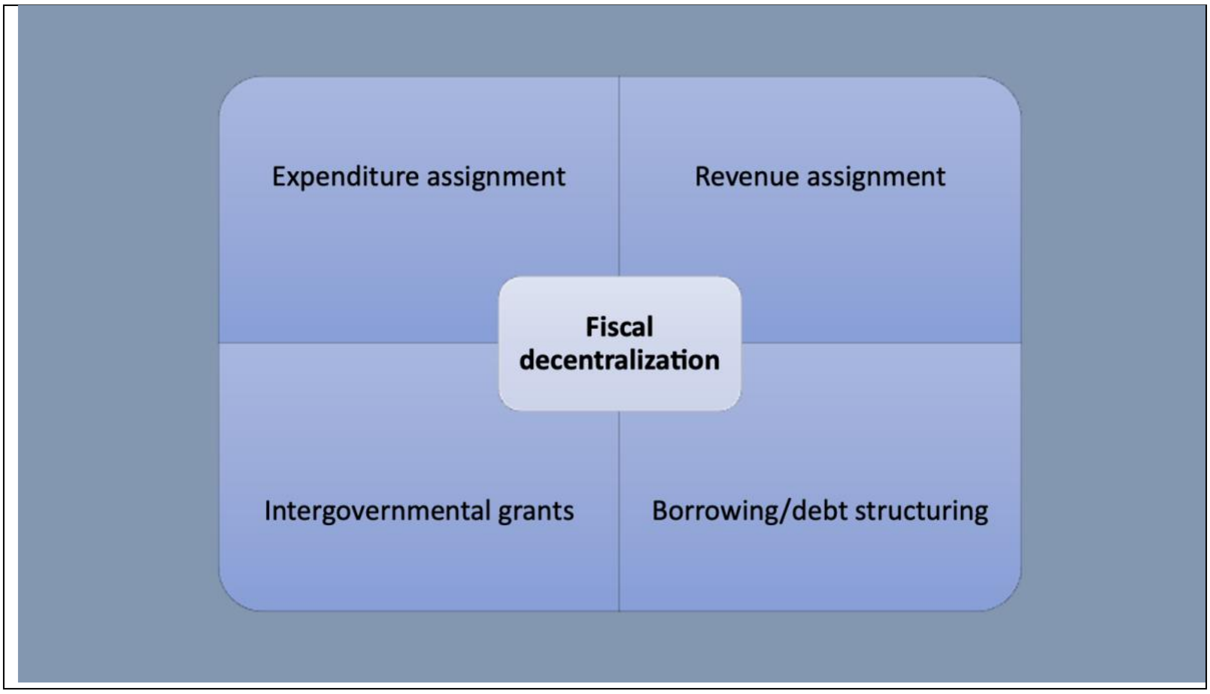
Intergovernmental fiscal transfers

1. Introduction

This brief provides an overview of intergovernmental fiscal transfers, a system by which national/central/federal governments transfer revenue to subnational and local governments. The transfers not only complement revenues raised locally but can be effective in driving national, regional and global aspirations at the local level. Thus, the realisation of the UN's Agenda 2030 and the AU's Agenda 2063 will to a certain extent be shaped by resources made available to local governments through intergovernmental transfers and grants. The brief covers the major aspects of intergovernmental transfers and grants with bias towards the African region.

2. Four pillars of fiscal decentralization

The diagram below depicts the four pillars of fiscal decentralisation. Once expenditure and revenue assignment has been determined and debt structure settled, it becomes crucial to determine the form and structure of intergovernmental grants to complement revenue raised locally. The design of these pillars should be informed by relevant principles. However, it must be grounded in the local context. Balancing these four pillars of fiscal decentralisation is often difficult to realise and requires regular review and adjustment.



3. Why are intergovernmental transfers necessary?

Intergovernmental transfers are necessary to address **fiscal imbalances** that exist between different levels of government. There are two main types of imbalances:

- **Vertical imbalance:** This occurs when a local government's responsibilities and expenditures are greater than the revenue it can generate on its own.
- **Horizontal imbalance:** This refers to the unequal capacity among different local governments to mobilize revenue and fund their responsibilities and operations. Some may have a strong economic base, while others lack the resources to finance essential public services for their communities.

4. Objectives of intergovernmental transfers

Intergovernmental grants serve several key purposes such as:

- Address fiscal imbalances by providing local governments with additional resources they need.
- Promote national objectives at the local level, such as implementing specific development and social projects and programmes.
- Respond to emergencies and other unexpected challenges.
- Incentivize good performance by rewarding local governments that performs well against a set criteria.

