POLICY NOTE 8

Intergovernmental relations and fiscal decentralization

Egypt Public Expenditure Review

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About this Policy Note

This report on intergovernmental relations and fiscal decentralization is one of 10 Policy Notes that constitute the *Egypt Public Expenditure Review* (PER), being prepared by the World Bank in collaboration with the government of Egypt. This Note draws on wealth of information that was pulled together by the World Bank in collaboration with Executive Ministries, the staff of the People's Assembly, and governorate officials and their staffs (notably Alexandra, Cairo, and Qina).

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Abbreviations and acronyms

EPC	Elected People's Council (directly elected every four years)
GDP	gross domestic product
IMF	International Monetary Fund
LE	Egyptian pound
LSDA	Local Services and Development Account
MoF	Ministry of Finance
NDP	National Development Party
OECD	Organisation for Economic Co-operation and Development

Summary

The purpose of this Policy Note is to support the dialogue on how fiscal decentralization —the sorting out of roles and responsibilities among types of governments—not only works but also fits into the broader public sector reform framework of the Arab Republic of Egypt.

A reform era?

Hegemony of the state

Geographical, cultural, and political factors have converged to make Egypt one of the world's most centralized systems of government —what the 2004 *United Nations Development Report* calls a hegemony of the state. Although there is an administrative division of responsibilities between central line ministries and levels of local administration, the key features of a fiscally decentralized system are missing: citizen participation in local governmental decisions; authority of local administrations to set spending priorities, manage their budgets, and generate revenues; and the power to hire, promote, and fire civil servants engaged in local service delivery.

Decentralization without authority

Patterns of intergovernmental affairs management range widely. One is simple administrative deconcentration of line ministries that largely supplant local decisionmaking on the budget. In the conceptually most complete form of devolution, significant tax and spending powers are assigned to local administrations that are then free to make decisions independently of the center. Egypt is at the centralization extreme of this continuum with a system that can be characterized as having administrative deconcentration without authority.

Two council system

The political nature of deconcentration without authority is illustrated by the two-council system. Each local governmental unit operates with two councils: the constitutionally established Elected People's Council (EPC) and a centrally appointed local Executive Council. The power lies almost entirely with the appointed council, which is composed of government administrators from the line (central) ministries or the ministry directorates. Although the EPCs have legally assigned functions, they have very limited power, which does not include having a meaningful role in the preparation of the budgets for the jurisdictions they represent. Not only are EPC members prohibited from interrogating members of the local Executive Council, but also the language of Law 43 sends a clear message of the EPCs' fiscal policy powerlessness by using words in reference to the EPCs such as "supervise" and "follow up" rather than "provide" or "produce." An exception is a provision for a Local Services and Development Account (LSDA) that gives the EPCs and the governor the right to establish certain nontax revenue accounts for activities such as housing provision, land reclamation, and industrial support.

An emerging decentralization dialogue

Now, however, decentralization is on the public sector agenda. It is rare to find a presidential address on the economy of the past two years without a reference to decentralization as a component of public sector reform. In September 2005 Prime Minister Ahmad Nazief announced that, starting with the coming fiscal year (2006–07), not only would governors play a direct role in preparing governorate budgets but also the central government would entertain the possibility of giving governorates expanded authority to impose user charges for services.

Indeed, some change is already under way. The Ministry of Planning is taking two steps: devolving some school building and renovation expenditures to the governorates and assigning 16.7 percent of public investment to governorates to allocate based on their priorities. In addition, some governorates (Alexandria and Qina, for example) have been granted waivers to experiment with mobilizing user-charge resources, to pursue their own agenda for development.

Structure and size of local administration

Legal framework

The system of local administration rests on two legal foundations: the Constitution and Law 43 (1979), as amended. The Constitution refers to local administration as the third branch of the executive authority of the government, after the president of the state and the government. It includes one broadly written article (Article 27) and specific constitutional provisions (Articles 161–163) that many argue provide the type of permissive constitutional language that already gives Egypt the legal room to transform local "administrations" into local "authorities" (governments).

Levels of local administration

Law 43 (1979) and its executive regulations and amendments establish five types of local administrations: governorate, markaz, city, district, and village. The governorate is the main service delivery unit of subcentral Egypt; it may be simple and completely urban (Alexandria, Cairo, Suez, and Port Saïd) or complex, consisting of one or more urban and rural communities. The markaz is the unit below the governorate in the hierarchy; it includes a capital city of the markaz and other cities, if they exist, as well as villages. Cities exist in all governorates, as a one-city governorate, the capital of a governorate, a capital of a markaz, or as a constituent city in a markaz. Cities may be divided into districts. The village is the smallest local unit in rural communities.

Size of local administration

During the 1990s the quantitative importance of local administration declined from 21.5 percent to 15.6 percent of total national expenditures. This gives Egypt a ratio of local administration expenditure to total government expenditure slightly above that of developing countries (14 percent), below that of many postsocialist transition countries (26.0 percent), and well below the developed country average (32 percent).

The normative/analytical framework

Five framing policy questions

Five questions frame the Egyptian decentralization dialogue: Which level of local administration should spend on what (expenditure assignment)? Which level should levy which source of revenues (revenue assignment and mobilization)? How might fiscal imbalances be resolved when the case for decentralizing spending is almost always better than that for decentralizing revenues (intergovernmental transfers)? How is the timing of revenues to be managed and monitored (borrowing and debt)? And, while the first four questions are addressed, what capacity building arrangements are required to make it all work?

The Egypt variant

Reflecting its system of deconcentration without authority—whereby government is carried out through decisions of line ministries and their directorates and for which any deviation from centrally prescribed practice must be approved by the center—***there is now no truly intergovernmental system operating in Egypt.***

Egyptian fiscal performance

Expenditures

Lack of decentralized expenditure assignment. With respect to international practice in decentralized countries, typical functions (or, what some countries label as "competencies") that are assigned to subcentral governments include those with local service benefit flow: for example, kindergarten, primary, and secondary education; community development, zoning, and land use planning; water distribution, sewerage, rainwater drainage; local streets and roads, recreational areas, public transport, sidewalks, street lighting; community fire and policing; sanitation and health; libraries, cultural centers, and public meeting facilities. However, one cannot track how Egypt compares with other countries because all spending is carried out by central entities; thus expenditure flow data gets reported by ministry sector rather than by function. This is more than a data problem; it is also a problem of a lack of transparency in the "who does what" question that undermines the ability to get a perspective on the efficiency of, and accountability for, the delivery of local public goods.

The wage bill dominates current expenditures. Local administration current expenditures—the sum of wages plus operating costs—have averaged 84 percent of total local administration spending, with the wage bill taking the largest share (an average of 65.2 percent). Between FY 1994/95 and FY 2003/04 wages as a percentage of local administration current expenditures increased by 9 percent, so that wages now account for LE 9 of every LE 10 of current expenditures. This is well above the typical norm of 60–70 percent. A second indicator of the wage bite: there is one local administration employee for every 21 citizens, whereas for decentralized Western Europe the ratio is about one for every 70 citizens.

Investment and capital expenditure. A similar story of ambiguity in the function of local administration unfolds with respect to capital expenditures. Because the accounting convention is to classify investment spending by ministry sectors, there is no clear picture of the scope of local investment projects. For example, the Five-Year (2002/03–2006/07) National Investment plan of LE 445,000 billion allocates LE 32,200 billion to education, and LE 17,400 billion to health. Yet the data show that the amount of investment allocated to local administration for each of these sectors is zero. This problem of tucking away investment of a local nature in central line ministry operations pervades the national plan: the Ministry of Planning data show just 1.7 percent of the LE 445,000 billion allocated to local administration—again, a policy as well as a data problem.

Financing local administration

Sources of local administration receipts. Egypt's local administrations have two sources of receipts: centrally shared revenues and "current transfers." There are two classes of shared revenues: sovereign taxes and nontax "current revenues." The sovereign taxes include centrally levied taxes on agricultural land, buildings, entertainment and amusement, and motor vehicles and motor vehicle operators, plus a series of surtaxes on other centrally collected taxes (profits, customs, security holding, tobacco, and profit taxes on commercial and industrial profits). Nontax "current revenues" consist of a series of user charges and fees and licenses. Together, the sovereign taxes and nontax revenues account for 17.5 percent of total local administration receipts. The other 82.5 percent comes from budget line items of the current transfers.

Little revenue autonomy. For the most part, all three of these local administration receipts are grants—not local own source revenues. To qualify as local or subcentral revenue a local government must have, at the very least, the authority to set the tax rate or the amount of the user charge or fee. This requirement is satisfied for only about 6.4 percent of the total receipts. This 6.4 percent comes in the form of a series of EPC-approved levies that are included in an LSDA. An LSDA may include special funds derived from levies related to activities such as cleaning, health services, local roads, land reclamation, housing, and industrial services.

Two financing issues. The structure of local administration receipts and the low degree of revenue autonomy raises two issues. The first is whether (and, if so, how) to mobilize additional own source revenues. The second is the distribution of local administration receipts with respect to rich and poor places.

Revenue mobilization. There are two good reasons for Egypt to embark on a policy of local revenue mobilization. One is to enhance the overall efficiency of the Egyptian fiscal system. The second is to give the central government added fiscal space.

- *Efficiency.* A fundamental requirement for fiscal efficiency is that, to the extent possible, the benefits of a flow of services should be matched with the requirement to pay (this is the "matching" or "benefits" principle of public finance). Because there are local variations in preferences for the mix of public sector services as well as differing costs for supplying those services, there is an efficiency gain in going to a decentralized system. It follows that for local service provision, subcentral units must be given the authority to tax and must be in a financial position to do so. By becoming accountable to the citizens for the taxes they raise, local officials have the incentive not only for improving service delivery but also, as the empirical evidence suggests, reducing public sector size.
- *Fiscal space.* Assigning taxes to subcentral governments has a further payoff: Because of their superior knowledge of citizen preferences and willingness to pay for such services, local officials can mobilize benefits-based revenues much more effectively than a central authority. This gives the center the added flexibility and fiscal space to focus on improving the operations of the newly centrally assigned tax system. The governorate of Alexandria is currently undertaking just such a local willingness-to-pay approach with respect to decisions about specific user charge financing. A more ambitious (and wholly practical) medium-term opportunity is to seize on the recognized need to modernize the more than a century-old urban property tax structure and, as part of the modernization, change it from a central-only levy to a concurrent central and subcentral tax. Indeed, failure to grant some local control over the property tax will undermine the achievement of the broader revenue mobilization objective.

Rich and poor places. Both the shared sovereign tax and the current nontax revenues are allocated on the basis of derivation (taxes are retained by the jurisdiction in which they are collected). It follows that differences in regional and industrial structure exacerbate disparities in access to public resources in favor of places with a rich tax base. This distribution mimics what one would expect from a devolved or "own" system of revenue mobilization (with the important exception that the decision to tax is local). Though such derivation sharing is not ideal practice, it can be maintained if compensated for by a transfer system that equalizes the place disparities. The challenge is to design a transfer formula that offsets the pro-rich distribution by targeting the transfer flow on the basis of some measure of local government capacity to raise revenues or some measure of fiscal needs (or both). Such equalizing formulas, common in most federal countries, are often structured so that jurisdictions with a relatively poor revenue base will have resources adequate to fund some agreed-upon minimum standard of services.

Egypt equalization. The empirical evidence is that the transfer share of local administration resources is not only not equalizing but, indeed, adds to the fiscal disparity between rich and poor places by distributing funds on the basis of population rather than some measure of poverty. Indeed, the data show that the higher the human development status of a governorate, the higher the amount of transfers it obtains from the central government.

Policy options and recommendations

The decision to decentralize is political. But once that decision is made, the fiscal design and sequence of the reform process matter. Recognizing that one does not start from a blank slate and that Egypt is now examining a range of public sector reform options, this summary identifies five pillars for a decentralization strategy:

- *Political decentralization.* The payoff of political decentralization (that is, local selection of local representatives) is that it provides the institutional accountability conduit for achieving the fiscal and economic efficiency promised by a well designed fiscally decentralized system. For Egypt, it is not a great leap to devolve fiscal decisionmaking about local public goods to the now centrally appointed local chief executives and the elected people's councils.
- *Deconcentration with authority.* It s also a relatively easy technical matter for Egypt to move from its present system of deconcentration without authority to one of deconcentration with subcentral government authority to participate in budget preparation by setting local spending priorities and making revenue-generating decisions. The governor and the governorate EPC provide good entry points. At the initial stages, this may be an asymmetric process. For example, urban governorates such as Alexandria, Cairo, and Qina are ready to take on expenditure authority for both operating and capital spending decisions on local public goods. One immediate option is to activate and accelerate the initiative taken by the Ministry of Planning regarding the expenditure of local development investment.
- *Expenditure and revenue assignment.* There are guidelines for sorting out responsibilities between the center and local administrations (which with devolution, become governments, not administrations). This is not a zero-sum game whereby the center loses (although some bureaucracies do).
- *Revenue autonomy.* Egypt has a list ready to go to initiate the decentralization dialogue on increasing revenue autonomy—the list of shared sovereign tax and current nontax revenues. Moreover, revenue devolution need not be limited to the governorate. Lower-level jurisdictions (such as city EPCs) can also be in a position to judge the merits of imposing taxes and charges for clearly local services.
- *Intergovernmental transfers.* Transfers between the central and subcentral governments (grants) will remain a key part of Egypt's system of decentralization. That system will, and should, incorporate elements of conditionality and unconditionality. A first step is to develop a transfer

formula that provides an agreed-upon degree of equalization for poor places. A more ambitious commitment to a full study of the options for an intergovernmental transfer system of conditional and unconditional grants is also merited.

