

# **Poverty Alleviation under Fiscal Decentralization**

**M. Govinda Rao**

## **I. Introduction**

Over the years considerable progress has been made in designing and implementing policies and in building appropriate structures of incentives and institutions to combat poverty. Yet, almost a billion people in the world continue to be in abject poverty. They can not afford minimum requirements of food, clothing, shelter, and education and health facilities. Majority of the poor live in less developed countries of South Asia, sub-Saharan Africa and Latin America. Therefore, nature and causes of poverty and interventions to improve the living conditions of poor continue to be a matter of concern and a priority area of research. While our understanding of this problem today is significantly better than what it was thirty years ago, there is no doubt that much more remains to be done to evolve effective policies and institutions and find more effective ways of implementing the to combat this multifaceted problem.

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 effective and the institutions evolved to implement them should complement the policy direction to ensure that the policies benefit the targeted groups.

Fiscal decentralization enters into poverty alleviation strategy in a number of ways. The proximity of policy makers to the target groups reduces information and transaction costs of identifying the poor and helps in 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 these public services. The 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. Of course, in actual practice, the extent to which such efficiency and welfare gains accrue and accountability improves in any country depends upon the nature of intergovernmental competition and political institutions<sup>1</sup>. It is also important to note that effective implementation of poverty alleviation policies depends upon the extent of involvement 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, if assignment of responsibilities is appropriate and the system intergovernmental fiscal arrangements produces the right type of incentives (Bird, 1993).

Although traditionally, redistribution is considered to be a Central responsibility, experience has shown that sub-central governments 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

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<sup>1</sup> For an illuminating analysis of efficiency implications of intergovernmental competition, see, Breton (1996).

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 not only offset the general fiscal disabilities of the poorer regions to enable them to provide comparable levels of public services at comparable tax rates, but also to ensure that certain key services falling into the class of “categorical equity” are provided in these regions at required levels<sup>2</sup>. The transfer system should ensure that 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 IV summarizes the role of fiscal decentralization in poverty alleviation.

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<sup>2</sup> 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 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.

## II. Poverty and Public Policy

### (i) Characteristics of Poverty:

Over the years persistent efforts at reducing poverty has yielded impressive results and yet, in 1985 almost a billion people in the world lived in abject poverty. Nearly a half of them lived in South Asia and another 25 per cent in sub-Saharan Africa (World Bank, 1992). Analysis shows that in most countries, poverty is concentrated in rural areas and often, largely poor migrants from rural areas constitute the urban poor<sup>3</sup>. It is also seen that poverty is closely related to malnutrition, lack of education, 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 seen that poor households tend to be large with more dependents. Thus, poor, be it in rural or urban areas, 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. 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 also lack human capital. Educational achievement as well as the health status of the poor is less than that of the population in respective countries. Lack of

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<sup>3</sup> In Latin American countries where the degree of urbanization is high, poverty is an urban phenomenon as well.

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 economies like India following public sector based, heavy industry dominated import-substituting development route produced insufficient growth to deal effectively with the problem of poverty. In contrast, countries following market based resource allocation with emphasis on competition and thrust on exports produced superior growth rates and reduced poverty levels faster (Bhagwati, 1990). In addition, the indirect route to poverty alleviation should also adopt such measures as ensuring greater availability of land to the poor through land reforms, augmenting the supply of arable land, creating productive employment opportunities by spreading irrigation, land development and agricultural extension and ensuring greater accessibility of the poor to social services. Such policies create incentives for faster agricultural growth. An important finding regarding growth patterns is that agricultural growth tends to reduce rural poverty (Ahluwalia, 1978).

The second set of policies is intended to reduce poverty by providing consumption entitlements to the poor in the short term by redistributing incomes in favor of the poor. This support-led security (Dreze and Sen, 1989) involves public provision of basic education, health, nutrition and housing. Dreze (1990), based on evidence from India, shows that access to services and targeting anti-poverty programs improves significantly in societies with higher literacy, particularly female literacy rates.

A prominent component of second route is designing and implementing self-employment and wage employment programs targeted to the poor to improve their

conditions to explicitly defined levels. Wage employment policies are the most desired instrument to provide basic consumption needs of the poor mainly because of its self-targeting nature. Although this is considered a pure redistributive, there is an attempt to use such employment schemes to generate local public services.

Although the policies to accelerate growth have led to an 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.

In undertaking direct measures to alleviate poverty, the role of human development too is critical. It is well known that the poor lack capital or assets 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 emerge by 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 occasioned by land reforms in the early phase of development (particularly in countries like South Korea, and Taiwan), the creation of physical and social infrastructure and rural institutions not only led to strong growth performances but also created a shared basis of economic growth and significant decline in poverty<sup>4</sup>.

