PROFILING OF FISCAL EQUALISATION ACROSS SELECTED AFRICAN UNION MEMBER STATES[1]

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1. INTRODUCTION

"The availability of financial resources is a basic condition for effective decentralisation. Without some degree of financial decentralisation, the transfer of responsibilities cannot be operationalised. But the financial autonomy of local governments is bound to be constrained by the limited scope for raising revenue locally, the fact that transfers from central government are often earmarked to specific programmes and activities, and the fact that salaries and recurrent expenditures tend to account for a large share of local government budgets. Limited financial autonomy may undermine local government's capacity to implement local development programmes which respond to the needs of local people."[2]

Fiscal decentralisation and fiscal equalisation are crucial elements for the success of decentralisation generally. Decentralisation is increasingly recognised by central governments as an approach to governance that is necessary to accelerate poverty reduction, create jobs and simulate local development. In order for states to address these developmental objectives, it is crucial that central governments share and transfer appropriate responsibilities, powers, competencies and functions to sub-national levels of government, especially local governments.

The three main dimensions of decentralisation are recognised as political decentralisation, administrative decentralisation and fiscal decentralisation. The balance and complementarity between these dimensions is essential. The strength and weakness of these elements differ across the African continent and African Union (AU) member states. However, many studies have argued that fiscal decentralisation in Africa remains the weakest of these three dimensions.

The primary purpose of this report is to provide a profile of fiscal equalisation, which is part of fiscal decentralisation, across 15 African Union member states. At its most elementary level, fiscal equalisation in this report is used as a measure of solidarity and support by central governments and States to local authorities and local governments. The report undertakes a brief literature review of the key issues on fiscal decentralisation and fiscal equalisation and points to the salient issues that African states needs to address going forward.

For the profiling element, eleven (11) African member states are identified from across of the five (5) AU regions:

a) North Africa: Algeria; Morocco;
b) West Africa: Senegal, Ghana;
c) Central Africa: Cameroon, Niger;
d) Eastern Africa: Ethiopia, Kenya, Uganda; and
e) Southern Africa: Malawi, South Africa.

[2] Cabral L (2011), Decentralization in Africa: Scope, Motivations and Impact on Service Delivery and Poverty, *Future Agricultures: Working Paper 020*, www.future-agricultures.org

2. KEY ISSUES ON FISCAL DECENTRALISATION AND FISCAL EQUALISATION

2.1 Key Elements of Fiscal Decentralisation

Decentralisation is generally defined as the transfer of responsibilities and functions from central governments to sub-national governments. Fiscal decentralisation is one element or dimension of decentralisation. Fiscal decentralisation is defined as the extent of expenditure and revenue powers and responsibilities that have been assigned to sub-national and local governments in order for the latter to discharge their duties.

Fiscal decentralisation comprises of the following elements[3]:

a. An adequate legislative and institutional enabling environment;
b. Assignment of an appropriate set of functions to sub-national governments;
c. Assignment of an appropriate set of local own-source revenues to sub-national governments;
d. The establishment of an adequate intergovernmental fiscal transfer system; and
e. The establishment of adequate access of sub-national governments to development capital.

More than a decade later another author provides a similar list of the building blocks of fiscal decentralisation:[4]

a) The assignment of expenditure responsibilities to different government levels;
b) The assignment of tax and revenue sources to different government levels;
c) Intergovernmental fiscal transfers;
d) Local government borrowing; and
e) Local government finance institutional structures and procedures.

What needs to be noted is that fiscal *equalisation* is a sub-component of fiscal *decentralisation* and principally focuses on the system, nature and quantity of inter-governmental transfers from central government to local governments.

2.2 The Importance of Fiscal Equalisation and Some Key Challenges

Fiscal equalisation interventions to local governments are mainly anchored in the intergovernmental transfer system. These systems address fiscal equalisation through either conditional transfers or unconditional transfers to local governments, or a combination of the two.