Further detail is provided in the matrix of policy options and recommendations (table 1).

Table **1** **Egyptian decentralization policy options**

Topic	Characterization of key findings	Specific policy actions/options
Political decentralization	Political decentralization is a prerequisite to effective fiscal decentralization because it provides the mechanism for accountability between citizens and government. In Egypt decentralizing will turn local administrations into local authorities.	1. Be opportunistic: initially focus on the governorate as the principal service delivery and tax unit.
Two-council system	Each governmental unit operates with two councils: the constitutionally established EPC and a centrally appointed local Executive Council. Power lies almost entirely with the appointed council, which is composed of government administrators from either the line (central) ministries or the ministry directorates.	2. Repeal the prohibition on the ability of the EPCs to interrogate central budget officials.
Structure of governance	If Egypt decides to decentralize, the question of capacity to govern will arise. There are three important aspects to building this capacity: organizational, institutional, and human.	3. After the assignment of expenditure functions and revenue authorities are determined (see below), empower the EPCs to make those decisions in cooperation with the local executive. Devise appropriate rules about the power relationship between the two councils. If the EPCs are given a meaningful role (for example, to advise and approve) in the budget process, the governor could remain an appointed position, at least in the medium term.
	Building capacity for an intergovernmental society requires changes in how the central government and subcentral units operate with respect to government-to-government relationships (organizational change), incentives (institutional change), and the quality of the political leadership and the civil service (human change).	4. Transform the Executive Council into a coordinating body for centrally assigned functions only. Establish a reporting hierarchy.
		5. Carry out a thorough review of the appropriate hierarchy for the governorate, markaz, city, and village.
		6. Establish a permanent Intergovernmental Advisory Commission of representatives of key fiscal ministries, local officials (executive and legislative), and private citizens whose task is to study and monitor issues that emerge in the decentralization dialogue. The Commission should be supported with technical staff.
Expenditure and revenue management: The governorate	1. Although the governor is assigned financial and administrative authority over the directorates, with decentralized budgets and functions, this authority does not allow for gubernatorial changes in general policy, which is set by the line ministry.	Set a goal to make the transition from a system of deconcentration without authority to one of deconcentration with authority. For example, make part of the current transfer unconditional as to its use (but maintain a capacity to monitor); enlarge the role of the governor and governorate EPC in formulating the budget; and systematically expand the governor's role in executing the budget.
	2. How authority for local administration expenditures is managed is important, partly because Executive Council members report to different central authorities.	

Table 1	Egyptian decentralization policy options (continued)	
Topic	**Characterization of key findings**	**Specific policy actions/options**
Expenditure assignment	Although current law formally assigns various competencies (functions) to the EPC, in practice the power to exercise those functions is not used.	Establish a process for assigning expenditures. Egypt has two starting points: functions now legally assigned to (but rarely exercised by) the EPC and functions of the EC. The resulting revision to the law can provide for local autonomy while maintaining the primacy of the central authority.
Revenue assignment	A significant degree of local taxing authority is a necessary component of fiscal decentralization; however, other than the LDSA, there is no revenue autonomy.	As with expenditures, Egypt has a starting point: the list of shared tax and nontax revenues. Revenue devolution need not be limited to the governorate level.
Transfers, autonomy, and equalization	Current transfers account for more than four-fifths of local administration receipts. However, as currently designed, the system not only reinforces central control over many local spending decisions but does so in a manner that exacerbates fiscal disparities between rich and poor places.	Data are available to simulate options for the overall design of a transparent intergovernmental grant system that incorporates some degree of fiscal equalization among rich and poor governorates.
Debt and borrowing	As decentralization proceeds, efficiency and equity argue for giving some degree of borrowing authority to subcentral (say, governorate) local units.	Several rules-based approaches can be used so that the central authority can monitor subnational borrowing and enforce the "hard budget constraint," whereby a subcentral government faces consequences if it spends more than it can afford.
Performance monitoring	Reflecting Egypt's high degree of fiscal centralization, data on local administration do not allow for effective monitoring of a system that is fiscally decentralized. This is particularly true for expenditure flows (organized by ministry sector rather than potentially decentralized function) and transfers (made through a nontransparent formula designed for filling gaps, to balance spending on behalf of local administrations and shared tax and nontax revenue collections).	Analyze how to transform the data reporting system from one organized by activities of ministries and their service directorates to one organized by function. One option is to select two or three governorates to pilot the design of a system of municipal accounts and financial statements (operating and capital budgets, annual financial reports, balance sheets). In addition, take steps to establish a consolidated financial account reporting system.
Benchmarking	Although a decentralization strategy need not be comprehensive, neither should it be ad hoc.	Set up benchmarks for measuring the process and progress of fiscal decentralization (for example, development of a transparent transfer formula, a governorate prepares its budget).

Final comments

Process

The sequence to decentralization reform ideally begins with the development of a research and knowledge base that then leads to a national decentralization. It is a process that Egypt has already launched with its recent tariff reforms and the study of its income, sales, and property taxes.

Pace

Careful consideration should be given to the pace of decentralization. An initial rush to devolve fiscal powers is probably not wise. Well designed decentralization requires conducting a series of studies then writing an omnibus law. It also requires a systematic approach to building capacity for central and subcentral authorities alike as well as the development of a database and set of financial reports that allow the performance of the new intergovernmental system to be monitored.

Asymmetry

One option, common worldwide, is to decentralize asymmetrically—that is, to recognize that places and sectors can be treated differently. Thus, some governorates or other subcentral governments may have more capacity than others to carry out the responsibilities of decentralized governance. Similarly, some functions (such as primary education and health) might be better entry points than others (large infrastructure projects). Such an asymmetric structure should be formalized in a manner that makes transparent both the criteria for differential treatment and the process for systematically bringing the initially unqualified places and sectors into the fiscal decentralization scheme.

Performance

A well designed decentralization strategy can be a key to accomplishing Egypt's broader public sector reform goals. But decentralization is also a component of that broader strategy. Thus, however decentralization proceeds, it must be coordinated with other reform areas, particularly the reform of central government tax policy, the civil service, and budget construction.

1 Introduction

As a result of its population and economic activity being concentrated along the Nile River and its political history of dynasties, centralizing foreign occupation, colonialism, and postwar socialism, Egypt has one of the most centralized public sector systems in the world. The 2004 *United Nations Human Development Report* characterizes the system of governance as "hegemony of the state" (UNDP/INP 2004, 38–39). Although there is an administrative division of responsibilities between central line ministries and levels of local administration, the key decision-making features of political and fiscal decentralization are missing: that is, citizen participation in local governmental decisions, the authority of local administrations to set spending priorities and manage their budgets, the local power to hire, promote, and fire local civil servants, and significant local government taxing and borrowing powers.

Egyptian centralization also reflects a view that dominated development thinking over the past half century—that if a country could come up with a national plan for generating and investing a sufficient amount of money in a manner consistent with macro-stability, then that country would have met the preconditions for a centrally led development strategy whereby the "flexibility to implement polices devised by technocrats was accorded a pride of place, and accountability through checks and balances was regarded as an encumbrance" (World Bank 1997, 1). And it was not an unreasonable strategy for a world emerging from the ravages of World War II, when much of the developing world was gaining its political independence and the Cold War was at its peak. Then development seemed a surmountable and largely technical challenge: good advisers would devise good policies, and technically assisted and institutionally capable governments would implement those policies. There was some progress, especially in infant mortality rates, life expectancy, and adult literacy. But there were also many failures. The failures were not just about an inability to demonstrate sustained growth rates. They were also about environmental deterioration, loss of civil liberties, corruption, and a poor record of delivering local public services such as clean water, sanitation, education, health, and poverty alleviation. These are the legacies of an era when the scope of central government expanded enormously.

Views about what is important to achieve development objectives are changing. Governments have been sorting out power issues in "inherently centralized" countries such as the kingdoms of Jordan and Morocco, postsocialist states emerging from nearly a half century of political and fiscal dominance by the former Soviet Union, military regimes looking to defuse political opposition (Pakistan), countries that view decentralization as a strategy for improving local service delivery in reaction to financial crises (Thailand), nation-states trying to avoid the centrifugal forces of separatism (Bosnia and Herzegovina, South Africa, Sudan, and many others), and much of an entire region (Latin America) where in response to a political demand for pluralism, democracy and participatory budgeting are taking hold.

The World Bank is explicit about the importance of these changes. The World Development Report 1999/2000: *Entering the 21st Century* (1999) concludes that two forces shape the world in which development is defined and implemented: globalization (the continuing integration of countries worldwide) and localization (the desire for self-determination and the devolution of power). The report further argues that these defining forces often stem from the same factors and support one another. The theme that emerges is that good governance matters, where governance is about how people determine collectively which governments should deliver services and levy taxes and how they should do so by establishing a set of transparent and competent public institutions that citizens can understand and control.

An emerging Egyptian decentralization dialogue

This rethinking of what works for development and improved service delivery is becoming evident in Egypt.[1] It is rare to find a presidential address on the economy in the past two years that did not refer to decentralization as a component of public sector reform. At its 2004 Annual Conference the dominant and ruling National Democratic Party (NDP) formally supported decentralization, including mobilizing sufficient resources to finance projects initiated and designed by the governorates.[2] Moreover, change is already under way. The Ministry of Planning has taken two steps: devolving some school building and renovation expenditures (LE 625 million) to the governorates, and, starting with FY 2005–06, assigning 16.7 percent of public investment (LE 2.88 billion)[3] to governorates to allocate based on their preferences and priorities. At the ministerial meeting following the September 2005 presidential elections, Prime Minister Ahmad Nazief announced that that starting in FY 2006–07 not only would governors play a direct role in preparing governorate budgets, but also the that the central government would entertain the possibility of giving authority to the governorates to impose user charges and have power in deciding their annual budgets. In addition, four major pieces of policy modernization and development legislation are under study: laws on local administration, civil service, consumption (sales) taxation, and property taxation (plus a companion law on property tax transfer and registration fees).

Another important indicator of an emerging Egyptian decentralization dialogue comes from outside Cairo (box 1). Egypt has at least two governorate stories, Alexandria and Qina. Alexandria is experimenting with mobilizing resources from untraditional or untapped sources to pursue the governorate's agenda of development projects. One strategy has been to expand the resources of a locally controlled LSDA with the proceeds from beach and parking area fees and additional fees on mines and quarries. This is coupled with other governorate-led actions that generate funding for development, such as seeking foreign grants and soliciting contributions

Box 1 Terminology

For convenience of terminology, the Cairo "headquarters" of the government of Egypt is referred to as the central government and the subcentral local administrations may be referred to as subcentral governments or as local government units. This allows one to refer to the relationship between the two as intergovernmental. In using terms such as subcentral government and intergovernmental it is understood that under current arrangements these subcentral units are branches or administrative divisions (local administrations) of the central government.

from businesses, nongovernmental organizations, and individuals. In Qina the governorate turned to a user charge strategy, by securing permission from the council of ministers and from line ministries to collect additional and new fees and impose fines on selected local administration services and public utilities.[4]

Purpose and scope

The purpose of this Policy Note is to support the dialogue on how fiscal decentralization—the sorting out of roles and responsibilities among types of governments—not only works but also fits into the broader framework of Egypt's public sector reform.[5] The next section provides a review of the variants of decentralization (options for Egypt), complemented by a review of lessons learned from decentralized fiscal regimes. The third section summarizes the central and subcentral (local) political and institutional administration in Egypt. The fourth section discusses the normative framework for fiscal decentralization design, including comparisons with other countries. The fifth section examines Egypt's intergovernmental fiscal performance under the established normative framework. Several annexes provide detail on intergovernmental arrangements and international practice.

2 Variants and lessons

The term decentralization *encompasses several variants.* They range from political and administrative decentralization without any significant degree of local decision-making, to the conceptually most complete form of devolution, in which after sorting out central and subcentral governmental roles, subcentral governments are free to make fiscal decisions independent of the center (table 2).[6]

Egypt can be characterized as having administrative deconcentration without authority. Not only do elected EPCs have very limited say in local administration spending and tax decisions (to the point of being prohibited from interrogating the centrally appointed local executive council).[7] Even the administrative head of the governorate, the primary local service delivery unit, has very circumscribed powers. For example, although the Minister of Planning may issue a decree to invest the presidentially appointed governors with the power to choose among investments, in the end the decision is still made by the line ministry (*diwan*) where the power resides (Shand 2005; annex 1).

