Poverty Alleviation under Fiscal Decentralization

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ABSTRACT

This paper attempts to analyze the design and implementation of poverty alleviation strategy in a multilevel fiscal system. It is argued that antipoverty intervention strategy comprises of three sets of measures, first to provide opportunities to the poor, second empower the poor to take advantage of the opportunities and third to provide protection against vulnerability. These involve both direct and indirect anti-poverty interventions.

In a multilevel fiscal system, antipoverty interventions will have to be pursued within the framework of a cooperative federalism. The paper shows that the system required to meet antipoverty interventions involves a combination of both general purpose and specific purpose transfers. While the former are necessary for 'capacity improvement' which helps to accelerate economic growth and impact on poverty, the latter are required to provide 'safety net' to the poor in the short term. The paper examines the appropriate design and implementation strategy for general purpose and specific purpose transfers.

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I. Introduction

Over the years considerable progress has been made in designing and implementing policies and in building appropriate structure of incentives and institutions to combat poverty. Yet, the problem of poverty continues to haunt humanity and over a billion persons can not afford minimum requirements of food, clothing, shelter, education and health facilities. Majority of the poor live in less developed countries of South Asia, sub-Saharan Africa and Latin America and the share of South Asia alone is 44 per cent. It is therefore, not surprising that nature and causes of poverty and interventions to improve the living conditions of poor continue to be a priority area of research. While our knowledge today is significantly better than what it was thirty years ago, much more remains to be understood to calibrate effective policies and institutions and evolve more effective ways of implementing them.

A successful poverty alleviation strategy in any country has four distinct elements. First, it is necessary to identify the poor and know what their characteristics are. Second, it is important to understand the reasons and the factors that cause poverty. Once the poor are identified and the causes of poverty known, it is possible to determine the third element of the strategy namely, designing a set of specific policies to improve the living conditions of the poor. Effective strategy to improve the living standards of the poor require measures to accelerate growth (capacity improving) as well as those which directly enhance their immediate consumption entitlements (safety net). Even in growth accelerating policies it is possible to bias the growth to ensure greater benefits to the poor. Finally, the implementation of these policies should be cost efficient and the institutions established to implement them should complement the policy stance.

I would like to thank, with usual disclaimers, Richard Bird, Robert Ebel, Alan Feizbein and for comments on the earlier draft of the paper.

Fiscal decentralization enters into poverty alleviation strategy in a number of ways. The proximity of policy implementers to the target groups reduces information cost of identifying the poor and transaction cost of designing potentially successful 'capacity improving' and 'safety net' policies. In an economy with significant inter-community (regional/local) variations in preferences, and when there are no significant economies of scale and scope, decentralized provision of public services can enhance efficiency in the provision of these services and result in welfare gains (Oates, 1999). Intergovernmental competition and the mechanism of exercising choice by the citizen-voters either through 'exit' or 'voice' helps to reveal the preferences for such public services. Competition can also result in innovations in the provision of public services. Besides, in respect of quasi-public goods, it is possible to identify the beneficiaries and impose user charges on them. Thus, decentralized provision of such services can also help to link revenue-expenditure decisions at the margin. This can improve both efficiency and accountability in the provision of public services.

The most important potential gain from decentralization, however, comes from strengthening the participation of the poor in the political process and local decision making. This helps to remove social and institutional barriers. More importantly, by bringing service agencies closer to the poor, decentralization potentially enhances people's control over the services. In short, decentralization is an important means of empowerment of the poor (World Bank, 2001).

Of course, in actual practice, the extent to which efficiency and welfare gains accrue in any country depends upon the nature of intergovernmental competition (Breton, 1996), local power structure and political institutions. It is also important to note that effective implementation of poverty alleviation policies depends upon the responsiveness and capacity of local government institutions. Governments that are 'closer to the people' should, in principle, be able to provide services more efficiently and effectively than a remote, centralized authority (Bird, 1993). However, there can be reasons for of decentralization failure (Breton, 2002) and among many reasons, empowerment of the poor and nature and extent of their participation depends on the local power structure and effectiveness of measures to avoid capture by local elite (Bardhan, 2002). Moreover, questions have also been raised about increased local corruption and absence of capacity by local governments to provide public services efficiently (Prud'homme, 1995; Tanzi 1995). The issue of corruption, however, is empirical for, it is not possible to judge a priori whether the local providers are more corrupt than national providers and vice versa. Similarly, the argument for lack of capacity calls for building the capacity in local governments and not avoid decentralization. It is only when the functions are assigned, capacity development is possible and once it is granted that decentralization results in greater efficiency, capacity building should be a natural corollary.

Although traditionally, redistribution is considered to be a Central responsibility, experience has shown that sub-central governments are expected to, and in fact do play an important role in designing and implementing poverty alleviation strategy (Pauly, 1973, Ladd and Doolittle, 1982, Brown and Oates, 1987). When this is recognized, it is important to note that different regions may have different needs and preferences for poverty alleviation and different capacities to meet those needs and preferences. If poverty alleviation is a national concern, but local governments are involved in designing and implementing certain key elements of the poverty alleviation strategy, the capacity of the latter to finance such programs out of their own resources is likely to differ widely.