Why is fiscal equalisation important? It has been argued that these transfer systems and fiscal equalisation are important for the following reasons[5]:

[3] Smoke P (2000), "Fiscal Decentralization in East and Southern Africa: A Selective Review of Experience and Thoughts on Moving Forward", Prepared for a Conference on Fiscal Decentralization International Monetary Fund Washington DC, November 20-21, 2000, New York University
[4] Tidemand, P (2012) "UNDP Local Governance and Local Development – Local Government Finance Policy Brief", UNDP Regional Service Centre, Johannesburg, South Africa

a) It assists in addressing sub-national government fiscal imbalances by supplementing inadequate local own-source revenues to improve the ability of sub-national governments to meet their expenditure responsibilities;
a) Intergovernmental transfers can be used to meet national redistribution objectives helping to offset fiscal capacity differences among sub-national governments; and
b) These transfers can be used to encourage local expenditures on particular goods and services that exhibit positive externalities or are considered to be basic needs that should be distributed less unequally than the ability to pay for them.

It is further argued that there are typically a number of problems associated with these transfer programmes:

a) Firstly, no single type of transfer meets all the desired objectives. Unconditional grants, for example, are best for income redistribution purposes, while conditional grants are a more efficient way of encouraging expenditures on particular types of target services;
b) Fiscal equalization grants are often considered important, but they are very difficult to design because of the technical and political complexities involved in defining an "optimal" distribution of income across decentralized jurisdictions and in determining a fair way to raise the revenues to be redistributed;
c) Also macroeconomic problems can be created if too large a percentage of central resources are guaranteed to sub-national governments annually. The potential dangers, however, must be balanced against the value of providing sub-national governments a stable revenue base and the potential microeconomic gains of decentralized service delivery;
d) Transfer programs may have conflicting objectives or unintended results. For example, an equalizing grant may be offset by conditional grants that go to wealthier areas, or grants may substitute for rather than stimulate local tax effort;
e) Too many transfer programs with different allocation criteria create an administrative burden for local officials and provide incentives for unproductive competition and strategic behaviour; and
f) Finally, many transfer systems are allocated with a degree of subjectivity that undermines basic economic objectives.

2.3 What is the extent of Fiscal Decentralisation and Fiscal Equalisation in Africa *and* What does this mean for Local Governments' Share of Nationally Raised Revenue and Overall Public Expenditure?

The "fiscal autonomy" of local governments is often assessed both by its share of national revenue *and/or* national public expenditure. Some of the studies below give an indication of the complexity of this issue.

In 1996 in a study[6] of selected African countries, local government revenue as a percentage of central government revenue showed the following: Cape Verde: 9,5%, Ghana: 4,8%; Madagascar: 1,4%; Senegal: 6,6%; Benin: 3,1%; Burkina Faso: 2,5%; Cameroon: 4,6%; Cote d'Voire: 4%; Mali: 1,8%; Niger: 6,4%; and Togo: 1,8%.

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[5] Smoke P (2000), "Fiscal Decentralization in East and Southern Africa: A Selective Review of Experience and Thoughts on Moving Forward", Prepared for a Conference on Fiscal Decentralization International Monetary Fund Washington DC, November 20-21, 2000, New York University

[6] Chambas G & Duret E (2000) *Local Taxation Versus Central Taxation: Micro-evidence from African Decentralised Governmen*t, Conference on Economic Development in Sub-Saharan Africa, CSAE, Oxford, April 2000.

Later in 2000 a study[7] on Southern and East Africa showed a number of interesting trends. In the case of South Africa, over a decade ago, local governments were responsible for raising 92% of their total revenues in 1999/2000. Ethiopian decentralized governments accounted for 43,5% of public expenditures in 1996, while Kenyan local governments accounted for only 4.2 % in 1995. Kenyan local governments at the same time raised 5.6 % of total public revenues. Ethiopian local governments, on the other hand, raised only 17.8 % of total public revenues such that they were dependent on transfers for nearly 60 % of their resources. In Uganda, local governments accounted for 21 % of total public expenditures (1995), but they raised only about 8% of total public revenues.

