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REVENEWS

Research & Policy Notes Concerning Public Finance in Developing Countries

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In This Issue

Many countries use some form of intergovernmental transfers to assist in the financing of local government expenditures. The literature in this area, while extensive and growing, has focused mainly on the developed world. For developing nations the work has either been extremely general or country-specific. Larry Schroeder's monograph entitled "Rural Development Grants to Local Governments in Asia" (Metropolitan Studies Program Monograph No. 19, March 1987) is thus a welcome addition to the field in that it is a comparative analysis of grant programs in four South and Southeast Asian countries: Bangladesh, Pakistan, Indonesia and the Philippines. The report is based on two in-depth country studies on the Philippines and Bangladesh conducted previously under the support of the Local Revenue Administration Project and on the author's research trips to Indonesia and Pakistan in June and July 1986. The latter involved data collection from both central and local governmental levels and interviews with government officials, local experts and academics.

The monograph can be purchased by contacting the Publications Officer at the Metropolitan Studies Program. It's price is $5.00 which includes surface mail postage; for air mail, please add $3.00 to the price.

Evaluating Intergovernment Grant Systems in Four Asian Countries

The monograph provides a description of both governmental and grant system structures in Bangladesh, Pakistan, Indonesia and the Philippines. That description provides the background for Schroeder's evaluation of the transfer programs in terms of several different criteria with the expectation that a grant scheme that is considered adequate in some areas may well fail in some others.

The grant systems in use vary widely across the four countries. In Bangladesh, the flow of intergovernmental transfers from the central government to the upazila and union parishads is made from the Development Assistance Fund and the Special Infrastructure Fund. While the former is a block grant for sectoral allocations to agriculture, industry, physical infrastructure, etc., the latter is a special allocation to upazilas to allow them to upgrade their facilities in the upazila centers. Rural Works Programme grants are now used to finance only zilla parishad activities.

Since Pakistan is a federal system each provincial government tends to treat its local authorities somewhat differently. As such there is considerable variation in grant systems among the provinces. In Baluchistan and Sind both recurrent and development grants are provided to rural local governments. The former essentially take the form of deficit grants, while the latter flow from the provincial Annual Development Programme. In the North West Frontier Province, however, no recurrent grants are provided to union and district councils and all grants flow only from the Annual Development Programme. The situation in the Punjab is more complex than in the other provinces. Here, instead of a couple of simple block grants, six different grant programs are utilized. All grants are a part of the Annual Development Programme and are provided to district councils, which then decide on allocations to the union councils.

In Indonesia, grants dominate the finances of both the provincial and second tier local governments. More than 72 percent of provincial revenues come from central government grants. Similarly, transfers from central and provincial levels of government constitute about one-third of routine revenues of second tier local governments, and slightly over one-half of all development revenues. The bulk of the development oriented grants to local governments flow through the Inpres (or Instructions from the President) grant programs.

The two predominant rural development grant schemes in the Philippines in the second half of the 1970s consisted of the general Bureau of Internal Revenue allotment and the Specific Tax allotment. Both of these use a weighted formula based on population, land area and equal shares, and are distributed to provinces, rural municipalities, cities and barangays, or neighborhood units of local government.

Evaluative Criteria

The first criterion relates to the size and growth of grant programs. With the exception of Bangladesh since 1983/84, the study indicates that there has been no significant increase in the role grants play in the overall allocation of funds by granting governments. This does not imply, however, that grants are unimportant to recipient governments. In Bangladesh, rural localities are heavily dependent on grant revenues—nearly 100 percent at the upazila level and above 80 percent at the zilla parishad level. In Pakistan, reliance on grants by unions ranges from 27 percent to 80 percent. Indonesian local governments remain extremely dependent upon centrally generated revenues, particularly because the central government retains responsibility for local employee compensation. Philippine municipalities were slightly less dependent on central government flows of funds with the Bureau of Internal Revenue (BIR) allotment constituting from 27 to 50 percent of general fund revenues in a sample drawn from four provinces in 1977.

