity weights for each of the five components are represented respectively by

$$\chi_1, \phi, \varepsilon, \upsilon \text{ and } \mu$$

such that each parameter is a weighted adjustment for the corresponding service allocation component. The adjustments are supposed to take account of the costs of socio-demographic disparities that distinguish the metropolitan municipalities (Category A) from the local municipalities (Category B). The parameter values were estimated from the 2001 Census data (StatSA, 2001). The five components represent the generic costs of the broad categories of infrastructural services. The socio-demographic disparity parameters are adjustment weights associated with sub components of these broad categories. The socio-demographic disparity weights may be designated as follows:

- $\chi_1$ for inadequate household water and sanitation,
- $\chi_2$ for households in informal settlements with no access roads,
- $\chi_3$ for inadequate household refuse and waste removal,
- $\phi$ for public facilities for households earning less than R1100 per month,
- $\varepsilon$ for small business areas with households earning less than R1100 per month,
- $\upsilon$ for development areas with households earning less than R1100 per month,
- $\mu$ is a performance related adjustment

Thus the full MIG formula will be:

$$MIG = \sum_{i=1}^{3} \chi_i B + \phi P + \varepsilon E + \upsilon N + \mu M$$

Where $i$ is an index for the three disparities ($\chi_1$, $\chi_2$, $\chi_3$).

The South African system of equalization grants was informed by many expert inputs. One of the key contributions for the development of the local government equitable
share model was from Inman, Petchey and Rubenfeld (1997). The model for South Africa developed a formula for allocating a variety of targeted equalization grants to municipalities in South Africa. The model developed the formula for the allocation of four different grants from a total recurrent intergovernmental grant pool.

**Monitoring and evaluation of IGFR allocations**

The process by which grant formulae and amounts are determined should be transparent and monitored, and responsible institutional agencies must be held accountable for implementing the budget programs for which allocations have been transferred over the medium to long term. In this regard, isolating specific purpose grants and equalization transfers targeting poverty reduction from the budget process entirely is not feasible since funds must be appropriated by the national legislature. Some countries, such as Australia, India and South Africa have found arms-length bodies such as the grants commissions to be extremely helpful as a means of ensuring that longer-run considerations are taken into account in designing grants. However, as noted by Shah (2005), these agencies do not have the power to hold the executives to account for the effective delivery of services and efficient use of state funds. In this regard, the national legislatures must play a more proactive role. South Africa, for example, has recently passed a Money Bills Act (2009) to give national Parliament the power to monitor, evaluate and hold the executive institutions accountable for the effective and efficient implementation of budgeted programs.

The Money Bills Act in South Africa emphasizes the principle that the annual budget is an important medium term expenditure framework (MTEF) planning tool, and expresses in financial terms the plans to be implemented for each financial year according to the IGFR objectives and targets with the national plan (Josie: 2012). All budget programs, including IGFR allocations, must be approved and monitored by Parliament according to principles of planning and control in the public sector and prepared according to an annual or medium-term budget cycle as illustrated in Figure 2. A broad general framework for preparing such a planning cycle is presented below:

- Planning of fundamental aims and policy objectives.
- Setting policy targets(outputs/outcomes, operational implementation (personnel & HR resources) planning and periodic (3-6 months) action plans with financial costs.
- Setting policy instruments (legal, institutional, financial, administrative, other)
- Budget preparation according to vote and programs.
- Controlling, measuring and monitoring legal compliance (in South Africa this includes the Public Finance Management Act; Municipal Finance Management Act, amongst others) through Parliament, auditor general, independent statutory institutions (e.g. Public Protector, Human Rights Commission) civil society.
- Reporting, analyzing and feedback. In South Africa this is done through Parliament, intergovernmental institutions such as the Presidential Coordinating Council, Budget Council, Budget Forums, Financial & Fiscal Commission (FFC) and the South African Local Government Association (SALGA).
As in most countries, in South Africa the budget determines income and expenditure; assists policy making and planning; authorizes future expenditure; provides the basis for controlling income and expenditure; sets standards for evaluating performance; motivates managers and employees and, is the basis for the co-ordination of programs and multi-purpose organizations and departments. Therefore, ensuring that the IGFR policy objectives, targets and instruments are implemented and attained is the main responsibility of the legislatures. The Money Bills Act (2009) in South Africa provides guidelines for the monitoring role of Parliament to ensure that money bills such as the budget and related legislation achieve their objectives. Figure 3 schematically illustrates the system for legislative monitoring of budget programs.
Figure 3: Parliament Oversight: Programme, Planning, Budgeting & Monitoring System