Two years later in 2002 the World Bank undertook a stock taking survey of decentralisation of 30 African countries. It measured the extent of decentralization in three areas, namely the political, administrative, and fiscal dimensions[8]. The general conclusion was that there is a moderate degree of decentralization in the Africa:

a. South Africa and Uganda scored the highest;
b. In the next band, with a moderate degree of decentralization, were 11 countries: Kenya, Ghana, Nigeria, Rwanda, Namibia, Senegal, Ethiopia, Zimbabwe, Tanzania, Cote d' Ivoire, and Madagascar;
c. The third band had the largest number of 13 countries: Zambia, Guinea, Mali, Eritrea, Burkina Faso, Malawi, Republic of Congo, Mozambique, Angola, Burundi, Benin, the Democratic Republic of Congo, and Cameroon; and
d. The final group with nominal or no decentralization, according to this study included 4 countries: the Central Africa Republic, Niger, Sierra Leone, and Chad.

In the area of fiscal decentralization, the extent was assessed against the following indicators:

- Arrangements for fiscal transfers from the central government to localities, and
- The proportion of public expenditure controlled by localities.

According to this study a country with an established and often-used formula for fiscal transfers and in which locally-controlled expenditures account for a high proportion of overall public expenditures would have scored high. The most alarming finding regarding fiscal decentralisation was that in 19 of the 30 countries analysed, local governments controlled less than 5% of the national public expenditure.

The study noted that the average for decentralized systems elsewhere in the developing world is 14% of public expenditure that is controlled at the local level. The study further noted that the highest percentage achieved, of over 10%, was considerably less that the average noted for other developing countries.

The only country found to have a very high degree of fiscal decentralization was South Africa, while the countries that scored high (i.e. where local governments control 5-10% of public expenditures) included Nigeria, Uganda, and Zimbabwe. Countries with moderate levels of fiscal responsibilities anchored at the local level (i.e. where 3-5% of public expenditures are controlled by local authorities) included Kenya, Rwanda, Ghana, Senegal, Burundi, and the Congo Republic, and Congo DRC.

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[7] Smoke (2000), ibid

[8] Ndegwa, SN (2002), *"Decentralization in Africa: A Stocktaking Survey", World Bank: Africa Region Working Paper Series No. 40 - November 2002*

The six countries that scored the lowest regarding the extent of fiscal decentralisation were Angola, Benin, Central Africa Republic, Sierra Leone, Niger, and Chad. These countries had less that 3% of public expenditure controlled by localities.

The study cautioned regarding the interpretation of these findings. Firstly the proportion of public expenditures controlled by the local authorities was very small such that even the 'high performers' are marginal in their performance compared to the global trends. Secondly, in a number of instances it was difficult to disentangle the proportion disbursed by local authorities but actually allocated and earmarked by central ministries. Lastly, it was noted that some of the figures for fiscal decentralization may reflect certain inaccuracies as no hard figures were found or those found were quite dated.

A general conclusion of the 2002 World Bank study was that political decentralization in Africa made the most progress, while administrative and fiscal decentralization were lagging behind respectively.

More recently in 2010, the USAID[9] undertook a comparative assessment of decentralization in Africa, focusing on 10 countries. This study concluded that decentralization has advanced considerably on the continent between 1990 and 2010, but with mixed results in these countries. It also argued that "*decentralization of responsibilities in the 10 African cases has been consistent with the principles of fiscal federalism*".

Some of the general findings on decentralization were that,

a. All African countries in the sample have passed framework laws for decentralization;
b. All countries feature some degree of devolution to elected sub-national government (SNG) officials;
c. Decentralization in Africa combines devolution with deconcentration; and
d. Political decentralization has not been reversed, and recentralization has been limited.