The second criterion involves assessing the grant systems in terms of fiscal planning. The statutory grant system in the Philippines seems to present a model that would assist greatly in local fiscal planning. Here grant flows in one year are to be tied to actual central government tax collections two years previous. This practice would allow local governments to have a much better idea of what kind of revenue increase or decrease they might expect and to plan accordingly. Yet revenue shortfalls have characterized the Philippine grant system and have affected local governments' capacity to plan effectively. Local govenments in Indonesia and Pakistan suffer from a lack of information regarding grant flows leading to delays in starting grant-funded projects. Considerable improvement would thus seem feasible in the fiscal planning implications of the grant systems in use in these countries.

Another evaluation criterion is the spending implications of grant programs. Each of the countries uses block grants with few strings attached, but one should not jump to the conclusion that granting governments do not retain major control over how these funds are spent. The upazila government grant in Bangladesh contains general guidelines regarding sectoral allocations. Similarly, in the Philippines there are numerous mandates regarding overall spending of total revenues, including grant funds. The sectoral block grants used in Indonesia give the central government absolute power to determine the allocation of those funds while the general grants allow localities to choose functional areas of expenditure. Within Pakistan, the provinces in general allow considerable latitude in determining the use of grant funds, with the exception of several highly specific rural development grant schemes in the Punjab.

Grant schemes can have potentially positive effects on local fiscal efforts and the author cites some minor instances of these. The matching grants in some provinces in Pakistan could provide an incentive for local revenue effort. Similarly, the upazila grant program in Bangladesh may evolve into a system where grant flows are determined by local tax effort. Sharing locally-collected property tax revenues with Indonesian localities can also have a significant effect on collection effort, though recently the extent of that incentive has been reduced. The fact that local governments in all four of the countries examined have minimal autonomy in setting tax rates generally acts as a dampener on local effort effects of grant systems. Little can therefore be expected from revisions in grant programs that alter the allocation formula unless greater autonomy to local governments is permitted. Schroeder also points to the unavailability of sufficient data required as the basis for devising a grant allocation formula that would include local fiscal effort. Income, for instance, is probably the most accurate reflection of taxpaying ability, but such data on income level for localities are available only for the Philippines.

The fourth criterion considered is that of redistribution. None of the formula-based rural development grant schemes reviewed in the study has necessarily been designed to direct funds to localities on the basis of level of local economic development. Using the local-level income data available for the Philippines, the author observes that income is not statistically related to either the BIR or the Specific Tax Allotment (STA). Hence there do not seem to be any obvious income redistributional effects of these programs. The primary determinant of grant allocations remains population. In the Philippines, Bangladesh and Pakistan, the analysis reveals that jurisdictions with larger populations receive lower per capita intergovernmental transfers. Perhaps this pattern can be ascribed to the attempt to use these grants to "equalize" across jurisdictions.

Maintenance of Projects

An interesting finding from the analysis is that granting governments are aware of the need for spending on maintenance of infrastructure facilities at the local level and some have designed grant-based strategies to ensure this. In Indonesia at least 25 percent of general Inpres grants are to be used for maintenance and sectoral Inpres grants may also be used for this purpose. An identical 25 percent was to be used for maintenance under the Rural Works Programme in Bangladesh but the newer upazila development grant does not contain any such provision. No maintenance requirements are part of the constraints governing allocation of grant funds in the Philippines or Pakistan, although the Philippines does require an interfund transfer into the Development Fund which is to be used for both maintenance and construction efforts. It appears, though, that the efforts in these countries to ensure expenditure on maintenance activities have not worked well. Three major factors prevent these efforts from succeeding. The first is the difficulty in differentiating between maintenance and reconstruction activities and mandating such a distinction for a large number of local governments. The second is linked to political factors. Since political leaders everywhere recognize the vote-winning characteristics of new projects, they tend to push for such activities rather than for the maintenance of existing projects. Finally the grant system itself may be structured so as to favor new construction or reconstruction of facilities rather than maintenance. What is needed, therefore, is additional research on how grant systems can be restructured to provide incentives for maintenance.