Whether this characterization of deconcentration without subcentral/local authority will change is for Egypt to determine. However, if Egypt embarks on some form of fiscal decentralization, the following overarching lessons can be brought to the reform dialogue:

- Well designed decentralization is not a zero-sum process. Where fiscal decentralization is well designed, nations are wealthier, grow faster, and are more stable than nations with centralized systems (Ebel and Yilmaz 2003).
- Because it is an intergovernmental partnership among types of governments, it is in interest of the central and local governments alike that both are in a fiscal situation that allows each level to perform its assigned roles.
- In the assignment process, spending functions and tax authority may be either largely exclusive or concurrent. For example, with respect to taxation, a common exclusive assignment is to grant local discretion over the setting of the property tax rate (for example, as in Australia, Canada, Mexico, Tanzania, and the United States) (Bird and Slack 2004). Concurrent and overlapping tax powers are also common. Thus, some countries tax sales twice—as in Canada's value added tax (Bird 2005), and in the United States nearly all state governments that tax personal and business income conform to some degree to the central government's definition of the tax base.
- The institutions of decentralization that work at one time or under one set of economic, demographic, and institutional arrangements may not work at another time. Indeed, this adaptability to change is one of the merits of a well designed decentralized system. A good example is Japan, which has made a transition from a formal system of controlled decentralization to what is now labeled integrationist, reflecting the fact that the system incorporates elements of both centrally led (top-down) and citizen-led (bottom-up) governance.

Table 2 Variants of decentralization

Form	Concept	Characteristics/Features
Political decentralization	Political decentralization entails some degree of transferring decisionmaking power to local officials. The concept implies that the selection of representatives by local citizens will lead to more efficient and effective decisions regarding not only what local services to deliver, but also how to help pay for these services out of locally mobilized resources.	Often requires constitutional or statutory reforms, development of pluralistic parties, and strengthening of legislatures and pubic participation in budgeting. It is possible—often likely—to have political but not fiscal decentralization. There are several voting methods (not all equally transparent) for selecting the local leadership.
Administrative deconcentration	Administrative decentralization refers to the redistribution of authority, responsibility, and financial resources among ministries of the central government, up to and including the creation of moderately autonomous field administrations. Often referred to as deconcentration. Ultimate decision power rests with the center.	Deconcentration with authority means regional branches of the center (such as governorates) are given the ability to make independent decisions. Deconcentration without authority requires that all deviations form normal practice be approved by the center.
Administrative delegation	Delegation is often seen as an intermediate step between deconcentration and devolution. Subnational governments (not branches of the center) act as agents for delivering certain services but are also subject to supervision by the center. These delegated responsibilities (mandates) should be fully funded by the center.	The center may create public enterprises, utility authorities, special districts or joint service councils, semi-autonomous school systems, regional project units, or special implementation units. Such organizations may have a large degree of decisionmaking discretion such as that of establishing special civil service rules and levying user charges and fees.
Fiscal decentralization as devolution	To be fiscally decentralized requires that local bodies have authority to make significant decisions regarding spending and taxation. That is, there must be some degree of local authority to determine the level of composition and the nature of local expenditure (expenditure autonomy) and service delivery and some ability to impose fees and taxes to finance those services without central interference (revenue autonomy). Such devolution is the most complete form of decentralization.	There are different degrees of fiscal decentralization. To stress the partnership nature of the intergovernmental sorting out of roles and responsibilities, there is almost always certainty about the need to complement local taxing powers with intergovernmental transfers.

Source: Authors' compilation.

- Decentralization need not, and usually does not, occur evenly across the board. That is, implementation will be asymmetric. Depending on a variety of political, economic, and institutional and organizational realities, different areas or service sectors may be treated differently (Bird and Ebel 2006).
- The importance of generating good data for monitoring the decentralization process is critical. Yet it is a matter often neglected, and that is a mistake. It is also true that measuring and analyzing the extent and nature of decentralization is far from simple.
- Governments must be allowed to build capacity in a learning-by-doing manner. It is wrong to delay reform on the basis that governments are not fit to grapple with reform of the intergovernmental system; rather, they build the capacity as they become intergovernmental.

A final point that is obvious but nevertheless worth putting on the record: fiscal decentralization can be done well or done badly. Done well, it can lead to the benefits promised by a well functioning intergovernmental system: enhanced macroeconomic performance, better local services (such as primary education, clean water, and access to health, justice, community public safety, and transportation) and, for some countries, enhanced national cohesion. But, if decentralization is done badly, it can lead to a macroeconomic mess, neglect of the needs of local citizenry (and especially the poor), corruption, collapse of the safety net, and social tension.

3 Structure and size of local administration

Legal and institutional framework

Egyptian local administration rests on two legal foundations: the Constitution and Law 43 (1979), as amended.[8] The Constitution refers to local administration as the third branch of the executive authority of the government, after the president of the state and the government. It includes one broadly written article, Article 27, plus three subsequent Articles that lead some experts to conclude that the permissive nature of the language provides Egypt the room to undertake a program a fiscal decentralization without the need for a constitutional change (box 2).

Law 43 (1979) and its executive regulations and amendments establish five types of local administrations: governorate, markaz, city, district, and village (figure 1)[9]:

- ***Governorate***: The governorate is the main service delivery unit of subcentral Egypt. It may be simple and completely urban (as in Alexandria, Cairo, Suez, and Port Saïd) or complex, consisting of one or more urban and rural communities. Simple governorates have no markaz or villages. The president appoints the chief executive, the governor.
- ***Markaz***: The markaz is the next unit in the hierarchy below the governorate. It includes a capital city of the markaz and other cities, if they exist, as well as villages. The markaz functions as the center for its constituent units and is headed by a markaz chief.
- ***City (madina)***: The city exists in all governorates: as a one-city governorate, the capital of a governorate, a capital of a markaz, or as a constituent city in a markaz. Cities may be divided into districts if it is determined to be functionally necessary.
- ***District (hayy)***: The district is the smallest local unit in urban communities. Districts are further divided into subdistricts or sections or neighborhoods called sheyakha to facilitate district management.
- ***Village (qariya)***: The village is the smallest local unit in rural communities. There are two types, villages that are considered local units (mostly the larger ones) and the smaller "satellite villages." The satellite villages, which are not considered local government units and thus have no public sector service role in the local administration system, are included in the jurisdiction of either a village or a markaz.

The local administration system can be classified in three levels for simple governorates and four levels for complex governorates. For simple governorates, the three levels are governorate, city, and district. For complex governorates, the four levels are governorate, markaz, city and village, and district.

Authority and administration

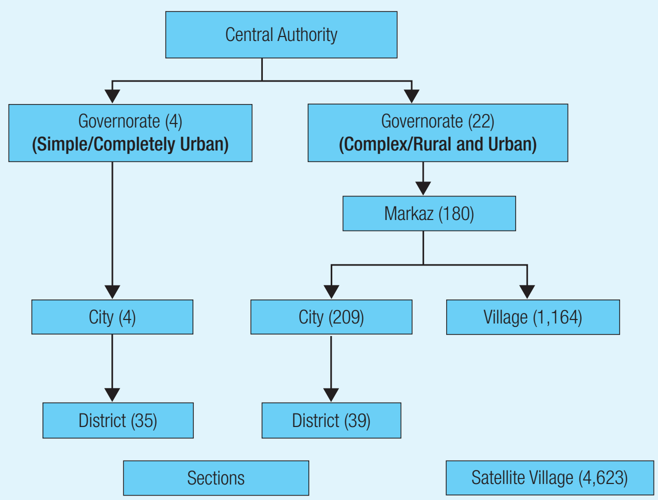
Administrative officers

All local administration officers are appointed by and serve at the pleasure of, the appointing authority—the governor by the president; the

Box 2	Constitutional provisions relating to local administration

- Article 27: Beneficiaries shall participate in the management of the services of projects of public interest and their supervision in accordance with the law.
- Article 161: The Arab Republic of Egypt is divided into administrative units enjoying legal personality, which are governorates, cities, and villages, and other administrative units may be established if the public interest so requires.
- Article 162: Local Popular Councils are to be formed through direct election, providing that at least half of its members are from workers and peasants. The law warrants the gradual transfer of authority to them.
- Article 163: The law shall describe the method of formation of Local Popular Councils, their jurisdiction, financial resources, their relations with the People's Assembly, their role in preparation and execution of development plans, and their control over various activities.

Figure 1 **Egyptian local administration**



chief of the markaz by the prime minister, city and district chiefs by the minister of local development, and the village chief by the governor. This is often a consultative process—for example, the Minister of Local Development typically nominates the governor and the governor is then consulted on the ministry's appointment of city and district chiefs. However, the mix of appointments creates incentives for intergovernmental conflict rather than cooperation among the subcentral government administrators since they are ultimately accountable to different officials in Cairo.

A two-council system

Each local administration unit operates with two councils: the constitutionally established Elected People's Council (EPC) and a centrally appointed local Executive Council. Of the two, the power lies almost entirely with the appointed council, which is composed of government administrators from the line (central) ministries or the ministry directorates. The EPCs are directly elected every four years, and at least half of the members must be workers and peasants.[10] The council members elect the EPC heads. Although the EPCs have been legally assigned functions, the reality is that they have very limited power, lacking any meaningful role in the preparation of the budgets of the jurisdictions they represent.[11] Moreover, not only are EPC members legally prohibited from interrogating members of the local Executive Council, but also the language of Law 43 (amended) sends a clear message of the EPCs' fiscal policy powerlessness by using words in reference to the EPCs such as "supervise" and "follow up" rather than "provide" or "produce." An exception is a provision for an LSDA that gives the EPCs and the governor the right to establish certain non-tax revenue accounts for activities such as housing, land reclamation, and industrial support.

The members of local Executive Councils are government administrators representing line (central) ministries and the ministry directorates. For example, at the governorate level, the council is headed by the governor and has in its membership the governor's assistant(s), the chiefs of the markaz, cities, districts, or urban administrative quarters, the heads of service directorates, and the authorities operating within the governorate. The secretary general of the governorate serves as the secretary general of the Executive Council as well. Similarly, the appointed chief executive officers of the markaz, city, district and village local government units are heads of the Executive Councils in their jurisdictions. And they have power: local Executive Council responsibilities include preparing the budget, assessing the performance of local administration projects and services, outlining the rules in the administrative and executive branches in their local activities, and setting the guidelines for managing and investing the governorate's real estate assets. This all serves to further stress the deconcentration without local authority characteristic of Egyptian governance. Another practical result of all these top-down arrangements is often a blurring of lines of accountability and a set of incentives for bureaucratic conflict rather than cooperation in carrying out the duties of local administration (box 3).

Size of local administration and how Egypt compares

One can obtain a perspective on the relative size of local administration through a measure of local administration expenditures as a percentage of total (national) public spending and as a percent of total gross domestic product (GDP) (table 3). ***During the 1990s the quantitative importance of local administration ranged from a high of 21.5 percent of total public spending to a present budgeted low of 15.6 percent.*** This 10-year decline in local administration is reflected in the percentage of the GDP number—from 5.9 percent to 4.6 percent (World Bank 2003). It is important to note that these percentages measure only where spending takes place and do not reveal anything about the degree of local autonomy (self-government).

For a variety of technical reasons it is difficult to compare the size of Egypt's local administration sector with the size of local government in other countries.[12] Recognizing these caveats, the share of local administration expenditure to total government expenditure is slightly above that of developing countries (14 percent); below that of many (still largely deconcentrated) transition countries (26 percent), and well below the (largely devolved) developed country average (32 percent).[13, 14]

Table 3 **Local administration expenditure as a percentage of national public sector spending and GDP, 1996/97–2005/06**

Year	1996/97	1997/98	1999/2000	2000/01	2005/06
Percentage of national expenditure	21.5	15.9	15.9	18.0	15.6
Percentage of GDP	5.9	6.1	7.4	6.6	4.6

Note: 1996–2001, actual data. 2005–06, budgeted data.
Source: Government of Egypt, Final Accounts.

Box 3 Administering administrative decentralization: An unwieldy whole?

Egypt's present system of administrative decentralization provides a checklist of the complexities and conflicts that can occur when development strategy is led from the center with little regard for decentralized systems of accountability and participation:

Accountability: The governorate. Even with deconcentration, the governor is more likely than a Cairo-centered line ministry to be attuned to local citizens' spending preferences and willingness to pay taxes. Nevertheless, even though some governors do better than others in manipulating central policies (for example, obtaining waivers from central rules and regulations), the system is stacked against the governor. First, although the governor is assigned financial and administrative authority over the decentralized service directorates, this authority does not allow for changes in the general policy set by the line ministry. Second, the heads of service directorates are members of the governorate Executive Council and, thus, report to their ministry; this means that the "decentralized" directorates are under little obligation to follow the directives of, or coordinate with, the governors. Third, the line ministry has the power to hire, fire, promote, and otherwise influence the performance of the "local" bureaucracy through the civil service.

Accountability: The governor. Most governors are appointed from outside the local unit (almost 70 percent of the governors are former military or police).

Accountability: The People's Assembly. Although the People's Assembly is charged with approving local units' budgets and plans of economic and social development, its de facto role in adjusting the ministry budgets is small. Its rules prioritize the central government's draft laws, thus contributing to this weak legislative role.

