Chapter 7

INTERGOVERNMENTAL TRANSFERS: THE FUNDING RULE AND MECHANISMS

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1. INTRODUCTION

No federal or decentralized system of government can function without intergovernmental transfers. Once responsibilities are assigned to the different public agencies both vertically and horizontally, a typical outcome is vertical and horizontal fiscal imbalances. It means that the assignment of revenue does not fully match the expenditure functions for each public agency. It requires interagency transfers to allow all jurisdictions to carry out their respective public responsibilities.

Intergovernmental transfers are understood in a broad sense at this point. They include direct payments, the sharing of revenues, and non-monetary transactions such as complimentary service delivery among agencies (e.g. administration) or the waiver of intergovernmental commitments. Revenue sharing, in particular the sharing of taxes, is often indistinguishable from grants and therefore deserves special attention in this context. Yet it must be clearly set apart from the sharing of tax bases. Base sharing resembles a revenue assignment that conveys rights, and hence legal entitlements, to exploit a tax base conjointly among governments. The advantage of base sharing over tax sharing lies in greater fiscal autonomy because different agencies can impose different tax rates on the shared base. Where legal entitlements from base sharing also exist for the sharing of the proceeds from taxation, this must be considered tax sharing conjointly with base sharing. In this instance tax assignment and intergovernmental transfers are necessarily blurred.

Base sharing is not dealt with in this paper because the emphasis is on transfers, not tax assignment. Tax sharing in the sense of sharing the proceeds from taxation will be discussed as a special transfer regime. It is often used to allocate funds from the national level to subnational tiers of
government, although the converse can also be true. However, tax sharing appears to require a nationally uniform tax rate to make sense, so tax sharing is conventional for taxes under the control of the national government.

In classifying and analyzing intergovernmental transfers one must ask:

- What is the purpose of such transfers?
- How should the transfers be funded? and
- What mechanisms are commendable to achieve the objectives of a transfer?

I shall analyze these questions in the following chapters in an abstract way as if one could design a transfer system from scratch. This is of course usually unrealistic as all decentralized or federal governments will have to respect their historical and political conditions, so reforms will be highly path-dependent. Yet speaking in abstract terms can raise the awareness on possible deficiencies of existing arrangements and serves as a benchmark for potential reforms. Furthermore, I try to include some international experience to illustrate the great variety and richness of institutional arrangements that have been adopted in rebalancing intergovernmental fiscal relations in different parts of the world. Finally, I sketch an incentive-neutral transfer scheme for a fictional country, Krakozhia, which aims at introducing a new scheme for its general purpose transfers using a methodology in the spirit of the mechanism developed by the Commonwealth Grants Commission of Australia.

2. THE PURPOSE OF INTERGOVERNMENTAL TRANSFERS

It is useful to distinguish the following types of transfers according to different purposes: (i) general transfers; (ii) specific transfers; and (iii) special transfers. The nomenclature may vary, especially as the purpose of these transfers is often not clear or mixed, but essentially these categories are found in all decentralized governments of the world.

General transfers. These serve to provide general revenue to an agency’s budget to fund basic operations where own revenue would not be sufficient to fulfill the agency’s responsibilities. General transfers or grants are thus used to redress existing vertical and horizontal fiscal imbalances that may exist between levels of government or among agencies at any one level of government. General grants are unconditional general purpose grants to balance the budgets of autonomous or quasi-autonomous public agencies.