Analysis shows that in almost all the countries, poor are mostly concentrated in poorer localities and regions. It is also seen that in places where poverty is concentrated, standards of physical and social services provided are low, resulting in low productivity of both capital (including land) and labor. It is therefore, necessary to design intergovernmental transfers to enable the poorer local governments to undertake both 'capacity improving' and 'safety net' policies. This requires designing and implementing general purpose and specific purpose transfers to the poorer regions. The former is required to offset their general fiscal disabilities so that they are enabled to provide comparable levels of public services at comparable tax rates. Similarly the latter is necessary to ensure that certain key services falling into the class of "categorical equity" are provided in these regions at required levels[1]. The transfer system should ensure that

[1] Feldstein (1975) calls services having a direct bearing on poverty alleviation such as education and health care which are deemed to be "fundamental interests" as subject to "categorical equity". These are different

poorer localities have adequate resources to deliver the desired 'package' of services without adversely affecting their incentive structure. (Rao and Das-Gupta, 1995).

This paper reviews the role of fiscal decentralization in poverty alleviation strategy. Section II analyzes the design of public policies to alleviate poverty. Based on experiences, it is argued that effective poverty alleviation strategy comprises of a combination of policies to accelerate economic growth and those, which directly enhance the consumption entitlements of the poor in the short run. Section III considers the role of central and local governments in designing and implementing poverty alleviation policies. Section IV deals with the rationale for and design and mix of different transfer schemes that would help the poorer regions to augment the standards of public services in general and "categorical equity" goods in particular. Section V summarizes the role of fiscal decentralization in poverty alleviation.

II. Poverty and Public Policy

(i) Characteristics of Poverty:

Over the years persistent efforts at reducing poverty has yielded impressive results and yet, according to the World Development Report, 2000/01, of the world's six billion people, about a half lived on less than $2 a day and those living in abject poverty - with less than $1 a day numbered 1.2 billion. Nearly a 44 per cent of people in abject poverty lived in Asia and another 24 per cent in Sub-Saharan Africa. (World Bank, 2001). Analysis shows that in most countries, poverty is concentrated in rural areas and often, largely poor migrants from rural areas constituted the urban poor[2]. It is also seen that poverty is closely associated with to malnutrition, illiteracy, low life expectancy, high mortality rate and substandard housing. Most rural poor depend on agriculture for their livelihood predominantly as wage laborers. The urban poor, in addition, have to contend with overcrowding, contaminated water and poor sanitation facilities. It is also

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from merit goods in the sense that these are concerned with *distribution* of consumption and not encouraging *additional* consumption. This is different from Musgrave's concept of "merit goods:" in the sense that the concern of categorical equity goods is with *distribution* whereas merit goods are considered for *additional* consumption. While merit goods may also be subject to categorical equity, the two concepts must be considered different.

[2] In Latin America where the degree of urbanization is high, poverty is an urban phenomenon as well.

seen that poor households tend to be large with more dependents. Thus, the poor lack access to basic services. It is also seen that adverse consequences of poverty are borne more by the women than men in poorer households and most of the public services impacting on the poor, by nature are local in character. Again, children, particularly female children suffer disproportionately (World Bank, 1992).

The basic cause of poverty, however, is the lack of physical and human capital. Rural poverty is highly associated with landlessness in South Asia, Africa and Latin America. Even in cases where the poor have access to land, they do not have ownership rights. In some cases, they have access to only community property. Thus the incentive structure and institutions are not congenial to improve the income earning capacity of the poor. Rural poverty is high also in drought prone areas and in places where farming relies mainly on rain-fed water resource. It is also shown that overwhelming proportion rural poor are concentrated regions with low and moderate rates and moderate to high instability in agricultural growth (Rao et.al, 1988). Equally important is the observation that the poor lack human capital as well. Educational achievement as well as the health status of the poor is less than that of the population in respective countries. Lack of access to physical assets and human capital also implies low levels of productivity and lack of income earning opportunities.

(ii) Poverty and Public Policy: Direct and Indirect Policy Interventions:

Policy interventions to ameliorate the conditions of the poor broadly fall into two categories (Ahluwalia, 1990, Bhagwati, 1988, Dreze and Sen, 1989). The first is the *indirect* strategy of orienting policies to accelerate growth and to direct the flow of growth benefits to the poor. This income generating strategy or what Dreze and Sen (1989) call "growth-mediated security" involves adopting policies that would provide compatible structure of incentives, and promote efficiency in resource allocation both in static and dynamic terms. Evidence shows that most planned economies with policies and institutions restricting the functioning of markets and protection from internal and external competition generated insufficient opportunities for the poor participate in economic activities. In addition, the lack of empowerment of the poor has denied them access to benefits from public actions as well as whatever growth the economies have experienced. The lack of secure environment from economic risks, natural disasters, and even social unrest, has made the poor vulnerable and prevented accumulation of material and human capital in them for a secure future.

The identification of the reasons for the persistence of poverty helps to evolve appropriate strategies. The specific policies to reduce poverty should be calibrated keeping in view the particular systems and institutions prevailing in individual countries. However, the broad common strategy for reducing poverty involves policies and institutional reforms to provide opportunities to the poor, facilitate their empowerment and reduce their vulnerability (World Bank, 2001). Opportunity for the poor is created by adopting policies to accelerate growth, helping to material and human capital for the poor, creating proper incentive structure through policy and institutional changes. This includes policies such as land reforms and providing nutritional supplement to school children, getting infrastructure and knowledge to poor regions and affirmative action to break social barriers and ensure gender equity. Empowerment of the poor is achieved by reforms in governance, inclusive decentralization and ensuring property rights and affirmative action to break social barriers and ensure gender equity. Ensuring security involves protecting the poor from vulnerability through micro-insurance, building capacity and preparing the poor to face financial and natural risks and addressing issues of civil conflict.

