



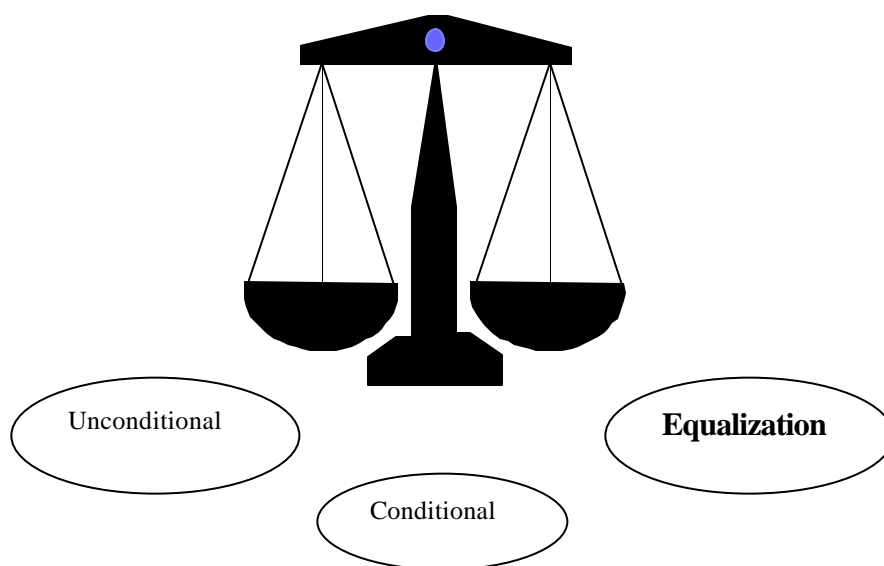
THE REPUBLIC OF UGANDA
LOCAL GOVERNMENT FINANCE COMMISSION



INTRODUCTION OF EQUALIZATION GRANT

“Analysis and Recommendations”

Grants.



THE LOCAL GOVERNMENT FINANCE COMMISSION.

Created by the Local Government (Resistance Councils) Statute No. 15 of 1993, Section 44.

Enshrined in the 1995 Uganda Constitution, Article 194.


Enacted in the 1997 Local Governments Act, Sections 75-77.


The Commission was inaugurated in February 1995 by the Minister of Local Government, Hon. Jaberu Bidandi Ssali.

MISSION STATEMENT.

?? To give sound, reliable and objective advice to government to facilitate decisions about adequate and equitable transfer of resources to local governments in the process of decentralization and about any related matter thereof.

?? To assist local governments achieve sound financial autonomy through:

 Efficient and effective mobilization of resources.

 Practicing accountability, transparency and responsible spending of public funds.

Acknowledgement.

The role of advising the President on all matters concerning the distribution of revenue between Government and Local Governments; the allocation to each Local Government of money out of the consolidated fund as well as the amount to be allocated as equalization and conditional grants is vested in the Local Government Finance Commission as spelt out in Clause 4 of article 194 of the 1995 Constitution.

In fitting with this constitutional function, the Commission embarked on this study aimed at designing an equalization system for the country. In performing this task, the Commission saw it fit to involve all stakeholders. These consisted of representatives from line ministries; officials from the ministries of Finance, Planning & Economic Development and Local Government as well as representatives from the local government associations.

The Commission is grateful to all people whose involvement in this work contributed to its success. In particular, we would like to thank the representatives of line ministries whose commitment and work in the initial stages of the study contributed to its success. The Commission is also grateful to its group of technocrats who shaped the ideas presented in the initial stages of this study into workable recommendations.

In particular, we would like to thank Messrs. Adam Babale, Yeko Mwanga and Lawrence Latim who worked on the equalization of the taxbase and Messrs. Francis Luwangwa, Musa Basajabalaba and Ms. Nagadya Erioth who worked on the equalization of the Expenditure Needs. The Commission is also grateful to Mr. Eigil Carner Nielsen, the Senior Advisor to the Commission for his supervisory role in the whole exercise. Thanks also go to Mr. Francis Luwangwa who co-ordinated the writing of this report.

Without some knowledge of international practice in equalization, designing an equalization system for the country would have proven a formidable task. In this regard, the Commission wishes to acknowledge with gratitude the role played by the various officials in Government Ministries, Institutions and Local Authorities in the Countries visited by delegations from the Commission. The Commission also wishes to acknowledge with thanks the help that was extended to them by the host institutions. In particular, we would like to thank the Ministry of Finance and that Housing & Local Government, Malaysia; National Association of Local Authorities in Denmark (NALAD), Denmark; Union of Local & Regional Governments in Latvia (ULRGL), Latvia and the Association of Local Authorities in Lithuania.

Thanks also go to all the Chief Administrative Officers, Town clerks and other local government staff for their co-operation during the data collection process. Similar thanks also go to the entire staff of the Local Government Finance Commission for the support they accorded to the research team during the study.

Last but not least I would like to express gratitude on behalf of the Commission to the Danish Agency for International Development (DANIDA) who funded this work. The Commission is grateful for their continued co-operation and support.

Dr. Dick Odur

Kampala, March 1999

Chairman: Local Government Finance Commission

Executive Summary.

Introduction.

The Equalization Grant should have been introduced in the fiscal year 1996/97. But up to now there have been no criteria for distribution of such a grant. In line with its constitutional responsibilities and following widespread complaints about inability of some local governments to provide services to an average standard, the Local Government Finance Commission constituted working groups to come up with such criteria.

The work methods included the study of the performance of existing grants, study tours to some countries where equalization schemes are practiced, review of relevant literature on international practices, field surveys and analysis and synthesis of findings.

It was found out that in the case of Uganda, wide disparities exist in revenue bases and expenditure needs of local governments. It was therefore important to consider two factors as the basis for an equalization scheme that is, Revenue potential and Expenditure need.

Revenue potential was chosen because the revenue/tax bases of local governments are not uniform countrywide. Because of this, local revenue collection by local governments exhibits significant differences in revenues per capita mobilized which leads to differences in their ability to finance service provision in their jurisdictions.

Expenditure need was chosen because the unit costs of delivering similar services are also not uniform across the various local governments. This is because of differences in their demographic structures, population densities, numbers of farming households etc. Thus, even if all local governments were able to collect the same amount of revenue per capita, there would still be differences in the quality of services delivered by them. For instance, with the same amount of money, a local government would be able to deliver a better quality of road per kilometre if its terrain is flat than if it were mountainous.

Methodology.

For revenue potential, Graduated Tax was chosen as the basis for revenue equalization. This was because it contributes an average of 80% to total local revenue. Secondly, the revenue bases for the other types of revenue namely; market dues, permits, fees & licenses and property tax are difficult to estimate at present. To compute the potential graduated tax, the number of taxpayers and personal incomes were estimated. The number of taxpayers was taken to be the male population in the age range 20-54 years. The average household expenditure, as calculated by the Statistics department was used as a proxy for personal incomes, the base for graduated tax. The graduated tax rates used were those that are given by the Ministry of Local Government.

For Expenditure Equalization, the criteria used was derived from the services that are devolved to local governments as specified in the Local Government Act, 1997. These criteria have been understood as the factors that determine differences in expenditure pressures exerted on these services and thus, the expenditure requirements of the various local governments. For instance total population was used a criterion for determining the general health expenditure requirements, population in the age-range 5-14 as a criterion determining expenditure needs for primary education, crop acreage for agriculture extension etc.

The criteria used are similar (except for detail) to those used in the calculation of the unconditional grant. The only difference is that there was need to calculate a national average expenditure need/requirement per capita. This was because, the equalization grant is not meant to benefit every local government. It is meant to be a subsidy only for those local governments that are found to be above average in their expenditure needs.

The national average expenditure need was obtained by calculating the average expenditure per capita (for all local governments) on each of the services identified. These were then weighted to obtain the national average expenditure need per capita.

It should be noted that similar methods (i.e. estimating both the revenue potential and expenditure need) are used for calculating equalization grants in other countries like Denmark, Australia, Japan, Latvia etc. Briefly, the results obtained from these calculations were:-

Revenue Potential.

- ✍the potential per capita tax revenue by district ranged between 1,100 and 5,000 shillings and averaged about 2,560 shillings.
- ✍Based on this criterion, 25 districts need to be equalized and the amounts ranged between 18.5 and 649.5 million shillings.
- ✍In order to equalize the districts by 100% to the national average revenue potential, about 6 billion shillings will be required.

Expenditure Need.

- ✍There were indeed variations in the level of expenditure needs of the different local governments. The expenditure needs per Capita varied within the range of Shs. 3,000 to 10,000 and averaged Shs. 4,563
- ✍Using this criterion, 24 districts had their expenditure needs per capita above average and thus qualified for equalization.
- ✍In order to equalize the districts by 100% to the national average, a total amount of Shs 6.2 billion would be needed with each of the beneficiaries getting between shs 40 million and 500 million.

Equalization based on both Expenditure Need and Revenue Potential of Districts.

Combining the equalization results of both the expenditure needs and the revenue potential:-

- ✍A total of 27 districts qualified for the equalization grant.
- ✍The amount of the grant payable to each beneficiary would range between 12 million and 850 million.
- ✍A total of 10.5 billion would be needed to fund the equalization scheme for districts.

The effectiveness of this equalization scheme in reducing differences in the revenue potential and the expenditure needs of the various local governments was tested. Indeed, the scheme was found to be effective in reducing those differences. An illustration of this fact is shown on page 30.

Equalization for Urban Authorities.

This methodology can also be applied to Urban authorities. A total of Shs. 1.575 billion has been recommended for this purpose. The allocation to urban authorities will be ready within 1-2 months

Recommendations

Equalization grant should have been introduced in the fiscal year 1996/97. Now that the criteria are available equalization grant should be introduced immediately as they are long overdue. This grant will help to reduce the differences in the fiscal capacities of local governments to finance their service needs.

The Commission recommends that 12 Billion be set aside for the grant. That is, 10.5 billion for districts and 1.5 billion for urban authorities.

The grant should be expended only within the five Priority Programme Areas (PPAs) of government that is Health, Education, District Roads, Water Supply and Sanitation and Agriculture Extension. Local governments should however be free to prioritize expenditure of the grant within the PPAs and inform the Local Government Finance Commission accordingly before the release of the grant.

