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# *Developing the Institutional Framework for Intergovernmental Fiscal Relations in Decentralizing LDTCs*

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## **1. Introduction**

By many accounts (e.g., World Bank, 2000), a large number of lesser developed and transition countries (LDTCs) are currently pursuing decentralization reforms as part of their efforts to make the public sector more efficient, responsive and accountable. Whereas in many highly centralized LDTCs local governments historically were merely considered agents of central government, local governments in many LDTCs are now expected to play an increasingly autonomous role in the financing and delivery of local government services. Before decentralization reforms in these LDTCs, local governments often reported to the Ministry of Local Government (MLG), the Ministry of Finance (MOF), or sectoral line ministries in the context of a hierarchical institutional framework. However, as a result of the more independent fiscal role to be played by local governments in a decentralized setting, there has been a need in decentralizing LDTCs to reform the institutional framework for monitoring and coordinating local government finances.

Decentralized systems of governance are unlikely to function efficiently without an appropriate degree of oversight, monitoring and coordination among the different levels of government. In many centralized countries, the MLG is tasked with the exclusive

responsibility to monitor and coordinate all aspects of intergovernmental relations, including local government finances.<sup>1</sup> While the MLG or MOF generally also play a role in intergovernmental coordination in more decentralized countries, different institutional set-ups are often relied on to assure that the system of local government finances achieves the objectives pursued by decentralization. For instance, it is not unusual for broad-based or inter-ministerial commissions to be tasked with the design and tracking of local government finance. Other decentralized countries rely more heavily on local government associations or even the legislative branch to monitor and analyze the system of local government finances. Finally, there are a small number of decentralized countries around the world that altogether lack specialized intergovernmental institutions to coordinate local government finance issues.

The reality is that in many previously centralized LDTCs, the traditional MLG often continues to act essentially as the only systematic link between the central government and local governments. However, as we discuss later in this study, the traditional MLG is often not well-positioned nor equipped to play a coordinating role in a more decentralized system. In this paper we review and assess a range of international practices with regard to intergovernmental institutional arrangements and draw a number of lessons to guide the design of the institutional framework for intergovernmental fiscal relations in LDTCs.

## **2. The different functions of the institutional framework for local government finances**

There is significant diversity around the world in the institutional arrangements for monitoring local government finances and coordinating intergovernmental fiscal arrangements. In fact, in addition to specific differences in institutional mechanisms, the actual mandate and role of the agencies monitoring or coordinating local government finances -such as a Local Government Finance Commission (LGFC) or an agency with similar responsibilities- often varies from country to country.<sup>2</sup>

Among the first questions that policy makers in decentralizing LDTCs should consider in developing an institutional framework for the evolving system of intergovernmental fiscal relations is what functions or roles their intergovernmental agency or agencies are expected to undertake. The list of these functions will depend on the exact institutional context of each country, but any agency in charge of monitoring and coordinating local

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<sup>1</sup> The name of the ministry with jurisdiction over local governments varies from country to country. The ministry may be known as the Ministry of Local Government, the Ministry of Local Development, or the Ministry of Home Affairs. Additionally, the administrative unit with authority over local government may be located within the President's Office or the Prime Minister's Office. In some other countries the ministry overseeing this task is the MOF. We will use the term Ministry of Local Government generically to refer the ministry or equivalent agency that has authority or jurisdiction over the local government sector.

<sup>2</sup> Again, the naming of such local government commissions varies from country to country. Unless otherwise noted, we will use the term generically to refer the commission or equivalent agency that has authority or jurisdiction over local government finance issues.

government finances is typically tasked with the responsibility for one or more of the following four functions related to intergovernmental finances:

1. Monitoring and oversight of local government finances: Perhaps the most basic role with which intergovernmental coordinating agencies are tasked is to “monitor” local government finances. Although the interpretation of the monitoring role covers a fairly wide range of possibilities, the execution of this role inherently implies that the intergovernmental coordinating agency should collect and tabulate basic local government fiscal variables for all local governments in the country.<sup>3</sup> As part of its monitoring role, the commission or unit could undertake a regular (e.g., annual) assessment of local governments’ compliance with certain specific regulatory or administrative requirements, such as compliance with basic expenditures norms, intergovernmental grant conditions, or local revenue collection guidelines.
2. Implementation: In most countries, the actual disbursement of funds to local governments is performed by either the Ministry of Finance directly, or by the Ministry of Local Government. However, in some countries, the intergovernmental coordinating commission is actually tasked with the partial or full responsibility of implementing or administering specific aspects of the system of intergovernmental finance. For instance, the commission could be assigned the task of operationalizing grant allocations by authoritatively computing the allocation of grant resources for local government jurisdictions. Although quite rare, in some countries (for instance, in Nigeria) the unit responsible for intergovernmental fiscal oversight further functions as an institutional mechanism for the actual disbursement of intergovernmental grants.
3. Dialogue and Communication: A third function of a local government finance agency or commission is to serve as a neutral platform to communicate, inform, provide training to local officials, discuss and coordinate policy issues or resolve disputes, between different central government stakeholders, between different levels of government, or even to mediate among local government units. Likewise, depending on the institutional context, a LGFC could be designed specifically to serve as a supporter or advocate for local government interests at the central government level.
4. Policy design, analysis and recommendations: A fourth main role that a LGFC could be tasked to perform would be to inform the policy debate surrounding local government finance. As such, the annual tabulations of local government finances produced by an intergovernmental fiscal agency could be used to produce basic policy analyses to assure that the system of local government finances is achieving its policy objectives. Basic descriptive statistics on local revenues and local expenditure levels could provide feedback on whether the system of subnational government finances is either improving or in fact

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<sup>3</sup> Unfortunately, the concept of “monitoring” of local government finances has been interpreted in many LDTCS as the control and auditing of individual local government accounts on a one-by-one basis.

exacerbating regional or local fiscal inequities. Likewise, basic comparative reports could be produced using the available local government finance data which would allow local communities to assess the relative performance of their local governments or even to create some measure of competition and replication of best practices.

Furthermore, in some countries, LGFCs are tasked (either on an *ad hoc* or on-going basis) with a more in-depth policy analysis of the system of local government finances. Depending on the specific policy concerns as reflected in their terms of reference, such local government commissions might be required to assess the vertical fiscal balance of the system of intergovernmental fiscal relations, make policy recommendations regarding appropriate revenue sharing arrangements, the size of intergovernmental grant pools, or propose modifications to grant allocation formulas.

### **3. Other causes of differences in international practices**

Since the institutional framework for intergovernmental relations varies from country to country in response to different policy objectives and distinct institutional arrangements, it would not be meaningful to try to identify a single international “best practice” in developing an institutional framework for intergovernmental fiscal relations. Instead we recognize that –in addition to the different role(s) played by the intergovernmental coordinating agencies in different countries- the institutional environment in which these organizations are placed is shaped by a number of features, including:

1. What type of intergovernmental fiscal system does the country have? Is the system of intergovernmental fiscal relations highly decentralized in nature (characterized by limited central government discretion over subnational finances and extensive subnational fiscal autonomy), are intergovernmental fiscal relations highly centralized, or does the country occupy a more intermediate position on the spectrum of intergovernmental fiscal relations? Obviously, a intergovernmental fiscal system that is highly conditional would pose different requirements on the institutional mechanism compared to a system of subnational government finance where subnational government have a high degree of autonomy with few intergovernmental requirements or conditions attached.
2. What is the source of authority for the intergovernmental coordinating agency or the Local Government Finance Commission? Is the agency’s role and composition defined in the Constitution, is its mandate based on relevant legislation, or is such a commission or unit alternatively created by parliament, presidential decree or government decision? Is it a permanent agency, or is it constituted from time to time on an *ad hoc* basis?
3. What is the composition and the predominant institutional affiliation of the commission or the intergovernmental coordinating unit? For instance, who chairs the commission, Ministry of Local Government (MLG) or Ministry of Finance?

Within what organization is the unit or the secretariat of the commission located? What is the composition of its membership, or –if its membership is not fully specified by legislation or regulation- who appoints or selects its membership? As discussed, the anchoring of the unit has an important impact on its operation and effectiveness.

4. To whom does the local government finance commission or the intergovernmental coordinating unit formally reports to? Does it report to the President or Parliament? Does it report to the Ministry of Local Government or Ministry of Finance, or does it report more than one central government agencies or even different government levels?<sup>4</sup> Depending on the nature of a country's political system, it may be felt that the power of the commission is enhanced if it reports directly to the President.