The three sets of interdependent strategies involve both direct and indirect policy interventions to ameliorate poverty are equally important. Indeed there is significant overlapping between direct and indirect policy interventions. Often the direct measures intended to improve the consumption entitlements of the poor may help to accelerate growth as well. Creation of rural infrastructure like ponds and rural roads under the "Employment Guarantee Scheme" in the state of Maharashtra in India is a case in point. The distinction between 'growth enhancing' and 'consumption redistributing' strategies gets blurred even more in the case of public provision of basic education, health, nutrition and housing. These measures targeted to enhance human capital of the poor can be considered direct anti-poverty intervention. However, long term impact of such a measure is to accelerate growth and impact on poverty as well. However, conceptually, these measures directly enhance income earning capacity of the poor unlike the first set of measures which is intended to accelerate growth and the its benefits eventually trickle down to the poor.

In spite of the fact that policies to accelerate growth have led to appreciable reduction in poverty levels in a number of countries, the prospect of eliminating the poverty problem altogether may not be achievable in the short and in some cases, even the medium term. Besides, political consciousness and rising expectations of the poor has made it necessary to adopt direct measures to yield immediate and visible results in terms of increasing their consumption levels. Even self-employment and wage employment policies or policies to improve human resource development can not improve the conditions of the old, destitute and disabled. Separate social security measures are required to ensure minimum acceptable consumption levels to these vulnerable sections.

Interestingly, direct policy interventions to ameliorate the conditions of the poor are not necessarily the most effective way to reduce poverty. The recent econometric studies on the efficacy of various items of expenditures on poverty shows that the impact of direct anti-poverty spending in reducing poverty was much lower than spending on infrastructure projects like roads in both China and India. In China, the number of poor reduced per 10000 yuan of expenditure was 6.8 in the case of R&D expenditure, and 3.22 in the case of roads, but just 1.5 in the case of poverty loans. Similarly, the number of poor reduced per million rupee spending was the highest in the case of roads (123.8) and R&D expenditures (84.5), but only 17.8 in anti-poverty programs (Fan, 2002).

Among various interventions to reduce poverty, the role of human development is critical as it provides opportunities, empowers the poor and provides security. It is well known that the poor lack capital or asserts and endowing them with human capital enhances their basic capabilities and increases their productivity and income earning opportunities. Anand and Ravallion (1993) show that human development impacts on poverty in three different ways. These are (i) capability building through economic growth (ii) capability expansion through poverty reduction, and (iii) capability expansion through social services. While the first route belongs to the category of "growth-led security", the other two can be categorized as "support-led security". Thus, social expenditures can improve the welfare of the poor both directly and indirectly.

Lasting solution to the problem of poverty, however, has to be found in improving the ownership of physical and human capital of the poor. Thus, growth-oriented indirect route is not necessarily a conservative option. It indeed has to be an activist strategy. Further, while the distinction between the indirect and direct approaches is useful for conceptual clarity, it would be erroneous to consider adopting a dichotomous view of them. There are several inter-connections between the two routes. More importantly, optimal policy design to alleviate poverty involves a proper mix of approaches to accelerate income generation and redistribute consumption. The appropriate mix of the two approaches depends on their "productivity", which varies according to the specific objective conditions in each country.

Experiences in many countries, particularly East Asian economies such as Taiwan (China), South Korea, Indonesia, Malaysia, and China illustrate the potential for extraordinary successes in alleviating rural poverty by a judicious choice of the two approaches. Impressive gains in alleviating poverty in these countries were attributable mainly due to significant public investment in rural infrastructure and human capital. In all these countries, rural transformation was achieved by improving the quality of physical and social infrastructure, improving agricultural productivity and expanding rural non-farm activities. Experience shows that publicly funded investments in rural infrastructure (roads, bridges, irrigation and electricity) and broad-based education and health care in rural areas are critical in the early years of rural transformation. Creation of this base for economic growth led to improvements in productivity, opened up markets, hastened demographic transition, enhanced mobility of labor, strengthened urban-rural linkages and accelerated rural industrialization. Together with changes in the incentive structure due to land reforms in the early phase of development (in South Korea, and Taiwan), large investments in physical and social infrastructure and development of rural institutions not only led to strong growth performances but also created a shared basis of economic growth and sharp decline in poverty[3].

The above analysis brings out some important features of governmental intervention necessary to reduce poverty. First, be it the indirect long-term growth accelerating strategy or the short-term strategy to redistribute consumption, public expenditure policy has a critical role to play in poverty alleviation[4]. Second, poverty alleviation strategy involves public expenditure programs to provide public and quasi-public services on the one hand and targeted direct transfers to the poor on the other. Third, in executing growth enhancing spending programs, both allocative and technical efficiency in public expenditures is important in a resource-constrained developing country. Thus, efficient allocation of public expenditures in the sense of both cost-efficient provision of public services and delivery of these services matching diverse preferences is an important component of effective poverty alleviation strategy. Fourth, to be cost efficient, it is necessary that policies implemented to ensure consumption entitlements to the poor need to be well targeted. This requires identification of the poor and designing and implementing appropriate redistributive policies to enable targeting the poor for improving consumption entitlements.