There is need to continuously review the other financing schemes (unconditional and conditional grants) to ensure that they are distributed on a fair and equitable basis in order for the equalization grant to be effective. This is because the equalization grant is a minor grant meant only for “filling in of potholes” of the disadvantaged local governments. It cannot therefore be expected to grow to a size that is comparable to the level of resources that are availed to local governments through the conditional and unconditional grants. The Commission will also continue with studies to further refine the formula for the distribution of the equalization grant.

The Commission should monitor and evaluate the functioning of the equalization grant to ensure that it is used to improve on the services where beneficiaries are found to be lagging behind others.

Financing.

The grant can be financed out of the annual growth in the government budget. The commission analyzed the medium term expenditure allocation ceilings. The results show that by restricting the growth in the level of some conditional grants, Shs. 5 - 9 billion can be realized, which can then be re-allocated for equalization. Other options can be explored to find money for equalization within the current expenditure ceilings.

This formula can also be used to distribute monies which are less than 12 billion by changing the degree (in percentage terms) to which local governments are equalized. For instance, equalizing 70% or 80% of the fiscal deficits of the beneficiaries.

Challenges.

It is expected that the development budget will be decentralized in the financial year 1999/2000. The decentralization of the development budget will result in a significant transfer of more financial resources to the local governments. There are concerns however that if the mechanisms put in place for the transfer of these resources do not promote equalization, they may introduce new inequalities among the local governments. There is therefore need to look at the mechanisms for the transfer to ensure that they do not either introduce inequalities thus undoing the impact of the equalization grants or do not duplicate the equalization mechanism already in place.

It has been observed in a number of fora that there are horizontal inequalities existing among local governments. Thus, much as the equalization grant is expected to address the vertical imbalances and to some extent the horizontal imbalances among the recipients, the horizontal imbalances among the lower level local governments (especially sub-counties) remain largely un-addressed. These imbalances therefore need to be addressed.

For the formula to be effective there is need to continuously improve on the quality of data that is used. This should be achieved by:- improving on information flow among the stakeholders especially financial information from the districts to the commission and secondly, conduct more frequent surveys to maintain up-to-date data.

The equalization grant has been calculated on the basis of the potentially collectable revenue and not on actual revenue collected. Given the very low collection rates obtaining currently, local governments should come to terms with improving revenue collection to ensure that local revenues play a more significant role in service provision. There is no room for complacency as regards local revenue collection.

Table of Contents.

	Page Number.
The Local Government Finance Commission	ii
Mission Statement.	ii
Acknowledgement.....	iii
Executive Summary.	v
 1. INTRODUCTION.....	 1
1.0: Background.	1
1.1: Fiscal Decentralization.	1
1.2: System of Intergovernmental Fiscal Transfers.....	2
1.3: The Need for Equalization.	3
1.4: Methodology.	4
1.4.1: Conditional Grant Study.	4
1.4.2: Field Surveys and Interviews.	5
1.4.3: International Experiences in Equalization Systems.....	6
1.4.4: Analysis.....	6
 2. THEORY OF EQUALIZATION.....	 6
2.0: Principles of Equalization.	6
2.1: Measurement of Equalization Need.....	9
2.1.1: Measurement of Revenue Potential/Fiscal Capacity.....	9
Formula for measuring Fiscal Capacity.	10
Application of the Formula.	10
Calculation of Fiscal Equalization Grants.....	10
2.1.2: Measurement of Expenditure Need.....	11
Determining the Criteria.....	11
Determining the weights.....	12
Calculating expenditure needs figures.....	12
Obtaining Expenditure Needs per Capita.....	13
2.2: Financing of the Equalization Scheme.....	13
2.3: Equalization in Other Countries.....	14
Denmark.	14
Canada.....	14
Australia	15
United Kingdom.	15
India.....	15
Japan.....	16
Malaysia.....	16
Latvia.....	17

Lithuania.....	17
2.4: Lessons for Uganda.....	17
3: PROPOSED METHOD OF EQUALIZATION IN UGANDA.....	18
3.0: Legal Provisions for the Equalization system.....	18
3.1: Determining the Basis for Equalization.....	19
Differences in ability to attract financial resources.....	20
3.2: Equalizing Revenue Potential.....	20
3.2.1 Structure of Local Government Revenues in Uganda.....	20
3.2.2 Graduated Tax (GT).....	21
3.2.3 Market Dues	21
3.2.4 Other Taxes.....	21
3.3 Proposed Equalization of the Tax base	22
3.3.1 Measuring the Fiscal Capacities of Local Governments	22
3.3.2 Potential Graduated Tax.....	22
3.3.3 The Estimated Number of Rural Taxpayers.....	23
3.3.4 The Average Graduated Tax Rate Per Person	23
3.3.5 Computation of Equalization.....	23
3.4: Equalizing Expenditure Needs.....	24
3.4.1: Nature of services provided by local governments.....	24
3.4.2: Making a formula for expenditure needs equalization.	24
Determining the Criteria.....	24
Determining the weights.....	25
Calculating expenditure needs figures.....	26
Obtaining Expenditure Needs per Capita.....	28
3.5: Summary of Findings.....	28
3.5.1: Revenue Potential.....	28
3.5.2: Expenditure Need.....	29
3.5.3: Equalization based on both Expenditure Need and Revenue Potential.	29
4: RECOMMENDATIONS.....	31
4.1: Recommendations.....	31
4.2: Challenges.....	32

List of Appendices.

Appendix I: Districts Qualifying by Taxbase Approach.

Appendix II: Districts Qualifying by Expenditure Needs Approach.

Appendix III: Districts Qualifying using both Expenditure and Taxbase Equalization.

Appendix IV: Budgeted Unconditional Grants to Districts; 1996/97 - 1998/99.

Appendix V: Budgeted Conditional Grants to Districts; 1996/97 - 1998/99.

Appendix VI: Budgeted Conditional & Unconditional Grants to Districts; 96/97 - 98/99

Appendix VII: Issues raised about the Proposed Equalization Scheme.

1. Introduction.

1.0: Background.

When decentralization was conceived in 1986, the overriding goal was to bring services and therefore government closer to the people. It was understood then and even now that local people are better "judges" of what can address their problems and what cannot. They therefore ought to be consulted before decisions are taken on which programs and projects to implement. This means that the Local People who as the ultimate beneficiaries should be able to effectively participate in decision making, financial resource allocation, and the actual execution of the decisions made.

To achieve the set targets and objectives, decision making must be reflected in the way financial resources are allocated and followed through with actual implementation. Therefore, all these processes are inter-linked and it is only by ensuring local participation that one can possibly hope to achieve a positive impact on local development. The link then that holds these processes together is the financial resource. It is thus necessary to ensure that at all levels of government, there are sufficient financial resources to match the responsibilities assigned to them.

1.1: Fiscal Decentralization.

The main aim of fiscal decentralization is to ensure that at all levels of government there are sufficient financial resources to match the responsibilities assigned to each level of government. Allocating local sources of revenue to local governments that can yield sufficient revenue to meet their expenditure needs would be the ideal solution. These are referred to as local/own sources of revenue.

In reality however, this is not practical. This is because the revenue/tax bases are not uniform countrywide. Charging local governments with the task of locally mobilizing all the revenues they need would result into significant differences in revenues per capita mobilized and thus, in the ability of the various local governments to finance service provision in their jurisdictions.

Secondly, for reasons of maintaining macroeconomic stability, it is essential for the centre to retain a significant level of influence on the amount of public revenue raised. This can only be done by maintaining central mobilization of revenue from some of the taxes. Thirdly, given the nature of their bases, some taxes can only be collected efficiently and cost-effectively by the centre for example import duty.

In essence therefore, tax administration and collection should only be decentralized if the nature of their bases is such that:-

- ✍ Local governments are in a better position (to ensure compliance) to collect revenue from these sources as compared to the central government e.g. market dues.
- ✍ They promote horizontal fiscal balance. That is, they do not, significantly, introduce inequities in the level of local revenues mobilized by the local governments.
- ✍ They promote vertical fiscal balance by strengthening local fiscal autonomy. This means that yields from those taxes are relatively high while the costs of administration and collection remain relatively low.

For the reasons mentioned above, it is not possible to decentralize completely, revenue mobilization. A significant amount of public revenue will continue to be mobilized centrally. Hence, a **System of Intergovernmental Fiscal Transfers** has to be put in place to ensure that some of the centrally mobilized revenues are passed onto the sub-national governments for subsequent allocation and management. These transfers are in form of central grants. Central grants can be used effectively to offset differentials in taxbases thereby promoting vertical and horizontal equity.

For such a system of fiscal decentralization to be successful, it must conform to the principles that:-

- ?? The fiscal autonomy of Local Governments is strengthened without ceding central ability to ensure macroeconomic stability.
- ?? Horizontal equity is established without killing off local initiative in revenue generation.
- ?? Vertical equity is established without impairing the ability of Central ministries to perform their role of policy formulation, monitoring and evaluation as well as quality assurance.

1.2: System of Intergovernmental Fiscal Transfers.

In Uganda, in conformity with the principles outlined above, local governments receive a number of central grants in addition to locally mobilized revenues. These are designed to achieve the three objectives stated above; that is vertical and horizontal equity as well as local autonomy.

Clause 1 of Article 193 of the Constitution of the Republic of Uganda, 1995 states that for any given year, local governments are to receive three grants namely Unconditional, Conditional and Equalization grants. Clauses 2-4 of article 193 define what is meant by each of these.

Unconditional grants are defined as the minimum grant that shall be paid to local governments to run decentralized services and are calculated based on the costs of running those services.

Conditional grants on the other hand consist of monies paid to local governments to finance programs agreed upon between the central government and the local governments and expended for the purposes for which they are made and in accordance with the conditions

agreed upon. Evident within this law is the need for the centre and local governments to arrive at a consensus through negotiations.

The distribution of Conditional and Unconditional grants as provided for in the definition above does not take into consideration the historical distortions which resulted into unequal distribution of social and economic infrastructure. Secondly, it also does not take into consideration differences in resource endowment among local governments as is evidently the case in Uganda.

In a recent survey made by the Local Government Finance Commission, Chief Administrative Officers (CAOs) confirmed that there indeed existed inequities among local governments. They identified three major factors as the main causes of inequalities among local governments. These were:- uneven social and economic infrastructure coverage, differences in revenue potential/resource base and differences in the demand for the services delivered by them due to differences in their demographic structures.

1.3: The Need for Equalization.