While it is impossible to present in a succinct manner the complete variety international approaches to intergovernmental coordinating agencies, we seek to present an overview of experiences and practices in nine countries, including Australia, Germany, Indonesia, the Netherlands, Nigeria, South Africa, Uganda, Ukraine and the United States. These countries together represent a wide spectrum of policy options in how to develop institutional mechanisms to oversee and coordinate intergovernmental fiscal relations in the context of a decentralized public sector. With the intention of providing a cross-section of the range of international experiences, Table 1 (on the next page) briefly summarizes the main features of the intergovernmental coordinating mechanisms of the nine countries reviewed for the purpose of this study.<sup>5</sup>

As more detailed description of the main features of the institutional framework for intergovernmental relations in each of the nine countries reviewed is provided in Annex 1 through Annex 9, respectively. A final dimension –which is considered in each of the country case studies, but not specifically included in Table 1- is an assessment of how well each system is judged to be performing. Although such an overall assessment might be somewhat subjective, the assessment highlights each system's main strengths and weaknesses, which increases our ability to draw lessons from these international experiences for the development of the institutional framework for intergovernmental fiscal relations in LDTCs.

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<sup>4</sup> For instance, South Africa's Financial and Fiscal Commission is tasked to make recommendations to Parliament, provincial legislatures, and other relevant authorities or organs of state. Similarly, Nigeria's fiscal commission has the power to advise both federal and state governments on fiscal issues.

<sup>5</sup> Although these countries were selected in order to provide a cross-section of international experiences, the list is by no means exclusive. For instance, interesting examples such as India or Pakistan's experiences were not included in the current overview due to limitations on time and space.

**TABLE 1:  
INTERNATIONAL PRACTICES IN COORDINATING  
CENTRAL-SUBNATIONAL GOVERNMENT FINANCES**

Country	Institution	1. Roles and functions	2. Source of authority	3. Leadership & Composition	4. Reporting
Australia	CGC	D - P	LEG	INDEP	MOF / PARL
Germany	FPR	D - P	LEG	MOF	GOV
Indonesia	DPOD	P	LEG	MLG	PRES/ PARL
Netherlands	VNG	D - P	Covenant	INDEP	PUBLIC
Nigeria	NRMAFC	M - I - P	CONST	MOF	GOV
South Africa	FFC	D - P	CONST - LEG	MOF	MOF/ GOV
Uganda	LGFC	M - D - P	CONST	MLG	MLG/ PRES
Ukraine	FAO	M - P	PARL	PARL	PARL
United States	ACIR	M - D - P	LEG	INDEP	GOV

Note: See the appendices for institutional acronyms and for details on each country's system of intergovernmental fiscal relations. (1) Roles and functions of intergovernmental agencies could include monitoring (M), implementation (I), facilitation of dialogue (D) and policy design (P). (2) Sources of authority include constitutional (CONST), legislative (LEG) or parliamentary (PARL) mandates. (3) The leadership and composition of the agency can be determined outside central government or independently (INDEP), by parliament (PARL), by the Ministry of Finance (MOF) or by the Ministry of Local Government (MLG). (4) The agency or commission can report to the President (PRES), one of the aforementioned government ministries branches, across government agencies (GOV), or to the public at large (PUBLIC).

#### **4. Alternative institutional approaches to coordinating local government finances**

As already noted, the mechanism for intergovernmental coordination used in different countries is driven by a variety of factors, including the mechanism's purpose; the scope and nature of intergovernmental fiscal relations, existing institutional arrangements, and the administrative capacity of central (and local) institutions. In practice countries follow one of five basic institutional approaches in coordinating intergovernmental (fiscal) relations between different central government stakeholders and between different levels of government:

Assign the responsibility to a single ministry. First, a common institutional mechanism to coordinate between a central government and local governments is to place the responsibility for intergovernmental coordination with a specialized ministry, most often a Ministry of Local Government (MLG).

Countries that rely on a MLG to coordinate with local governments frequently (although certainly not always) have a relatively centralized system of governance, whereas MLG rarely plays an important role (if any) in countries with highly decentralized local government systems.<sup>6</sup> While the organizational structure of a local government ministry lends itself well to the purpose of exercising central or hierarchical control over deconcentrated local government units, the international experience suggests that the concept of a MLG is not well-positioned to play a coordinating role in the context of a decentralized public sector (as discussed further below). In this light, it should be no surprise that reliance on a MLG in dealing with intergovernmental affairs is a common practice among LDTCs in Africa and (albeit to a somewhat lesser extent) in Asia, where many countries have historically dealt (or continue to deal) with local governments as deconcentrated units of the central government in the context of centralized public sectors rather than as truly autonomous partners in governance.

There are clear advantages and disadvantages to having a Ministry of Local Government as the exclusive link between the central government and the local government level. The key advantage of this approach is that local governments have a clear point of contact and counterpart within the central government. Given its singular focus on local governments, the Ministry of Local Government has the opportunity to develop a strong administrative capability in monitoring and interacting with local government officials.

An important concern with relying predominantly on a MLG for the coordination and monitoring of local government finance issues is that despite its name, the Ministry of Local Government is not always a strong supporter of "true" decentralization or devolution. For example, Bahl (1999) suggests that while the MLG is often interested in

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<sup>6</sup> For instance, some federal countries and unitary countries with highly decentralized subnational government systems typically rely on the Ministry of Finance or a LGFC to deal with intergovernmental fiscal relations. In this regard, one may consider the examples of Australia, Canada, Nigeria, Russia, South Africa and the United States.

expanding the size of the local government sector, the ministry also has an inherent desire to control the allocation of these “local” resources itself, rather than passing these resources on to autonomous local governments based on an objective allocation mechanism. In many countries this inherent conflict of interest makes the MLG a less-than-objective supervisor of local government finances.

A second disadvantage of relying on a MLG as the predominant mechanism for coordination between the central government and local government is that the MLG is often considered as “just another ministry” with an exclusive focus on the “local government sector” by other central government ministries. In reality, many intergovernmental fiscal issues are cross-cutting issues that require involvement not only from the MLG, but also the Ministry of Finance (and/or the Ministry of Planning) as well as relevant sectoral line ministries. When exclusively relying on a MLG as the intergovernmental coordinating mechanism, the potential effectiveness of the institutional framework depends largely on the political strength and clout of the ministry to bring on board other central government stakeholders.

Local government finance commissions or forums. A second set of institutional arrangements used in many countries to coordinate central-local government relations is the reliance on Local Government Finance Commissions (LGFCs). The introduction of a broad-based local government finance commission is often based on the recognition that no single stakeholder at the central government level is able to decide on local government finance issues without significant consultation and concurrence of other stakeholders, either within central government or local government. As a result, a broad-based or government-wide commission is given cross-cutting jurisdiction over variety of different aspects of local government finance. As the review of international practices shows, within this category, there are significant variations in international practices as to the scope, organization and nature of local government finance commissions.

A first important distinction between different types of such commissions found internationally is the composition and orientation of such a Commission. Three basic setups are common. The first type of local government commission is mostly made up of regional and local government officials and has a “vertical” orientation –in which case the function of the Commission is typically to accommodate dialogue and to give a voice to subnational governments in the system of intergovernmental fiscal relations. For instance, Germany’s *Finanzplanungsrat* and Nigeria’s National Fiscal Commission provide good examples of such a vertical orientation.. A second type of local government finance commission is a commission that is comprised of different central government stakeholders, in which case the LGFC generally acts as a “horizontal” mechanism to coordinate between various central government ministries that are active at the local level; Shah (2004) refers to this latter type of arrangement as a “forum” rather than a commission. A third arrangement is the establishment of an independent commission – comprised neither of subnational government representatives nor central government stakeholders- which does not necessarily have a strong vertical or horizontal orientation. Such independent finance commissions –which typically comprise leading academics, technocrats, policy experts and sometimes senior statesmen- are used in some countries

to obtain independent recommendations on the state and direction of the system of intergovernmental relations, without either level of government dominating the discussions. In order to maintain their independence, many such independent LGFCs are often established on a non-permanent basis, either on a recurring basis to review the intergovernmental fiscal system (e.g., such as in Pakistan or India), or on an as-needed basis in order to address a specific challenge in the intergovernmental fiscal system (for instance, the Danish Commission on Administrative Structure, 2004).

Regardless of the vertical or horizontal coordinating role of the finance commission or forum, a further important distinction among different such commissions is the institutional orientation and leadership of such commissions within the executive branch. Commissions with jurisdiction over local government finances are often either institutionally oriented towards the MLG or the Ministry of Finance. Less frequently, intergovernmental commissions functionally report directly to the President's Office or to the Prime Minister's Office.<sup>7</sup> Systems in which MLG plays a leading role in the LGFC (e.g., as chair of the commission or as provider of the Commission's secretariat) face many of the same challenges faced in countries in which the MLG has sole policy-discretion over local government issues. In these instances, the effectiveness of the LGFC depends to a large extent on the ministry's political clout, the commission's technical capabilities, and the ability of commission to secure buy-in from other central government ministries. Indonesia's Regional Autonomy Advisory Board (DPOD) is an example of a local government commission led by the Ministry of Home Affairs.