III. Poverty Alleviation Strategy: Role of Central and Local Governments.

(i) Policy interventions in a unitary system:

Public spending policy, thus, plays a critical role in anti-poverty interventions. Interventions are made in terms of (i) influencing the resource allocation by providing physical and social infrastructure which would help to accelerate growth and/or to direct the benefits of growth to the poor; (ii) short term expenditure programs to create self employment and wage employment opportunities; and (iii) making targeted transfer payments to the poor.

[3] A good discussion on the contribution of these factors in imparting dynamism to rural transformation in East Asian economies can be found in World Bank (1993). Ranis (1995) also stresses the importance of well developed rural infrastructure and institutions (like farmers' associations) and effective land reforms in accelerating growth and reducing poverty in South Korea and Taiwan.

[4] For an important contribution detailing the various aspects of public expenditure policy targeted to alleviate poverty see, Van De Walle (1995).

Public expenditure policy directed to reduce poverty has different dimensions when it is implemented in a small country with single layer of government from that of a large country with multilevel governments. In the former, a single policy making authority does designing and implementing expenditure policies and, therefore, implementation is easier. However, provision of public services in a single layer is an exception rather than a rule, confined to a few city-states. In most economies, both advanced and developing, the public services are provided in the framework of multilevel decision making framework. This is also true irrespective of whether the country has a democratic or a totalitarian regime. Even in many constitutionally declared unitary countries there are at least three layers of government providing public services (Breton, 1987). When public services are provided in multilevel governmental framework, relative roles of different levels of government in designing and implementing pollicies to accelerate growth and redistribute consumption in favor of the poor becomes are critical. Efficiency consideration requires that assignment of functions to different levels of government should be based on their comparative advantage.

(ii) Multi-level fiscal system and anti-poverty interventions:

What is the role of central and local governments in reducing poverty? If poverty alleviation is considered a purely redistributive task, implementing these policies is mainly the responsibility of the central government because of the externalities involved. The potential mobility of economic agents constrains the efficacy of subnational governments in implementing such policies. Besides, benefits of poverty alleviation programs implemented in one jurisdiction may spill over into another (Boadway and Wildasin, 1984). Similarly, local initiative in poverty alleviation may drive up the cost to the residents of the jurisdiction by mobile taxpayers and mobile poor. More importantly, if "poverty anywhere in the country is the concern everywhere", a central government intervention is necessary to ensure optimal resource allocation to redistribution (Brown and Oates, 1987, Ladd and Doolittle, 1982)[5]. However, the fact is that subnational

[5] Pauly (1973) and Tresch (1981) suggest that redistribution should be viewed as a local public good and when population is not mobile across jurisdictions, local initiative in poverty alleviation is desirable.

governments do undertake significant amount of redistributive activity even when their efficacy is seen to be doubtful (Oates, 1999)

However, from the above, it would be erroneous to conclude that subnational governments do not have any role in implementing direct poverty alleviation policies. Governments that are closer to the people, as a rule, should be able to provide services more efficiently than a remote, centralized authority. Proximity to the people reduces information and transaction costs in designing and implementing anti-poverty strategy significantly. Local governments have a distinct advantage in identifying the poor and understanding their multi-dimensional characteristics due to their proximity to the people. Problems of the poor need to be seen in the context of their specific locations. Poor live in hostile environs and face exploitative economic and social systems. Causes of poverty, and the solutions to deal with them differ vastly from one region to another. Local government's familiarity with the institutional conditions within respective jurisdictions helps them to design and implement programs and schemes to target the consumption entitlements to the intended groups. Local participation in financing and implementing anti poverty programs also improves accountability to local citizens on the one hand and to higher level governments on the other.

Thus, poverty alleviation is essentially a function that should be executed concurrently by both central and local governments. Inter-jurisdictional mobility of economic agents makes it necessary to assign the functions of raising resources through redistributive taxation to the central government. However, designing and implementing anti-poverty policies by the central government will result in higher transaction and information costs. At the same time, if poverty alleviation policies are entirely assigned to local governments, it could not only cause inefficiencies due to induced mobility of labor and capital but also create moral hazard problems. To attract capital into their jurisdictions, local governments may actually follow 'anti-poor' rather than 'anti-poverty' policies. In the event, there can be serious underprovision of anti-poverty interventions. Thus, designing and implementing anti-poverty policies is a concurrent responsibility of different levels of government. Central government has to raise significant portion of financing these policies. It also has to evolve a regulatory system or an incentive scheme to minimize the moral hazard problem and ensure that minimum levels of anti-poverty policies are implemented in every local jurisdiction. Local governments, on the other hand, have to design effective policies appropriate to their respective jurisdictions, identify the poor and implement the policies to benefit them.

(iii) Typology of decentralization:

The above analysis indicates that the role of central and subnational governments in implementing direct measures to alleviate poverty has to emerge within the principles of co-operative federalism (Inman and Rubinfeld, 1997). Significant part of financing poverty alleviation expenditures will have to be generated by redistributive tax policies at the central level. Redistributive taxation at sub-national level has the potential of inducing migration of capital. Besides, there is also a moral hazard problem as the local governments in their attempt to attract capital might indulge in "race to the bottom" which could result in non-optimal poverty alleviation effort. At the same time, it seems that there are significant information and transaction cost advantages in implementing anti-poverty policies by local governments. In some countries with a high degree of centralization like Indonesia, the central government involves local governments in public expenditure policy by *delegating* certain functions and here, the local governments merely carry out the functions as agencies of the central government (Shah, 1998). In many transitional economies like Vietnam, expenditure functions are *deconcentrated* (Rao, Bird and Litvack, 1998, World Bank, 1996). In such cases, local governments will have limited flexibility to design and implement programs. In most federal countries, there is *devolution* of expenditure functions to local governments. In such cases, the responsibility of designing and implementing the programs are entirely assigned to the local governments and they also have at least a part of their own resources to implement anti-poverty programs.