Accountability: Organizational. Law 43 (1979) assigns to various actors roles in monitoring the Executive Councils and EPCs. These actors are the president, the prime minister, the Council of Ministers, the Parliament, the Supreme Committee of Local Administration, the Minister of Local Development, and other central institutions such as the Central Authority for Organization and Administration and the Central Agency for Audits.

This administrative overlapping, in which a large number of public entities are involved in providing and producing local public services, creates a lack of clarity. It is often difficult to get an answer on basic institutional questions such as which entity is responsible for a specific function or task.

Ad hoc. During the 1960s, 1970s, and 1980s, six laws were issued to organize the local system in Egypt: Law 124 of 1960, Law 57 of 1971, Law 52 of 1975, Law 43 of 1979, Law 50 of 1981, and Law 145 of 1988. It is noteworthy that Law 50 of 1981, which amended Law 43 of 1979, adjusted 62 articles of the original law and added 10 new articles. Over the same period, the name and function of the chief ministry concerned with local administration changed several times—from the Ministry of Local Government to the Ministry of Local Administration, to the Ministry of Rural Development, to the Ministry of Local Development. In addition, the changes in law and central ministerial administration have been accompanied by a series of ministerial decrees (including ex post approval of the alleged illegal innovations in the governorate of Qina).

Accountability: Intra-central. The urban property tax is a wholly central undertaking with few incentives for efficient tax administration. The base and rate are determined by the People's Assembly with tax receipts returned to governorates on a derivation basis. The valuation, billing, and collection process is carried out by a Ministry of Finance (MoF) district office. The entity charged with monitoring this entire process (including appeals) is the Cairo-based Real Estate Tax Department, but it does not have a direct line of authority over the performance of the district office. One result: uncollected taxes exceed collections (in Cairo, by a 6:1 ratio).

Adversarial: Intra-subcentral. An incentive for lack of cooperation exists intragovernmentally between the governor and the heads of lower level executive councils, especially those of the markaz, city and district. The reason stems from the differences in appointing authority (the governor, by the president, the markaz, city and district heads by the prime minister). Circumstances have arisen in which a governor has formally requested a lower-level executive council member be transferred out of the governorate.

4 An intergovernmental system: Five questions facing any decentralizing society

There are five questions that Egypt—or any decentralizing country—must address: Which type or level of local administration does what (assignment of the expenditure function)? Which level levies which revenues (finance or revenue assignment)? How can fiscal imbalances and disparities among places be resolved when the case for decentralizing spending is almost always greater than the case for decentralizing revenues (a role for intergovernmental transfers)? How is the timing of revenues to be managed and monitored (debt and the hard budget constraint)? And, while the first four questions are addressed, what capacity-building arrangements are required to make it all work?

The five questions frame the intergovernmental system; all pieces must fit together. To be sure, the sequencing of reform is likely to be uneven in its implementation and will take time (Bahl and Martinez-Vazquez 2005). The recent South African experience provides an example. In support of South Africa's apartheid system (officially, 1948–91), the 1986 Provincial Government Act abolished provincial legislatures and replaced them with a centrally appointed executive authority which made provincial budgets subject to ratification by the national parliament. Following the dismantling of apartheid, South Africa moved quickly to enact a new Constitution (1996) and a Local Government Municipal Structures Act (1998), which assigned to provincial and municipal governments a wide range of responsibilities, including a large degree of revenue autonomy. But the fiscal transition has taken time, particularly for the provinces, which are still largely financed by transfers from the center.

The first three questions are highly intertwined (the fourth, borrowing and debt, is more a matter of the timing of fiscal flows than of intergovernmental structure).

Function: Expenditure assignment

A first step in intergovernmental reform is to secure agreement on expenditure roles among governments. And the first rule is that the question of function (sometimes referred to as the competency among governments) precedes that of revenue assignment and design of transfers between central and subnational governments. That is, finance follows function. There are two merits to this rule: The first is that one cannot establish the required level of subnational revenues without having a reasonably clear sense of the bundle of services one expects a local government to deliver, to which the revenues will be applied. Failure to follow this rule leads to two negative consequences, as demonstrated by the flawed Brazilian constitution of 1998: inefficiency and macro-instability. The inefficiency resulted from the fact the local government units became engaged in wasteful spending. With the central government seeing the lack of an expenditure strategy, the inefficiency was compounded by a perverse macro policy as the center embarked on a policy of pushing its deficit down by implementing a series of unfunded expenditure mandates. The result was to undermine the local fiscal autonomy intended (Spahn 1998).

The second reason that finance follows function is that revenue assignment often requires prior knowledge of expenditure assignment. For example, if a service is devolved that can be fully or partially funded by matching the flow of its benefits to specific users, then a system of devolved user charges makes sense.[15] If, however, the benefits of a local service are more general—for example, with respect to a local role in providing local infrastructure and education services—then it follows that revenue assignment involves devolving a broader tax base (for example, on local property or income and consumption). The point is that one taxes in order to spend; so it is important to first have a spending plan.

Finance: Revenue assignment

In programs of gradual fiscal decentralization, it is important that "finance follows function" becomes a guideline and not a reason for delaying the revenue assignment decision. First, a fundamental requirement for efficiency is that to the extent possible, the benefits of a flow of services should be matched with the requirement to pay (this is the "matching" or "benefits" principle of public finance). Thus, whenever there are local variations in preferences for the mix of public sector services as well as differing costs for supplying those services, there is an efficiency gain in carrying out and paying for the public sector function using decentralized arrangements.[16] Second, empirical analysis suggests three points:

1. The simultaneous decentralization of a national government's taxing and spending powers exerts a negative and significant influence on overall public sector size.
2. Revenue-sharing arrangements in which decisions are made nationally tend to eliminate the hard budget constraint effect of decentralized spending power.
3. Revenue decentralization has a payoff in terms of improving a nation's macroeconomic performance (Ehdaie 1994; Ebel and Yilmaz 2003).

Transfers: When function and finance do not match

Once the expenditure assignment and revenue assignment decisions have been made, there will be two types of imbalances: vertical and horizontal. The vertical imbalance stems from the fact that there is no a priori reason why the amount required to pay for local expenditure assignments will equal the ability of the subcentral governments to generate those revenues. The horizontal imbalance problem is that this gap will be worse in poor jurisdictions. That is, there will be disparity in the financial ability of subcentral governments to provide some agreed-on minimum standard of local public services. Thus, except in the (probably unlikely) case of a rich government being able to self-finance all its assigned expenditures, transfers will remain a key part of the intergovernmental system.

A well designed transfer system will have elements of both conditionality and unconditionality. The Egyptian transfer system is structured as if it were a block grant, so the focus of this discussion is on unconditional grants.[17]

There are three decisions to make in designing a transparent transfer system. The first is to determine the pool of revenues from which the total transfer will be drawn. To provide fiscal flexibility to the central government plus an added degree of certainty to the recipient unit, the pool should include most, if not all, central revenues.[18] The second is to create a rule to determine the size of the distributable pool—that is, clarify how one determines the total to be set aside for transfer purposes. Here, again, certainty matters. One solution is to agree that some fixed percentage of the total pool will be set aside for grant distribution. A next-best solution is to make determining the size of the transfer pool part of the budget preparation process. The third decision is to make the transfer formula-driven, ideally basing it on objective criteria of the fiscal capacities of local government units (addressed below).

Timing: Borrowing and debt

In principle, there is no reason that a subcentral government should not borrow. Indeed, as long as that government is subject to a clear set of rules that establish accountability and lead to a hard budget constraint, borrowing to finance capital expenditures promotes efficiency and equity. Because capital (investment) expenditures provide a flow of current benefits over time (the life of the project), it is efficient to spread the capital cost recovery process over that time. Moreover, using other peoples' money provides fiscal space for economic development spending. Equity is satisfied by spreading the payment of the capital costs over successive generations that benefit from the year-to-year flow of services after the initial investment year. Repayment may be based on revenues from the investment itself (for example, if user charges are imposed on a market) or from general taxes.[19]

For advanced countries in which subnational governance and capital markets are well developed, there is little, if any, reason for a higher level of government to legally constrain borrowing by lower levels. The capital markets become the agent for enforcing financial discipline through bond rating mechanisms and the understanding that a profligate local government will be allowed to fail.[20] The typical practice, in developed and developing countries alike, is to establish a rule-based system designed to ensure accountability and fiscal discipline.[21] Thus, in some countries the central government imposes strict administrative controls. For example, borrowing by local authorities is subject to approval by the central government in Ireland, Japan, Korea, and the United Kingdom. Other countries rely on mechanisms for formal cooperation and coordination. For example, in Germany the Financial Planning Council establishes an intergovernmental (central, *Lander*, and municipal) debt strategy, whereas in the Netherlands regular meetings are held between the central authority and the association of municipalities. Several countries use a balanced budget requirement monitored by the center (as in Ireland and Spain). There are also limitation arrangements (as in Poland), whereby subnational governments are subject to specific limits on debt and debt service. And, as in Egypt, many states enact "golden rule" laws or regulations designed to ensure that borrowing is for long-term investment only.[22]

Enforcement procedures are coupled with these ex ante fiscal discipline mechanisms. In Poland the Regional Clearing Chamber may require a subnational authority to amend its budget. In Brazil the Fiscal Responsibility Law and its companion legislation (approved in 2000) allow states and municipalities to borrow under the conditions that they maintain debt stocks below specified ceilings and establish annual targets for revenues, expenditures, and the balance and changes in the stock of debt. Local government units that fail to comply with these rules face sanctions, including fines and the nullification of contracts. For governors and mayors who are chronic rule breakers, there is the threat of impeachment and imprisonment.

The local capacity to implement

The arguments and principles with respect to the four questions discussed above are more than theoretical constructs. A robust set of global experiences attests to their functionality. But, to get to the point of functionality, public policymakers, practitioners, and members of civil society must work toward developing a capacity to govern. There are three facets to capacity development: organizational, institutional, and human capital. With respect to decentralization and intergovernmental relations, the organizational aspect deals with structures of governance: for example, how many types of subnational governments shall be established? Are special purpose districts (such as joint service councils) desirable? Is the size of local government right or can there be too many small governments (the fragmentation problem)?[23] And once a policy strategy is agreed upon, what institutions and mechanisms are required to make it work? Thus, in the comprehensive peace agreement between the government of Sudan and the Sudan Peoples' Liberation Movement/Army, intergovernmental institutions were established, including a Fiscal and Financial Allocation and Monitoring Commission charged with the responsibility to design and monitor the flow of intergovernmental transfers.

Then there is the question of a set of short-, medium-, and long-term strategies for developing human capacity—that is, human capital with the capability to deliver on the policy goals as well as make decisions relating to the organizational and institutional arrangements. Capacity development is about learning, knowledge development, policy research and development, technical assistance, and training. Japan's system of personnel exchanges provides a successful model.

5 Egyptian fiscal performance

The next step is to integrate the normative framework with an examination of fiscal performance. This discussion is often accompanied by a caveat about the data: because the Egyptian system is deconcentrated, there is no a clear connection between data on local administration, which is tucked away in central ministry budgets, and the budget reporting system that one would get from a decentralized system (a system that readily answers the five questions that frame a decentralized public sector). Expenditure numbers are reported by ministry tasks rather than by functions of local government. On the receipts side, reporting is by type of shared tax and nontax tax revenues, neither of which qualifies as subcentral government revenue. The discussion below distinguishes between local administration revenues (tax and nontax) and transfers, which does become useful for setting the stage for a dialogue on Egypt's decentralization options. However, from a fiscal decentralization perspective, there is no difference between central revenue and the gap-filling transfer. With the exception of the LSDA, it is all central transfer.

Local administration expenditure

Commonly accepted criteria for intergovernmental expenditure assignment include considerations of the geographical area of benefits (if the benefits of a service accrue locally it is a local function; if the benefits cross local jurisdictional lines, there is a case for special districts or joint service councils). In addition there are considerations of the cost of production (building a sewage treatment plant that serves a wide region may be more cost-effective than having each local jurisdiction build its own capital-intensive treatment plant) and ability to manage (the government providing the service should have adequate legal authority and management capability to perform the functions).[24]

Typical functions assigned to subcentral governments include kindergarten, primary, and secondary education; community development, zoning, and land use planning; water distribution (but not necessarily supply), sewerage, and rainwater drainage; local streets and roads, recreational areas, public transport, street lighting, and sidewalks; community fire and policing; sanitation and health; and libraries, cultural centers, and public meeting facilities. ***For a service to be assigned to a subcentral government does not mean that service will necessarily be solely local.*** Indeed, services are often supplied intergovernmentally.

There are many examples of concurrent competencies: health (supply is regional or central, distribution is local), social welfare (pensions funded centrally, elder care provided locally), transportation (national and local roads), environment (the locality may act as a central agent), sanitation (regional sewage treatment but local garbage collection), and primary education (teacher certification and certain aspects of curricula set centrally, teacher service standards and salary scales fixed by a governorate, and textbook selection a school-level decision) (Gershberg 2005).