It is as a result of these inequities that the need for equalization arises. Equalization is the desire by the central government to provide extra funds to those local governments whose revenue raising capacities are weak and expenditure needs great (as compared to other local Governments) to enable them provide a “minimum” level of service to their constituents. The main vehicle for channeling these funds to those "needy" local governments is the **Equalization Grant**.

Clause 4 of Article 193 of the 1995 Constitution (elaborated on in Section 84 of the Local Government Act of 1997) defines the Equalization Grant as “..money to be paid to local governments for giving subsidies or making special provisions for the least developed districts; and shall be based on the degree to which a local government is lagging behind the national average standard for a particular service”.

By implementing the equalization grant scheme, it is expected that local governments which are disadvantaged either in terms of high expenditure need or low revenue potential will be subsidized to a level where they can atleast provide a "minimum level of service delivery".

The gist of this publication is therefore geared towards **making recommendations to Government about the design of an Equalization Grant Scheme** to play the above role as best as possible under the current circumstances.

1.4: Methodology.

In fitting with its constitutional obligations, the Commission started work on the design of an equalization grant scheme in august last year. This work consisted of mainly four phases.

1.4.1: Conditional Grant Study.

In the first phase, the Commission constituted five working groups, one on each of the five priority areas namely:- Health, Education, Water, Agriculture and Feeder Roads. The groups consisted of representatives from the relevant sector ministries, from the Ministries of Local Government and Finance as well as from the Secretariat of the local government associations. The Local Government Finance Commission (LGFC) facilitated these groups.

The terms of reference for the working groups were to review the sufficiency and fairness of the sectoral allocations within these sectors across the various local governments. In particular, they reviewed the conditional grant allocation mechanisms for these sectors with a view of finding out whether these grants were distributed in a fair and equitable manner.

The results and recommendations of the groups are contained in a report that was published by the Commission about the same. The main finding of the groups was that the method of distribution of conditional grants maintained the inequalities that were inherent among local governments since these grants were given based on existing capacities.

The Commission has thus recommended the review of the formulae used for the distribution of the conditional grants in order to remove this inequity. The sector ministries concerned should therefore take it as matter of urgency to implement this and other recommendations contained in the report.

Review of the Unconditional Grant.

Article 193 of the 1995 Constitution; clause 2, defines unconditional grant as the minimum grant that shall be paid to local governments to run decentralized services and shall be calculated as:-

$$Y_1 = Y_0 + bY_0 + X_1 \quad \text{where,}$$

Y_1 is the minimum unconditional grant for the fiscal year.

Y_0 is the minimum unconditional grant in the preceding year

b is the percentage change if any, in the general price levels in preceding year and

X_1 is the net change in the budgeted cost of running added and subtracted services in the current year.

Analysis by the Commission indicates that roughly 50% of the un-conditional grant are transferred to the local governments in form wages and salaries of local government civil servants and worse still the grant is inadequate.

During the **fiscal year 1995/96**, unconditional grants transferred to local governments to finance decentralized services were disproportionately small relative to total district transfers. Most line ministries never revealed their true financial dealings with local governments and consequently decentralized services were severely under funded. This disparity was consequently in-built in the constitutional formulae.

The formulae do not capture any growth in government revenues or expansion of already decentralized services and even some services e.g. forestry, library services etc have been decentralized without the necessary funds.

Due to the above factors, the Commission recommended to government: -

To review the formulae to include an element which automatically captures revenue growth of the center.

The services, which were decentralized without the necessary funds, should be identified and their appropriate funds decentralized.

The relevant stakeholders should review the question of district structures with a view to exercising the principle of equity and fairness in the transfer of wages to local governments.

1.4.2: Field Surveys and Interviews.

The second phase consisted of conducting field interviews and questionnaire administration. Taking into consideration knowledge on the operation of the conditional and unconditional grant systems obtained from the first phase, a questionnaire was designed to collect information on the level of service delivery, expenditure needs as well as the revenue potentials of the various districts. It was decided that these would provide the dimensions for measuring the degree of "need" among the various districts.

The questionnaire sought information on all the major expenditure items as well as the major sources of revenue in the three categories, that is; local revenue, central government transfers and external sources. The questionnaire was administered in all the 45 districts, a number of urban councils and interviews held with some of the Chief Administrative Officers. This exercise took about two months to complete.

1.4.3: International Experiences in Equalization Systems.

The third phase in the work of designing an equalization system focussed on learning from the experience of other countries. This was done in two ways. First, the researchers conducted an extensive review of literature on equalization that is practiced in a number of countries.

Secondly, the Commission organized study tours to countries that were practicing decentralized forms of governance and whose system of intergovernmental fiscal relations contained an element of equalization. It was found necessary to visit a broad spectrum of countries consisting of representatives from the low income, middle income and high-income countries. Thus two teams were constituted.

The first, which visited Denmark and Malaysia in August 1998, consisted of representatives from the Ministries of Finance and Local Government, Local Government Associations and the Local Government Finance Commission. The second, which consisted of only technocrats from the Local Government Finance Commission, visited Denmark, Latvia and Lithuania (two countries of the former Soviet Union) in November of the same year.

The mission of the two teams was to learn firsthand from the systems being practiced in those countries and make recommendations on what is suitable for the Ugandan system under the present circumstances. The recommendations of the two teams are, once again, available in a report published by the Commission under the title " International Experience in Local Government Budgets and Grants Management System".

1.4.4: Analysis.

The final phase was that of analysis of data and synthesis of the findings obtained from the other phases in order to come out with recommendations on a system of equalization in Uganda. The Commission has reached the end of the final phase and is delighted to present its findings to all stakeholders.

2. Theory of Equalization.

2.0: Principles of Equalization.

Enabling all local governments provide certain minimum levels of public services to their constituents is the principle behind equalization. An equalization grant would therefore aim at providing extra funds to those local governments whose revenue raising capacities are weak and expenditure needs great, to enable them provide that “minimum” level of service within their jurisdictions. The grant is justified on the basis of fostering horizontal equity.

The formulae used to identify the beneficiaries and the subsequent allocation of such a grant to different local authorities vary depending on perception and approach. But, it is the formulae that form the central element of the equalization grant system. They are therefore the subject of intense debate in many instances.

In an attempt to come up with a realistic formula, it is important for government to gauge the equalization need of each local government by providing:-

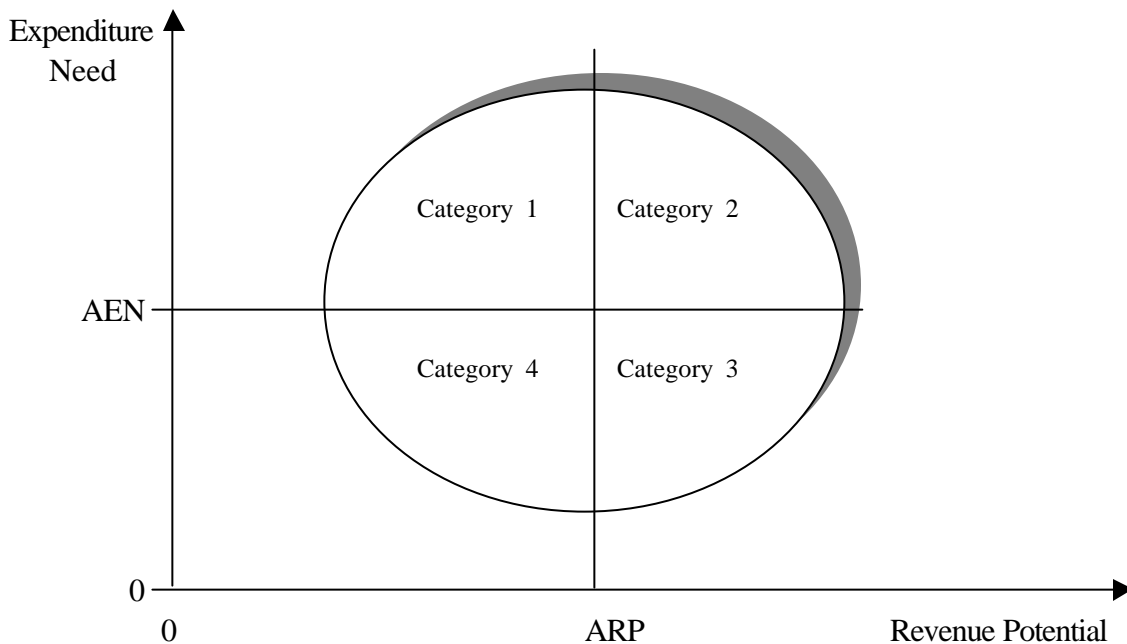
- a) Some estimates of its expenditure needs
- b) An assessment of the revenue potential to finance these needs.

It is necessary to look at both the revenue potential and expenditure needs of each local government because:-

- ~~/~~ If the revenue potential of a local government is ignored, it could reduce its tax effort and collection with the sole aim of receiving correspondingly higher central transfers in form of equalization.
- ~~/~~ Local governments have differences in their level of expenditure needs due to differences for example in the size of the population, length and quality roads or deficiencies in school and hospital capacities.

Using these two factors, it is possible to categorize local governments into four as shown below:-

1. those whose expenditure needs are above average but revenue potential below average
2. those with both expenditure needs and revenue potential above national average
3. those whose expenditure needs are below average but revenue potential above average
4. those with both expenditure needs and revenue potential below national average



where ARP is the national average revenue potential and the AEN the national average expenditure need.

Category 1 would thus automatically qualify for equalization since its expenditure need is above average with a revenue potential below average. Some local governments in categories 2 and 4 would qualify depending on the difference between the revenue potential and the expenditure need.

Local governments in category 3 would not qualify for equalization because their expenditure needs are below average and their revenue potentials are above average. They are therefore potentially able to finance the service needs of their constituents to a level that at least matches the national average.

2.1: Measurement of Equalization Need.

As can be deduced from above, the need for equalization arises out of a low revenue base and a higher than average expenditure need. In measuring the need for equalization therefore, it is vital to measure both the revenue potential and the expenditure need separately. The results can then be merged to find out whether a district would have a fiscal deficit if it desired to provide services to the national average standard.

2.1.1: Measurement of Revenue Potential/Fiscal Capacity.

Fiscal capacity is commonly defined as the ability of a government to raise revenues from its own sources. There are many ways to measure or estimate the fiscal capacity of a local government. However, it should be recognized that estimating fiscal capacities using the ability of local government units to raise revenues from their own sources is conceptually and empirically difficult.