Alternatively, the Ministry of Finance can be designated as having a prominent role on local government finance matters and the LGFC. This is more typical in the case of federal systems (e.g., Australia, Germany or Nigeria). The Ministry of Finance typically has a general mandate over local government finances, as its function is broadly to assure the efficient and equitable collection and allocation of public resources. Local government finance commissions that have significant involvement from the Ministry of Finance (through chairmanship, staffing or reporting) generally tend to perform better. First, the Ministry of Finance by its very nature tends to be a politically strong ministry, giving it a better position to act as a coordinator of the various other ministries with interest in local government finance issues. Second, Ministries of Finance tends to have a relatively stronger human resource base, and often have a pool of public finance experts at their disposal that are able to produce the budgetary and fiscal analyses needed to properly analyze local government finances. Third, the Ministry of Finance is not constrained by the inherent conflict of interest that makes many MLGs only lukewarm supporters of decentralized local governance.

Relying on the legislative branch to monitor and coordinate local government finances. A third institutional arrangement used in some countries to coordinate intergovernmental

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<sup>7</sup> In many instances, LGFCs statutorily report to the President, but in fact do not do so in practice. For instance, this is the case for Uganda's Local Government Finance Commission, which is institutionally more closely linked to the MLG. In contrast, the presidential commission on sub-federal fiscal relations appointed by Russia's President Putin (the so-called "Kozak Commission") is such an example where the Commission has a strong presidential link.

relations is the reliance on the legislative branch to monitor and coordinate local government finances. The justification for such an arrangement lies in the oversight responsibility that parliament typically has over the nation's public finances, including the system of subnational finance. Important examples of intergovernmental mechanisms tied closely to the legislature include the former U.S. Advisory Commission on Intergovernmental Relations (created by Congress in 1959, and eliminated in 1996), and the Fiscal Analysis Office (FAO) of the Ukrainian Parliament's Budget Commission, which specialized in monitoring the country's intergovernmental fiscal relations.

The fact that both the U.S. ACIR and the FAO were ultimately disbanded suggests the difficulty of maintaining an intergovernmental coordinating agency outside the executive branch.

Local government associations and non-governmental organizations. A fourth institutional arrangement used sometimes to coordinate intergovernmental relations is a formal reliance on local government associations for monitoring and regulating the system of local government finances or other non-governmental organizations. Although most types of intergovernmental institutional arrangements somehow include local government associations as an institutional partner (for instance, as one of the members of the LGFC), in some countries the local government associations have a much more exclusive and formal role as the central government's key partner in making local government finance policy. For instance, in the Netherlands the central government concluded a formal covenant with the Association of Dutch Municipalities (VNG) and the Association of Provincial Governments (IPO) to form an intergovernmental framework for discussing and achieving consensus on local government policy issues. Similar arrangements exist in Denmark and the Baltic countries of Estonia and Latvia.

An institutional approach with a prominent, formalized role for local government associations is more likely to take place in developed countries where (a) the local government associations have the institutional and technical capacity to engage in policy analyses and informed policy dialogues with central government counterparts, and (b) the local government associations are sufficiently representative to be able to credibly speak on behalf of all local governments.

Other institutional arrangements in the absence of a single, exclusive central-local government coordinating mechanism. A final institutional approach to intergovernmental fiscal relations is to pursue a system of intergovernmental relations that lacks a single formal central-subnational government coordinating mechanism. In the absence of single exclusive, specialized mechanism to coordinate intergovernmental relations, either a particular government agency is given some limited responsibility over local government finance issues (for instance, a unit within the President's Office or with the Ministry of Finance), or the responsibility for local government issues (including local government finance issues) is fragmented across central government agencies without an overall coordinating mechanism.

While a few countries simply elect not to have a dedicated agency for intergovernmental relations (for instance, as evidenced by the discontinuation of the U.S. Advisory Commission on Intergovernmental Relations in the United States in 1996), the absence of a formal institutional mechanism for intergovernmental relations is generally an indication of institutional capacity problems. For instance, the current absence of an effective intergovernmental fiscal coordination mechanism in Tanzania has contributed to significant miscommunications between various stakeholders in the financing of local government services.<sup>8</sup>

Absent a formal central-local government coordinating mechanism involving either the Ministry of Local Government, the President's Office, or the Ministry of Finance (or in the case that the formal institutional structure is very weak), it is not unusual for other government institutions -such as the Central Bank or National Statistics Bureau- to play a more relevant role in reporting on local government finances. For instance, the only systematic overview of local government finances in Swaziland is presented by the Central Bank. Similarly, despite the existence of a *National Revenue Mobilization Allocation and Fiscal Commission*, the Central Bank of Nigeria provides the only available annual report of state and local government finances in Nigeria.

## **5. Lessons Drawn from International Experiences**

As a large number of LDTCs around the world are seeking to adopt their institutional framework for intergovernmental fiscal relations to a more decentralized government structure, what are the main lessons that can be learned from international experiences in countries that have a longer track record in coordinating intergovernmental relations in the context of a more decentralization public sector? We believe there are five main lessons from the international practices.

*Lesson 1. The nature of the intergovernmental fiscal system –and its requirements- should drive the institutional framework (and not the other way around).*

Different intergovernmental fiscal systems have different institutional requirements. Exclusive reliance on the Ministry of Local Government for monitoring and administering local government finances often makes good sense in smaller countries that have a relatively centralized government structure with little autonomy at the local government level. In fact, in countries with a centralized intergovernmental fiscal system, the MLG has a more hierarchical relationship with the local government units and introducing a parallel agency in this environment could undermine the administrative authority of the Ministry. Furthermore, there is less of a need for a broad-based local government fiscal institution in more centralized systems since most of the local government allocations are conditional grants which are either controlled by the MLG or

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<sup>8</sup> The Government of Tanzania is currently considering several institutional arrangements that will strengthen (horizontal and vertical) intergovernmental fiscal coordination.

by the sector ministries, thereby preempting the need for a more broad-based, overarching local government finance authority.

In contrast, introduction of a Local Government Finance Commission or Forum would be a more appropriate institutional set-up for larger countries with more decentralized intergovernmental fiscal systems (for instance, countries that rely more heavily on subnational revenue autonomy, revenue sharing or substantial equalization grants). The role of an intergovernmental fiscal institution in a more decentralized (for instance, in a federal) system may aim more at assuring a subnational government voice in the central government's decision-making process on local government finance issues and to limit the influence of national politics on intergovernmental finances. For instance, the Commonwealth Grant Commission in Australia was established for this purpose.

How is this lesson –that the institutional framework should be adapted to the nature of decentralized system- to be applied? One important implication is that decentralizing countries that are ready to evolve away from a traditional MLG-based approach should avoid “jumping on the bandwagon” and introduce a Local Government Fiscal Commission without carefully considering the actual gaps or weaknesses in the existing intergovernmental framework that the new agency is expected to fill. During the initial stage of decentralization reform, the predominant institutional concern for intergovernmental institutions is often the provision of policy coordination at the central government level, as well as the development of the center's capacity to monitor local government finances and produce rudimentary policy analyses to inform the policy debate. Depending on institutional considerations specific to each country, a Local Government Fiscal Forum (that brings together various central government stakeholders) or alternative institutional approaches (for instance, strengthening the technical capacity of the Ministry of Finance in the area of local government finance) may be appropriate to address these needs.

*Lesson 2. The monitoring of local government finances is a fundamental task that must be introduced early on in the process of decentralization. This task, although quite rudimentary, is an often overlooked function in the design of the institutional framework for local government finances.*

As part of the institutional framework for local government finances, it is important at a minimum to put in place a rudimentary reporting and monitoring system to track local government finances. Quite often, local government fiscal data are monitored by the Ministry of Finance. The Ministry of Finance is able to take the lead in this activity for a variety of reasons. First, the finance ministry often not only has the analytical capability to take on this task but also has direct access to the data on grant disbursements from the central to local government level. Agencies other than the Ministry of Finance have less access to the data and are not able to systematically track local government finances. Although the MLG could have a clear mandate to engage in monitoring of local finances, it appears that in most countries the institutional culture of the MLG is typically more of an implementing agency. In this sense, MLG often “monitors” and audits accounts of individual local governments for compliance with regulations and conditionalities, but it

seldom tabulates and aggregates local government finance data for policy analysis or comparative purposes.

In some instance, a third party plays a lead role in monitoring and reporting on local government finance issues. For instance, in Ukraine, an important role in monitoring and analyzing local government finances has been played by the Fiscal Analysis Office of the Parliamentary Budget Committee; in Nigeria, the Central Bank is in fact the main agency monitoring and producing public reports on local government finance issues.

However, in some countries –particularly those with more a centralized intergovernmental fiscal structure, or with a historically centralized mindset- the systematic monitoring of local government finances appears to be falling through the cracks. Again, this is especially true for countries where the MLG is the main link in intergovernmental relations. In Indonesia, the contentious division of responsibilities between the Ministry of Finance and MLG –and the weak nature of Indonesia’s Regional Autonomy Advisory Board- has resulted in fragmented and weak monitoring of local government finances. Likewise, no single institution has been systematically monitoring local government finances in Tanzania. Similarly, in Nepal, the central government has no institutional mechanism to systematically monitor expenditures either at the district-level or at the village level.