It is difficult to recommend any general model of decentralization applicable to all the countries. Effectiveness of the model of decentralization chosen for designing and implementing anti-poverty programs depends on a variety of factors like the size of the country, level of economic development, social, economic, ethnic and linguistic diversity and capacity of local institutions. In any case, neither delegation nor deconcentration can be considered as true models of decentralization for subnational governments do not exercise any flexibility or autonomy in such models. These should be construed as a mere administrative arrangements in which the central government implements its policies through subnational government.

In the delegation and decentralization models, the local governments act at the behest of central government, as its agencies. The accountability of local governments in this case is mainly to the central government. In the devolution model, however, local governments actively participate in designing and implementing anti-poverty programs and, accountability is both to the residents of the locality below and to the higher level governments above. Therefore, in order to increase the stakes of local governments in anti-poverty programs, it would also be desirable to make the local residents to bear a part of the cost of such programs. Thus, for reasons of efficiency in the delivery mechanism and to ensure greater accountability, it is desirable to have a cooperative solution- a cost sharing programs between the central and local government in anti poverty interventions.

(iv) Fiscal decentralization and delivery of services:

However, as mentioned earlier, poverty alleviation is not simply redistributing consumption entitlements from the rich to the poor. A critical element of poverty alleviation strategy is to adopt policies to accelerate growth and direct the benefits of growth towards the poor. In this, both central and subnational governments have important roles depending upon conditions prevailing in different countries. The primary precondition for growth is stable macroeconomic environment. Macroeconomic stability promotes savings and investment. It must also be noted that increasing prices impose disproportionate hardships on the poor. Stabilization involves externalities spanning across the entire country, this is predominantly a Central task.

Equally important precondition for growth accelerating strategy is efficient provision of physical and social infrastructure. Subnational governments can play an important role in enhancing efficiency in the provision of infrastructure facilities.

Intergovernmental competition in the provision of pubic services and better matching of demand for with supply of public services by more flexible bundling enhances the choice of consumer-voters. The wider choice of jurisdictions with different bundles of non-private goods and tax payments enables the consumer-voters to exercise their choice either through "voice" or "exit".

Most public series supplied by subnational governments fall into the category of "quasi-public" services with no significant scale economies. Provision of such services at local levels helps to ascertain the demand for these services and based thereon, recover user charges on them. Thus, local provision of these services links revenue and expenditure decisions at the margin and this helps to improve efficiency and accountability in the delivery of such services (Breton, 1997). This is particularly true of services such as education, healthcare and nutrition, which have important bearing in human development.

IV. Intergovernmental Transfers and Poverty Alleviation

(i) Fiscal assignments, imbalances and intergovernmental transfers:

Public expenditure policy designed to deal with the problem of poverty employing both indirect and direct approaches involves efficient provision of services, ensuring accessibility of services to the poor to enhance their productivity and improve consumption entitlements and making targeted transfers. As mentioned earlier, efficiency considerations warrant decentralized provision of public services. This is true of both growth enhancing and consumption redistributing public services as well as targeted transfers. While local governments have comparative advantage in providing public services, central government is better placed to raise revenues. Stabilization and redistribution considerations warrant assignment of major taxes with nation-wide bases and borrowing powers to the central government and subnational governments can raise revenues from largely immobile tax bases confined to their jurisdictions. Thus, assignment of tax powers and expenditure functions according comparative advantage results in vertical fiscal imbalances. Therefore, the assignment system should balance efficiency gains from such assignment with efficiency loss due to fiscal imbalances and separating of revenue–expenditure decisions at the margin. Second, the transfer system designed to offset the imbalance between revenues and expenditures at subnational levels should not result in laxity in revenue effort and fiscal profligacy.

As mentioned earlier, analysis shows that poor are concentrated in poorer regions where they do not have proper access to basic physical and social infrastructure. Thus, the basic component of growth accelerating strategy is to provide transfers to offset fiscal disabilities of poorer regions/localities to enable them to provide comparable levels of public services at comparable tax rates. Inter-regional differences in the standards of public services can arise either due to variations in fiscal abilities (disabilities) or deliberate choices exercised by different regions. Differences in local fiscal abilities are due to differential revenue capacity or variations in the unit cost of providing public services that are due to reasons beyond the control of local governments. It is necessary to rectify these sources of inequity by providing general purpose transfers to fiscally disadvantaged localities. This enables such localities to provide comparable standards of physical and social infrastructure at comparable tax rates and helps to accelerate economic growth and reduce poverty in these regions. Thus, the transfer system intended to reduce poverty by accelerating growth in poorer regions should be designed to offset fiscal disabilities arising from revenue and cost disabilities in these regions.

Such general purpose transfers merely *enable* the fiscally disadvantaged localities to provide standards of services comparable to other localities. Whether or not they actually provide comparable standards of services is left to local choice. It improves the capacity of the poorer regions to deliver standards of social and economic services. These transfers are not specifically targeted to the poor; but the poor will benefit from the general capacity increase in the region.