Therefore, in most cases two measures i.e. macroeconomic indicators and the representative tax system are used. Macroeconomic indicators are measures of income and output, which serve as a proxy of ability of the residents of a particular local government to bear tax burdens. Such indicators include personal income and gross domestic product of a particular local government.

The representative tax system (RTS) attempts to measure the fiscal capacity of a local government by the revenue that could be raised if the local authority taxes all the standard tax bases with the standard tax effort. To be able to estimate equalization entitlements using a representative tax system, information on the tax bases and tax revenues for each local authority is required.

Since data necessary to compute tax bases are usually published regularly by various levels of government, a representative tax system can be readily adopted in many developing countries.

Formula for measuring Fiscal Capacity.

Fiscal capacity can be measured using the following formula.

$$C_i = \sum_j B_{ij} * t_j$$

where C_i = tax capacity of local authority i
 B_{ij} = local authority's j^{th} tax base,
 t_j = standard tax rate (e.g. national average) on the tax base.

It is important to apply a standard tax rate to the local authorities' tax base rather than the local authority's own effective tax rate, in order to ensure that the local authorities with high tax efforts are not penalized. Local authorities with an effective tax rate below national average would be penalized because their calculated potential fiscal capacities would be higher than when they are calculated using their own tax rates.

Application of the Formula.

- 1 Identify the tax bases. Use major tax bases only in the calculation of fiscal capacity.
- 2 Collect data on selected tax bases. Figures of the previous year can be applied. However, in the case where the data is provided by the local authorities, it is important to have well established rules on reporting and auditing procedure as well as penalties for false reporting.
- 3 Select the standard tax rate. This can be done in a number of ways. For example, use of an effective tax rate of the whole country, use of an arithmetic mean of all local governments effective tax rates, use of arithmetic mean of selected local governments' effective tax rates.
- 4 Calculate the fiscal capacities using the above formula.

Calculation of Fiscal Equalization Grants

A typical formula that considers only the equalization of fiscal capacities and based on the representative tax system can be given as follows:

$$TR_i = P_i (B/P - B_i/P_i) * t \quad \text{where}$$

TR_i	=	Fiscal Equalization grant to local authority i,
P_i	=	Population for the local authority,
B_i	=	Tax base of the local authority,
P	=	Total population of the country,
B	=	Total tax base of the country,
t	=	The country's average effective tax rate on the tax base.

$B/P - B_i/P_i$ measures the gap between the national average per capita tax base and the per capita tax base of local government i. This formula states that the central government transfer will bring the fiscal capacity of local governments below average up to the national average that is, assuming 100% equalization.

2.1.2: Measurement of Expenditure Need.

Let us begin with the simple notion that expenditure by local governments arises out of the fact that they (local governments) have been given the responsibility to provide certain services.

Local Governments therefore incur expenditure to provide these services. The level of expenditure incurred by districts to provide each of these services is determined by one or more **factors**. For instance, the level of expenditure to be incurred by a district on provision of primary education is determined by the number of children in the school going age i.e. 5-14 years. High numbers of school going children means that more classrooms, more teachers and more education materials are required. Building more classes and paying salaries for more teachers and purchasing more educational materials would mean higher expenditure requirements.

However, since resources are limited, this will translate into higher pressure on expenditure. Differences in the expenditure pressures in the different local governments result in differences in expenditure needs per unit if these services are to be provided to fairly the same level of quality. We therefore use such factors as the number of children of school-going age as **criteria for determining the expenditure need of the various local governments**.

Deriving a formula for Expenditure Needs Equalisation.

Determining the Criteria.

Using the services devolved to local governments as the starting point, we can identify the factors/criteria which are supposed to reflect the circumstances that give rise to the expenditure needs of local governments. For every service that is delivered by the local government, there is

a criterion or a number of criteria which influences the degree of expenditure pressure exerted on that particular service.

It is important that these criteria should be as objective as possible. Objective in the sense that they are not open to manipulation. Data pertaining to the criteria should also be easy to obtain. This means that they should feature in official government statistics. Finally, the causality between the criterion and the local government service responsibilities categorized under it should be clear.

Determining the weights.

All criteria are useful in explaining differences in expenditure pressures. However, their relative importance in determining total local government expenditure varies. It is therefore necessary to attach weights to these criteria. The weights are determined using the technical method. In this method, the average expenditures made by local governments in each of the service areas identified are used as a measure of the weights that they attach to them.

Calculating expenditure needs figures.

Having obtained the criteria as well as the weights for each criteria, the next step is to calculate the expenditure needs of individual local governments.

This is done by calculating the expenditure needs figure first. The expenditure needs figure is the proportion of potential demand for services in a local government represented by a particular criteria out of the total demand for the same services nationwide multiplied by the weight of the criteria.

For instance if district A has a school going child population of **1000** and the corresponding figure for the whole country is **10,000** children. Assume also that the weight for age group (5-14years) as a criterion is **0.4**. The expenditure needs figure regarding this criteria for district A is obtained as follows :-

Exp. Needs figure = $(1,000/10,000) \times 0.4 = 0.04$. The meaning of this figure is that District A has 4% of the total potential demand for Primary Education nationwide.

Expenditure needs figures for all the criteria are then added up to obtain the total expenditure needs figure for the respective local government.

Obtaining Expenditure Needs per Capita.

The expenditure need per Capita (EN_i) for a particular local government (i) is then obtained by multiplying its expenditure needs figure (NF_i) by the total local government expenditure (TE) and dividing the product by its total population (P_i).

$$EN_i = (NF_i \times TE) / P_i$$

It is the Expenditure Need per Capita that provides a measure of the expenditure pressure exerted on each local government and thus the equalization need. The higher the expenditure needs per capita, the higher the expenditure pressure and the greater the need for equalization.

For purposes of equalization, there is need to compare the expenditure need of each local government to a national average. This national average is calculated as a weighted average of the expenditure need per capita of all local governments.

The difference then between the national average expenditure need and the expenditure need of a local government forms the basis for equalization. Those local governments above the average expenditure need would qualify for equalization grants. Equalization for Local Government i is then calculated as

$$EQ_i = (EN_i - ENN) \times P_i \times EF \quad \text{where}$$

EQ_i	=	Equalization grant for local government i
EN_i	=	Expenditure Need per Capita for local government i
ENN	=	Average National Exp. Need per Capita
P_i	=	Total population for local government and
EF	=	Equalization factor.

Equalization can be done to the level of 100% or less depending on the availability of funds.

2.2: Financing of the Equalization Scheme.

Financing differs from country to country depending on the politics, level of development and degree of inequality among local governments. In theory however, it is believed that an ideal fiscal equalization program should be self-financing. Local governments are assessed positive and negative entitlements that total zero. In effect the local governments with negative entitlements would contribute to an equalization pool. In this case, the central government acts as a conduit for the transfer of funds from the pool to local government. In the case of Uganda, the 1995 Constitution provides that equalization grant be paid from the consolidated fund.

If in practice, the interstate or inter local authority revenue sharing pool creates administrative difficulties, the equalization program can be financed out of general revenues from the central government.

2.3: *Equalization in Other Countries*

According to literature¹, Inter-governmental fiscal transfers are very instrumental in addressing vertical and horizontal fiscal imbalances and ensuring a minimum level of public services. Below is a synopsis of how some countries use intergovernmental fiscal transfers to achieve the above objectives.

Denmark.

In Denmark the basic principle used in intergovernmental fiscal transfers is that expenditure responsibilities or decision making should occur at the lowest level of government consistent with the goals of allocation efficiency and reflecting economies of scale. Public sector tasks/responsibilities are distributed through legislation and public resources are shared according to the magnitude of responsibility assigned to a particular level of local government.

The Danish System of equalization is aimed at smoothing out differences in tax bases and expenditure needs. The equalization grant was introduced purposely to compensate for the inadequacy of revenue caused by a tax base smaller than the average and local authorities, which have expenditure needs above the average. All Municipalities with tax base above average and expenditure needs below average pay some money into an equalization fund. This money is then redistributed to those municipalities with tax bases below average and expenditure needs above average.

Canada.

In Canada, a system of grants and statutory subsidies was established to compensate for the lost revenues when local authorities were restricted to direct taxation. Equalization transfer program plays a major role as a revenue source of the “have little” provinces. It is a constitutionally mandated unconditional block transfer designed to support reasonably comparable levels of services at reasonable levels of taxation. The program uses a national average standard as the basis for equalization. The basic formula is that of the local authority’s tax capacity.

¹ Works by Anwar Shah (1994), The Reform of Intergovernmental Fiscal Relations in Developing and Emerging market Economies (World Bank Publications), Jun Ma (1996), "Intergovernmental Fiscal Transfer" A Comparison of nine countries (The World Bank) and Study Tour Experiences of Denmark, Malaysia, Latvia and Lithuania.

Australia

Australia operates an intergovernmental fiscal transfer system for both the federal and lower level governments. The federal government collects about two thirds of the total government revenues but spends only a third of total public expenditure. This implies that one third of the total public revenue is re-distributed through various forms of transfer to lower governments.

The federal government grants to lower level governments are administered by the Common Wealth Grants Commission. The Commission distributes the general-purpose grants using a system that measures the states' revenue capacities and expenditure needs. The major objective of the system is to make it possible for any state with reasonable tax effort to provide the level of public services not substantially below other states.

United Kingdom.

In United Kingdom (UK) local governments derive their powers and functions from the central government. The central government retains almost all major taxes namely, personal income tax and corporation tax. Revenues for local authorities consist of grants-in-aid from the central government, property tax, fees and charges on services provided by local governments, trading profits, rent, interest etc. Grants from the central government are justified on the grounds that the division of tax powers between levels of government leaves the local authorities with very limited fiscal resources. However, under the current labour government, there is a move towards greater local autonomy.

There are two types of grants, the general-purpose grants and specific grants. The general-purpose grant is used to address regional inequality. Thus the higher the ratio of need to resources available in a particular local authority, the more grant in aid it receives. The specific grants address the spill-over or externality effect of specific projects such as roads, education and social welfare.

India.

In India, the intergovernmental transfer system consists of three elements. First, a general purpose grants mechanism designed to address inequalities uses a state's share of income taxes and excise tax and is operated by the Finance Commission. Second, transfers from the federal government to states to support their development plans, which are approved by the Planning Commission. Third is the local government borrowing authorised by the central government.