Accordingly, for newly decentralizing states, a first step is to initiate a dialogue on this expenditure assignment question about which type or level of local administration does what. Then they can proceed to the enactment of a law on local government that specifies how the service delivery role will be sorted out. Egypt is not yet at this point (though some governorates have initiated such discussions ad hoc) and it needs just such a dialogue. A starting point is to take a close look at how Egypt's present expenditures flow with respect to local administrations as a whole. In reviewing these data, there are two points to note with respect to format. First, it is has been necessary to rely on the four-chapter (*babs*) format of wages, operational costs, investments, and capital transfers.[25] Second, although data could be reported by broad categories of budget and bureaucratic sector, no data set conforms to the types of categories that give adequate insight into how the local administration budget might look if the budget format were focused more on service flow (function) (Shand 2005).

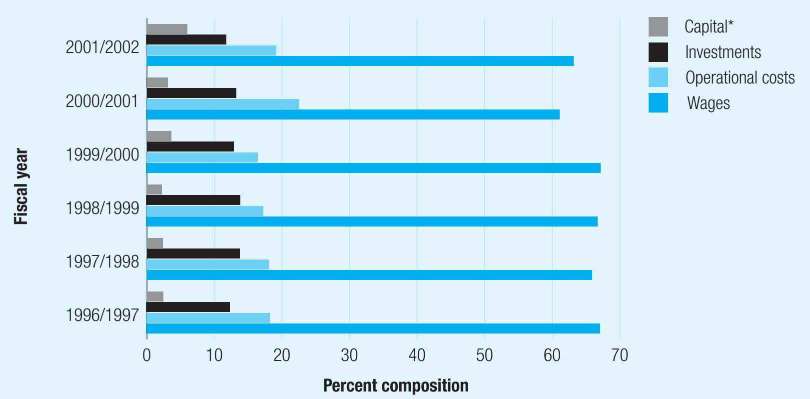
Current spending

Local current expenditures—wages plus operating costs—have averaged 84 percent of total local administration spending, with the wage bill taking the largest share (an average of 65.2 percent) (figure 2). There has been a slight increase in operational costs relative to wages, but the change has been small (19.2 percent for the most recent data, compared with a seven-year average of 18.4 percent).

Other data reveal the bite that the wage bill takes out of the total spending on behalf of local administration (table 4). Between FY 1994/95 and FY 2003/04, wages expenditure as a percentage of local administration current expenditures increased by 9 percent. The wage bill now accounts for LE 9 of every LE 10 of current expenditures, well above the typical share of 60–70 percent. A second indicator of the wage bite is the ratio of local administration employees to the number of citizens; it is 1:21, whereas in decentralized Western Europe this ratio ranges from 1:70 to 1:80 (Handoussa and El-Oraby 2004).

The distribution of local administration current expenditure by sector and region—as close as one can get to conventional function assignment—shows that nearly two-thirds of local current expenditure is allocated to education and health services (table 5). This percentage varies among regions, reaching nearly 70 percent in urban Egypt. Also, a considerable share of local current expenditure is labeled "General Secretariat and Local Councils." A definitive assessment of the appropriateness of this share requires further analysis

Figure 2 Local administration's total expenditure composition, percent



Note: Capital refers to debt payment.

Table 4 Local administration wages as percentage of local administration current expenditure, 1995–2004

1994/95	1995/96	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	Percentage change 1995/96–2003/04
82.3	84.1	85.7	86.1	87.0	87.8	88.7	89.1	89.7	9.03

Source: People's Assembly 2005.

Table 5 Local administration current expenditure distribution by sector and region, 2001

Sector	Urban	Lower Egypt	Suez Canal	Upper Egypt	Frontier	All Egypt
General secretariat and councils	19.24	17.13	36.76	15.16	23.22	22.30
Education	59.20	52.05	40.57	53.07	50.20	51.02
Health affairs	13.71	10.24	10.06	13.37	13.00	12.08
Housing and utilities	0.54	2.60	2.14	1.99	0.74	1.60
Social affairs	2.68	2.69	3.90	2.29	2.40	2.79
Supply and internal trade	1.17	1.74	1.15	1.31	0.97	1.27
Agriculture	0.39	8.48	1.86	8.35	4.11	4.64
Manpower	0.57	0.48	0.76	0.43	0.58	0.57
Transportation and roads	0.69	1.31	0.31	0.50	1.39	0.84
Youth and sport	1.06	1.80	1.86	1.67	1.68	1.61
Organization and administration	0.09	0.11	0.16	0.17	0.45	0.20
Veterinarian medicine	0.65	1.36	0.46	1.69	1.26	1.08
Total	100.00	100.00	100.00	100.00	100.00	100.00

Source: The People's Assembly.

Table 6 Local administration share of national investments by sector, in the National Five-Year Plan, 2002/03–2006/07

Percent

Sector	Overall investment allocations (LE billion)	Investment allocated to local administration (LE billion)	Percentage of total
Agriculture	58,900	0	0.00
Industry	60,900	76.3	0.13
Petrol	40,900	0	0.00
Electricity	32,800	883.4	2.69
Construction	15,500	0	0.00
Transportation and communication	58,200	2,583.0	4.44
Commerce	15,700	0	0.00
Tourism	22,200	0	0.00
Housing	36,300	0	0.00
Utilities	38,500	3,097.6	8.05
Education	32,200	0	0.00
Health	17,400	0	0.00
Other social services	15,500	816.	5.27
Total	445,000	7,456.6	1.70

Source: Ministry of Planning 2005.

on what is included in this line item. However, the size of this share—larger than the combined budget shares of all other local services excluding education—raises a concern.

Investment and capital transfers

There is a similar story of consistent overall shares when one expresses the sum of investment and capital transfers (debt repayment) as a percentage of total local expenditure (see figure 2). However, the relative importance of capital transfers in the form of debt repayment is growing (by a small amount, but nevertheless tripling in relative share between 1995/96 and 2001/02) while investment spending is on the decline. The Ministry of Planning has announced that starting with FY 2005/06, it will take a step toward deconcentration with authority by assigning 16.7 percent (LE 2.09 billion) of public investment to the governorates to manage based on their preferences and priorities.

The local administration share of national investment spending by sector is based on Egypt's Five-Year Plan for Social and Economic Development (2002/03 through 2006/07) (table 6). Here the problem of the data link between a deconcentrated and a more functionally decentralized system becomes particularly apparent: the plan shows an allocation of just 1.7 percent of total investments for local works. The reason: the bulk of investment funds are allocated directly to the central service ministries, so capital spending is tucked away in line ministry budgets. Thus, one cannot conclude from the data (see table 5) that there is no local investment action in the development sectors of education, health, and housing or the major income-generating sectors of construction, industry, commerce, and agriculture. As Egypt decentralizes, one of the new institutional capacities to be developed will be a decentralized system of data collection and monitoring.

Revenue assignment and mobilization

The importance of local revenue mobilization

As with expenditure assignment, there are guidelines for efficiently and effectively assigning revenue authority among government levels. As with expenditures, assignment may be concurrent or exclusive. To secure fiscal efficiency and accountability, fees and taxes should fall on those who benefit from the spending. To the extent that the beneficiaries of local services can be specifically identified, there is a clear-cut case for granting local governments the authority to levy a range of user charges, fees, and licenses. Similarly, to the extent that one can make a case for generalized local service benefits, local authority over broad-based taxes (such as those on real estate, personal income, business receipts, and visitor spending) should be explored. For the informal business sector, it is probably necessary to resort to presumptive taxes.

Once the question of the assignment of revenue among different types of governments is sorted out, there must be a mechanism whereby the local administration can be held accountable by the citizenry for tax actions. At a minimum, this requires that some formal local unit (such as the governor or EPC) be given authority—independent of the central government—to determine the local tax rate imposed on the selected bases. Indeed, local control over the tax rate is the essence of fiscal decentralization. If this minimum condition is not met, a tax is not a local tax. Note that this criterion of local control over and responsibility for the tax rates does not rule out central revenue administration (billing, collection, audit, and appeal). A set of guidelines for drawing distinctions by degree of subcentral government revenue autonomy is available (table 7), as is an international comparison of the country data (table 8).[26]

Table 7 Concept: Classification of local taxes by degree of local autonomy

High revenue autonomy (fiscal decentralization)	Subcentral government unit sets tax rate and base as well as administers the tax.	Highest degree of own-source revenues. These usually include fees and charges.
	Subcentral government sets tax rate and base.	High degree of autonomy in Egypt's nontax revenues as grouped under the LSDA.
	Subcentral government sets tax rate only.	**Tax rate authority is a necessary and sufficient condition for categorization as local "own" revenue** (thus, if the tax is used centrally as well as locally, as with a tax on income or sales, the subcentral government tax base could be in conformity with the center and the tax could still be a local tax—otherwise known as "piggybacking").
	Subcentral government sets tax rate, but only within centrally permissible ranges.	A typical practice is to cap the top rate.
	Tax sharing, whereby the central/local revenue split can be changed only with consent of the local government.	Can result when a local authority collects the tax and remits it to the center.
	Revenue sharing, with share determined unilaterally by central authority.	100 percent control by the center; this category is a source of much misspecification of central versus local revenue.
No local autonomy	Central government sets rate and base of subcentral government revenue and determines share, if any (Egyptian case).	May accompany political decentralization. Often the source of misspecification (the IMF's *Government Finance Statistics Yearbook* [2004] incorrectly classifies this as a "local tax").

Source: Adapted from OECD 2002.

Table 8 Practice: Revenue and tax autonomy for selected countries

Country (year)	Estimated own-source revenues as percentage of total subnational revenue
Belgium*	97,100
Bulgaria*	13.4
Cambodia (2003)	<5.0
China (2002)	<5.0
Czech Republic (1999)	40.2
Denmark (1999)*	96.0
Egypt (2005)	**6.4**
Estonia (1999)	15.4
Germany (1999)*	53.0
Hungary (1999)	33.3
Indonesia (2002)	15.5
Latvia (1999)*	14.1
Lithuania (1999)	4.8
Philippines (2000)	30.0
Poland (1999)	35.2
Romania (1999)	21.0
Slovakia (1999)	42.1
Slovenia (1999)	28.1
Spain (regions, local)*	22.0, 84.0
Switzerland (cantons, communities) (1999)*	89.0, 87.0
Thailand (2002)	10.9
Vietnam (2003)	<5.0

Note: "Own source" refers to total taxes, revenues for which the subcentral government sets the tax base plus taxes when it sets only the rate. Revenues include taxes plus nontax sources levied by the local government (for example, fees and charges). The range for Belgium reflects local municipalities (97 percent) and regional governments (100 percent). The asterisk denotes a tax (not a revenue) autonomy ratio.
Source: European data are from OECD 2002. East Asian data are provided by Taliercio 2005.

Egypt's local administrations have two major sources of operating revenue: shared taxes (sovereign current revenue, annex 2), and nontax revenues (current local revenue, annex 3). Since the authority to levy the tax is solely a central government decision, none of the sources of local government receipts that are listed as sovereign taxes, or, with the exception of the charges and fees grouped under the LSDA, those listed as current (nontax) revenue qualify as "own" local or subcentral revenues.

However, this is not to say that these revenue sources cannot be transformed. Candidates for devolution to subcentral governments include sovereign taxes on agricultural land, buildings, entertainment and amusements, and motor vehicles and operators of motor vehicles. Also, several current nontax revenues could work subnationally for fees and charges on utilities—water distribution, wastewater treatment, garbage removal, and electricity distribution. To that one can add the generalized benefits taxes listed above: broad-based, low-rate personal income and business taxes as well as excises on sales, including visitor levies—and, as part of the Egyptian tax modernization strategy, the urban real property tax (box 4).

Given that the central government has administrative systems in place for all these revenue sources, capacity to assess, bill, collect, and audit is not a major concern. Indeed, for a transition period (and maybe longer), the central government can still be responsible for carrying out the tasks of revenue administration. What matters here is that the subcentral taxing unit (for example, the governorate) that receives the tax and nontax receipts is also responsible for setting the tax rate.

In making a transition to revenue decentralization, three policy questions are likely to be raised:

- *Are there too many taxes on the revenue devolution menu?* No. Indeed, it is desirable to have a mix of taxes so that any one or a few revenue sources do not become so overutilized that their inherent structural defects become a problem, undermining the efficiency and accountability goals of tax policy.
- *If one fiscally decentralizes, is there a danger of overtaxation?* Of course, there is always this danger, particularly if there is no clear match between the added revenue burden and the flow of services financed (recall the Brazilian example). However, there are two ways to minimize the likelihood of overtaxation in the transition to revenue decentralization. The first is to follow the Alexandria example and carry out a willingness-to-pay survey as a prelude to establishing a user charge. The second is for the central government to vacate part of its tax rate to the subcentral government, which, in turn, must face up to the task it is authorized to do: levy its own local tax rate in addition to the now-lower central tax rate.

That said—that the transition to a devolved revenue policy need not lead to overtaxation—it is important for Egypt's policymakers to recognize that there is merit in viewing a policy revenue devolution policy in the other direction—that is, as mobilizing new revenues that are now largely beyond the reach (and credibility) of central tax policy.