Introducing a new specialized agency such as a LGFC into the institutional framework must not be seen as fail-safe solution. For instance, despite introduction of the LGFC in Uganda in 1995, none of the three key stakeholders in intergovernmental financial relations (including the MLG, Ministry of Finance, or the LGFC) has been systematically monitoring or tracking basic local government finances on a regular basis in recent years.<sup>9</sup>

*Lesson 3. The legal source of authority for intergovernmental oversight matters little.*

While in some countries the local government commission or its equivalent is established by the constitution, in other countries the creation of such an agency only takes place at the legislative level. International experiences suggest that the establishment of the agency at a higher source of legal authority does not seem to influence the agency’s effectiveness. In particular, it does not appear that an intergovernmental coordinating agency or a LGFC established by constitutional mandate is necessarily more powerful than an agency or commission established by a legislative mandate. For instance, the LGFC in Uganda has a constitutional mandate, but in reality has been proven to be politically quite weak. In contrast, Australia’s Commonwealth Grants Commission and Germany’s Financial Planning Council have only a legislative mandate but have been able to place a much more significant stamp on intergovernmental fiscal relations over time.

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<sup>9</sup> In fairness, Uganda’s LGFC is currently in the process of sharpening its technical skills which would allow them to put together an annual review of intergovernmental finance in the near future.

*Lesson 4. The composition and affiliation of an intergovernmental fiscal agency should be determined mainly by the agency's functions, but should keep in mind that intergovernmental fiscal policies are inherently political.*

International experiences suggest that there are two main reasons, both important and legitimate, for establishing local government fiscal commissions. First, a country with a highly decentralized intergovernmental fiscal system may seek to introduce an intergovernmental commission or a similar agency to de-politicize intergovernmental fiscal relations and/or give subnational governments a formal voice in policy formulation at the central government level. In this case, local government officials or independent members would tend to form an important component on the commission's membership. An alternative important reason to establish an intergovernmental fiscal commission – more common in LDTCs with historically more centralized local government finance systems- is to assure greater coordination and cooperation between central government stakeholders on local government finance issues. If a council is established for this reason, then the MLG, Ministry of Finance, and sector ministries would be common members of the commission.

The review of international practices underscores that the composition or institutional affiliation of the agency or commission is of paramount importance in its successful operation. The political independence and success of Australia's Commonwealth Grant Commission can be attributed in part to its composition of independent members, and its institutional anchoring within the Department of Finance. While its placement in the Finance Department assures its credibility and proximity to key decision-makers, it simultaneously prevents excessive control over the Commission by Australia's Treasury, which is Australia's fiscal policy-making body. Likewise, the composition of the German Financial Planning Council reflects Germany's policy context; the Council –led by the Federal Ministry of Finance- assures the preeminence of national policy objectives in the development of intergovernmental fiscal policies.

In contrast, the seeming failure of the DPOD in Indonesia to adequately perform its functions may be in some part attributed to the mismatch between the functions of the board and its membership: for example, the Minister of Defense is a core member of the DPOD, but not the Ministers for Education and Health, both of which need to be directly involved in the decentralization process.<sup>10</sup>

Likewise, as we explain further in Annex 7, the weakness of the Ugandan LGFC in performing its functions may in part be due to its institutional affiliation with the MLG, which sees the Commission more as a competitor than as a partner in assuring sound local governance. There is also a divergence between the composition of Uganda's LGFC and its functions: the majority of Uganda's LGFC is nominated by local governments, which would suggest that its main function is only to assure that local governments have a voice at the national policy-making level. However, given the Commission's legal mandate and the conditional nature of Uganda's system of intergovernmental fiscal

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<sup>10</sup> The membership of the Minister of Defense may reflect the politically charged demands of some regions in Indonesia.

relations, in practice LGFC's main functions are to guide and monitor local government revenues, local government expenditures, the vertical allocation of resources (i.e., the level of grant resources that flow to the local government level) and the horizontal allocation of resources (i.e., the transfer formulas). Again, the composition of Uganda's LGFC and its institutional positioning relatively close to the MLG make it difficult for the Commission to either enhance the coordination between central government ministries on local government finance issues, or for it to act as a credible representative of local government interests at the national level.

As noted earlier, one of the key goals of developing the institutional framework for local government finances in decentralized LDTCS should be to improve the ability of the public sector to monitor and track the system of local government finances. Based on technical capacity arguments alone, this function often seems to be performed best by the Ministry of Finance or a technical unit closely affiliated with the Ministry of Finance. Allowing the Ministry of Finance to play an important role in the monitoring local government finances would also assure policy buy-in from the Ministry of Finance over local government finance issues. Finally, the Ministry of Finance may also be perceived as more neutral by local governments, since it does not suffer from the same conflicts of interest that often strain relations between local governments and MLG.

Although popular among some international aid agencies and donors, establishing an independent local government fiscal commission for the purpose of monitoring local government finances often does not provide an adequate institutional framework in decentralizing LDTCS, and in most cases would simply result in administrative duplication.

*Lesson 5. The strength of the intergovernmental coordinating agency is based on its technical competence, how well the agency informs the policy debate, and therefore on its credibility with local governments and the rest of the central government agencies.*

The comparison of international practices highlights that the intergovernmental fiscal agencies in different countries formally report to different agencies. In Uganda, the LGFC reports to the President through the Minister of Local Government. In many other countries, the LGFC or its institutional equivalent reports to government (either the executive or legislative branch) through the Ministry of Finance. Although (as noted in "lesson 4"), the composition and affiliation of an intergovernmental fiscal agency can hamper its effectiveness and credibility, ultimately it also matters little who the agency formally reports its findings to. In other words, the agency gains little leverage *per se* from "reporting to Parliament" or "reporting to the President".

Instead, the credibility of an intergovernmental fiscal agency arises predominantly from the agency's technical expertise and the usefulness of the reports and analyses it produces in informing the policy debate. In a sense, this lesson underscores the importance of earlier lessons that the nature of the intergovernmental fiscal system should drive the institutional framework (Lesson 1) and that the monitoring of local government finances

is one of the most rudimentary functions of the institutional framework (Lesson 2). In fact, the history of the U.S. ACIR shows that policy relevance is continuously important; if an intergovernmental coordinating agency fails to perform relevant functions beyond those of mere academic interests, its institutional existence may be at stake.

A good example of the degree of leverage and influence that technical expertise can bring to bear is the role of the Association of Dutch Municipalities (VNG) in the formulation of local government policies in the Netherlands. Although the VNG lacks any legal policy-making authority, it has been able to win major policy influence, first, through its technical expertise and professionalism, and second, by broadly obtaining the support from all municipalities by fairly representing all local governments, rather than serving the narrow interests of a subset of municipalities. Similar experiences can be reported for Denmark, and the Baltic countries of Estonia and Latvia.

Based on the limited technical capacity of local government associations in many LDTCs, care must be exercised in assigning local government associations a major role in the institutional framework for intergovernmental relations. With some notable exceptions (Nepal, for instance), local government associations in most LDTCs simply may not have the prerequisite technical capabilities to be a credible partner to the central government. This means that there is a need to significantly strengthen the institutional and technical capabilities of local government associations in order for these organizations to fulfill a more significant role in intergovernmental relations in the future.

## **6. Concluding Remarks**

The main goal of this review has been to provide an overview of the international experiences in developing an institutional framework for intergovernmental fiscal relations and to explore the relevance of these experiences for lesser developed economies. Because of the multi-dimensional nature of intergovernmental fiscal relations, the review of the international experiences focused on considering specific aspects of institutional intergovernmental arrangements in nine countries, including the nature of the intergovernmental fiscal system, the main task(s) of the intergovernmental agencies, the legal source of authority of these agencies, as well as their institutional affiliations and reporting mechanisms.

The institutional arrangements considered as part of our international review contain several lessons for governments of developing economies. Perhaps the most important lesson is that no “one size that fits all”: there is no single best institutional approach to organizing intergovernmental fiscal relations. The most-suited institutional framework is defined not only by the nature of a country’s intergovernmental fiscal system, but also by the relative (technical and political) strengths and weaknesses of the different stakeholders in a country. Thus, while in more centralized public sector, the Ministry of Local Government could take a leading role in coordinating local government finances, this approach is likely not suitable for more decentralized LDTCs.

Neither should a Local Government Finance Commission be considered a panacea for assuring proper intergovernmental coordination; whereas broad-based local government finance commissions have proven to be an appropriate institutional approach to assure appropriate coordination between different government levels in a number of developed countries (for instance, Australia or Germany), the overall record of fiscal commission in the context of LDTCs has been significantly less positive. Depending on the country's context, alternative institutional arrangements –including greater reliance on local government associations, civil society or parliament- should be considered as part of the mix in strengthening the institutional framework for intergovernmental fiscal relations in decentralizing LDTCs.

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## **Annex 1**

### **Australia's Commonwealth Grants Commission**

Australia's system of fiscal federalism relies both on unconditional grants as well as a series of specific purpose (conditional) grants.<sup>11</sup> While the system of untied equalization grants from the central government to the State governments in Australia is managed by the Commonwealth Grants Commission (CGC), specific purpose payments are managed by the central government line Ministries responsible for the functions that are the subjects of the grants. The Commonwealth Grants Commission (CGC) is an independent body that reports to the national Parliament through the Minister of Finance and exists as a result of central government legislation. The CGC was formed in 1933, as a result of disillusionment with the political committees that had recommended the distribution of grants prior to that time.