5. Types of intergovernmental grants

Generally, there are two main types of grants, each with its own characteristics and implications for local governance:

5.1. Unconditional Grants

These grants provide local governments with the discretion to spend the funds as they see fit on recurrent and capital expenditure. Because the grants do not come with conditions, they enhance local budgetary autonomy.

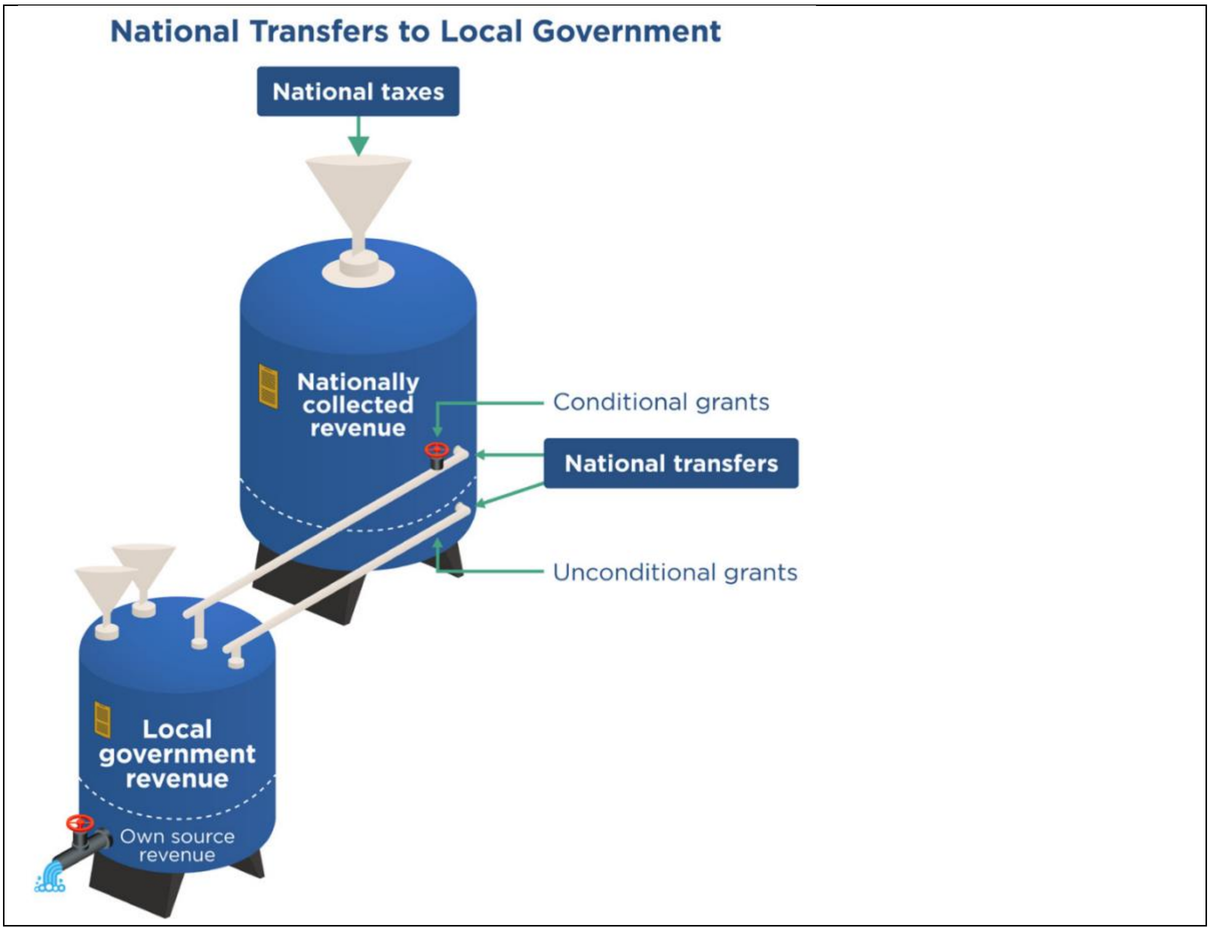
- **Benefit:** They give local governments the flexibility to address their most pressing local needs.
- **Downside:** A potential risk is that they may lead to poor financial behavior, such as wasteful spending, or could discourage local governments from making an effort to mobilize their own revenues.