Until 1984, assistance to backward states took the system known as "gap-filling". This meant assessing the revenue receipts and expenditures incurred and recommending deficit grants to fill the financing gaps arrived at on that basis. The system was found to be inefficient. The Commission adopted a new system based on the following criteria:

- 20 per cent on the basis of population,
- 60 per cent on distance of per capita income from the highest major income state,

- 5 per cent on the basis of infrastructure,
- 5 per cent on the basis of the area of the states subject to certain normative limits, and
- 10 per cent on the basis of tax effort defined as the ratio of per capita own tax revenue to the square of per capita income.

Japan.

In Japan, intergovernmental transfers are basically designed to remove vertical financial imbalances. There are five types of fiscal transfers from the centre to local governments but only local allocation tax is used for equalisation.

The local allocation tax is designed to address equalisation of local governments' fiscal capacities and to ensure sufficient funds for the services that local governments are required to provide. Its aim is to equalise the fiscal capacities of local governments by supplementing the shortage of their local tax revenues. The tax is to enable local governments to provide public services at the standard level prescribed by the central government. As a rule, the amount of the ordinary allocation tax is determined by the index of fiscal capacity. The index of fiscal capacity is calculated as the ratio of the basic financial revenue divided by the basic financial need. Local governments with financial needs less than their basic financial revenue are entitled to retain their surplus.

The calculation of 'needs' does not have to correspond to actual expenditures by specific local governments but on reasonable and standard fiscal needs based on an average condition of "a model local government". Since the financial revenues are collected by the central government, the calculation of the basic local revenue is not difficult.

Malaysia.

The division of public tasks is provided and guided by the Constitution. Under the existing law, the state government gets revenues from taxes, fees and other sources, which they are entitled to as long as they are raised in their area of jurisdiction. States also receive grants from the federal government whose basic aim is to ensure balanced development among states and districts and between people living in rural and urban areas.

Equalisation grant is given for economic and infrastructure development to ensure an improved quality of living. The grant is specifically to assist those states which are less developed to enable them achieve a faster growth. The grant is financed from the Federal Government Budget. It is allocated basing on the level of economic development, development of infrastructure and other social economic factors.

Latvia

In Latvia, the system of local government fiscal equalisation provides for a partial equalisation (not up 100%) of differences between financial necessity and estimated local revenue for each local government. The aim of the system is to stimulate local government's initiatives and independence in creating their own financial resources as well as to secure protection for financing activities by local governments.

The program is self-financing, administered by the State Treasury but supervised by a Board established by the Cabinet of Ministers.

Lithuania

Equalisation in Lithuania is administered basing on general principles that relate to structural differences in local government revenues and demographic differences measured by such ratios like the number of able-bodied population, the number of residents between the ages of 0-18 and the number of pensionable residents.

The factors that determine the equalisation grant are reviewed every three years and the grant is self-financing i.e. local governments with high revenue per capita contribute to an equalisation fund.

2.4: Lessons for Uganda.

From the foregoing review of the different systems of equalization, it is clear that a lot can be learnt for the benefit of the design of the Ugandan Equalization System.

Equalization grant is applied taking into account the existence of other grants and their activities.

In many instances equalization is applied with the basic objective of providing basic public services that do not differ widely among local governments. Therefore, in determining which local government is or is not capable of providing comparable public services, measures of revenue (tax) capacity and expenditure pressures are used. Some countries employ both measures while others just apply one of them. Others measures of special burdens are also sometimes taken into consideration.

Measurements of fiscal capacity for local governments is based on only tax (revenue) bases that are assigned to local governments either by legislation or otherwise.

In determining the beneficiary, many countries use the national averages. Those states, which lie below the average, are compensated with an equivalent amount that enables them to provide comparable public services.

As regards determination of equalization according to expenditure needs, it is important for the stakeholders to agree on the following: -

- Which services to equalize
- The criteria for equalizing those services should be objective and not easy to manipulate.
- The weights for each of the criteria

Funds to finance the Equalization program can be sourced from the center or contributions from the local governments that are above average of the fiscal capacity measure and/or below average in the expenditure pressure measure.

Equalization can be based on minimum service levels prescribed by the central government. In this case local governments that are not capable of providing basic minimum services are granted subsidies to enable them achieve the minimum services.

Equalization can also be based on the level of economic development, development of infrastructure and other local economic factors.

Experience seems to indicate that an independent Commission is better placed to manage equalization fund for reasons of impartiality, objectivity and fairness.

3: Proposed Method of Equalization in Uganda.

3.0: Legal Provisions for the Equalization system.

The equalization grant is provided for in the 1995 Constitution of the Republic of Uganda in Article 193 clause 1(c) & clause 4 and elaborated on in the 1997 Local government Act, section 84 sub-section 1(c) & sub-section 4.

Article 193 clause 1 of the 1995 Constitution states that “ The president shall for each financial year, in accordance with this Constitution, cause to be presented to parliament proposals as to the moneys to be paid out of the consolidated fund as-.....

(c) equalization grant in accordance with clause (4) of this article”.

Clause (4) of Article 193 of the Constitution defines equalization grant as “ ...the money to be paid to local governments for giving subsidies or making special provisions for the least developed districts; and shall be based on the degree to which a local government is lagging behind the national average standard for a particular service”.

Section 84; sub-sections 5 and 6 of the Local Governments Act of 1997 further provide that this grant shall be remitted direct to Districts, City, Municipal and Town Councils. It is these councils that are supposed to indicate how the equalization grant obtained from the central government is to be passed onto lower levels of local government.

From these legal provisions, the following conclusions can be drawn about equalization grants: -

1. The equalization grant is to be funded by the Central Government and out of the consolidated fund.
2. It is to benefit only some but not all local governments that are found to be seriously disadvantaged.
3. It is only districts among rural councils and city, municipal and town councils in urban councils that will receive equalization grants direct from the central government.
4. Although the central government will deal directly with only districts, city, municipal and town councils, these local governments are obliged to indicate how they will pass on the grant to local governments with a smaller jurisdiction or administrative councils
5. The grant will only be a subsidy and therefore government will have no obligation of compensating the beneficiaries to the full extent of their deficiency.

In addition, it is the view of the Commission that for the grants to be effective, local governments will need to specify for each preceding year how they used the grant and the achievements made. There will be need therefore to put in place a monitoring system to ensure that the grant is used for the purposes for which they are given.

To operationalise the equalization fund as spelt out in these legal provisions, mechanisms should be put in place to ensure that: -

- ?? The revenue potential of each local government to fund its service needs is taken into consideration.
- ?? These provisions are not abused by anybody.

3.1: Determining the Basis for Equalization.

Considering the views of local governments as well as the theoretical basis elaborated on above, the aim of the proposed equalization system should be to reduce the differences in the ability of the various local governments to provide an average service level to their constituents. Differences in the ability of local governments to provide services to at least the average pertaining in the country arises from basically two factors: -

- ?? Differences in the expenditure needs of the local governments.
- ?? Differences in the ability of local governments to attract financial resources to finance these expenditure needs.

Differences in ability to attract financial resources.

Local governments obtain financial resources from four sources namely: -

- ?? Central Government via grants (unconditional and conditional).
- ?? External sources especially NGOs and Donors.
- ?? Local Revenue.
- ?? Non-budgeted sources like donations and revenues raised from fundraising occasions.

Therefore the services delivered by local governments are constrained by funds from these sources. Expressed mathematically: -

$$LG \text{ services} = CG + UG + LR + D + NB$$

Where *LR* = local revenue; *CG* = Central grants; *UG* = Unconditional grants; *D* = Donors and *LG* = Local government; *NB* = non-budgeted sources.

It has been established that the distribution of (unconditional and conditional) grants does not introduce new inequalities among local governments, although they tend to perpetuate the existing inequities since they are given based on existing capacities.

Revenue from external sources and non-budgeted items depend partly on the versatility of the leadership of the local governments in question and partly on the objectives of donors. The leadership of those local governments can therefore address differences in revenue obtained from these sources best.

It can therefore be concluded that any scheme, which seeks to equalize the pressure on expenditure in each local government, in an attempt to provide an average service level to the population, should seek to equalize: -

- ?? Differences in the expenditure needs of the local governments.
- ?? Differences in the local revenue potential.

3.2: Equalizing Revenue Potential.

3.2.1 Structure of Local Government Revenues in Uganda

The Local Governments Act, 1997² outlines the sources of local governments revenues as consisting of graduated tax, market dues, property tax, licenses and permits, vehicle parking fees, user-charges, agency fees and other revenues which may be prescribed and approved by the Minister responsible for Local Governments.

In practice, district councils collect revenues from graduated tax, market dues, licenses and permits, and other own sources.

3.2.2 Graduated Tax (GT)

Graduated tax is the single most important source of local revenue. Between 1995/96 and 1997/98, the GT has been contributing close to above 80 % of own revenues of most districts. As can be observed from the Chart on the next page, the trend of the average contribution of the GT to local revenue has been growing. In 1994/95 financial year it contributed to about 72 % and this rose to about 84 % in 1997/98 financial year.

3.2.3 Market Dues

Market dues are the second most important source of local revenue. For the period 1995/96 to 1997/98, market dues have been accounting for less than 10 % of local revenues of most districts. On a national average, the market dues' contribution to local revenue was 18 % in 1994/95 but declined to about 7 % in 1997/98.

The contribution of market dues to local revenue has not only been varying widely from year to year within the same district, but also from district to district within the same year.

This is in conformity with the fact that market sizes (sizes of local economies) vary a lot resulting in collectable dues to fluctuate accordingly. In addition, the rural economies are agricultural in nature, and because of seasonality in agriculture, volumes of tradable commodities also fluctuate by the seasons resulting in variations in collectable dues. Other factors such the management of a market (private or public) may also affect revenue collections.