The Commission's main function, working with the State Treasuries, is the development of the equalization formula. In contrast, the vertical allocation of resources (i.e., the size of the funding pool transferred in the equalization process) is the responsibility of the central government, through the Treasury.

The Commission's role of advising the government on the distribution of the equalization funds is guided by the fiscal equalization principle which it is asked to apply by law. The law states that "each State will be given the capacity to provide the same standard of services to its citizens, on condition that they each apply the same effort to raise revenue from their own sources and operate with the same level of efficiency in service provision." In recent times, there has been some discontent at the state level with the allocation of equalization funding, but most of the discussion has been about the level of funding made available, not the distribution of those funds between States.

Although the Commission reports to parliament through the Ministry of Finance, the CGC was structured as a highly independent body. The Commission consists of no more than five members, appointed by the central government for a period of up to five years, after discussion and negotiation with the States. Members can be re-appointed and do not represent any region or interest groups, but are appointed for their personal qualities. They are generally drawn from academia, retired civil servants from either the state or central government level, or the legal community. In the 70 years of the Commission's operations, there have been only four former politicians appointed to the CGC. The Members are supported by about 45 permanent staff employed by the central government. Where necessary, academic or other assistance is contracted, by either the Commission or the States, to assist in the work, but this is not a usual way of operating.

The States have a strong say in the terms of reference for Commission inquiries, and influence and participate in the Commission's research programs. The Commission visits all States on a cyclical basis and gives them open access to all aspects of its work. Once a five-yearly review of the equalization formula is completed, the States are given access

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<sup>11</sup> This annex draws heavily on Searle (2002) and Searle (2003).

to all papers relating to that inquiry, including the staff advices to the Commission and the detailed Minutes of the Commission's meetings.

The Australian experience is that a separate agency, responsible for a very limited range of functions, has allowed intergovernmental fiscal relations to be largely isolated from politics. There has very rarely been any political influence on the distribution of equalization funding since the CGC was formed. Overall the Australian system works fairly well for Australia, but has developed in a way that is extremely demanding of data. The excessive demand for data has resulted in part from the ability of the States to participate in identifying differences in costs of service provision and revenue capacities. That ability of the States has, however, also been a big influence in the acceptance of the Commission's results and the exclusion of unwanted interference in its deliberations.

## **Annex 2**

### **Germany's Financial Planning Council**

The Federal Republic of Germany has a complex system of intergovernmental fiscal relations. Significant revenue sharing takes place since the Constitution (or Basic Law) requires vertical fiscal balance between the federal, state, and local levels of government. In order to achieve horizontal equity in the context of a system where revenue sources are highly devolved, an extensive system of equalization grants occurs on a "fraternal" basis between the states.<sup>12</sup>

In order to assure proper intergovernmental coordination of budgetary and fiscal policies, the annual budget formulation process in Germany is preceded by a series of discussions with a number of advisory councils and coordination between the federal government and the states (Länder) and local governments through the Financial Planning Council (Finanzplanungsrat). The role of the Financial Planning Council (FPC) is "to give recommendations for the coordination of the financial planning of the Federation [Bund], the states [Länder], and the municipalities." Through discussions at the Council, consensus is reached on the target level of aggregate expenditure growth at each level of government, the distribution of public resources across the three levels of government, and the permissible amount of government borrowing for the upcoming budget year plus the three following years.

The Basic Law of Germany states that the "financial requirements of the Federation and of the Länder shall be coordinated in such a way as to establish a fair balance, avoid excessive burdens on taxpayers, and ensure uniformity of living standards throughout the federal territory" (Art. 106, Section 3(2)). In accordance with this constitutional clause, the Financial Planning Council is established by the *Law on the Foundations of Budget Rights of the Federation and the States* (Gesetz über die Grundsätze des Haushaltsrechts des Bundes und der Länder, 1969). The Financial Planning Council meets twice annually, is chaired by the Federal Minister of Finance and consists of representatives of all three levels of government, including the State Finance Ministers of all 16 German states.

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<sup>12</sup> This annex relies in part on Boex, Martinez-Vazquez and McNab (2000) and Werner (2003).

Since the recommendations of the Financial Planning Council are not officially binding, the effectiveness of the Council depends largely on its professional and political credibility. In practice, the leadership of the federal Minister of Finance in the planning process guarantees preeminence of federal objectives in the development of national fiscal policy.

Although the Financial Planning Council's affinity to the Ministry of Finance provides the Council with credibility and political strength, there are several negative points associated with this strong leadership. First, the German system of intergovernmental fiscal relations has evolved into a highly technical system with limited transparency, which may have reduced the accountability of subnational governments. Second, although the system of intergovernmental coordination was previously highly consensus-driven, there has been increasing criticism of the federal government's stewardship over the system of intergovernmental fiscal relations in Germany. With its affiliation close to the federal government's power center, it has been argued that the Council's recommendations have been increasingly politicized in the aftermath of German reunification. In fact, in 2001 a number of Länder filed suit with the German Constitutional Court, arguing that they were being disadvantaged by the equalization system; the Court found in favor of the Länder, prompting the federal government to make (limited) reforms to the equalization system.

### **Annex 3**

#### **Indonesia's Regional Autonomy Advisory Board (DPOD)**

In 1999, Indonesia started down a path of major intergovernmental reforms noted for its "Big Bang" approach to decentralization.<sup>13</sup> On January 1, 2001, expenditure responsibilities assigned to the subnational level increased significantly, resulting in a near doubling of local government spending with local government spending exceeding 30 percent of public sector budget. The centerpiece for the new fiscal federalism in Indonesia is the new system of transfers comprising revenue sharing of natural resource revenues, personal income taxes and property taxes, the *DAU* (*Dana Alokasi Umum*), a large unconditional grant intended to fund subnational governments in an equalizing manner, and the *DAK* (*Dana Alokasi Khusus*), a set of yet to-be-developed conditional grants.

In principle, the current system of intergovernmental fiscal relations in Indonesia provides the vast majority of subnational resources (89.9 percent in 2001) through unconditional grants (revenue sharing and the *DAU*). However, there is a growing disconnect or schism between Law No. 22/1999 on Regional Governance (which determines the functional responsibilities for local governments) and Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions, which defines central-local funding arrangements.

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<sup>13</sup> This annex draws heavily on Brojonegoro and Martinez-Vazquez (2002), Martinez-Vazquez and Boex (2004) and Searle (2003).

The Regional Autonomy Advisory Board (DPOD) is the pivotal central government agency coordinating the current system of intergovernmental fiscal arrangements. The Board has the formal legal authority to decide the DAU allocation that should be proposed to the Parliament (through Budget Committee C). The DPOD has existed for many years but its functions and membership were changed with the introduction of local autonomy under Law 22 of 1999. According to the Law, the tasks of the DPOD are to advise the Government on:

1. the formation, eradication, amalgamation and extension of local governments;
2. the capacity of local governments to perform their statutory functions; and
3. the financial balance of the central and local governments.

Law 22 further specifies that the DPOD reports to the President as Head of the Government and is made up of:

- Minister of Home Affairs (as Chair)
- Minister of Finance (as Deputy Chair)
- Minister of Secretary of State
- Other Ministers, depending on the issues being discussed
- Representatives of Provincial governments
- Representatives of Kota governments
- Representatives of Kabupaten governments.

Presidential decree No. 151 of 2000 specifies the membership of the DPOD in greater detail to include 15 members, namely:

- Minister for Home Affairs (chairman)
- Minister for Finance (deputy chair)
- Secretary of State
- Minister for Administrative Reform
- Minister for Defense
- Chairman of the National Development Planning Board (BAPENNAS)
- two representatives each of Provinces, Kota and Kabupaten and
- one representative of each of the associations of Provinces, Kota and Kabupaten.

The DPOD is structured as a potentially powerful force in Indonesian governance and has been given some key functions in intergovernmental fiscal relations. In reality, the Board has not worked well. A first problem is the existence of institutional discord between the Board's two main stakeholders, namely the Ministry of Home Affairs (MOHA) and the Ministry of Finance. Although DPOD is anchored (both politically and physically) within MOHA, it has been argued by some that the Ministry lacks the technical capacity (and potentially the political muscle) to drive the intergovernmental fiscal agenda. In contrast, the Ministry of Finance's Directorate General for Center-Region Fiscal Balance is technically stronger, but institutionally lacks the official mandate or the political positioning within its own ministry to play a more dominant role.