- *Do subcentral governments have the capacity to administer these new revenue-mobilizing responsibilities?* The answer is "yes" for some governorates (for example, through experience with the LSDA) and "not at this time" for others. Thus, there is likely to be an asymmetric approach to implementing fiscal decentralization. It is also good to keep in mind that to capture the efficiency and accountability benefits, fiscal decentralization does not require building a huge new revenue administration apparatus.

Egyptian practice

Setting aside the normative discussion of revenue decentralization, it is useful to establish a baseline of current arrangements for financing

Box 4 **A local urban property tax**

The Egyptian Ministry of Finance is examining the merits of modernizing the fully centralized property tax (Law 56/1954, Governing Built Properties). Based on annual rental value, the tax is riddled with exemptions, exclusions, and incentives for poor tax administration. The tax yields now only 0.22 percent of total tax revenues compared with 20 percent during the 1930s and 1940s. As modernization (primarily broadening the base) proceeds, Egypt must consider the merits of devolving all or a substantial part of the tax base to subcentral governments. Indeed in some decentralized countries, the property tax accounts for more than a third to a half of all local revenues.

There are several reasons why the tax on real estate comes with a high degree of localization. First, relative to taxes on income and consumption, the tax base is relatively immobile, thus minimizing the potential tax-induced distorting effect on private market decisions. Second, when the benefits of a public service accrue locally and thus enhance property value and use, the tax on real estate provides both an efficiency and an equity link between the flow services and the "tax price" payment for those local public goods. Third, assigning the property tax decision and responsibility to the local authority frees the central government from having to mobilize revenues to finance local services, thereby providing the center with added fiscal space to tax and spend for public services with regional or national benefits.

However, the Egyptian property tax is a wholly central undertaking. The base and rate are determined by the People's Assembly, with the tax receipts returned to local administrations on a derivation basis (that is, where they were collected). The valuation, billing, and collection process is carried out by an MoF district office, whose valuation results must be approved by both the governor and the MoF. The entity charged with monitoring this entire process (including taxpayer appeals) is the Cairo-based MoF. However, it does not have a direct line of authority over the district office's assessment, administration, billing, and collection.

Though these entities are all part of one (central) government, the result is a web of practice with little incentive for efficient tax administration. The center as a national government fails to directly reap the benefits of rigorous collection and enforcement (because the revenues are distributed to local administration). And the local administration entity that benefits from receipt of the revenues is not the same entity that is responsible for levying or collecting the tax, chasing arrears, or dealing with appeals.

This web of disincentives for aggressive tax administration is reinforced by the twin realities that few penalties are imposed for nonpayment and that revenue shortfalls for local administration are covered through a system of central-to-local transfers. In short, there is little, if any, accountability in the property tax system (or, indeed, for the system of local administration revenues) and thus little incentive to collect, enforce, and even sometimes cooperate (for example, the Real Estate Tax Department cannot get Alexandria to report the sum of property tax arrears in that governorate). This lack of accountability attests to the need for a thorough review and sorting out of tax policy and tax administration roles to get the incentives right for property tax modernization.

One option is to decentralize the authority to tax property. Such a decision has implications beyond tax policy since it would have to be accompanied by (some) decentralized spending authority. (Otherwise a whole new set of disincentives for efficient governance would be triggered.) If Egypt decides to pursue a policy of fiscal decentralization, the new local governments must have access to a broad-based tax that allows them to be financially sustainable and forces them to be fiscally accountable to their citizens for the provision of local public services. And, for the reasons cited here, the property tax is an ideal candidate for broad-based tax devolution.

local administration. In this section we discuss the relative importance of the mix of sources of local administration revenues and the revenue buoyancy estimates for sovereign tax and nontax current revenues. Two annex tables present the decade-long record of changes in the composition of shared taxes (annex 3) and of nontax revenue (annex 4).

The importance of both types of shared taxes has steadily declined relative to the growth of current transfers (table 9). Thus, in 1994/95, total shared taxes and shared nontax revenues were 26 percent of total local administration financing. By 2001/2002 that combination had fallen to 18 percent. The balance—in relative terms—was made up by current transfers, which now account for four-fifths of total revenues. This is quite high by international standards, where, for developing countries, transfers typically account for 40–50 percent of total local financing. As the annex tables show, the relative decline has been the greatest for fees for the Suez Canal, utilities, local project profits, and—notably—the LSDA.

When the information on the relative trends in percent composition is combined with revenue buoyancy calculations, the relative importance of the sum of taxes relative to transfers is revealing. The data show that with respect to changes in GDP, both sovereign and nontax revenue sources have been unresponsive to economic growth, while for every 1 percent change in GDP, transfers have grown by more than 1.6 percent (table 10).[27]

From a policy perspective, what can one conclude from these numbers? From an accounting perspective, one cannot conclude very much, because a decline in one type of central grant (revenue sharing) is being replaced by an increase in another type of grant (current transfers). From a local administrative perspective, as a whole it does not matter much where the central revenues come from.

But when it comes to getting the incentives for efficient government right there are two important implications. First, when a centrally determined local tax is complemented by a gap-filling (account-balancing) transfer, there is no incentive to collect locally (because raising local revenues reduces transfers). In contrast, if the local revenues are made "own" revenues and then coupled with a formula-based transfer system that takes into account measures of local tax effort or local fiscal capacity (ability to raise local revenues relative to local expenditure need), the incentive for efficient revenue administration is greatly enhanced. Second, as the data in this report suggest, even under current arrangements, the transfer system has distributional affects across governorates. The policy question that arises is whether the current transfer is designed to offset—equalize—the result of derivation-based tax and revenue sharing.

Table **9** **Tax, nontax, and transfer receipts as a percentage of local administration current revenue (1995–2003)**

Revenue type	1994/95	1995/96	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03
Shared tax	13.36	12.10	12.31	11.57	10.67	9.26	8.62	7.95
Nontax	12.58	12.4	12.04	11.65	11.11	10.23	9.71	9.57
Total shared tax and nontax	**25.94**	**24.52**	**24.34**	**23.22**	**21.78**	**19.49**	**18.34**	**17.52**
Current transfers	**74.06**	**75.48**	**75.66**	**76.78**	**78.22**	**80.51**	**81.66**	**82.48**
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: The People's Assembly, 2005.

Table **10** **Revenue buoyancy of local administration financing sources**

Classification	Revenue buoyancy, 1994/95–2001/02
Sovereign tax sharing	.48
Nontax revenue sharing	.80
Sovereign tax and nontax	.63
Current transfers	1.64
Total revenues	1.38
Current expenditure	1.38

Source: Authors' calculations.

The transfer system

Once the costs of the locally assigned functions and the amount of potential revenues that local administration can generate are added, there will most likely be an inequality. Indeed, for all but the wealthiest local jurisdictions, local expenditure needs can be expected to exceed potential revenue capacity. The term for this difference is "vertical imbalance," reflecting the fiscal reality that central governments typically capture most of a country's tax collections while subnational units are poor in revenue resources relative to the cost of servicing a well designed system of intergovernmental expenditure assignments. A closely related issue is that of "horizontal imbalance," which occurs when the differences in expenditure needs and tax-generating ability vary across similar levels of subcentral governments.[28, 29]

Several transfer schemes may be designed to address these two types of imbalances (box 5). Thus some transfers may come in the form of matching or nonmatching conditional grants (say, for investment purposes). Others can be designed as unconditional "equalization" transfers structured to enable localities with different fiscal capacities to provide a common minimum standard set of services. In principle, all transfers should be transparent and formula-based, with the uses of the funds tracked by the granting unit.[30] International practice ranges widely, reflecting different jurisdictional targeting. For example, Indonesia's system of equalization is designed to empower district governments; Canada's targets provinces; and the Philippines' focus is on intermediate and municipal and village governments alike. It also reflects differences in intended fiscal outcomes (for equalization purposes, the conceptual best practice is the Australian goal, which takes into account the concept of different fiscal capacities among subnational governments).

Transfers account for more than four-fifths of total local administration financial sources (and, thus, expenditures)—and more than 90 percent in some governorates. This emphasizes the importance to Egypt of getting its system right both in terms of the transparency of the process and as a tool for equalizing across rich and poor governorates. Yet the record is discouraging. The system is focused on the vertical imbalance (box 6) and its process is not transparent (there are no announced or legally stated criteria by which transfers are allocated).

Borrowing and debt

Two key aspects to Egypt's practice on local borrowing and debt policy underscore the characterization of the fiscal system as one of deconcentration without authority. First, there are specific limits: though the local administrations may debt finance up to 20 percent of shared tax and nontax revenues for carrying out productive or necessary investment projects (Law 43, 1979), all borrowing is subject to approval by the Ministry of Local Administration. Borrowing in excess of the 20 percent limit requires approval by the Prime Minister (Law 50, 1985). Second, prime ministerial approval is required for all external borrowing (as well as for accepting an external grant). Such rule-based borrowing with respect to both practices is a typical feature of all but the most devolved intergovernmental systems (Joumard and Kongsrud 2003).

The total debt of the local administration system between FY 1995/96 and FY 2000/01 demonstrates a sustained increase in the local administration's total debt, the growing importance of local financing, and minimal dependency on the foreign loans and credit facilities as debt instruments (table 11). Much more study of the nature of local administration debt and debt management is needed before one can draw many policy conclusions.

Box 5 **International practice: Equalization and intergovernmental transfers, selected countries**

In Indonesia transfers are designed to empower district governments: The equalization grant pool is a fixed percentage (25 percent) of central resources (in practice, budgeted rather than actual resources) after tax sharing with the regions. The central government distributes the pool on a formula that takes into account both revenue capacity and expenditure needs. Revenue capacity is estimated as standardized own revenues plus tax-sharing receipts plus 75 percent of share natural resource receipts. Expenditure needs reflect population, poverty rate, land area, and a construction cost index. Recognizing that the district is the primary unit of decentralized service delivery, 90 percent of the grant goes to districts and 10 percent to provinces. The grant finances 70 percent of district spending and 50 percent of provincial expenditure. There is also a new earmarked grant system (DAK, accounting for only 3 percent of grants) that builds in some equalization. Regions with low fiscal capacity pay only 10 percent in matching funds while those with high fiscal capacity pay up to a 50 percent match.

China is ever so slowly experimenting with a "Robin Hood" system, using transfers to channel funds from its relatively rich eastern and coastal provinces to its poor western region. China relies largely on earmarked grants, which account for 95 percent of all grants, two-thirds of which consist of revenue sharing on a derivation basis (similar to Egypt). Thus there is no equalizing element. A small equalization grant does exist (3 percent of total grants). The pool is determined annually during budget preparation (thus ad hoc); however, it is formula based, derived from regression analysis of a "standard budget," and relies on variables such as provincial GDP, student-teacher ratios, number of civil servants, and population density.

The Philippines provides an example of distributing the transfer pool among multiple levels of subcentral governments. Under the Local Government Code, local governments receive a fixed share of central tax revenues through the Internal Revenue Allotment (IRA). The pool is equal to 40 percent of average internal tax collections three years before. The IRA pool is first divided among types of subcentral governments: provinces (23 percent), cities (23 percent), municipalities (34 percent), and *barangays* (20 percent). The distribution formula is based on pollution (50 percent), land area (25 percent), and sharing across provinces.

Hungary, like many regimes of the former Soviet sphere, has systematically moved from revenue sharing to equalization grants. The typical socialist country of Central and Eastern Europe in the former Soviet sphere was not dissimilar to current-day Egypt in that it financed local administration through a combination of tax sharing on a derivation basis and an intergovernmental formula grant designed to fund the expenditure capacity (not needs) requirements of centrally set socialist service delivery "normatives." At first (1991) 100 percent of the centrally levied and administered personal income tax was returned to municipalities on a derivation basis. During the 1990s Hungary systematically reduced that from 100 percent to 50 percent to 35 percent to, currently, 5 percent. In doing so, it also systematically moved these central funds into an intergovernmental grant pool to be distributed according to needs. The result: from derivation to equalization.

Canada equalizes on the basis of the potential revenue capacity of its provinces. The goal of the Canadian system is to equalize tax bases. To accomplish this, the central government calculates a per capita provincial standard tax rate and applies that to the potential tax base of each province (the standard rate is the average per capita tax base of five middle-income provinces). The central government then calculates the revenues that would result from applying the (implicit) average tax rate to each province. It then calculates two numbers: the amount of tax revenues that a province would generate if it received own revenues equal to the average per capita tax collection of the five provinces, and the potential yield it could generate by applying the five-province average tax rate to its actual base (a "representative" yield). The amount of the transfer is based on the difference of the two numbers. Because for a poor province the lower number is based on potential revenue, the transfer is neutral with respect to actual tax effort. That is, a poor province is not penalized if it makes an actual per capita "tax effort" greater than its "representative" potential tax effort. The Canadian transfer pool is funded from general tax revenues.