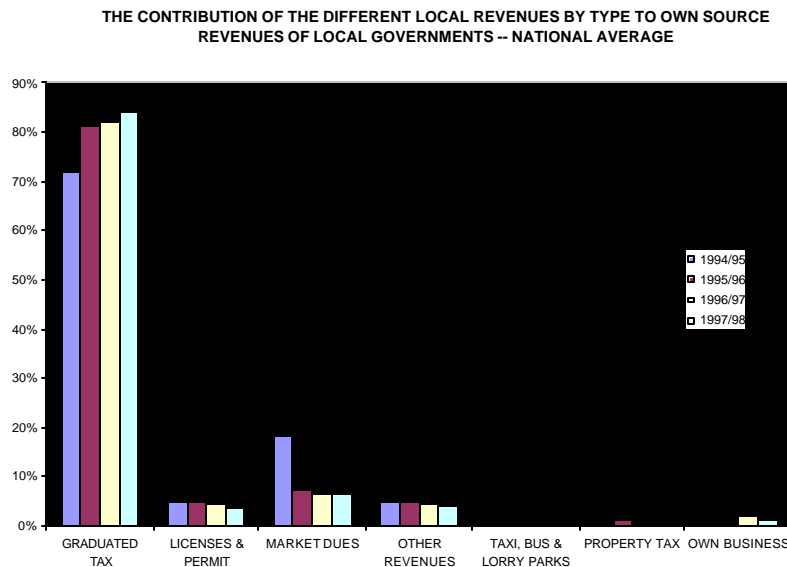
3.2.4 Other Taxes

Licenses and permits is the third single important source of own revenue after the graduated tax and market dues. They have, on average, been contributing about 4 percent of the local revenue of most local governments.

Property tax and fees from taxi, bus and lorry parks are virtually non-existent in almost all districts. It is however not clear why local governments are not collecting property tax. There

² Fifth Schedule

is need to follow up and establish how this revenue source could be developed. The picture may be different for an urban district like Kampala and other urban local councils.



3.3 *Proposed Equalization of the Tax base*

3.3.1 Measuring the Fiscal Capacities of Local Governments

As noted earlier, graduated tax and market dues are at the moment the major revenue sources of local governments.

From the current available information, it is not possible to compute the potential revenues from market partly because the base could not be determined. Therefore it was excluded from this scheme. Similarly, property tax was excluded from this equalization proposal because its contribution to local revenue is less than 5 % on average.

A fiscal capacity is therefore being measured using the potential graduated tax revenues. This should be reasonable as graduated tax forms about 80% of local revenues in most local governments. Property tax, market dues, licenses and permits, and other revenues could be introduced in the computation of equalization grants in the future when more reliable data on them becomes available and their contribution to local revenues increase.

3.3.2 Potential Graduated Tax

The principle factors that contribute to differences in the collection of graduated tax by districts are the number of taxpayers and their presumed wealth or incomes: local communities are

principally engaged in subsistence agriculture and their wealth is assessed to derive a proxy of their incomes for taxation purposes.

The potential graduated tax revenue was calculated as a product of estimated rural taxpayers and an imputed average graduated tax from district expenditure surveys³.

3.3.3 The Estimated Number of Rural Taxpayers

Part II of the Fifth schedule of the Local Governments Act, 1997 requires that graduated tax be levied on every male person of, or above the apparent age of 18 years...; and on female persons of or above the apparent age of 18 years engaged in any gainful employment or business.

To estimate the number of rural taxpayers, the current population projection for every district classified by age groups was obtained from the Statistics Department, Ministry of Finance, Planning and Economic Development. It was assumed that every male person in the age group 20 – 54 pays graduated tax. The female population was excluded because they contribute to the same household incomes, which is used for assessing the GT that the males pay. Therefore taxing them would amount to double taxation. The estimated rural taxpayers also excluded age 18 – 19 as they were assumed to be generally at school.

3.3.4 The Average Graduated Tax Rate Per Person

For each local government, the district average graduated tax per tax payer was derived by multiplying household expenditure (proxy of income) by a tax rate estimated from the local government graduated tax schedule. Based on the schedule the taxpayers were found to contribute about 1.7 % on average of their household incomes as graduated tax.

3.3.5 Computation of Equalization

Theoretically the size of the equalization grant for a local government should be measured as a product of the total population of the local government and the gap between a national average per capita graduated tax revenue and a local per capita potential graduated tax revenue. i.e.

$$? \left[\begin{array}{cc} \text{the national} & \text{Potential GT per} \\ \text{average potential} & \text{capita for a} \\ \text{GT per capita} & \text{particular local} \\ & \text{government} \end{array} \right] \times \text{The population of} \\ \text{the particular local} \\ \text{government}$$

³ The Statistics Department estimated each District's average personal income using the household expenditure data of 1997.

3.4: Equalizing Expenditure Needs.

3.4.1: Nature of services provided by local governments.

Part II of Schedule 2 of the Local Governments Act, 1997 lists the services, which are to be provided by the Local Governments. The major ones include: -

- ? ?Running of District Hospitals, Health Centres and Dispensaries.
- ? ?Control of Communicable Diseases e.g. TB, HIV, and Leprosy.
- ? ?Rural Ambulance Services
- ? ?Primary Health Care
- ? ?Vector Control
- ? ?Environmental Sanitation
- ? ?Health Education
- ? ?Rural Water Supply
- ? ?Provision of Nursery, Primary, Secondary, Technical and Special Education.
- ? ?Child and Maternal Welfare
- ? ?Agricultural Extension services and
- ? ?Road Construction, Rehabilitation and Maintenance.

Local Governments therefore incur expenditure to provide these services. The level of expenditure incurred by districts to provide each of these services is determined by one or more **factors**.

3.4.2: Making a formula for expenditure needs equalization.

Determining the Criteria.

Using the services devolved to local governments listed above as the starting point, we identify the factors/criteria, which reflect the circumstances that give rise to the expenditure needs of local governments. For every service that is delivered by the local government, there is a criterion or a number of criteria that influences the degree of demand for that particular service, thus determining the need for expenditure.

That is, in a district with a relatively high population of children in the school going age, the pressure on the local government to provide school services will be higher than in a similar local government with another distribution of the population

Shown in the table below are the district service responsibilities categorized by their criteria.

Table 1: Proposed Expenditure Need Criteria.

Service responsibilities	Criteria that determines pressure on expenditure.
?? District Hospitals ?? Health Centres and Dispensaries ?? Control of Communicable Diseases e.g. TB, HIV, Leprosy ?? Rural Ambulance Services ?? Primary Health Care ?? Vector Control ?? Environmental Sanitation ?? Health Education ?? Rural Water Supply	1. Total Population
?? Primary Education	2. Population (5-14 yrs)
?? Special Education ?? Secondary Education ?? Technical Education	3. Population (15-19 yrs)
?? Child Welfare Expenses	4. Population (0-4 yrs)
?? Road Construction, Rehabilitation and Maintenance	5. Km of District Roads/Per Unit Population
?? Extension Services ?? Rural Water Supply	6. District Area
?? Maternal Welfare Expenses	7. Infant Mortality Rate
?? Agricultural Extension Services (Crops)	8. Crop Acreage
?? Agricultural Extension Services (Veterinary)	9. Livestock Population
?? Extension Services (Fisheries)	10. No. of Landing Sites

NB: The types of Expenses on service provision are derived from the services devolved to districts as specified in the Local Government Act of 1997; Schedule 2 part II.

Determining the weights.

All the criteria above are necessary in explaining differences in expenditure pressures from local government to local government. But, as already said, it is vital to attach weights to these criteria to show their relative importance in total local government expenditure.

The technical method has been used to derive the weights. The method uses the average countrywide expenditures in each of the service areas identified in table 1 as a measure of the importance that the local governments attach to them. Below, is an explanation of how the weights have been obtained.

The weights have been calculated on the basis of actual district expenditure on those services falling under each criteria category for the period 1996-1998.

The following Formula has been used :-

Let E_i be the calculated average expenditure for all districts on service i for the period **1996-1998**. Let also w_i be the weight of expenditure on service i in total expenditure.

$$w_i = E_i / \sum_{i=1}^{17} E_i \quad \text{where (no. of services) } i = 17 \text{ (table 1)}$$

$CW_j = \sum_{i=1}^{17} w_i$ where CW_j is the weight for criteria j given as a total of the individual weights of the expenses under that particular category.

And $\sum_{j=1}^{10} CW_j = 1$.

Table 2: List of Weights.

Criteria	Weight
1. Total Population	0.3885
2. Population (5-14 yrs)	0.3978
3. Population (15-19 yrs)	0.1305
4. Population (0-4 yrs)	0.0385
5. Km of District Roads/Per Unit Population	0.0219
6. District Area	0.0102
7. Infant Mortality Rate	0.0056
8. Crop Acreage	0.0025
9. Livestock Population	0.0025
10. No. of Landing Sites	0.0020

The weights then simply represent a measure of the average expenditure on the given services determined by one criterion in the entire country.

Calculating expenditure needs figures.

Having obtained the criteria as well as the weights for each criteria, the next step is to calculate the expenditure needs for each criteria of individual local governments.

This is done by calculating the “expenditure needs figure”. The expenditure needs figure is the proportion of potential demand for services in a local government represented by the value of a

particular criterion out of the total demand in the country for the same services nationwide (the value of the criterion for the country) multiplied by the weight of the criteria.

Expenditure needs figures for all the criteria are then added up to obtain the total expenditure needs figure for the respective local government. Below is an example of how the calculation of the total expenditure needs figure for Apac District.

Need Criteria	Weight	Spending	Need	Exp. Needs Fig.
		District	National	
Total Population	0.3885	544342	21029023	0.010056
Popn (0-4 yrs.)	0.0385	103539	4148009	0.000961
Popn (5-14yrs.)	0.3978	158784	6056772	0.010429
Popn (15-19yrs.)	0.1305	57610	2234392	0.003365
IMR	0.0056	114	122	0.005233
Area	0.0102	6488	238827	0.000277
Crops Acreage	0.0025	272467	5060134	0.000135
Livestock popn.	0.0025	212638	10186281	0.000052
Km. of District Roads	0.0219	0.00116	0.08353	0.000304
No. of Landings Sites	0.002	174	7097	0.000049
Total	1			0.030861

Total expenditure for all districts on PPAs 77,377,430,275
 Expenditure Needs figure for Apac District 0.030861
 Expenditure Needs per Capita = (0.030861 x 77,377,430,275) / 544342 = 4,387.

Where PPAs is Priority Programme Areas – the areas of responsibility devolved to local governments as shown in table 1 on page 25.

The first column contains the criteria and the second column the weights attached to each of them. In the third column, district figures are indicated for each of the criteria for example; the population (0-4 years) for district A is 103,539. The fourth column gives the corresponding figures for the whole country. The last column (expenditure needs figure) is obtained by dividing the product of columns 2 and 3 by column 4.

The total population in Apac district is 2.55% of the total population in the country, whereas the population in the age-group 5-14 years old represents 2.62% of the total population. Multiplied by the criterion weights we now get that district A will need 1.0056% of the total expenditure in the whole country for the services determined by the total population and 1.0429% of the total expenditure on all services in the country for services determined by population in the age-group 5-14 years.