On fiscal decentralization the study found that,

a. Sub-national governments are limited by the nature and extent of fiscal decentralization;
b. Own-source revenues in African sub-national governments are largely insufficient to cover significant responsibilities in decentralized public services;
c. Sub-national governments rely heavily on inter-governmental transfers from the centre for their revenues. These transfers are based on formulas in many cases, and not on the discretion of central governments;
d. Central governments sometimes offload responsibilities to sub-national governments without adequate finances;
e. It is unclear what level of government is responsible for which services in many instances;
f. Central governments can control fiscal decentralization by monitoring expenditures and setting standards and guidelines for sub-national governments to follow;
g. African countries have small local tax bases and sub-national governments have limited own-source revenues; and

[9] USAID (2010**), Comparative Assessment Of Decentralization In Africa: Final Report And Summary Of Findings**, USAID, ARD, Inc., Vermont. The countries assessed were Botswana, Burkina Faso, Ethiopia, Ghana, Mali, Mozambique, Nigeria, South Africa, Tanzania, and Uganda.

h. At the local level, own sources are typically limited to taxes and fees such as property rates, market fees, vehicle fees, and fees for registry services (marriage certificates, etc.).

On a positive note this study pointed out that, "a *major achievement here is the creation of regularized, formula-based revenue transfers from the centre, though these are relatively small in several cases*".

The further recent UNDP study (2010)[10] on local governments in Eastern Africa concluded that most local governments raise less than 50% of their annual budgets from internal sources. Local governments in this sub-region tend to rely on inter-governmental transfers from central governments and external financing. The transfers are both unconditional and conditional transfers.

In a parallel UNDP study (2010)[11] for Southern Africa, it argued that the general tendency in this sub-region is towards increasing the use of fiscal transfers and a decreasing reliance on local sources of revenue.

Lastly a UCLG 2010[12] report provides an overview of 23 African countries' local expenditure share of total public expenditure *and* the weight of local authorities in total public revenue. The table below captures the variation. The overall average for the continent for both indicators is 8%.

	Countries	**Local Share of Total Public Expenditure (2007)**	**Weight of Local Authorities in Total Public Revenue (2007)**
1	Benin	4%	4%
2	Burkina Faso	2%	2%
3	Cote d'Voire	6%	7%
4	Egypt	11%	1%
5	Gabon	3%	4%
6	Ghana	10%	7%
7	Kenya	5%	3%
8	Malawi	9%	7%
9	Mali	3%	4%
10	Mauritania	1%	1%
11	Morocco	8%	11%
12	Mozambique	2%	1%
13	Niger	2%	4%
14	Nigeria	15%	15%
15	Rwanda	23%	21%
16	Senegal	3%	4%
17	South Africa	18%	18%
18	Tanzania	16%	24%
19	Togo	2%	2%
20	Tunisia	10%	8%
21	Uganda	23%	4%
22	Zambia	4%	5%
23	Zimbabwe	9%	10%

[10] UNDP (2010) **Local Governments in Eastern Africa**, ibid
[11] UNDP (2010) **Local Governments in Eastern Africa**, ibid
[12] UCLG (2010) **UCLG Gold II Report on Local Government Finance: Challenges of the 21st Century**

The key conclusions of this study are that with regards to the ratio of local to public expenditures:

- 3 countries fall in the highest ratio of 17%-23%;
- 16 countries fall in the band of less than 10%; and
- 11 countries are under 5%.

This shows that the contribution of local authorities to public expenditure is far below those of Europe where the average is 25%.

At the same time table above shows that with regards to local own resources and revenue *versus* total government resources and revenue the trends are as follows (note: own revenue here includes autonomous revenue and inter-governmental transfers):

a. In the majority of 17 countries, local revenues represent less than 10% of public revenue;
b. In 13 countries local revenue constitutes less than 5% of pubic revenue; and
c. 2 countries fall in the band of 15-19%; and
d. Another 2 countries exceed the 20% ceiling.