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<sup>5</sup>. Second, poverty alleviation strategy involves public expenditure programs to provide public and quasi-

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<sup>4</sup> 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.

<sup>5</sup> For an important contribution detailing the various aspects of public expenditure policy targeted to alleviate poverty see, Van De Walle (1995).

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 to the diversified preferences of different sections of people 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 – through the provision of 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.

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 policies 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)<sup>6</sup>. However, the fact is that subnational 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 due to their proximity to the people. Their familiarity with the institutional conditions within respective jurisdictions helps them to design and implement programs and schemes to

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<sup>6</sup> Pauly (1973) and Tresch (1981) however, 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.

target the consumption entitlements to the intended groups. Local participation in financing a part of the schemes and in implementing the programs also improves accountability to local citizens on the one hand and to higher level governments on the other.

### **(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 some limited flexibility in the design and implementation of 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 on objective conditions prevailing in different countries. The experiences in fast growing East Asian economies has shown that accommodating public expenditure policies should ensure stable macroeconomic environment. Macroeconomic stability promotes savings and investment. (World Bank, 1993, Rao, 1998). It must also be noted that increasing prices impose disproportionate hardships on the poor. Ensuring macroeconomic stability is task of the central government because stabilization policies involve externalities spanning across different regional jurisdictions. There has to be

only one authority administering money supply. The borrowing powers of sub-national governments too can not be unrestrained.

Equally important task of growth accelerating strategy is to provide satisfactory levels of physical and social infrastructure in an efficient manner. Subnational governments can play an important role in enhancing efficiency in the provision of infrastructure facilities. Intergovernmental competition in the provision of public 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 enables the consumer-voters to exercise their choice either through “voice” or “exit”.

Most public services 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 helps to link revenue-expenditure decisions at the margin, which 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 the 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 subnational 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 assignment according to comparative advantage with efficiency loss due to fiscal imbalances and divorcing 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 to enable them to provide comparable levels of public services at comparable tax rates. This contributes to accelerating growth rates and helps to reduce poverty in these regions. Fiscal disabilities in poor regions can be in terms of low revenue raising capacity or high unit cost of providing public services. 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.

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 will require improvement in physical and social infrastructure in these regions. 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. In addition, 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:

The 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 cases 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 induce 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 Oates (1982) argues that fiscal differentials are capitalized into property values. When fiscal differentials are fully capitalized, 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 <sup>7</sup>. 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, general-purpose transfers from the Center to the subnational governments are given 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 resulted in “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 from an improper design of the transfer system are well known. In general formula based system of transfers should be preferred over negotiated system to avoid uncertainty 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 transfers and above all, has serious disincentives on prudent fiscal management (Bird and Vaillancourt, 1998). Thus, “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. Simplicity in the design of transfers makes it easy to understand and reduces information requirements. A simple and a formula based system of transfers ensure transparency and helps to build trust and confidence among the subnational governments.

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<sup>7</sup> The notable exception is United Subnational governments of America.

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. The simplest method is to give transfers on the basis of shortfall in fiscal capacity weighted with cost disability factors. 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 State ought to spend to provide specified levels of public services and the revenue it can raise at a given standard level of tax effort.

(iv) Specific purpose transfers:

Enabling the poorer regions to provide social and physical infrastructure at comparable levels at standard tax rates compensates for general fiscal disabilities. By itself, it does not ensure the provision of minimum required levels of those services, which have a direct impact on reducing poverty. 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, agricultural extension and rural roads 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 in different regions 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<sup>8</sup>. 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.

## 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.

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<sup>8</sup> This can be estimated in an equation:  $\ln E_i = \beta_1 \ln W_i + \beta_2 \ln P_i + \beta_3 \ln X_1 + \dots + \beta_j \ln X_j$  where,  $E_i$  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 revenues),  $W_i$  reflects wealth of the community per pupil (poor), and  $X_1, X_2, \dots, X_j$  represent other variables influencing demand for the service.

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, the 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 sub-national governments in the task of poverty alleviation. The proximity of subnational governments to the poor, and familiarity with the varying institutional situations in different regions provides 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 tool in the poverty alleviation strategy.

The paper analyzes the design of the general purpose and specific purpose transfer schemes relevant for poverty alleviation strategy. General purpose transfers 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 accelerated growth in these regions will hasten poverty reduction. 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 categorical equity services are provided in required quantities. The wealth neutrality condition of such 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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