5.2. Conditional Grants

Conditional grants come with specific requirements for how the money must be spent, which are determined by the national government.

- **Benefit:** They ensure that funds are used for their intended purpose, often a national priority.
- **Downside:** They can constrain the autonomy of local governments and often come with strict reporting requirements. Additionally and the African context, local governments sometimes

fail to spend conditional grants due to a lack of capacity or because the funds are dispersed too late in the fiscal year.

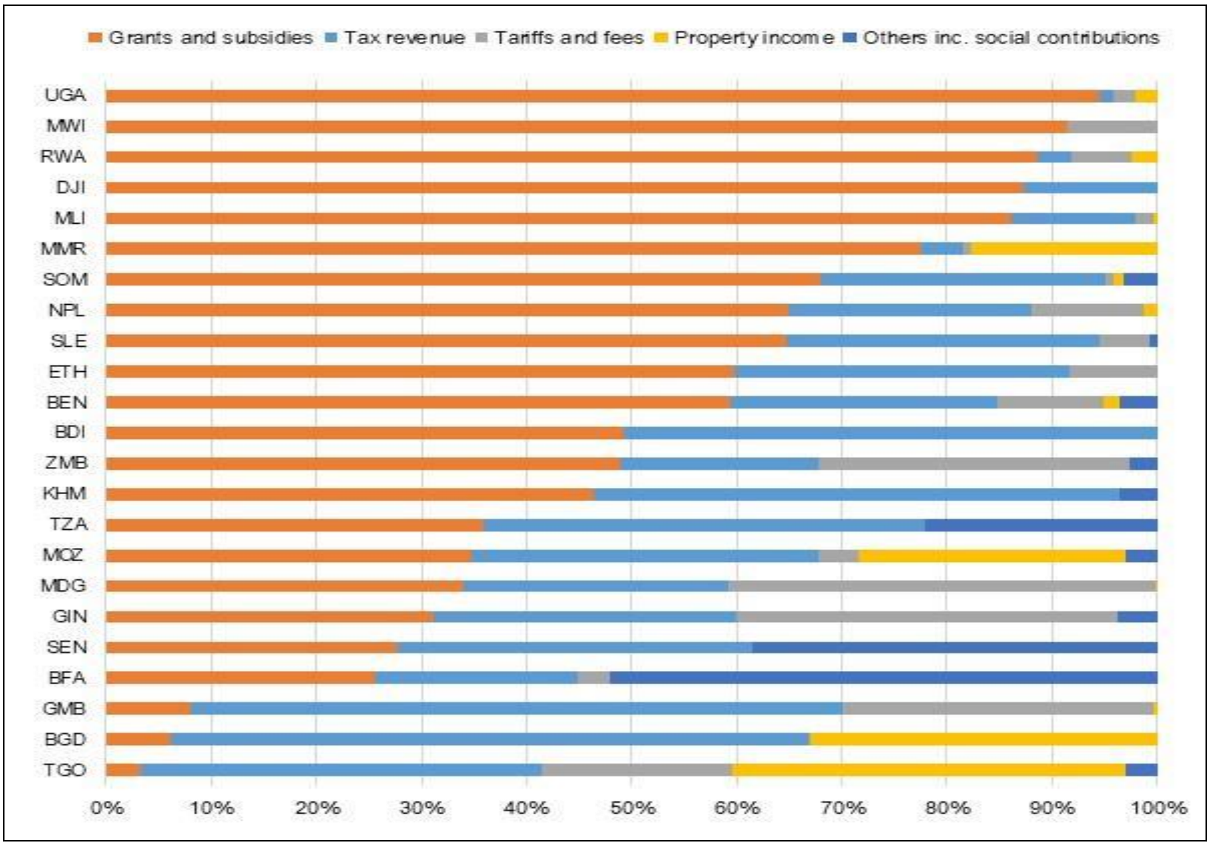


Source: De Visser, Steytler and Chigwata (2021)

6. The significance of intergovernmental transfers as a revenue source

The World Observatory on Subnational Government Finance and Investment (WOFI) Report published in 2022 established that intergovernmental transfers are a major source of revenue in least developing countries, including African countries. In Uganda and Malawi, for instance, grants and subsidies account for more than 90 percent of local government revenue. This means that transfers and grants are the main vehicle for delivering services and the realisation of regional and global aspirations – Agenda 2063 and SDGs. The design of grants and transfers is therefore significant for local autonomy, local accountability and realisation of national agendas, among other objectives.