In contrast, the objective of specific purpose transfers is to *ensure* that the poor get access to specified services that increase their consumption entitlements and those that directly improve their earning capacity directly. Provision of such services should be targeted to the poor irrespective of whether they live in poorer or richer regions. Direct antipoverty interventions such as employment policies targeted to the poor, provision of basic education, health and housing facilities to targeted groups of population (women, ethnic groups) fall into this category. Such direct anti-poverty interventions are best achieved through specific-purpose transfers in a multi level fiscal system.

Thus, intergovernmental transfer system designed to meet anti–poverty strategy should help to reduce poverty by both accelerating economic growth and directly improving the consumption entitlements of the poor. General improvement in capabilities of poorer regions to augment their infrastructure has to be achieved through general purpose transfers. Similarly, direct anti-poverty intervention requires specific purpose transfers. Thus, anti-poverty strategy involves an optimal mix of both general purpose and specific- purpose components. The former should be equalizing; it should *enable* the fiscally disadvantaged subnational units to provide comparable levels of public services at comparable tax rates. On the other hand, specific purpose transfers are necessary to *ensure* that some specified services, which directly impact on poverty, are provided at required quantities.

(ii) General purpose transfers:

Rationale for equalizing transfers on equity and efficiency grounds continues to be a controversial issue. Proponents of equalization argue for general purpose transfers to promote equal treatment of equals (Buchanan, 1950, Boadway and Flatters, 1982). Taking comprehensive income, which includes current consumption, net accretion to wealth and current benefits from government services as a measure of well being of individuals, it has been shown that, even when fiscal systems of the center and individual subnational jurisdictions treat equals on equal footing, nation-wide horizontal equity may be violated. This happens because, fiscal activities of subnational governments cause differential net fiscal benefits (expenditure minus taxes or NFB) to individual equals and the central income tax as is presently structured cannot take account of real income differences from differential NFBs. Thus, even when subnational governments levy a proportional income tax at uniform *rates*, revenue collection and therefore, per capita expenditures in richer jurisdictions will be higher. As public services are assumed to be a perfect substitute for private goods, the residents in these jurisdictions will receive higher standards of public services even as the tax is paid at the same rate.

Differences in NFBs are caused mainly because the subnational governments cannot levy benefit taxes. Besides, free-riding behavior among subnational governments induces them to levy resource based or origin based taxes and the resulting inter-jurisdictional tax exporting can be an additional source of inequity. In addition, inequity is caused also by the redistributive policies of subnational governments.

Horizontal equity can be established by giving transfers to equalize net fiscal benefits across states. Such transfers discourage fiscally induced migration, reduce barriers to factor mobility and thereby, enhance economic efficiency. Thus, equalizing transfers are argued to be one of the rare instances in economics where efficiency and equity considerations are in harmony (Boadway and Shah, 1994). .

Scott (1952) and later Courchene (1978) however, consider that equalization transfers to offset net fiscal benefits can be a source of inefficiency. Poorer regions are assumed have low productivity and equalizing transfers tend to discourage migration of labor from low productivity to high productivity regions. Besides, if as Oates (1982) has argued fiscal differentials are fully capitalized into property values there may not be any efficiency or equity basis for equalizing transfers.

Thus, while it is acknowledged that the provision of public services in a multilevel governmental system should replicate the advantages of a unitary system, the rationale of equalizing transfers for the purpose remains controversial. Nevertheless, if the depressed regions' low incomes were due to under-exploitation of the potential due to poor infrastructure, transfers given to these regions would raise the income levels and reduce poverty. Even when the low incomes in poorer regions are due to poor resource endowments, enabling these regions to make higher allocation to human resource development could increase productivity of population, increase labor mobility and in the long term, accelerate growth and reduce poverty in these regions. In any case, in most democratic countries with multilevel fiscal systems equalization transfers is a reality and in some, it is a matter of political preference as well [6]. There is wide inter-country variation in the degree of equalization depending on historical and political factors as much or more than theoretical considerations (Bird and Vaillancourt, 1998).

(iii) Design of general purpose transfers:

As mentioned above, the objective of general purpose transfers from the Center to the subnational governments is to enable the sub-central governments to provide a given level of public services at a given tax rate. Such transfers, therefore, should be designed to offset the fiscal disadvantages arising from lower revenue capacity and higher unit cost of providing public services. To be objective, the transfer system should be based on a simple and predictable formula rather than negotiated.

Thus, the desirable transfer system should be equitable and have the right type of incentives for both the donor and the recipient. The classic example of disincentive to the donor was seen in China under the "fiscal contract" system that prevailed until 1994. The system resulted in the provinces adopting strategies to reduce their contribution to the center and this caused "the decline in the two ratios"; the share of government revenues to GDP declined from 31 percent in 1979 to 12 percent in 1996 and the share of central government expenditure in the total declined from 51 percent to 27 percent during the same period (Ma Jun, 1995). In India too, severe disincentives arising from devolution of very high proportions of personal income tax and manufacturing excises is alleged to have distorted the tax structure (Burgess and Stern, 1993, Joshi and Little, 1996).

The disincentives to the recipients due to improper design of the transfer system are well known. In general formula based system of transfers should be preferred over negotiated system to avoid uncertainly and arbitrariness. However, even formula based system unless properly designed, could have serious disincentives on fiscal performances of subnational governments. Often, transfers are designed to close the gap between actual (projected) revenues and expenditures of the subnational governments. Transfer systems in both India and Pakistan have such "gap-filling" components. Such "fiscal dentistry" has no economic rationale, does not meet the basic objective of equalization

[6] The notable exception is United Subnational governments of America.

and above all, has serious disincentives on fiscal management (Bird and Vaillancourt, 1998). "Fiscal dentistry" in India has been alleged to be an important reason for increasing "budgetary cavities" at the State level (Rao, 1998). Similar disincentives are pointed out in the fiscal transfer system of Pakistan.