Legend

Source: Josie: 2012
The fundamental role of national government in IGFR systems:

The role of national or central government in managing and coordinating IGFR policies emerges as a fundamental factor for the effective and efficient implementation of fiscal decentralization policies. With regards to designing equalization transfers, national government has to be aware that it is ultimately responsible for macro-economic management and hence the implementation of fiscal and monetary policies that will facilitate its employment, price stability and growth objectives. Effective monetary management requires overseeing both the money supply and the level of public debt. The former is not an issue since it is the clear responsibility of national government. However, the public debt includes not only national public debt but also any debt issued by the other spheres of government. In practice this means that the three classic government functions of allocation, distribution and stabilization is the responsibility of all three spheres of government. For addressing pro poor policy objectives, the issue is how the actions of the national and sub-regional spheres of government can be coordinated to achieve national redistributive objectives. In this regard it is important to note that in designing equalization policy instruments, a fundamental principle is the manner in which the responsibility of revenue raising functions is assigned to the different spheres of government so that each sphere can not only contribute to, but also take ownership for addressing pro-poor policy objectives.
Recommendations for Sudan and Concluding Remarks

The preceding sections of this paper presented an overview of selected IGFR systems and the application of fiscal decentralization policies using South Africa as an example. It covered the constitutional and institutional basis for IGFR and presented some of the principles and practices that inform the implementation of fiscal decentralization.

From the review of the literature on practices and policies for intergovernmental fiscal relations this section will highlight some perspectives that may be relevant for Sudan as it seeks to address pro-poor and poverty reduction policy objectives across the different regions of the country. Some of the principles and practices discussed in the literature provide a useful guide for identifying and assessing appropriate fiscal decentralization reform architectures for pro-poor and poverty reduction fiscal transfer mechanisms in Sudan’s current IGFR transfer system.

In particular, principles and practices regarding fiscal decentralization principles, methods and mechanisms that address harmonization and equalization of transfers; policy options for optimal sub-regional own revenue collection, and institutional, administrative, financial and legislative policy instruments for effective implementation and monitoring of fiscal decentralization will be important.

In Sudan, as with other developing and emerging economies, of all the sub-regional governments, the financing of local government is critical for a well-functioning and pro-poor fiscal transfer system, as local governments are closest to communities and have better knowledge and understanding of their conditions of disadvantage, poverty and deprivation. This issue speaks to the fiscal decentralization principle of subsidiarity and should be given serious consideration when developing pro-poor and poverty reduction fiscal transfer systems for economies in transition.

One of the key principles that emerged from the review is that an ideal system of intergovernmental fiscal arrangements should be consistent and achieve continuous improvement in the level of basic services across the nation as resources permit. In particular, consistency must ensure that budget allocations must be predictable and stable in the medium term. This principle implies that an ad hoc system of allocations must be avoided to prevent a breakdown in the delivery of services at sub-regional level. In addition, the system must finance services in an equitable manner among sub-regions while at the same time allowing sub-regional governments to develop their capacity to assume full responsibility for providing basic social services in their own jurisdictions.

From the literature relating to policies and practices, it is also evident that formula-based equalization grant allocations have a number of advantages over those that are determined on an ad hoc basis by national government. Among others, advantages include transparency, reliability, predictability, stability and limited impacts from fiscal constraints and day-to-day political considerations. These advantages are extremely important for DTEs, such as Sudan where sub-regional governments may have relatively limited revenue-raising power. A further important consideration for DTEs is that formula-driven grants can
be designed to be in place for medium term expenditure intervals for several years before being reviewed. Of course, for vulnerable and disadvantaged sub-regions it will be critical for formulae to be designed so that risks of unexpected changes in revenue are borne by national government. In many DTEs this is especially important where vulnerable sub-regions have little revenue-raising ability, and where they cannot use debt as a method of insuring themselves against revenue fluctuations.