Subnational government (SNG) revenue in LDCs by category as a % of total SNG revenue



Source: OECD & UCLG, WOFI, (2022)

7. Designing a progressive intergovernmental fiscal system

A well-designed intergovernmental fiscal system is crucial to address both national and local objectives. Relevant literature and international best practices suggest that a progressive intergovernmental fiscal system should incorporate several key design principles:

7.1. An objective process

The intergovernmental fiscal system should rely on credible data and use a clear criteria and formulas to determine allocations. Independent financial commissions, which advise the government on intergovernmental fiscal relations matters, are another mechanism of enhancing the objectiveness of grant design and transfers. For instance, Kenya has the Commission for Revenue Allocation.

7.2. **Predictable transfers**

Local governments need to be able to plan and budget for the future. It is therefore important that the intergovernmental fiscal transfers are designed in way which gives local government a sense of predictability of funds they will receive. One of the key features of South Africa's intergovernmental fiscal systems is the allocation of what each sphere of government and each government within a sphere will receive in the current financial year as well as projections for the subsequent two financial years. Such multiyear projections places local governments in an informed position to plan and budget accordingly.

South Africa: Allocations and predictions for each municipality

			National Financial Year		
			Column A	Column B	
	Number	Municipality	2025/26	Forward Estimates	
				2026/27	2027/28
			R'000	R'000	R'000
EASTERN CAPE					
A	BUF	Buffalo City	1 296 018	1 365 808	1 427 605
A	NMA	Nelson Mandela Bay	1 637 749	1 739 300	1 817 952
B	EC101	Dr Beyers Naude	126 546	131 231	137 143
B	EC102	Blue Crane Route	73 464	75 684	79 097
B	EC104	Makana	135 052	140 120	146 429
B	EC105	Ndlambe	142 119	147 290	153 935
B	EC106	Sundays River Valley	122 783	127 670	133 431
B	EC108	Kouga	203 533	213 418	223 037
B	EC109	Kou-Kamma	72 001	74 812	78 184
C	DC10	Sarah Baartman District Municipality	113 301	116 246	121 511

Source: Extract from South Africa's Division of Revenue Act, 2025

7.3. **A transparent process**

Intergovernmental grants should be determined in a transparent process. This is important to enhance trust in the process. Transparency can be achieved through formula-driven allocations, public access to formulas, and timeous publication of the final allocations for each level of government and each government in a level.

7.4. **A fair process**

Resources should be shared or distributed fairly. However, fairness does not necessarily mean equality. In Africa and due to skewed development and disparities, fairness is also about equitability. This means that the intergovernmental fiscal system should account for the varying needs and capacities of different local governments rather than treating them all the same.

7.5. **A participatory process**

Local governments should have a voice in the process of designing and implementing the intergovernmental fiscal system.

7.6. **A stability and flexible system**

Lastly, the intergovernmental fiscal system should be stable enough to provide certainty but also flexible enough to adapt to changing economic and political conditions.

8. Beyond the design of the intergovernmental fiscal system: success factors and broader variables

The success of any intergovernmental fiscal system depends on more than just its design. Political and economic variables also play a significant role. Some of the key considerations include:

- Do national authorities adhere to the established "rules of the game"?
- How much are political considerations prioritized in the decision-making process?
- Are grants and transfers distributed to local government timeously?
- Is there a sufficient amount of resources available for sharing and redistribution, which is influenced by a country's overall economic performance?

9. Key take aways

- The localization of Sustainable Development Goals (SDGs) is dependent on local governments having adequate resources.
- Intergovernmental grants are a necessary complement to local revenue to achieve development and effective delivery of public services at a local level.
- The design of intergovernmental grants and transfers is, therefore, significant
- A progressive intergovernmental fiscal system must balance promoting national objectives with preserving local autonomy, responsiveness, and accountability.

10. Resources and materials

- Paul Smoke. CEPA strategy guidance note on fiscal federalism and decentralization
- De Visser J, Steytler N and Chigwata T. 2021. Fact sheets on Decentralisation in Africa: A short guide
- OECD. 2019. Making Decentralisation Work: A Handbook for Policy-Makers. OECD Multi-level Governance Studies.
- Boex J, Williamson T and Yilmaz S. 2024. Fiscal Decentralization, Local Public Sector Finance, and Intergovernmental Fiscal Relations: A Primer on Multilevel Government Finance. Washington, DC: Local Public Sector Alliance / World Bank