The sum of all the expenditure needs figures tells us that Apac district, in order to deliver an average level of services, needs 3.0861% of the total district expenditures in the country. More than what a simple per capita criterion would allocate.

Obtaining Expenditure Needs per Capita.

The expenditure need per Capita (EN_i) for a particular local government (i) is then obtained by multiplying its expenditure needs figure (NF_i) by the total local government expenditure (TE) and dividing the product by its total population (P_i).

$$EN_i = (NF_i \times TE) / P_i$$

It is the Expenditure Need per Capita that provides a measure of the expenditure pressure exerted on each local government and thus the expenditure need. The higher the expenditure needs per capita, the higher the expenditure pressure and the greater the need for equalization.

For purposes of equalization, there is need to compare the expenditure need of each local government to a national average. This national average is calculated as a weighted average of the expenditure need per capita of all local governments.

The difference then between the national average expenditure need and the expenditure need of a particular local government forms the basis for equalization. Those local governments above the average expenditure need would qualify for equalization grants.

Equalization for Local Government i is calculated as

$$EQ_i = (EN_i - ENN) \times P_i \times EF$$

Where EQ_i = Equalization grant for local government i
 EN_i = Expenditure Need per Capita for local government i
 ENN = Average National Exp. Need per Capita
 P_i = Total population for local government and
 EF = Equalization factor.

Equalization can be done to the level of 100% or less depending on the availability of funds.

3.5: Summary of Findings.

Using the methodologies described above, computations were made for the revenue potential and expenditure needs of the different local governments and the following results were obtained.

3.5.1: Revenue Potential.

- ~~/~~ From the computation, the potential per capita tax revenue by district ranged between 1,100 and 5,000 shillings and averaged about 2,560 shillings.
- ~~/~~ Based on this criterion, 25 districts need to be equalized and the amounts ranged between 18.5 and 649.5 million shillings.
- ~~/~~ In order to equalize the districts by 100% to the national average revenue potential, about 6 billion shillings will be required.

3.5.2: Expenditure Need.

- ~~/~~ There were indeed variations in the level of expenditure needs of the different local governments. The expenditure needs per Capita varied within the range of Shs. 3,000 to 10,000 with one out-lier at Shs. 24,904.
- ~~/~~ The national average expenditure need per capita was established to be Shs. 4,563
- ~~/~~ Twenty-four districts had their expenditure needs per capita above average and thus qualified for equalization.
- ~~/~~ To equalize the expenditure needs of the beneficiary districts down to the national weighted average (100% equalization), a total amount of Shs 6,253,945,527 would be needed with each of the beneficiaries getting between shs 40 million and 500 million.

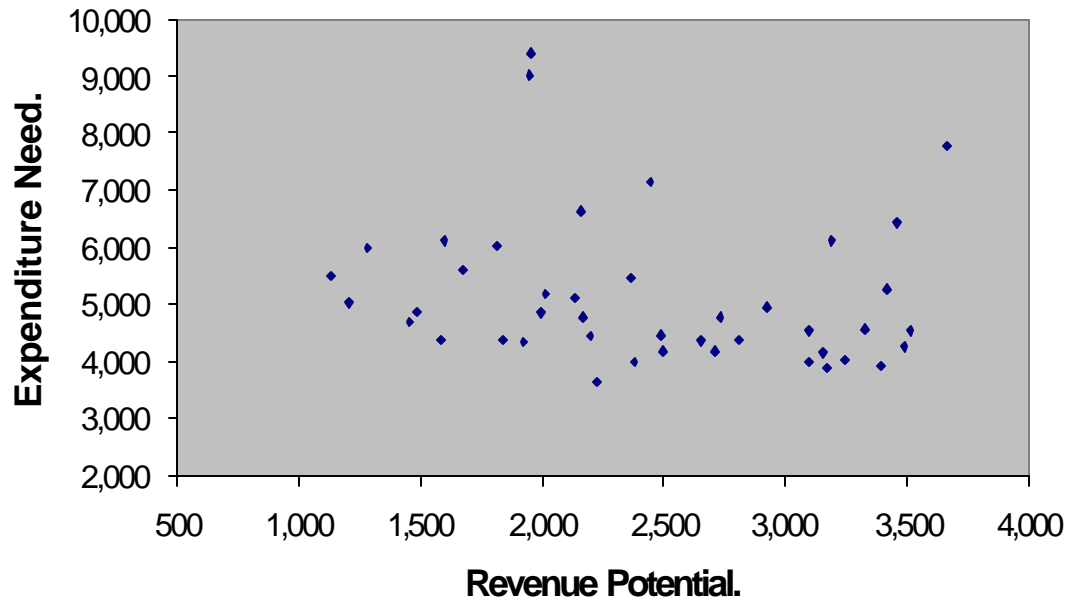
3.5.3: Equalization based on both Expenditure Need and Revenue Potential.

Combining the equalization results of both the expenditure needs and the revenue potential:-

- ~~/~~ A total of 27 districts qualified for the equalization grant.
- ~~/~~ The amount of the grant payable to each beneficiary would range between 12 million and 850 million.
- ~~/~~ A total of 12.75 Billion would be needed to fund the equalization scheme, 10.5 billion for districts and 1.575 billion for urban councils.

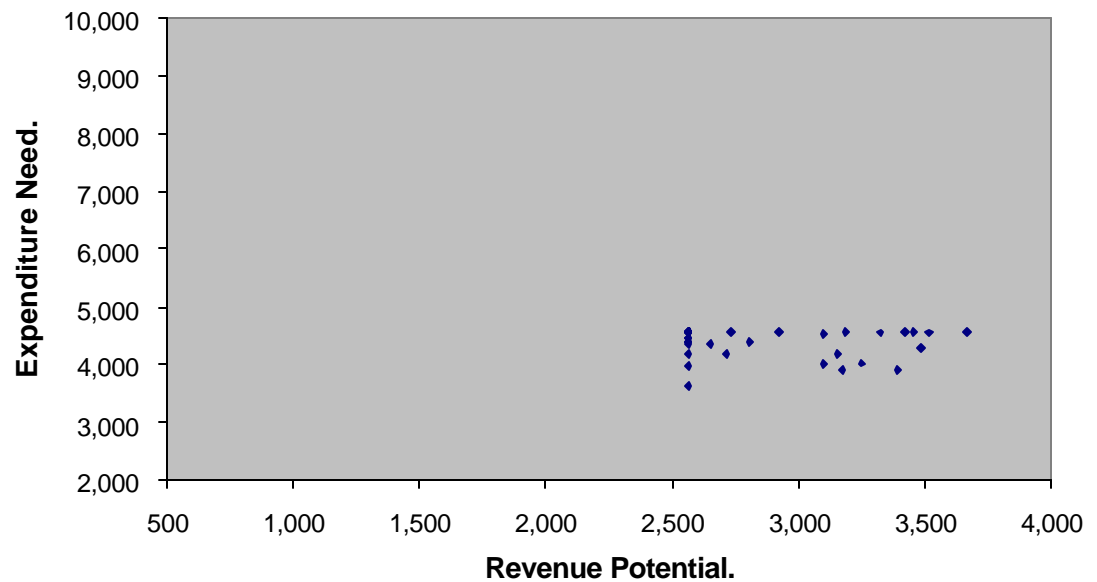
The effectiveness of this equalization scheme in reducing differences in the revenue potential and the expenditure needs of the various local governments was tested. Indeed, the scheme was found to be effective in reducing those differences. An illustration of this fact is shown on the next page.

**Differences in the Degree of Need among Districts
(before equalisation).**



As shown in the figure below, the proposed equalization scheme would indeed reduce the differences in expenditure need as well as revenue potential of the local governments.

Differences in the Need of Districts (after equalisation).



4: Recommendations.

4.1: Recommendations

Equalization grants should have been introduced in the fiscal year 1996/97. Now that the criteria are available equalization grants should be introduced immediately as they are long overdue and significant differences in the fiscal capacities of local governments to finance their expenditure needs exist. The grant can be financed out of the annual growth in the government budget.

The grant should be expended only within the five Priority Programme Areas (PPAs) of government that is Health, Education, District Roads, Water Supply and Sanitation and Agriculture Extension. Local governments should however be free to prioritize expenditure of the grant within the PPAs or any other public services and inform the Local Government Finance Commission accordingly before the release of the grant.

The Commission recommends that the grant should be released on a quarterly basis for it to have a significant impact on the ground. It also recommends that 15% of the total equalization pool be set aside for the equalization of the urban authorities.

There is a need to continuously review the other financing schemes (unconditional and conditional grants) to ensure that they are distributed on a fair and equitable basis in order for the equalization grant to be effective. This is because the equalization grant is a minor grant meant only for “filling in of potholes” of the disadvantaged local governments. It cannot therefore be expected to grow to a size that is comparable to level of resources that are availed to local governments through the conditional and unconditional grant schemes. The Commission will also continue with studies to further refine the formula for the distribution of the equalization grant.

The Commission should monitor and evaluate the functioning of the equalization grant to ensure that it is used to improve on the services where beneficiaries are found to be lagging behind others. In this regard therefore, it is essential that sector ministries speed up the compilation of National Standards of Service Delivery without which the work of monitoring and evaluation will prove to be very difficult.

4.2: Challenges.

It is expected that the development budget will be decentralized in the financial year 1999/2000. The decentralization of the development budget will result in a significant transfer of more financial resources to the local governments. There are concerns however that if the mechanisms put in place for the transfer of these resources do not promote equalization, they may introduce new inequalities among the local governments. There is therefore need to look at the mechanisms for the transfer to ensure that they do not either introduce inequalities thus undoing the impact of the equalization grants or do not duplicate the equalization mechanism already in place.

It has been observed in a number of fora that there are horizontal inequalities existing among local governments. Thus, much as these equalization grants are expected to address the vertical imbalances and to some extent the horizontal imbalances among the recipients, the horizontal imbalances among the lower level local governments (especially sub-counties) remain largely un-addressed. These imbalances therefore need to be addressed.

For the formula to be effective there is need to continuously improve on the quality of data that is used. This should be achieved by:- improving on information flow among the stakeholders especially financial information from the districts to the commission and secondly, conduct more frequent surveys to maintain up-to-date data.