The DPOD also contends with several operational problems, which may stem from its institutional positioning. The Board only meets formally (that is, with the Minister of Home Affairs as Chairman) on an ad hoc basis when a policy issue must be discussed or approved, but is often more of a rubber stamp than a decision-making forum. It rarely has all the Ministerial members present, their roles being handed to senior officers of their Ministries. The work is actually done by officials of the two key Ministries in a fairly unstructured way before the meetings of the DPOD. The preliminary meetings of officials are sometimes joint meetings and sometimes involve the representatives of the subnational government associations. There is also somewhat of a mismatch between the functions of the agency and its membership. With its lack of involvement in intergovernmental fiscal relations, for example, why would the Minister for Defense be a Member but not the Ministers for Education and Health, both of whose Ministries are directly involved in intergovernmental relations?

Despite the powerful role assigned to the DPOD in the relevant legislation, the DPOD is failing to live up to its potential. While the Board was established as a body that is expected to make decisions on a technical basis, it currently lacks the technical expertise or support to do so. While the Minister for Finance (through its Directorate General for Center-Region Fiscal Balance) is better off than others in this regard, even the Ministry of Finance relies very heavily on external technical support. The Ministry of Home Affairs is also assisted by external technical experts, for instance, to evaluate some claims for the creation of additional regions. This is something the Ministry might be expected to have the capacity to do internally. On the other hand, more serious policy-level reforms (for instance, the revision of Law 22) seem to be taking place without the requisite technical expertise and largely without the involvement of other government stakeholders.

#### ***Annex 4***

##### ***The partnership between the Association of Dutch Municipalities (VNG) and the central government in the Netherlands***

The Netherlands is a geographically small country with a high population density and a relatively politically homogenous population.<sup>14</sup> The centralized nature of governance in the Netherlands is reflected in a highly centralized system of intergovernmental fiscal relations.<sup>15</sup> Historically, the Dutch local government structure has also been highly centralized in a political sense; in fact, the mayor of each municipality is still formally appointed by the Crown (i.e., the central government).<sup>16</sup>

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<sup>14</sup> This annex draws on Netherlands Ministry of Home Affairs (2003); OECD (1997); and VNG (2003).

<sup>15</sup> This summary focuses predominantly on the role local governments in the Dutch system. While a provincial level of government exists, the role of this intermediate tier is largely administrative, as few public services are actually delivered by this intermediate level of government.

<sup>16</sup> In 2003, a number of Dutch municipalities were allowed to experiment with the use of local referendum to indicate a (non-binding) preference to the Minister of Home Affairs for the selection of a mayoral candidate. In September 2003, the Dutch cabinet approved a proposal to move ahead with a constitutional amendment to introduce directly elected mayors.

Although the local government level (comprising 489 Dutch municipalities) is responsible for the delivery of a broad realm of government services (including public education, health care, and various aspects of local social policy), local governments have virtually no revenue autonomy. Instead, local governments receive virtually all local resources either from intergovernmental grants from the Municipal Fund, or from a series of targeted conditional grants. The Municipal Fund is an equalization fund driven by a complex formula, which is managed by Ministry of Home Affairs (MOHA) together with the Ministry of Finance.

The Department of Intergovernmental Relations (DIR) at the Ministry of Home Affairs (MOHA) is formally tasked with maintaining relations between the central government, the provinces, and the local government level. In addition, however, sectoral ministries maintain their own relations with local governments in the policy areas where government services are either devolved to the local government level or where municipalities act as agents of the central government. Whereas local governments have the responsibility for delivering many “local” government services, central government line ministries nonetheless have significant responsibilities for regulation, supervision and financing these services. As such, intergovernmental sectoral policy issues (including regulatory, legislative, and financial issues) are dealt with at a sectoral level by the responsible line minister. The role of the DIR is limited to overseeing this process and to assure that sectoral policies conform to the intentions of overarching central government policies and to assure that intergovernmental relations take place in a democratic, workable and effective manner.

In recent years, less emphasis has been put on hierarchical relations between central and local authorities, and more attention has been paid to closer cooperation between the different levels of government on the basis of a partnership approach. Improved cooperation between the different tiers of government was achieved in 1999 with the Public Administration Accord New Style (Bestuursakkoord Nieuwe Stijl or BANS). The Accord –with is an umbrella agreement for a large number of sector-specific policy agreements (covenants)- was concluded between the central government (with the Ministry of Home Affairs in a facilitating role) on the one hand and local governments and their representatives (the Association of Dutch Municipalities or VNG) on the other hand. Policy topics governed by this Accord include such issues as rural development, youth policies, water policy and public safety issues.

Although legislation does not assign the Association of Dutch Municipalities (VNG) a formal advisory role in local government policy issues, BANS assigns a prominent role to the VNG as a partner of central government in determining national policies on local issues. This voluntary accord between the central government and VNG reflects two important principles. First, it signifies an understanding at the central government level that intergovernmental relations are stronger when founded on partnership and constructive engagement rather than when based on top-down regulation. Second, the accords reflect that VNG is a respected partner, based on three pillars:

- a. Members. The Association represents the interests of all local governments; all municipalities are voluntary and dues-paying members of VNG.
- b. Institutional governance. The Association is governed in a way that assures representation of all local governments with regional offices and sectoral departments.
- c. Expert staff. The Association has extensive technical expertise and is able to credibly engage the central government on a variety of local policy issues. VNG has a professional staff of over 300. Over the years, the Association has established a number of commissions in a variety of policy areas to represent the interests of the local government level in discussions and negotiations with the central government.

There are numerous positive elements in the collaborative partnership arrangement (BANS) between the VNG and the central government in the Netherlands. The accord provides a systematic framework or coordination platform for policy discussions between different central government stakeholders and the local government level. As such, this mechanism at once provides a supra-ministerial mechanism to coordinate between the different central government players, but the mechanism is also able to give the local government level a real voice in policy discussions surrounding policy issues that effect local governments despite the context of a highly centralized public sector. On the negative side, this collaborative partnership arrangement solely exists at the discretion of the central authorities. Prerequisites for such a partnership approach include a technically capable and well-organized local government association, as well as technically strong a well-connected central government coordinating unit (e.g., within MOHA or the Ministry of Finance). Such prerequisites may make it hard to replicate the Dutch model in many developing or transition economies.

## ***Annex 5***

### ***Nigeria's National Revenue Mobilization Allocation and Fiscal Commission***

The Nigerian fiscal system and the country's system of fiscal federalism are defined to a large extent in the Nigerian constitution of 1999.<sup>17</sup> The constitution prescribes three levels of government: a federal government, state governments, and county-like local governments. Thirty-six states are defined in the constitution (plus the Federal Capital Territory, Abuja), and there are at present 774 local government areas.

The constitution defines the expenditure responsibilities of each level of government. While the federal government provides public services that are of national scope or importance, such as national defense, important expenditure responsibilities are assigned to the state and local levels of governments. Key local expenditure responsibilities include primary education and a host of traditional local government functions (such as operating local markets), while state governments play a key role in providing health care, secondary and tertiary education, and physical infrastructure. The constitution also defines the manner in which resources are shared among the different levels of

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<sup>17</sup> This annex relies in part on Alm and Boex (2002).

government. Revenues are highly centralized. With the exception of the VAT and some minor federal revenues, all federally collected revenues are paid into the “Federation Account,” which (less specific first charges) is then shared by formula among governments at the federal, state, and local levels. The value-added tax (VAT) itself is also shared by formula among government units at all three levels of government. The main source of revenues for the Federation Account is petroleum taxes.

Nigeria’s system of unconditional grants through the Federation Account and the VAT (known together as the Federal Allocations) is administered by a constitutionally-mandated Revenue Mobilization, Allocation and Fiscal Commission. According to the Constitution:

- The Revenue Mobilization, Allocation and Fiscal Commission comprises the following members:
  - (a) a Chairman; and
  - (b) one member from each State of the Federation and the Federal Capital Territory, Abuja who in the opinion of the President are persons of unquestionable integrity with requisite qualifications and experience.

In practice, the Commission is made up the Federal Minister of Finance and representatives from each of the states, typically the State Finance Commissioners or State Accountants-General of each state.

- The Commission has the power to:
  - (a) monitor the accruals to and disbursement of revenue from the Federation Account;
  - (b) review, from time to time, the revenue allocation formulae and principles in operation to ensure conformity with changing realities.
  - (c) advise the Federal and State Governments on fiscal efficiency and methods by which their revenue can be increased;
  - (d) determine the remuneration appropriate for political office holders [...] ; and
  - (e) discharge such other functions as are conferred on the Commission by this Constitution or any Act of the National Assembly.

In practice, the Commission meets in Abuja on a monthly basis to allocate the previous month’s tax receipts among the recipient governments. This is done literally; every state receives its monthly allocation check during these meetings. Local governments are not directly represented in the Commission, but each state representative also receives a check that is to be deposited directly in the accounts for the local government authorities within each state.

In order to maintain independence in the highly politicized approach to governance in Nigeria, government agencies and commissions need to avoid potentially controversial or divisive policy issues. Thus, despite its mandate, the Commission (and perhaps even the Nigerian Ministry of Finance) has traditionally downplayed its policy roles and focused more on the hands-on monitoring and the actual administration/implementation of the

federal allocations. The major benefit in this context of the joint participation of the federal Ministry of Finance and representatives of every state in the monthly process of dividing up (both vertically as well as horizontally) the federal allocations is that the process provides for some measure of transparency and oversight –assuring that everybody gets his or her “fair share”- in a public sector that is otherwise rather opaque.