Incentives (and disincentives) in intergovernmental transfers depend upon not only the design of the transfers but also a number of institutional factors. A measure of stability and continuity in the transfer system is important to enable the recipients to adopt a medium term fiscal strategy and plan their expenditure implementation. A formula based system of transfers as against negotiated system imparts a measure of fairness and objectivity and reduces lobbying and transaction costs to the recipients. It also ensures transparency and helps to build trust and confidence among the subnational governments. Simplicity in the design of transfers makes it easy to understand and reduces information requirements.

Equalization in multilevel fiscal systems could follow a variety of forms. The simplest form is to equalize only the fiscal capacity of the poorer localities to the average level, but this will not offset the inequities arising from cost disabilities (density of population, price differences). Weighing the above with an index of cost differences across localities would be desirable, but difficulties in measuring such an index makes it difficult to apply this in practice. Often, the policy makers also perceive that cost differences are not very important and simply ignore them. A more comprehensive method, however is to design the transfers to equalize the 'need-revenue' gap (Ahmad, 1998, Bradbury, et al., 1984). The `need-revenue' gap measures the difference between what a locality ought to spend to provide specified levels of public services and the revenue it can raise at a given standard level of tax effort.

Designing the transfer system to offset fiscal disabilities can be done in a variety of ways. In Canada, for example, the Department of Finance estimates transfers as a shortfall in fiscal capacity of the province from the benchmark capacity. The "five province standard" (excluding Atlantic Provinces and Alberta) or the average of the fiscal capacities of five provinces is taken as a benchmark. In this system, there is no provision for offsetting fiscal disabilities arising from differences in the unit cost or need. In Australia, on the other hand, both revenue and cost disabilities are taken into account in the estimation of "relativities" which forms the basis for the determination of inter-state distribution of equalizing transfers.

In most developing countries, however, non-availability of data on relevant variables poses a serious constraint in designing a proper transfer system[7]. Measurement of fiscal capacities and needs (unit costs) in the most challenging part of designing the equalization formula. The Representative Tax System approach developed by the Advisory Commission on Intergovernmental Relations (ACIR) in the United States has gone a long way in developing an acceptable approach to measuring fiscal capacity. However, in most developing countries, the required information on tax bases is not always available nor are the tax systems transparent enough to clearly identify the base. Information requirements for estimating expenditure needs or cost disabilities are even more.

(iv) Specific purpose transfers:

General purpose transfers given to offset fiscal inequities, by themselves, do not *ensure* the provision of minimum required levels of services that directly impact on poverty reduction. Following Feldstein (1975), such services can be categorized as those fulfilling "categorical equity" and are deemed to be of "fundamental interests". These services help to build capacity or directly address the issue of inadequate consumption entitlements of the poor. In respect of these services, individual consumption should not depend upon the income levels or wealth positions of individuals. In other words, in respect of services belonging to the "categorical equity", consumption levels should be "wealth neutral" or should not be related to individuals' ability to pay. Services like basic education, healthcare, housing and nutritional supplement to the children fall into this category. In addition to these, there are direct poverty alleviation expenditures on various self-employment and wage employment schemes and transfer payments and the amount spent on these items in different regions should be related to the magnitude of the poverty problem in these regions. Neutrality with respect to fiscal capacity in the case of such services can be ensured by the central government itself providing them in required quantities but that would deny efficiency gains from local choice. Therefore, ensuring minimum standards of these services to satisfy wealth neutrality condition has to be achieved by appropriately designing intergovernmental transfers.

The design of the transfer system, therefore, should be specific purpose, open ended with matching requirements from the recipient. The donor can neutralize the effect of inter-community differences in fiscal capacity (wealth differences), by using a matching grant formula in which the matching rate varies inversely with local fiscal capacity (Feldstein, 1975). Local demand for services like basic education, healthcare or even other direct anti-poverty policies depend on the price elasticity, and elasticity with respect to local wealth[8]. Once the two parameters are estimated it is possible to design the matching grant that would ensure equal access to these services irrespective of the wealth of the subnational jurisdiction. Thus, ideal design of the specific purpose transfers for poverty alleviation should be such that the grants should vary with the number of poor (magnitude of poverty), and matching rate should vary inversely with the fiscal capacity of the community. This would ensure that expenditure per poor would be as much in poorer communities as they are in richer ones.

The method of implementing specific purpose transfers depends upon the extent of decentralization. In a deconcentrated system, the local government is merely an implementing agency. The funds required for ensuring the prescribed standards of services in the localities are given entirely by the Central government. The Central government also stipulates the method of implementation and the locality merely implements Central decisions. In contrast, in more decentralized systems, specific purpose transfers result in two-step targeting. In the first, the Center transfers funds to subnational governments for specified purposes. In the second, the locality either

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[7] For an incisive analysis of the transfer system in a variety of developing countries, see Bird and Vaillacourt (1999)

[8] This can be estimated in an equation: $ln\ E_i = \beta_1\ ln\ W_i + \beta_2\ ln\ P_i + \beta_3\ ln\ X_{1\ +\ldots\ldots+} + \beta_j\ ln\ X_j$ where, *Ei* represents education expenditure per pupil (anti-poverty expenditure per poor), P_i represents the net price the community pays for the service (which is given by, amount of expenditures financed from own

transfers or spends the money to benefit the targeted groups as required. Proper designing specific purpose transfers is particularly important in the second case to preserve the incentives and to ensure that the transfers are spent for the specified purposes.