Australia's system is designed to measure relative fiscal capacity—the relationship between equalized tax revenues and representative (equalized) spending needs. The distributive pool is broadly defined for central taxes (personal income, corporate net income, value added, and excises). The formula is a three-step calculation: First, the revenue capacity of each state is calculated in a manner similar to Canada's method. This gives a measure of the ability of each state to generaterevenues from a "representative" tax base multiplied by a statewide average tax rate ("representative tax rate"). A similar representative method is applied to estimate expenditure needs on a state-by-state basis. Expenditure needs are calculated on the basis of separate sets of indicators for each of 41 expenditure categories assigned to subnational governments (for example, medical services are based on population adjusted for age and sex, health is based on infant mortality). Each of these indicators is assigned a weight, which is used to aggregate the relative expenditure needs of each state. The indicator of expenditure needs less the indicator of revenue-raising capacity determines the relative expenditure gap of each jurisdiction.

Source: Dillinger 2005; World Bank 2005; Bird and Tarasov 2002.

Box 6 **Egypt's transfers are not targeted to poor place**

To assess the appropriateness of the current government transfers system, Amin (2005b) conducted a governorate-level regression analysis to find the major determinants of the distribution of government transfers to the 26 governorates. The results suggest that the transfer follows population, not poverty. Indeed, the study concludes that the higher the human development status of a governorate, the higher the amount of transfers it obtains from the central government. The analysis further shows that citizen participation is not a significant factor in the design of the transfer policy.

Table 11 **Local administration debt by source, 1996–2001**

Loan source and amounts	1995/96	1996/97	1997/98	1998/99	1999/2000	2000/01
National Investment Bank						
LE million	1,276	1,189.6	1,696.8	1,651.5	1,538.1	2,114.8
Percent of total	85.60	77.38	87.95	83.37	64.80	67.92
Local loans[a]						
LE million	214.6	347.7	229.8	326.9	833.3	997.8
Percent of total	14.40	22.62	11.91	16.50	35.11	32.05
Foreign loans[b]						
LE million	—	—	—	1.2	—	—
Percent of total	0.00	0.00	0.00	0.06	0.00	0.00
Credit facilities[b]						
LE million	—	—	2.7	1.4	2.1	1.1
Percent of total	0.00	0.00	0.14	0.07	0.09	0.04
Total						
LE million	1,490.6	1,537.3	1,929.3	1,981.0	2,373.5	3,113.7

a. Specialized government institutions such the Agriculture Credit Bank.
b. Denotes private market activities.
Source: Government of Egypt, Final Accounts, 2005.

ANNEX 1

Decentralized ministry directorates

Central ministries have two types of decentralized directorates: 12 with decentralized functions and budget appropriations and 13 with decentralized functions from their central ministries but no decentralized budget appropriations. The 12 with decentralized budget appropriations are largely focused on activities with strong local service characteristics (housing, health, education, social affairs), and the 13 that have only decentralized functions deliver more regional or national services (communication, electricity, water, and land reclamation). Although the governor is legally accorded financial and administrative authority over directorates with decentralized budgets, this authority does not allow for any change in policies or expenditure and revenue assignments set by the ministries. The heads of these service directorates are also members in the governorate Executive Council, making the operation and management of this council complicated and delicate. For the directorates with only decentralized functions, the governor must go to the home ministries on all administrative matters. Once again, the governorate EPC has no meaningful role to play in affecting the directorates' policies or their performance.

Box A1 Classification of Central Ministry Directorates

Directorates with decentralized functions and budgets	Directorates with decentralized functions only
Agriculture directorates	Security affairs directorates
Veterinarian medicine directorates	Industry directorates
Transportation and roads directorates	Electricity directorates
Supply and internal trade directorates	Water resources and irrigation directorates
Real estate tax directorates	Economic affairs directorates
Housing and utilities directorates	Land reclamation directorates
Health affairs directorates	Culture directorates
Manpower directorates	Communication directorates
Education directorates	Tourism directorates
Youth and sport directorates	El-Azhar (Islamic education) directorates
Organization and administration directorates	El-Awqaf (religious endowments) directorates
Social affairs directorates	Financial affairs directorates (MoF oversees revenues and expenditures at the governorate level)
	Planning and followup directorates (MoP works at governorate level to assess local needs before preparing the five-year social and economic plan)

Note: Services directorates are the operational arms of the central ministries at the governorate level. The service directorate equivalent at the lower local levels is a service department.
Source: Law 43 of 1979 (as amended).

ANNEX 2

Description of sovereign shared taxes

Agriculture land tax

This tax is computed on the basis of the assessed rental value of agricultural land, determined every 10 years. It is administered jointly by the MoF (Real Estate Tax Department) and the Ministry of Agriculture. Although the tax base valuation update should increase absolute revenue, two factors continue to diminish this source of revenue: the tax exemptions and the Islamic inheritance law that divides all properties among the children of a deceased owner into smaller plots of land. Twenty-five percent of the agriculture tax is allocated to the governorate in which the land is located and 75 percent to the villages where the tax is collected. Revenue from this tax accounted for almost 18 percent of local tax revenue in FY 2001/02 (annex table 2).

Property tax (land and buildings, Law 56 of 1954)

This tax is considered the urban equivalent of the rural agriculture land tax. All commercial and industrial buildings in cities are required to pay a specific rate on their assessed rental value, less an allowance for expenses. This tax is administered by the MoF (Real Estate Tax Department) and through district tax collection offices that report to the governorate. As with the agriculture land tax, 25 percent of the tax on buildings is allocated to the governorate in which they are located and 75 percent to the cities where the tax is collected. Despite the boom in the construction sector through the 1990s, especially in the second half of the decade, building tax revenue grew only 22 percent between FY 1992/93 and FY 2000/01. This tax accounted for 11.7 percent of total local tax revenue in FY 2001/02, compared with 6.58 percent in 1992/93. The tax is riddled with exemptions and exclusions, and its administration lacks effective enforcement.

Entertainment and amusement taxes

These taxes are levied on all owners of theaters, cinemas, nightclubs, and other places of entertainment. Prenumbered tickets are used to estimate tax liabilities based on specific criteria. This tax is jointly administered and monitored by the MoF (Real Estate Tax Department) and Ministry of Culture through local-level directorates that occasionally send representatives to performances to verify attendance. This tax contributes slightly to local tax revenue. Its share of local tax revenue was 3.6 percent in FY 2001/02, compared with almost 4 percent in FY 1999/2000.

Motor vehicle tax and driver's license fees

These charges are administered by the Ministry of Interior and accounted for 14.2 percent of local tax revenue in FY 2001/02. More than two-thirds of these taxes and fees are collected in the three major urban governorates (Cairo, Alexandria, and Giza).

Local share of common revenue

This source is structured as a surtax on central tax bases, levied on four types of tax: import duties and export taxes, taxes on investment security holdings, taxes on cigarettes and other tobacco products, and profit taxes on commercial and industrial concerns. Fifty percent of these tax revenues remain in the governorate where they are collected. The remaining 50 percent are transferred to the Joint Fund to be distributed to all governorates, excluding Cairo and Alexandria, according to a specific formula. The rate of the surtax is not stable. Many actors and many laws have determined this rate over time. This source of revenue contributes considerably to local tax revenue—almost 37 percent in FY 2001/02. As with other sovereign shared taxes, the receipts are distributed on a derivation basis (that is, where they were collected) and thus accrue to urban governorates, where the trade and industrial tax base is located.

The Joint Fund

The Joint Fund is not a tax but is considered here as shared revenue. It is administered by the MoF. However, the way in which the fund resources are distributed among eligible governorates is decided after a consultation with the Ministry of Local Development. The criteria used to allocate the resources to the governorates include population, geographic area, and need. The contribution of the fund to local tax revenue increased from 20.7 percent in FY 1992/93 to 30.2 percent in FY 2000/01, a percentage change of 45.9 percent, before a considerable decrease in FY 2001/02 to 19.25 percent (see annex table 2). Because this fund excludes Cairo and Alexandria, it mostly supports the budgets of the Lower and Upper Egypt governorates.

Taxes on Suez Canal Authority profits

These taxes are collected by the MoF to distribute among the five governorates surrounding the Suez Canal, Port Saïd, Ismailia, Suez, North Sinai, and South Sinai. A surtax, the receipts are distributed as follows: 50 percent to Ismailia, 30 percent to Port Saïd and Suez, and 10 percent each to North and South Sinai. The relative importance of Suez Canal taxes has declined by 40 percent since 1992. Though the receipts accrue to the five governorates, all expenditures financed by this source must be approved first by the Ministry of Planning and then by the People's Assembly. The projects financed with these funds must have a regional or national character.

Table A2 Composition of local administration sovereign revenue

Percent

Tax type	1992/93	1993/94	1994/95	1997/98	1998/99	1999/2000	2000/01	2001/02
Agriculture/land	15.57	16.80	12.88	10.99	11.14	11.29	12.25	17.97
Building	6.58	7.86	5.99	6.88	7.85	7.95	8.02	11.69
Entertainment	3.23	3.53	3.04	3.52	3.52	3.77	1.83	3.64
Motor vehicles	9.23	10.32	7.77	7.23	7.50	7.66	8.24	14.22
Common revenue share	26.88	22.89	28.82	31.22	30.60	30.77	30.91	37.11
Joint fund share	20.70	23.60	27.83	30.49	29.89	30.06	30.20	19.25
Suez Canal fees	17.82	14.99	13.68	9.68	9.49	8.51	8.55	7.60
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: The People's Assembly 2005.

ANNEX 3

Description of nontax current revenue

Utility revenues include mainly water supply, wastewater management, garbage removal, and some local electricity distribution projects. The major source of these fees comes from the National Water Authority, which sets a variable rate for people with metered usage and a fixed rate for those with unmetered usage. Utility revenues accounted for just 6.23 percent of local nontax revenue in FY 2000/01 (annex table 3). This contribution is almost the same between FY 1992/93 and FY 2000/01, suggesting that there was no major change in the pricing system or structure of user charges over this period.

Service directorates fees and user charges are collected by the directorates at the local level, which provide a variety of services to local residents. Examples of these fees are public educational institution and health clinic registration fees and veterinary services charges. The largest percentage increase was in the Service Directorates category, which primarily derived from fees collected from the beneficiaries of health and education activities.

Local licenses fees are primarily derived from annual licensing of commercial, industrial, and sports establishments. Current law permits the governorates to license almost all regulated activities within their jurisdictions. Fees for local licenses as a percentage of local nontax revenue experienced a 5.1 percent increase between FY 1992/93 and FY 2000/01. This source is ranked as the third contributor to local nontax revenue, almost 7.2 percent in FY 2000/01, after LSDA and local productive projects profits.

Revenues from productive projects are derived from projects established through a Ministry of Planning fund or a foreign donors' fund to support local development efforts to be self-sufficient. The contribution of these projects to local nontax revenue was stable at about 10 percent over the period from FY 1992/93 to FY 2000/01. Because many of these projects are included in the national program of privatization, and some have already been privatized, they will cease to be a component of public finance.

Quarries and mining fees are derived from entities that have been given a concession to extract sand, gravel, or other building materials from public quarries or mines. The annual fee is remitted to the local unit where the quarry or mine is located. Its contribution to local nontax revenue is small.

Local services and development account does not accurately capture the composition of this budget line item. Law 43 of 1979 gives local units, specifically EPCs, the right to establish and run local accounts without seeking approval from the central government. However, the law gives the governor the right to issue the decrees required to organize these accounts. The fact that all lower-than-governorate local units have permission to establish this one type of local account gives this line item its current name. However, governorates are also permitted to establish and operate other types of local accounts—for example, for land reclamation, housing, and industrial services. Thus the budget line item of LSDA for governorates may include several separate accounts. In addition, an EPC may set up special funds for cleaning, health, and roads.

Local accounts and special funds are similar in that revenues raised by them remain with the local unit, unlike most other government revenues, which have to be returned to the central government if not disbursed. Such accounts and funds offer local units access to resources over those centrally allocated. They provide local units more flexibility while responding to local needs. According to the local administration law these accounts and funds must be used for the purpose for which they were established.[1] However, local accounts and special funds differ in two ways. First, special funds raise revenue from just one source, user fees, while the local accounts can obtain revenues from all available sources. For example, LSDAs at the governorate level obtain their revenues from the fees imposed by the governorate popular council, profits of the projects, legacies, donations, grants, and 50 percent of the local revenue that exceeds the governorate's local revenue estimates. Second, most of the projects financed by local accounts are investments, while most of the projects financed by special funds are service projects.

Local accounts and special funds are the major contributors to local nontax revenue by a share of 64 percent in FY 2000/01. However, this percentage includes not only the revenues generated by the fund in that year but also the balances accumulated from previous fiscal years.

Source: Amin 2005a.

1. Law 145 of 1988, amending Law 43 of 1979 for Local Administration, states that the government is to issue a decree to organize the management of such funds.