Decision Making

The author also examines the implications of the grant schemes for decentralized decision making. He concludes that while grant systems may promote some decentralization, local governments nevertheless remain highly dependent upon their higher level counterparts. Although the local government system in Bangladesh has become much more decentralized with significant fiscal flows to upazilas, considerable powers have been retained centrally. In Pakistan, provinces enjoy a great deal of autonomy while local governments within the provinces remain relatively unimportant. Here grants constitute a significant part of local government total revenues but only relatively insignificant portions of provincial resource allocation. The recent change whereby members of provincial and national assemblies in Pakistan are provided with significant amounts to allocate as they see fit could, however, undermine the role of local governments and lead to greater centralization. The bulk of the resource allocation questions in Indonesia are answered centrally. The general Inpres block grants are not conditional, but these flows constitute only half of total Inpres grant funds. The fact that personnel decisions and compensation are made centrally indicates that the system is still fairly centralized. The case was much the same in the Philippines in the 1970s where empirical indicators suggested that the central government grew relative to subnational governments and exercised considerable control over resource allocation for local governments through grants and local resource mobilization. Finally, in all four countries local revenue raising opportunities are limited by central regulations, thus further retarding the process of decentralization.

Absorptive Capacity

The study raises the issue of whether rural local governments in developing nations have the capacity to spend effectively large flows of money from higher level governments. This issue is crucial if grants are to be used as a primary instrument in decentralized development efforts. Both the upazila grants in Bangladesh and the barangay grants in the Philippines face similar absorptive problems. The slow rate of expenditure of grant funds in Indonesia is also an indicator of this fact. What is clearly required is further research regarding absorptive capacity of local governments in the Third World.

Conclusions

Schroeder concludes by emphasizing the diverse and extensive features of the intergovernmental grant programs in these four Asian countries. He shows that nearly all possible forms of intergovernmental transfer programs are utilized in these four countries but that ad hoc or politically-based grant mechanisms dominate. If grants are to be used to strengthen local governments in the area, more formalized grant structures relying on formulas and hard data ought to be developed.

Related Reading on Grant Systems in Developing Countries

Metropolitan Studies Program staff publications include several other studies of grant systems which may be of interest. A lengthy chapter on intergovernmental grants in the Philippines is provided in Roy Bahl and Barbara Miller, eds., *Local Government Finance in the Third World: A Case Study of the Philippines* (New York: Praeger, 1983). On Bangladesh, see the volume collectively authored by team members on LRAP's Bangladesh project: *A Plan for Increased Resource Mobilization by Local Governments in Bangladesh, Volume I and Volume II* (Metropolitan Studies Program Monograph No. 14, May 1984), and Roy Bahl, "Intergovernmental Grants in Bangladesh" (Metropolitan Studies Program Occasional Paper No. 87, May 1984). For a more general discussion of grants see Lady Ursula Hicks, "Intergovernmental Relations with Special Reference to the Less Developed Countries" (Metropolitan Studies Program Occasional Paper No. 29, June 1976).

In Jamaica

In March Jamaica Tax Structure Examination Project (JTSEP) director Roy Bahl and Professor Dan Holland of MIT traveled to Kingston to continue the company tax work.

Two more JTSEP staff papers have been published. Staff Paper No. 32, "Tax Policy for Life Insurance Companies, Building societies, Superannuation Funds and Individual Retirement Accounts in Jamaica," by Gerard Brannon and Jorge Martinez (December 1986, 63 pp, $3.00) considers the alternative tax reforms for these financial intermediaries from the perspective of the special role they play in the Jamaican economy.

Staff Paper No. 33, "International Aspects of Revisions to the Jamaican Company Tax," by Oliver Oldman, H. David Rosenbloom and Joan Youngman (March 1987, 40 pp, $3.00) looks at the Jamaica company tax policy choices in light of the Government's objective of increasing investment from abroad.