The two countries that display a high degree of fiscal decentralization are South Africa and Ethiopia.

All the above studies provide a complex picture of the pattern and trends of fiscal decentralization and fiscal equalization in Africa. In general it shows that much more needs to be done to allocate resources and funding from central to local governments.

2.4 Which Criteria and Parameters are Generally Considered in Fiscal Equalisation Interventions and Programmes in Africa?

Globally it has been suggested that there are five types of formulae used for general transfers[13]:

a. Transfers based on equal per capita transfers (e.g. Germany, Canada and Cameroon);
b. Formulae based on general indicators of expenditure needs;
c. Formulae based on specific indicators of expenditure needs (e.g. South Africa);
d. Formulae based on fiscal capacity;
e. Formulae that consider both expenditure needs and fiscal capacity (e.g. Australia, Denmark, Japan, United Kingdom).

Arising from the brief literature review there appears to be two broad sets of criteria used to design and craft fiscal equalisation interventions to support and finance African local governments:

- Local Government Functional-Linked Criteria; and
- Developmental-, Equity- and Redistribution-Linked Criteria.

[13] World Bank (2011) **Cameroon: Path to Fiscal Decentralisation**, Poverty Reduction and Economic Management Africa Region, World Bank

The first set of criteria and parameters used for fiscal equalisation takes its cue from the maxim "*finance follows functions*". For example, the UNDP study for Eastern Africa[14] states that the key services that are assigned to and provided by local governments are:

a) provision of social services such as education, health, housing;
b) planning; infrastructure development and maintenance;
c) waste management and environmental conservation;
d) facilitate local economic development;
e) security for people and property; and
f) to some extent
g) judicial services.

In addition, the USAID[15] study of 10 African countries indicates that "t*he most commonly devolved areas in Africa have been the major public services of health, education, water and sanitation, and basic infrastructure, along with responsibilities for civil services and registries, and some responsibilities in local economic development."*

Regarding the specific criteria used to design the intergovernmental transfers to local governments across these countries, the study above notes the following; a system of weighting is often used that considers -

a. Basic demographic criteria, including the population of a sub-national government unit, age and labor force distributions,
b. Human development criteria such as poverty rates,
c. There is also often a small guaranteed baseline amount fixed for every sub-national government, and
d. Sub-national government tax effort, or may incorporate some co-financing requirement on the part of sub-national government.

Formula-based transfers are generally used across countries, but these vary in terms of completeness. It has been noted that in Francophone and Lusopohone countries these formulas have been implemented "*in a more limited or modified fashion*". The overall value of formula based transfers is that they offer predictability and support greater fiscal autonomy of local governments.

In a comparative study undertaken by Kenya's Commission on Revenue Allocation (CRA) it identified the following common parameters used for revenue allocation in Africa and further abroad:[16]

[14] UNDP (2010) **Local Governments in Eastern Africa**, UNDP Regional Service Centre, Johannesburg, South Africa
[15] USAID (2010), **Comparative Assessment Of Decentralization In Africa: Final Report And Summary Of Findings**, USAID, ARD, Inc., Vermont
[16] CRA (2012) *Presentation on Revenue Sharing to the Induction of the Transitional Revenue Authority on the 8th August 2012*, Mombasa

	Parameter	Countries
1	Population	Nigeria, India, Indonesia, Philippines
2	Population density	Nigeria
3	Equal share	South Africa, Nigeria, Philippines
4	Land Area/Terrain	India, Nigeria, Indonesia, Philippines
5	Education	South Africa, Nigeria, Ethiopia
6	Internal Revenue Effort	Nigeria
7	Health	South Africa, Nigeria, Ethiopia
8	Water	Nigeria, Ethiopia
9	Poverty	South Africa, Indonesia
10	Economic Activity	South Africa
11	Fiscal distance capacity	India
12	Fiscal discipline	India
13	Construction index	Indonesia
14	Administration and general service costs	Ethiopia
15	Urban development	Ethiopia
16	Rural road/Inland waterways	Ethiopia, Nigeria
17	Agriculture and rural development	Ethiopia
18	Environment	Ethiopia
19	Micro and small scale enterprise development	Ethiopia