We should note that the fact that Revenue Mobilization Allocation and Fiscal Commission fails to take on the responsibility for systematic policy analysis does not mean that there is no need for such policy-focused analysis. In fact, in response to perceived problems with the structure of subnational governments, the President – together with the forum of the 36 Governors- appointed an ad-hoc *Technical Committee on the Review of the Structure of Local Government* in June 2003 to analyze and consider local government finance issues (Igbuzor 2003).<sup>18</sup>

It would be fair to conclude that the role of the Nigerian Revenue Mobilization Allocation and Fiscal Commission in Nigeria looks better on paper than it functions in reality. In fact, this could be said of the entire Nigerian system of intergovernmental fiscal relations (Alm and Boex 2002). The Commission’s interpretation of its mandate is very limited, possibly to avoid political problems. It performs its limited role well, although arguably quite inefficiently (with state-level members traveling to Abuja on a monthly basis!). More importantly, the Commission fails to be a serious platform for discussion, reporting or analysis of the effectiveness of intergovernmental fiscal relations in Nigeria.

## ***Annex 6*** ***South Africa’s Financial and Fiscal Commission***

South Africa’s current system of intergovernmental transfers –as part of the wider system of intergovernmental fiscal relations- emerged from the Constitutional negotiation process during the post-apartheid democratic transition and has undergone a substantial transformation during the second half of the 1990s.<sup>19</sup>

Instead of the highly fragmented system of subnational governments used during the apartheid era, South Africa’s new Constitution harmonized the structure of the public sector by establishing three “distinctive, interdependent and interrelated” spheres of government, notably the national, provincial and local spheres. (The choice of the term “spheres” emphasized the fact that the different government tiers are partners in the public sector, as

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<sup>18</sup> The ad hoc committee –consisting of politicians, academics, lawyers, and other citizens- is tasked with: (1) Examining the problem of inefficiency and high cost of governance with a view to reducing the costs and wastages at the three tiers of government; (2) Reviewing the performance of local governments within the last four years and consider the desirability or otherwise of retaining the local government as the third tier of government; (3) Examining the high cost of electioneering campaign in the country and consider among other options, the desirability of whether political parties, rather than individual office seekers, should canvass for votes in elections, and (4) Considering any other matter, which in the opinion of the technical committee are germane to the goal of efficient structure of governance in Nigeria.

<sup>19</sup> This annex relies on South African Treasury (1999) and FFC(2003).

opposed to strictly hierarchical units). The Constitution established nine new provinces, most combining some of the governments and administrations of the previous dispensation.

In South Africa's new fiscal federalism, the Constitution (Schedules 4 and 5) lays the foundation for provincial expenditure responsibilities.<sup>20</sup> Provinces currently account for some 60 percent of non-interest expenditures and 70 percent of public service employment. Despite their significant expenditure responsibilities, provinces have limited sources of own revenue. Provincial own revenues currently account for less than 4 percent of provincial budgets. Provincial revenues are derived mainly from motor vehicle licenses, hospital fees and gambling levies. Provinces are therefore highly dependent on intergovernmental transfers to finance their activities while local governments, in contrast, have significant revenue bases.

In order to assure relative resource adequacy within each sphere of government, the Constitution (Section 214) stipulates that nationally raised revenue must be distributed "equitably" between the three spheres of government, and that the provincial share must again be divided equitably between the nine provinces. The division of national fiscal resources is guided by the Financial and Fiscal Commission (FFC), which proposes an initial division of revenue to the Minister of Finance. Resource sharing between the different levels (spheres) of government then takes place as an informed policy decision about the relative importance of the activities at each level of government. Although analyses of the different functions and the impact on service delivery of different funding levels should inform the vertical division, the South African system explicitly recognizes that the relative priorities are fundamentally a political choice.

The primary objectives of the Financial and Fiscal Commission (FFC) are outlined in Section 220 of the Constitution. The roles and functions of the FFC include:

- To make recommendations on financial and fiscal matters to Parliament, provincial legislatures and any other authorities as determined by national legislation;
- To maintain the independence and impartiality of the FFC;

In addition, Sections 3 and 26 of the Financial and Fiscal Commission Act provides for the FFC:

- To act as a consultative body and give advice on financial and fiscal matters to organs of state;
- To perform its functions as required by the Constitution or by national legislation;
- To act on its own initiative or on the request of an organ of state;
- To ensure the efficient and effective functioning of the FFC;
- To undertake research and publish reports
- To report annually to both houses of Parliament, to each provincial legislature and to organized local government, on the activities of the Commission during each financial year.

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<sup>20</sup> These are either exclusive or concurrent functions; concurrent functions are those shared with national government. For instance, responsibility for the three main social services (health, education and welfare), is shared with national government. Exclusive provincial functions include provincial planning, roads and transport, and provincial economic affairs.

The FFC is commission of experts and has a mandate to make recommendations on financial and fiscal matters to parliament, the provincial legislatures, and any other institutions of government when necessary. The commission has a professional staff of about 20. All Commissioners are appointed by the President, either in consultation with Cabinet or as nominated by the Executive Councils of the nine provinces. The composition of the Commission is currently being modified, reducing its membership from 22 members to nine. The new composition profile of the Commission will be as follows:

- A Chairperson and Deputy Chairperson;
- Three persons selected, after consulting the Premiers, from a list compiled in accordance with a process prescribed by national legislation;
- Two persons selected after consulting organized local government, from a list compiled in accordance with a process prescribed by national legislation; and
- Two other persons.

As a statutory institution, the FFC is formally separate from government and therefore it should technically be able to perform its checks and balances between the three levels of government. As such, the commission would be able to facilitate cooperative government on intergovernmental fiscal matters on a more or less independent footing. In practice, the Commission may not be as independent as intended. The Commission has statutory obligations to work closely with various central government agencies including Parliament, the President's Office and (the Intergovernmental Relations Department of) the Ministry of Finance, which has the ultimate power in intergovernmental allocation decisions.

### ***Annex 7***

#### ***Uganda: Local Government Financial Commission***

Although Uganda is often held up as an example of good decentralization reform in Africa, decentralization reform in Uganda is also facing some significant challenges. While Uganda's system of intergovernmental grants contains both an unconditional grant component as well as an equalization transfer scheme, a large share of the transfer system in Uganda is made up of a large number of sectoral conditional transfers. These often highly-conditional grants greatly limit local government autonomy by imposing excessive control from the line ministries over local government activities. Uganda is currently trying to reform these sectoral transfer schemes to provide greater discretion to local government authorities, but the success of these reforms is by no means assured.

Although the Ministry of Local Government plays a central role in administering local government finances and coordinating other local government issues, a permanent Local Government Finance Commission (LGFC) was established in 1995 with the mission to develop an equitable system for allocation of financial resources from the consolidated fund to local governments and promote efficient and effective local revenue mobilization.

The Commission is constituted by seven members. Four of these are nominated by the district councils (3) and urban councils (1). The other three are nominated by the Minister responsible for local governments in consultation with the Minister responsible for finance. The Commission has a Secretariat headed by a Secretary and a staff strength of more than 25, including approximately eight applied economists.

The LGFC was first envisioned by the Local Government (Resistance Councils) Statute of 1993 and later enshrined in the Ugandan Constitution of 1995. The Commission's constitutional mandate is further spelled out in the Local Governments Act of 1997. The functions of the Commission as spelt out in the Constitution and the Local Governments Act include:

- Advising the President on all matters concerning the distribution of revenue between the Government and local governments and the allocation to each local government of moneys out of the Consolidated Fund.
- To monitor Local Governments' budgets to ascertain whether they significantly detract from priority areas in which event the Commission is required to inform the Council concerned and the President (through the Minister responsible for Local Governments) for appropriate action.
- In consultation with the National Planning Authority, consider and recommend to the President the amount to be allocated as equalization and conditional grants and their allocation to each local government.
- Consider and recommend to the President potential sources of revenue for local governments.
- Advise the local governments on appropriate tax levels to be levied by local governments.
- Deal with disputes between local governments over financial matters and tender advice relating thereto to the parties involved, the Minister of Local Government and the Minister of Finance as may be necessary.
- Perform such functions, as Parliament shall prescribe.

One important institutional or political challenge faced by Uganda's LGFC is that the Commission may in fact have been given too broad of a mandate, with an excessively broad scope to monitor and advise on local government issues that otherwise fall squarely within the realm of the Ministry of Local Government or the Ministry of Finance. As a result, the LGFC has difficulty distinguishing its own role from that of the other key stakeholders, with as a result that the Ministry of Local Government sees the Commission more as a competitor than as a partner in assuring sound local governance.