The equalization grant has been calculated on the basis of the potentially collectable revenue and not on actual revenue collected. Given the very low collection rates obtaining currently, local governments should come to terms with improving revenue collection to ensure that local revenues play a more significant role in service provision. Therefore, there should be no room for complacency as regards local revenue collection.

**SUMMARY OF ISSUES RAISED AT THE WORKSHOP ON
INTRODUCTION OF EQUALIZATION GRANT AT HOTEL
AFRICANA ON 10th March, 1999.**

- a) Stakeholders should be given time to study and respond on the concept paper presented by the LGFC on proposed mechanism for distributing the equalization grant.
- b) The workshop recommended that equalization should start immediately.
- c) Equalization should be based on both the expenditure need and the taxbase and should be simplified to enable stakeholders to fully understand the gist of the equalization scheme.
- d) The issue of implementing the grant leaves a lot to be answered. Should it be conditional or unconditional? Should it concentrate on PPAs or more services or even concentrate on particular services, more particularly the revenue generating services?
- e) The workshop recommended that although there is need to equalize, local authorities should strive to enhance their revenue collection efforts.
- f) Services rendered by the urban authorities are unique in nature and need to be analyzed critically when formulating criterion for distributing the grant.
- g) The workshop further observed that due to time constraints debate on the global amount to be set aside for equalization as well as refinement of the criteria should not delay negotiations with the Ministry of Finance for inclusion of the grant in next years budget allocations.

COMMENTS MADE BY PARTICIPANTS ON THE PROPOSED EQUALIZATION SCHEME AT THE ONE-DAY WORKSHOP ON INTRODUCTION OF EQUALISATION GRANT IN UGANDA HELD AT HOTEL AFRICANA ON 10TH MARCH, 1999.

The workshop was called by the Local Government Finance Commission to present and discuss the results and recommendations of a study, which it had undertaken for developing a mechanism for distributing equalization, grant. Mr. Tom Nkayarwa, Director, Local Government Inspectorate on behalf of the Permanent Secretary, Ministry of Local Government, chaired the half-day workshop.

The list of Participants is attached.

1. OPENING REMARKS: Chairman, LGFC

Questions/Requests to the Workshop

The Chairman implored the workshop to:

- reach an understanding, with the guidance of the Ministry of Finance, on how much should be set aside as equalization grant
- deliberate on the form in which the grant is to be applied (i.e. conditional or unconditional?)
- answer the question of the frequency of the grant (lumpsum, quarterly, etc0
- consider the issue of monitoring and accountability
- think of how to handle mid-term requests as is common in emergencies and disasters. He hinted that there could be contingency funds to address such problems
- agree on the number of beneficiaries
- agree on the global amount to be set aside in 1999/2000

He then outlined what would be done with the proposal after the workshop and this consisted of:

- Polishing the recommendations (10th March)
- Presenting the recommendations to the LGFC Commissioners (11th - 12th March 1999)
- Forwarding the recommendations to authorities as required by the constitution
- Awaiting whatever developments are to come

2. REACTIONS

Every participant began by commending the LGFC for coming up with the equalization grant distribution proposal and observed that it was an innovative approach.

2.1 COMMENTS BY ULAA – Secretary General; Mr. Raphael Magyezi

Concern:

He and other members of the local authorities have not had time to read and give considered comments on the report he stressed that it was necessary to involve the Local Governments (LGs) from start to end, this could not be the final step. He therefore requested to be given time so as to allow him present the report to the local authorities task force in financial affairs whom he believed would respond in a week's time.

Initial Reactions

- a) Equalization grant should be started immediately. But LGs be given at least a week to study the concept paper and discuss it within the task force of ULAA before they respond appropriately. The task force of ULAA comprises representatives of Chief Administrative Officers, Chief Finance Officers and the Chairmen, LC 5.
- b) Salient issues that the LGs will be interested in discussing are:-
 - Whether the Grant should be conditional or unconditional.
 - The suitability of the factors used in the proposed formulae. Already it is apparent that:
 - Demographic factors are more prominent in the expenditure need calculations than others like area.
 - Fiscal capacity calculations uses GT only. What is the implication of leaving other taxes out?
 - Expenditure need and tax-base are the only factors used. Aren't there other factors left out?
 - As local authorities they need to know the nature and methodology used to collect the data that is now being used group districts as needy. This will also mean answering the question of the extent of consultation that was made and the level of transparency in the whole system being proposed.
 - Should local governments be equalized on the basis of a particular service that is lagging behind or on an aggregate basis?
 - The impacts of the decentralization of the development budget on the available grant systems.
 - LGs are also interested in examining the amount available for the grant. Is it going to be an annual calculation? What is the reaction of the MFEPD? Is 16b sufficient compared to the recurrent budget of 600 billion in the National budget.

2.2 COMMENTS BY MOFPED: Commissioner for Budget Ms F Kutesa.

Noted that:

- The document is an additional tool that the MFPEP will use for budgeting
- Because of the importance of the proposal, there is need for the MFPEP to conceptualize the paper before giving more considered comments. The ministry would therefore be in position to give its comments later.

Initial Reactions

The Ministry of Finance is faced with a challenge on how to address the issue of equalization grant in the coming 99/2000 budget with lots of unanswered questions.

- Paramount is the question relating to source of funding -- where will the money come from?. 12 b for 27 districts and 2b for urban authorities is not a small sum of money
- How will donor funds be handled?
- How will the equalization grant relate with other grants. It seems equalization grant is similar to the conditional grant.
- Should equalization grant be a topped-up? In which case you ask affected districts to determine an amount over and above what they need? Is it possible for LGs to choose areas to be topped-up?.
- How will the funds be monitored and accounted for.
- If starting this financial year, should conditional grant be maintained as it is now?
- As a suggestion the number of districts should be reduced from 27 and focus on particular services (say health, etc)

2.3 PARLIAMENTARY COMMITTEE ON PUBLIC SERVICE AND LOCAL GOVERNMENT: - Chairperson Hon. Winnie Babihuga.

Initial Reactions

- The fact that 55% of LGs need equalization after only about 1 year in the decentralization process could be implied from the fact that services decentralized did not have matching funding
- In general there is need to :
 - improve local revenues e.g. the administration of the GT should be made more user-friendly
 - level of accountability to be improve
- Are we funding PPAs again? Looking at PPAs only ignores some important overhead costs like staffing and their remuneration. She strongly felt that the center should make this a priority area
- Questions to the analytical staff: Did you account for project distributions (both GOVT and NGOs). As better endowed LGs (with projects) are at an advantage than those not. Definite deficit areas should be identified
- MOLG should pull up in its responsibility for monitoring decentralization. Line ministries are expected to have minimum level of service delivery. The MOLG has a responsibility for coordinating sector policies and this will address some haphazard policies that some ministries have.

2.4 COMMENTS BY ASSOCIATION OF CAO'S: - Treasurer Mr Bisense

Initial Reactions

- The grant should come very fast
- As to the question whether it should be conditional or unconditional: LGs will accommodate transient conditions for such a time that they will still be comfortable being guided.
- The question as to whether the grant should be conditional or not should not arise because the law distinguishes them clearly.
- It is not good to continue emphasizing PPAs because it leaves out most of the infrastructures such as buildings.

2.5 REACTION BY THE UNDER SECRETARY FINANCE AND ADMINISTRATION MOLG/ COMMISSIONER LGFC

- We should not talk of top-up as this will confuse the grant with conditional grant
- Clause 5 of Article 193 of the Constitution requires that LGs indicate how the grant will be distributed. Therefore much of the conditions will come from down.

2.6 REACTION BY A REPRESENTATIVE OF KCC

- The grant should be conditional although conditions could originate from down or above. The conditions we set will help in assessing what has been achieved in reducing “lagging behind”.
- This then emphasizes the need for monitoring. The level of monitoring should depend on the result of economic analysis of the degree of lagging behind
- Expenditure needs and taxbases of urban authorities are different from those of rural LGs. Therefore urban authorities should be treated as special :- on the one hand, expenditure needs should capture the complexity of demand and on the other, the tax base should not emphasize on the GT since the tax is for instance declining in KCC

2.7 REACTION BY MWHC

- Although we need more time to digest and react on the report, the workshop should accept the proposal so that budget negotiation with the MFPED begins.
- Other points he pondered on:
 - **Is the grant recurrent? In his opinion the grant should aim at generating value, say building offices, markets, roads etc.**
 - Is the equalization grant going to be a repetitive amount, say 12b every year? In his opinion it should not be money disbursed every year. The money should target say erecting a building, after that it should not continue flowing.
 - There is need to administer the money from the center as differences exist in the district civil service setup (which affects accountability). It is also apparent that some districts do not have the capacity.
 - The problem of coordination between the line ministries and MOLG is a real one needs to be addressed

2.8 REACTION BY A CONSULTANT ON FEEDER ROADS STRATEGY

- By way of information, he stated that the 1992 Feeder Road Strategy required districts to contribute 50% for feeder road maintenance. But until now the maximum districts have been contributing has been 3%
- Administrative weaknesses in LGs should be recognized
- The formulae used for equalization is good for urban roads where traffic is a major factor damaging roads. In districts it is a question of access, implying that damage on roads is caused by terrain. Therefore for rural roads, consideration of area or road density should be instead taken. Therefore the formulae is good but theoretical.
- The new strategy they are proposing will require LGs to contribute 40% for road maintenance. Therefore if roads mean development, then there is need to review the 3% currently being devoted to roads

2.9 REACTION BY A COMMISSIONER LGFC (BAGUMA)

- Remuneration should be an important factor in equalization.
- Central administration of the fund will call for additional expenditure, therefore we should be aware of this
- There is need to consider equalizing infrastructure

2.10 REACTION BY A COMMISSIONER LGFC (JOEL KAFUKO)

- The question of accountability should not be a major factor for penalizing LGs because it is not true that as you go down you get less qualified persons
- The grant should address the issue of property valuation in urban authorities so as to enable them to collect more property tax..

3.0 WAY FORWARD (Chairman LGFC)

- Time is a big constraint therefore the global amount to be put aside should not be subjected to further debate
- Discussion with stakeholders will continue for refining the mechanism of allocating the grant
- There is still room for improvement

Caution by the Chairman LGFC

Equalization grant is a minor grant compared to other grants. It is meant for filling up potholes. Therefore effort for improvement should equally be put in the other grants.

General Agreement

~~✍~~ Negotiations with MFPED to secure the money in the budget was endorsed to proceed.

~~✍~~ Comments from stakeholders to continue flowing-in to the commission.