Table A3 Composition of local administrations' current local revenue, 1993–2001

Percent

Type of nontax	1992/93	1993/94	1994/95	1997/98	1998/99	1999/2000	2000/01	Percent change
Utilities	6.08	7.53	7.97	6.73	6.73	6.54	6.23	2.34
Service directorates	2.94	2.96	3.66	4.17	4.49	4.53	4.63	57.36
Licenses and fees	6.82	5.97	9.07	7.70	7.45	7.56	7.17	5.10
Local project profits	10.20	9.73	14.00	11.23	10.87	10.76	10.11	–0.93
Quarries and mines	0.66	0.69	0.89	1.05	1.19	2.30	1.13	71.43
Other revenues	5.57	5.90	5.62	7.56	7.19	7.11	6.75	21.17
LSDA	67.72	67.22	58.79	61.57	62.08	61.22	63.99	–5.51
Total nontax revenues	100.00	100.00	100.00	100.00	100.00	100.00	100.00	

Source: The People's Assembly.

ANNEX 4

Government transfers

Table A4 Ratio of government transfers to total current expenditure by governorate, 1995–2004

Percent

Governorate	1994/95	1995/96	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04
Cairo	54.51	56.52	55.46	56.76	59.58	64.87	66.98	68.52	71.38
Giza	64.22	63.77	64.34	65.31	66.51	70.36	71.62	72.60	75.48
Qalyubiya	81.19	81.71	82.30	82.06	82.85	84.68	85.24	86.05	87.35
Gharbiya	82.33	83.20	84.30	81.89	83.15	85.67	86.61	87.03	87.94
Manufiya	83.46	83.12	83.85	84.90	85.63	87.04	88.17	88.54	89.37
Kafr Al-Shiekh	82.82	84.03	85.95	86.14	87.03	85.96	87.56	88.36	89.11
Dakahliya	84.08	84.85	86.91	87.99	88.66	89.93	90.88	91.37	91.91
Dumyat	76.59	80.62	80.25	81.00	82.27	83.75	85.21	85.34	86.69
Alexandria	53.45	56.47	58.00	62.10	62.41	67.01	70.05	74.29	73.89
Matruh	70.49	72.06	69.73	70.36	70.81	58.82	76.31	76.29	78.64
Bahayra	70.32	71.01	73.36	75.47	77.56	79.65	79.96	82.87	85.46
Port Saïd	51.91	52.92	48.25	50.16	52.42	56.31	56.05	56.45	58.21
Ismailiya	33.41	42.86	51.16	52.97	60.35	65.31	66.65	61.71	60.38
Suez	40.21	42.99	48.88	49.96	53.99	57.90	59.04	59.77	55.45
Red Sea	58.78	59.33	44.46	44.98	47.98	55.34	50.15	51.11	52.96
North Sinai	66.43	70.81	72.72	74.19	76.40	80.03	81.76	79.35	79.61
South Sinai	34.60	39.55	33.41	36.15	38.09	45.10	47.19	45.27	44.32
Sharqiya	86.19	86.47	85.59	87.03	88.75	90.01	90.74	92.21	91.81
Fayyum	74.64	76.61	75.35	75.29	77.38	81.84	83.44	82.70	83.34
Bani Suwayf	81.69	82.98	82.01	82.09	84.63	84.32	84.20	85.05	85.88
Minya	82.00	82.43	82.58	84.30	84.60	86.65	87.10	87.45	88.17
Asyut	85.94	86.07	85.56	85.86	86.83	88.33	88.85	88.76	88.94
New Valley	89.80	90.79	90.09	90.38	90.48	90.80	91.35	92.09	92.60
Suhag	82.88	85.23	81.07	81.47	81.75	82.75	84.55	85.33	86.27
Qina	81.92	81.17	83.01	84.44	84.60	85.41	84.80	84.98	84.64
Aswan	83.76	86.19	85.16	87.53	87.79	88.70	89.11	88.68	88.47
Luxor	43.81	53.59	65.28	70.28	70.22	72.84	75.59	77.57	78.39
Total	74.06	75.48	75.66	76.78	78.22	80.51	81.66	82.48	83.33

Note: The table is based on the final accounts up to FY 2000/01.
Source: The People's Assembly.

Notes

1. The dialogue—and action—is already under way with respect to central finance. Egypt is in the process of studying, enacting, and in one case finalizing several public sector reforms. They include recently concluded reforms of the tariffs (2004) and taxes on imports and profits (2005) plus an examination of rationalizing and simplifying sales and excise taxation (including, as an option, adopting a full-fledged value added tax) and the urban property tax.

2. The NDP recommendations included mobilizing sufficient resources to finance the projects initiated and designed by the governorates; giving governors the right to appoint the heads of the central ministries' directorates after consulting the ministers concerned; enlarging the role of local entities in preparing and executing the budget; enlarging the role of local entities in physical planning at the local level; and enhancing the role of the elected local council, especially in checking and following up the functions of the appointed local council.

3. This is to be a participatory process among the governorates. The LE 2.88 billion comes out of the budget of the Ministry of Local Development, which retains the authority for final approval on how the grant is allocated. Governorate-by-governorate distributions have yet to be announced (as of 10 October 2005).

4. In discussions (on 8 August 2005) the governor of Qina acknowledged that some have observed that he broke some central laws in order to accomplish needed efficiencies in governorate operations. It was only by allowing those actions that he was able to successfully obtain approval from the central government. That this appears to be true—that a law was broken—reinforces the point. Much more important, this episode (and probably others to come like it) reveals one of the fundamental systemic weaknesses of a deconcentrated control-oriented government system: a central power unable to cope with (in this case the most simple) of innovations characteristic of entrepreneurial local governments. One of the chief merits of a decentralized fiscal system is that when a local official goes to the community and secures community participatory agreement (as this governor did) on a matter as straightforward as levying student fees to improve school performance, the central bureaucracy has the benefit of staying uninvolved in such purely local fiscal matters.

5. The focus is on fiscal decentralization. Thus the power sharing in issues such as the nature and structure of elections, representation in the People's Assembly, and international environmental compacts (even though they may have significant local implications, as does the management of the Nile River basin) are not examined here.

6. It is important to make clear that the variants should not necessarily be thought of as a sequence (that is, that a country moves through stages of decentralization—though that certainly can happen). Nor are the variants mutually exclusive. Thus, a country could be politically decentralized but have little or no fiscal decentralization, as is still true of some of the Central and Eastern European and all of the Central Asian republics. And a country that is generally agreed to have a high degree of fiscal devolution is also almost sure to incorporate elements of delegation and deconcentration (for example, the two North American decentralizers, Canada and the United States, routinely combine devolution of fiscal powers with provisions whereby independent subcentral governments act as service delivery agents of the center). However, it is not possible to have fiscal decentralization without political decentralization.

7. Law 124 of 1988.

8. Egypt's Constitution (1971, as amended May 1980) provides for a strong president empowered to appoint one or more vice presidents, the prime minister, the cabinet, and the governors of the 26 provinces (governorates). The parliament—

the People's Assembly (Majilis al-Sha'b)—consists of 454 members, 444 of them popularly elected and 10 appointed by the president. Assembly members sit for five-year terms and may stand for re-election. There is also a Consultative Council (Shura) with 264 members, 167 of them popularly elected and 97 appointed by the president, that performs an advisory role but lacks legislative power.

9. Law 43 of 1979 and its executive regulations were amended mainly by Law 50 of 1981 and Law 145 of 1988.

10. The governorate people's council is formed of eight members from each district or administrative quarter. The exceptions are in the governorates in the Suez Canal region (Ismailia, Port Saïd, and Suez), and the Frontier governorates (Matruh, New Valley, Red Sea, North Sinai, and South Sinai), where each district or administrative quarter is represented by 12 members. The law does not impose a residency requirement on council members.

11. Functions include supervising utilities and activities that fall under their local unit (tier), within the context of national public policy; requesting data related to local economic (project) activities; approving drafts of the annual budget and economic and social plans; outlining and approving plans for local projects requiring local community efforts and resource mobilization; and proposing new local fees and duties.

12. There are several reasons for this difficulty, chief among them that there is only one standardized source for such comparisons (the International Monetary Fund's Government Finance Statistics) and those data suffer from incomplete reporting by many countries. Even when countries do report, numbers may differ from year to year across countries. When reporting data on the ratio of local administration to total expenditures, no distinction is made between a government that has a public sector that is largely devolved (as in many OECD countries) and one in which local administration expenditures are largely deconcentrated (as in Egypt). This information is particularly important for any discussion of fiscal decentralization. One way to minimize the effect of such measurement incongruities is to limit comparisons to like countries in terms of degree of decentralized governance.

13. For data consistency in these comparisons, the 18 percent figure for FY 2000/01 from table 1 is shown in the annex.

14. To put these fiscal comparisons in further perspective, the data on the ratio of total government expenditures to GDP reveals that Egypt's ratio of 36.7 percent (FY 2001/02) is in line with the developing and transitional world. For example, Jordan is at 31.3 percent, Oman 30.8 percent, Algeria 30.4 percent, Hungary 49.3 percent, Estonia 35.1 percent, South Africa 29.5 percent, and Syria 23.2 percent (IMF 2004). In interpreting these data, is it most important to once again recognize that the ratios do not measure the degree of local fiscal autonomy (though the OECD and developed country average may be much closer to allowing that interpretation).

15. The twin issues of willingness to pay for public services and the degree of cost recovery are not addressed here. The Alexandria governorate carried out willingness-to-pay studies in order to set some user charge levels. Also see Gulyani (2005).

16. This idea is expressed in the decentralization theorem (Oates 1972) and the principle of subsidiarity, as embedded the European Union's European Charter on Local Self-Government.

17. This is not to say it is an unconditional block grant but rather to stress that (a) because the system is deconcentrated, there is no conventional system of conditional grants, and (b) there is a gap-filling grant that, like a block grant, can be examined for its distribution and equalization characteristics. The equalization issue is of interest in this analysis.

18. The problems of a small pool are discussed in Ebel, Fox, and Melhem (1995).

19. Sources of borrowing include bond finance (once local fiscal integrity is established and capital markets develop—this will take a while for the decentralized Egyptian governments); the commercial banking system; a central government loan fund operating out of ministries of local government; and a municipal development bank, usually capitalized by the center. Which option is appropriate for a given country depends on many factors. In most countries where capital markets are not well developed, the central government or its agency establishes a limit on the total amount of credit available to local governments, sets the terms of the loans, defines the acceptable uses of debt finance, and controls the flow of loan funds.

20. Failure can be addressed through a variety of mechanisms: municipal bankruptcy laws (as

in Hungary) and temporary takeover of the finance of the subnational government by a higher-level government or a special entity (as in Mexico, the Netherlands, Poland, and the United States).

21. Borrowing is usually a minor source of revenue for local governments in developing market economies. This reflects the generally small role played by local governments and their limited sources for finance.

22. This information is largely drawn from Joumard and Kongsrud (2003).

23. The question of an empowered intermediate government is often at issue. For example, Indonesia empowers districts. Pakistan formally rejects a provincial-district hierarchy but nonetheless empowers provinces in their role as determiners of the design of the pass-through of the National Support Fund (the major intergovernmental grant) to district governments. The postsocialist central European governments initially abolished intermediate levels (historically the political arm of the communist system) but are now reconsidering their merits on efficiency grounds. The Sudan Comprehensive Peace Agreement (of January 2004) established two regional entities: a fiscally autonomous regional government of South Sudan (with 16 states) and a northern region (26 states) tightly controlled by the new interim government of National Unity.

24. Although the policy must be locally determined, the managerial and administrative aspects may be (and often are) privatized or contracted to another type of government.

25. As of FY 2006, the budget is reported in eight chapters: salaries and wages, goods and services, interest, grants and contributions, other current expenditures, investment expenditures, financial assets, and loans (Shand 2005).

26. The table is useful and revealing, but care should be taking in making country comparisons. The ratio of subnational to total public sector size varies by country. In the table, nearly all countries shown have subntional to total ratios higher than Egypt's, suggesting that in terms of "own" currency Egypt does indeed have a very small degree of own revenue autonomy.

27. The current transfer acts as a spending and shared tax gap-filler. These estimates are also consistent with the data that showed a decline in the size of the local administration sector both as a percentage of national expenditure and relative to GDP (see table 1).

28. For a through review of fiscal imbalances, see Bird and Tarasolav (2002).

29. Such fiscal disparity is a problem in all decentralizing countries regardless of whether the public sector is tilted toward devolution or deconcentration (Upper and Lower Egypt, the Chinese Western Provinces and the Eastern Coastal region, Russia east and south of the Ural Mountains and Russia west and east, Sudan in the Khartoum region and Darfur, and so on). Properly measured, neither gap is subject to political manipulation. Thus an accounting deficit (expenditures greater than revenues) in a jurisdiction is not necessarily evidence of a vertical fiscal gap. Similarly, with respect to horizontal imbalances, fiscally rich and poor areas can be empirically defined (Bird and Tarasolov 2002; Ahmad and Tanzi 2002).

30. A bit more problematic in some countries (such as Egypt) when structuring of public transfers is how to account for the grants made by external players such as international finance institutions, bilaterals, and nongovernmental organizations (Weist 2002). Although most such external grants (even if in-kind) to a subcentral administration are not to be discouraged, they require local reporting to the central authority and, if large, should be taken into account when the center (or other granting administrative unit) engages in an equalization transfer policy.

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