There is also a divergence between the composition of Uganda's LGFC and its effective functions. The majority of Uganda's LGFC is nominated by local governments, which would suggest that its main function is to assure that local governments have a voice at the national policy-making level. However, given the conditional nature of Uganda's system of intergovernmental fiscal relations, in practice LGFC's main functions are to coordinate the interests of different central government stakeholders and to monitor and guide the vertical and horizontal allocation of resources to local governments. The

composition of the LGFC and its institutional positioning relatively close to the MLG make it difficult for the Commission to either enhance the coordination between central government ministries on local government finance issues, or for it to act as a credible representative of local governments at the national level.

### **Annex 8**

#### ***Ukraine: Fiscal Analysis Office of the Verkhovana Rade (Parliamentary) Budget Committee***<sup>21</sup>

Ukraine's population, land area and degree of urbanization are similar to that of France or Italy, with a population of about 52 million and its area covering 579 thousand square kilometers. Ukraine operates under a unitary fiscal system of government, although it has some characteristics of a federal state; there are 27 regional governments, 490 local district governments and 447 municipalities. The system of intergovernmental fiscal relations is largely unconditional in nature. Local governments in Ukraine receive most of their resources (about 85%) from central-local sharing of national revenue collections. The Ukrainian system of local government finance further incorporates targeted intergovernmental grants and a local equalization fund.

The central legal foundation for intergovernmental fiscal relations in Ukraine is the country's Constitution, while provisions for the implementation of decentralized governance in Ukraine are specified in the *Law on Local Self-Government* and other relevant legislation. However, the system of intergovernmental relations in Ukraine is interwoven in a peculiar manner, including relations between executive and legislative branches, between the center and subnational units, and between state administration and local self-government.

For instance, while the constitution includes provisions for local state administrations and local self-government, it also emphasizes that local councils may only be considered local government bodies when they represent the common interest of the locality; otherwise, they simply act as deconcentrated agents of the center. As such, the system combines a system of vertically subordinated, deconcentrated system of executive power with a three-tiered system of mutually independent legislatures at the national, regional and local levels. Needless to say, the current legal framework is strife with ambiguities and intergovernmental coordination challenges.

The system of intergovernmental relations in Ukraine is *de facto* "coordinated" due to vertical accountability structure that connects the executive agencies at the central, regional and local levels and makes all levels of government ultimately accountable to the president. In fact, the President's Administration has significant power over the regional governor and the regional executive apparatus; in turn, the regional governments have a high degree of control over local governments. Likewise, subnational financial administrations have dual subordination both to their elected council as well as to the

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<sup>21</sup> This annex draws heavily on O'Connell and Wetzel (2001) and Fiscal Analysis Office (1998-).

Ministry of Finance. The Ministry of Finance is thus a key player in the implementation of intergovernmental fiscal relations in Ukraine.

However, an important coordination and policy analysis role in Ukraine's system of intergovernmental fiscal relations is also played by the Fiscal Analysis Office (FAO) of the Verkhovna Rada (Parliament's) Subcommittee on Taxation. The parliamentary Fiscal Analysis Office (among others, with support from USAID) has built considerable expertise in analyzing fiscal policy issues and has become a major stakeholder in debates surrounding fiscal decentralization policies. Ukraine's national legislature obviously has an important stake in any intergovernmental fiscal mechanism, particularly given the closely interwoven nature of the different levels of government. The Fiscal Analysis Office gives parliament the capability to engage in non-partisan, unbiased and objective analysis in order to pursue sound fiscal policy decisions.

Whereas it is not unusual for parliamentary committee's to consider intergovernmental fiscal issues at some point in the budget process, there are few countries where the parliamentary fiscal analysis office plays a leading role to the extent as is the case in Ukraine. As part of its operations, the FAO in Ukraine produces a quarterly Budget and Fiscal Review that considers not only national budget revenues and expenditures, but also reports on local budget formulation and execution on a quarterly basis. The FAO not only monitors overall trends in local government finances, but also produces analytical studies on different intergovernmental finance options, and plays a leading role in policy discussions surrounding decentralization reforms.

Ukraine's approach to monitoring and analyzing local government finances and informing the policy debate on local government finances is quite different from most other countries. Rather than anchoring this role within the executive branch –either within a single Ministry or through a super-ministerial commission-, Ukraine located this responsibility firmly within the legislative branch. This approach is working in Ukraine for two reasons. First, in Ukraine's system of government, parliament plays a strong role in policy-making and oversight. Second, it was possible to locate the responsibility for monitoring and analyzing local government finances within the legislative branch as a result of the guaranty that the debate surrounding intergovernmental finances would not be politicized. This was achieved in Ukraine by assuring that the work of the Fiscal Analysis Office reflects a high level of professionalism and objective technical expertise.

## ***Annex 9***

### ***United States: Advisory Commission on Intergovernmental Relations***

The United States of America relies on a highly decentralized fiscal system, with the Constitution guaranty that the state level is fiscally completely independent of the federal government. The Constitution enumerates the functions of the federal government, and assigns all functions not specifically assigned to the federal level as being the

responsibility of the states, or of the people.<sup>22</sup> States have complete budgetary autonomy and full discretion in raising revenues as long as the state tax system does not result in interference with interstate trade.

Although the separation of functional responsibilities of federal and state governments has limited the need for intergovernmental coordination, overlaps in policy interests are unavoidable between different levels of government. In those instances, the main policy tool used by the federal government to influence state-level policies is conditional funding. For instance, access for federal funding for interstate highways (which are typically funded jointly by federal and state governments) is conditional on a state's compliance with a series of administrative and regulatory requirements, including determination of state speed limits, state drunk-driving laws, state regulation of driver's licenses, and so on.

Given the (demographic as well as geographic) size and diversity of the United States, assuring intergovernmental (fiscal) coordination between the federal government and the states has been a particular challenge. Given the fact that states pursue their expenditure and revenue policies independently from the U.S. Treasury and the Office of Management and Budget, neither of these federal agencies are particularly well-positioned to coordinate intergovernmental fiscal relations in the United States. In response, in 1959 Congress passed Public Law 80-156 establishing the U.S. Advisory Commission of Intergovernmental Relations (ACIR) as a "permanent, bipartisan body of 26 members, to give continuing study to the relationship among local, state, and national levels of government."

ACIR's Commissioners represented most of the federal government's partners in the intergovernmental arena. There were 26 members on ACIR's Commission who served two-year terms and could be reappointed. They included:

- Six Members of Congress appointed by the House and Senate leadership;
- Four Governors; three State Legislators; four Mayors, and three county officials appointed by the President from nominations by the respective national associations of state and local governments; and
- Three private citizens and three representatives of the federal executive branch appointed directly by the President.

The Act provided that the Commission would:

- Bring together representatives of the Federal, State, and local governments for consideration of common problems;
- Provide a forum for discussing the administration and coordination of Federal grant and other programs requiring intergovernmental cooperation;

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<sup>22</sup> The tenth amendment to the US Constitution (1791) reads: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people."

- Give critical attention to the conditions and controls involved in the administration of Federal grant programs;
- Make available technical assistance to the executive and legislative branches of the Federal Government in the review of proposed legislation to determine its overall effect on the Federal system;
- Encourage discussion and study at an early stage of emerging public problems that are likely to require intergovernmental cooperation;
- Recommend, within the framework of the Constitution, the most desirable allocation of governmental functions, responsibilities, and revenues among the several levels of government; and
- Recommend methods of coordinating and simplifying tax laws and administrative practices to achieve a more orderly and less competitive fiscal relationship between the levels of government and to reduce the burden of compliance for taxpayers.

Among others, the ACIR pursued its functions by monitoring, analyzing and reporting on the conditions of the federal system. The ACIR regularly published technical reports considering specific intergovernmental fiscal issues and published an annual review of the “Significant Features of Fiscal Federalism” which contained a detailed summary of federal, state and local fiscal systems.

In 1996, Congress starved ACIR of its federal funding by only appropriating resources “for the purposes of the prompt and orderly termination of the Advisory Commission on Intergovernmental Relations”.<sup>23</sup> A reason often cited why the Republican-dominated Congress terminated ACIR in 1996 is based on the argument that the ACIR generally advocates a proactive federal role in the U.S. system of intergovernmental (fiscal) relations, whereas the predominant political philosophy within the Republican camp sought to reduce the fiscal strength of the federal government in favor of state power. Others argued that ACIR was too academic; had outlived its use; or that U.S. state and local governments were sufficiently technically advanced not to need a federally funded coordinating agency.

In the aftermath of the dissolution of the ACIR, the American Council on Intergovernmental Relations was established as a nonprofit organization incorporated for charitable and educational purposes. The Council began operations in October 1996, and was formed by former staff members of the U.S. Advisory Commission on Intergovernmental Relations, designed to be a successor to that agency, as a federalism clearinghouse, a nonpartisan research entity, and a policy forum. In reality, the American Council on Intergovernmental Relations has had only very limited success in continuing the legacy of the ACIR without federal funding and in the absence of an official federal mandate. For instance, the Council is no longer updating or maintaining the series *Significant Features of Fiscal Federalism*.

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<sup>23</sup> Although there is no longer a national Advisory Commission on Intergovernmental Relations, individual U.S. states do have similar advisory commissions at the state-level to advise on state-local relations.