The common trend appears to be that African central governments are cognisant of their responsibility to directly support local governments in the latter's execution of the above legally mandated functions and duties. The substantive definition of this package of services and functions is what differs between African local governments, although there is general trend to assign local governments those functions that focus on basic social services. In addition to the above functional mandates assigned to local governments, central governments also craft conditional and unconditional grants to assist local governments in achieving broader developmental, redistribution and equity objectives of central governments.

In a 2006 study on Local Development Practices and Instruments in West Africa (looking at Benin, Burkina Faso, Guinea, Guinea, Mali, Niger and Senegal) the example is provided of how central governments, working together with the UNDF, are using the Local Development Funds (LDFs) to assist in realising the Millennium Development Goals. The LDF instrument in this instance is comprised of three specific funds:

- A *Social and Collective Investment Fund* intended for the construction, repair or rehabilitation of collective social infrastructure;
- An *Inter-Communal Fund* that focuses on natural resource management; and
- A *Support Subsidy for Local Economic Initiatives* intended to support income generating activities and to support monetary poverty.

The above UNCDF funds are further influenced by a range of other factors and parameters:

a) A determination of the financial endowment of communes: this includes demographic criteria and consideration of the geographic location of communes and communities;
b) Evaluating the performance of communes: this evaluation at the end of the financial year of communes can have a positive or negative impact;
c) The principle of budgetary support: this takes the form of block grants to communes who in turn decide on the micro-projects to support;
d) The use of the Treasury circuit is double-edged sword: practice has showed that this can help to speed up or delay the transfer of funds;
e) Co-financing of investments: financial subsidies granted to communes can be used as co-financing with other sources of funding; and
f) Counter-part funds in cash: in the majority of these projects preference is given to local counterpart funds in cash entered in good and due form in the local budget.

To meet the developmental and redistribution objectives, the main indicators used for fiscal equalisation generally focus on (among others) demographic patterns, poverty levels, economic development potential, and urban and rural settlement typologies.

Given that the above is one example of an African sub-region, the profiles will show that different countries across the continent have adopted a range of innovative funding instruments to fund conditional and unconditional transfers to local governments to meet both their legally mandated responsibilities and functions *and* broader developmental and redistribution objectives. The actual criteria and parameters used to design transfers also have a lot of commonalities as shown above. This also applies to the functional responsibilities, despite key differences across countries. There also both similarities and differences between local revenue structures.

The profiles that follow probe further into some of the country differences and variations on this issue.

3. CONCLUSION

"Shared tax systems and state controlled financial transfers are increasingly more widespread as the main sources of local budget funding. However the terms of fiscal distribution are generally unfavourable for local governments and intergovernmental transfers are not carried out on a regular basis."[17]

This report has provided a picture of the patterns and complexities of fiscal decentralisation and fiscal equalisation in Africa.

What is clear is that general principles of inter-governmental grant design remain valid in Africa for the foreseeable future. This is the first step on the path to promoting and ensuring greater fiscal equalisation. These principles are[18]:

a. Providing revenue adequacy;
b. Preserving budget autonomy;
c. Enhancing equity and fairness;
d. Stability and predictability;
e. Incentive compatibility;
f. Focus on service delivery;
g. Avoid "equal shares";
h. Avoid sudden large changes.

Greater resources must be allocated to local governments to deepen local democracy and advance local development that complements the efforts of the central government and State.

(See Profiles attached)

end

[17] UCLG (2007:p22) **Decentralisation and Local Democracy in the World: Executive Summary – 2007 First Global Report**, UCLG, Barcelona
[18] UNDP (2005) **Fiscal Decentralisation and Poverty Reduction**, UNDP