Most countries have specific purpose transfers with varying local participation. Even countries with comprehensive equalization schemes have devised specific purpose transfers to deal with "categorical equity" services. In India, there are specific purpose transfers for creating self-employment and wage employment schemes, provide nutritional supplements to school children, education and family welfare schemes. Many of the programs are designed on shared cost basis. In deconcentrated countries like Vietnam where local governments do not have worthwhile powers to raise revenues, the central government has devised National Programs for poverty alleviation, eradication of major diseases and for providing basic services to disadvantaged groups like destitute and ethnic minorities (Rao, Bird and Litvack, 1999).

(vi) Transfers in a three-tier system:

Most decentralized systems have more than three tiers of government though the extent of decentralization to the third tier is in the nature of deconcentration. The principles of the transfer system detailed above applies to governmental systems with multiple layers though there can be a number of operational issues in designing and implementing them. Three important issues pertinent to countries with three (or more) tier systems may be noted. First, the third tier receives transfers from both the central and the regional governments though in many federations, the regional (state) governments resent direct transfers to local governments from the Center. In India, for example, when constitutional status was sought to be given to the third tier in the late 1980s, proposal to give direct transfers from the Center to local governments bypassing the State governments was not acceptable to the latter.

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revenues), *Wi* reflects wealth of the community per pupil (poor), and $X_1, X_2, \ldots\ldots, X_j$ represent other variables influencing demand for the service.

Second, in most cases, even the general capacity augmenting type of transfers received by the third tier are in the nature of specific purpose transfers and the implementation of programs by them is closely monitored. They do not have independent revenue raising decisions. In other words, in many countries, the third tier is more an agency than an independent fiscal decision making unit. This is partly due to the perception that the local governments do not have the capacity to undertake independent decisions. Such systems however, do not reap efficiency gains from decentralization.

Finally, in most countries in which the regional (State) governments are strong, the third level of governments is weak. This is true of federal countries like India and Pakistan where the State (Provincial) governments have significant revenue and expenditure powers. The local governments, on the other hand, have to exercise their powers concurrently with the state governments and the latter have been reluctant to share powers with them. In contrast, the local governments in countries in which regional governments do not exist like in Indonesia are relatively stronger.

V. Concluding Remarks

The foregoing discussion shows that poverty alleviation is not merely a redistributive function. It involves both capacity improving and safety net policies. While policies aimed at accelerating growth and directing the benefits of growth will help to reduce poverty in the long term, direct redistribution such as providing basic education, healthcare and employment policies provide safety nets to the poor in the short term. In addition, the old and disabled poor need to be provided with doles.

Analysis shows that the poor are concentrated in poor regions. Poverty is also associated with low levels of human development and access to social services. In improving the conditions of the poor, therefore, public expenditure policy has to play a critical role. To accelerate growth, it is important to ensure that the fiscal disabilities of poorer regions arising from low revenue capacity and high unit cost of providing public services are compensated. Similarly, it is necessary to ensure that certain minimum standards of services, which have a direct bearing on poverty situation, or “categorical equity” services should be provided in poorer regions.

In small city-states with single layer of government there is no ambiguity in carrying out the task of poverty alleviation. The central government itself has to design and implement capacity improving and safety net policies. This could be done by directly reallocating the resources through various expenditure programs or by making transfer payments.

In a multilevel fiscal system, however, solutions to poverty alleviation problem have to be found within the principles of co-operative federalism. While redistribution is primarily a central government function, there is much to be gained by involving the subnational governments in the task of poverty alleviation. The proximity of subnational governments to the poor, and familiarity with and understanding of varying institutional situations and hostile environs in which the poor habit in different regions provide distinct advantages to the decentralized governmental units in designing and implementing antipoverty policies. Thus, while the resources for the programs have to be generated by the central government from redistributive taxation, local governments will have predominant responsibility of designing and implementing antipoverty policies due to their information and transaction cost advantages. This implies that the central government will have to find much of the resources for poverty alleviation programs whereas, the local governments will undertake actual design and implementation of these programs. This makes intergovernmental transfers an important policy instrument in the poverty alleviation strategy.

The paper analyzes the design of general purpose and specific purpose transfer schemes relevant for poverty alleviation strategy. General purpose transfers are meant to augment the capacity and therefore, should be designed to offset fiscal disabilities of poorer regions. This would enable them to provide social and physical infrastructure at levels comparable to those in richer jurisdictions at equivalent tax rates. Such transfers will enable the depressed regions to fully utilize their growth potential and this impacts on poverty. In order to design and implement effective antipoverty programs, in addition to the general purpose transfers, it is necessary to provide specific purpose transfers. These transfers are intended to ensure that the services required to combat poverty directly or "categorical equity" services are provided in required quantities. The wealth neutrality condition of these antipoverty programs requires that they should be provided within the framework of a cost-sharing scheme between the central and local governments. The shares to be paid by the local governments should vary inversely with the wealth position or fiscal capacity of the local governments. Thus, specific–purpose matching transfers are recommended with matching ratios varying inversely with the fiscal capacity of the localities.

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