Both of these studies were carried out as a part of the Project's work on company taxation under the general direction of Dan Holland.

In China

Roy Bahl spent most of the month of March in China doing research as part of a World Bank mission. The subject of his analysis was local public finance as well as the land use tax in China. He worked in Beijing, Shanghai, Zhejiang Province and Shandong Province.

Visitors to Metro

Janet Poley of United States Department of Agriculture visited Metro in March to discuss mutual interests in the problem of sustainability of development projects in Third World countries.

Four officials from various countries in Africa visited Metro in April to discuss decentralized planning and problems regarding financing of projects in their countries. Professors Haggblade and Miner discussed with them their experiences in several different countries of Africa. Visiting Metro were: M. Valentin Tapsoba, Project Manager, Catholic Relief Services (CATHWELL) Burkina Faso; M. Ali El Akkaoui, Regional Delegate (Tensift Region), Ministry of Plan, Morocco; Cit. Suaka-NZeza Na Bembo, Division Chief, National Economy & Industry (Shaba Region), National Economic Council, Zaire; and M. Ibrahim Maiga, Counsellor for Regional Development (Region of Sikasso), Office of the Governor, Ministry of Interior, Mali.

In Egypt

Professor Bill Fox of the University of Tennessee spent two weeks in Cairo, Egypt under the auspices of the Local Revenue Administration Project. While there he reviewed the progress of USAID's tax administration project as well as the overall revenue/taxation environment in Egypt. His report to the Mission also considered how USAID might provide future assistance for tax administration in the country.

Staff Publications and Presentations

The late Robert Kearney, Professor of Political Science, and Barbara Miller have written a book entitled *Internal Migration and Its Social Consequences in Sri Lanka* (Boulder, CO: Westview Press, 1987). The authors examine three aspects of social change in Sri Lanka which are related to the rapid increase in internal migration during recent decades: imbalances in the sex ratio in districts of the Dry Zone, rising rates of suicide all over the nation but particularly in the Dry Zone, and increased ethnic tensions and violence between the Sinhalese and the Tamils. In conclusion, policy options for reducing the negative effects of internal population movements are reviewed.

In January, David Robinson gave a paper on "Migration to Colonial Mérida" at the International Conference of Latin American Geographers held in Mérida, Yucatán. He also gave an invited presentation on "Spatial Patterns of Socio-Economic Change in Yucatán" to the School of Anthropology, Autonomous University of Yucatán (Mérida).

Roy Bahl gave a lecture to the World Bank Urban Staff Retreat in January at the Homestead in Homestead, Virginia, on the subject of "Local Public Finances in China."

In February Metro issued the proceedings of the July 1986 conference on "Tax Reform and Private Sector Growth." Included in the monograph (Metropolitan Studies Program Monograph No. 18, 82 pp, $5.00) are expanded versions of the presentations by Roy Bahl, Ved Gandhi of the IMF, Malcolm Gillis of Duke, Charles McLure of the Hoover Institution, and Larry Schroeder. The conference, jointly sponsored with AID, was held in Washington and examined specific comprehensive tax reforms (Jamaica and Indonesia) as well as the broader policy environment and an agenda for continuing research.

Staff News

In April, Maxwell School Dean Guthrie Birkhead appointed David Greytak as Director of the Metropolitan Studies Program to fill the spot left vacant by Larry Schroeder who wanted to return his attentions to research and teaching. Schroeder continues to direct the Local Revenue Administration Project. Greytak, who has been Associate Director of Metro, led the Ecuador Fiscal Administration Study and has participated in numerous LRAP projects throughout the years.

Barbara Miller, who has edited this publication since its inception, has left the Metropolitan Studies Program and Syracuse University to pursue an NSF grant-related research at the University of California, Berkeley. Her efforts supporting the dissemination of the international research under the auspices of the Metropolitan Studies Program have been prodigious and will be sorely missed.

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