**Principles and practices for equalization grants**

With respect to fiscal transfers, the main principle to emerge from the review is that major grants, especially those that play an equalizing role, should be unconditional and non-matching. This will ensure that sub-regional governments are able to exercise the utmost discretion within national norms and standards. As stressed above, achieving that objective is one of the most difficult problems in systems similar to South Africa. National government and the provinces bear joint responsibility for ensuring that public services in areas like education, welfare, and health satisfy national equity criteria. Unconditional grants have one important benefit, which arises from the fact that sub-regional governments should bear responsibility for the consequences of their expenditure. In this sense the grants must be supported by regulations to prevent the potentially serious problem faced by many federations with large vertical fiscal imbalances – the problem of bailouts of irresponsible (or over-zealous) sub-regional governments. This is the so-called "soft budget constraint problem".

Conscious of the risks of sub-regional governments defaulting because of the “soft budget constraint”, DTEs must consider the risks that are inherent in equalization grant allocations in fiscal decentralization systems. These risks include the principle of affordability in that the size of the equitable share should be within the realm of fiscal realities and macroeconomic constraints. Secondly, sub-regional grants should take account of sub-regional own source revenues. Thirdly, conditional or specific purpose grants should be used to target and support specific elements of basic services (such as poverty reduction, hospitals, schools and public infrastructure) in the context of pro-poor policy objectives and job creation.

The review of the literature indicated that there is general consensus that socio-economic disparities and differences in fiscal requirements must be taken into account in equalization grants. In IGFR systems where sub-regions have little revenue-raising capacity the inclusion of socio-economic and fiscal disparities in grant allocations will contribute to fiscal equity, the efficiency of the IGFR system and meeting pro-poor redistributive objectives. There are two factors that must be considered in this regard. Firstly, the cost of providing public services must be balanced against exogenous macroeconomic impacts from the vagaries of international commodity price fluctuations, droughts, floods and other factors outside the control of policy makers. These factors will have inflationary effects on the unit costs of labor, energy, equipment and raw materials and negate any attempt to establish certainty, predictability and stability in grant allocations.

Secondly, the cost of providing services will be influenced by the differences in the resources required to achieve comparable service levels. As observed in the literature, such differences arise due to disparities in demography, geography, and historical legacies of
inequalities in levels of development, including critical capital backlogs among sub-regions. Balancing the costs of disparities against the macroeconomic constraints in a DTE will be a challenge because many such countries do not have the material conditions, capacities and resources for estimating the costs of disparities.

**Institutional considerations for effective and efficient equalization**

Following from the discussion of the allocation principle, it is important for policymakers to have a sound understanding and analysis of the national context and situation of the political economy of the country. This understanding must be informed by good data so as to determine the normative principles and policy objectives for a redistributive equalization grant design. On this basis, policymakers will be able to make the empirical rules based on institutional choices (e.g., constitutional and legal framework), judgments (e.g., what disparity indicators and which regions to prioritize) and compromises between competing principles (e.g., consensus arrived at through negotiations within institutional bodies such as an intergovernmental forum, grant commissions and legislatures).

While there are many IGFR institutional arrangements these may not be appropriate and applicable across all IGFR systems. In his evaluation of IGFR institutions, Shah (2005) concludes that an independent agency model will generate higher overall transactions costs and less desirable potential outcomes. The reason for this is because the independent nature of grants commissions and their pursuit of ideal complex systems undermine the role of public participation, oversight, transparency and accountability in the formulation of recommendations. In addition to increased agency costs, participation and monitoring costs will also rise without any assurance that the higher transaction costs will generate better outcomes.
Summary of basic principles for an optimal revenue sharing system

From the literature reviewed thus far, it is clear that a long-term vision for an equalization system for a DTE such as Sudan implies that there are certain principles that an optimal grant system should satisfy. Among others these include the following:

- To the extent that the Constitution provides that national revenue be divided equitably between national and sub-regional governments, these should ideally be sufficient to allow spheres to provide the mandated national basic levels of public services. In addition, conditional grants may be used to direct national resources to achieve particular objectives that national government may identify from time to time, such as poverty reduction, public infrastructure and the development of institutional capacity.
- The equitable share component of the equalization grant should be based on an objective measure of the norms and costs of delivering the mandated services in each sphere. Objective criteria may be translated into a transfer formula. The amount transferred to each sub-region could be based on an assessment of the minimum amount of money that would be required for the government to deliver an optimal standard level of services in an efficient way.
- The transfer amount should take account of disparities in demography, geography and other socio-economic conditions (for example poverty levels, health, income inequality, unemployment and infrastructure backlogs) that affect the costs of delivering the services. Such grants could have the following characteristics:
  - Be unconditional in the sense that a sphere would be free to choose the exact mix of services most preferred by their constituents, provided they met the basic norms and standards set nationally for poverty reduction, health, education and welfare. This would encourage responsibility and would not distort the incentives for spending and raising revenues.
  - The amounts provided to each sphere should be stable over the medium term to ensure the planning of expenditures and not be subject to uncertainty or budget shocks.
  - A formula, rather than administrative discretion, should drive the amounts provided so that the process is as transparent and objective as possible.
  - The size of the equitable share should be affordable given the fiscal realities facing national government.
  - Sub-regional equitable shares relative to the national equitable share should take account of own source sub-national revenues.
  - Where it is deemed desirable for meeting national norms and standards, the division of equitable shares should support specific elements of basic services that have spillover effects (such as teaching hospitals, and public infrastructure such as roads) through conditional grants to.
- The use of the equitable shares is subject to important constraints and expectations. Sub-regional governments must provide basic services according to the nationally agreed mandates, and must be held accountable to the national and sub-national legislatures and to the public in the relevant jurisdiction.
- The level (norms and standards) of services provided by all spheres will evolve and be raised as the economy develops and generates the resources to meet social pressures for higher standards.
• The equitable shares must continually be balanced against the requirement to maintain viable national economic and fiscal policies in the face of increasing demand for services.

• As the ability of sub-regional governments to raise their own revenues is enhanced, they should become more responsible and accountable to their electorates.

• Sub-regional restructuring should focus on equalization systems that extend benefits to areas that have been historically disadvantaged and under-serviced in the past.

• The relationships among the three spheres of government – national, provincial/state and local- must nurture co-operative intergovernmental relations institutions for establishing equalization systems and norms and standards for basic services through consultation.

Thus, in balancing the need to provide basic services against current fiscal realities, the long-run payoff of investment in services for poverty reduction, education and health, is that it creates the conditions for stronger economic growth and generates a healthier fiscal environment for further sustainable savings and investment.
Concluding remarks

The long-term vision of the inter-governmental system is one where national government, in consultation and co-operation with sub-national spheres, sets standards for basic public services. Ideally, these standards should be transparent and should be provided for in national legislation. Sub-national spheres have the responsibility to design and deliver programs within their jurisdictions that satisfy these national standards, utilizing the resources available to them.

To address pro poor poverty reduction objectives, political accountability is important for ensuring that public services are delivered in efficient ways and that they meet the needs of citizens. Therefore, explicit and unambiguous delineation of accountability relationships between the different spheres of government is critical. Nurturing responsible sub-regional decision-making through consensus may involve some transition, but it will pay dividends in the long run.

While the fiscal decentralization challenges facing many developing transitional and emerging economies appear daunting, the progress already made inspires hope and confidence that the vision of a fair and just society and the commitment to a better life for all will be possible. All the policies and practices reviewed are informed by their own historical context and may not necessarily be applicable in all respects to other developing countries. Some of the principles and practices relating to equalization grants to mitigate the effects of socio-economic and geo-spatial disparities may be of relevance for other countries emerging from underdevelopment and oppression. However, each country will have to forge its own path while drawing on the international experiences, practices and principles relevant for its unique context.
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