CHALLENGES OF FISCAL DECENTRALIZATION IN DEVELOPING AND TRANSITIONAL ECONOMIES—AN ASIAN PERSPECTIVE

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CHALLENGES OF FISCAL DECENTRALIZATION IN DEVELOPING AND TRANSITIONAL ECONOMIES - AN ASIAN PERSPECTIVE

M Govinda Rao*

Abstract

The paper analyzes fiscal decentralization trends in three large Asian developing countries making a transition from plan to market economy. The analysis helps to identify the emerging challenges in achieving fiscal decentralization. The challenges arise from transition to market, and replacement of command and control systems with market-based policies, instruments and institutions. The approach to meet the challenges has to be holistic and should encompass all levels of government.

Introduction

For a variety of reasons, a number of countries in recent years have made significant attempts to decentralize their fiscal systems for a variety of reasons. The reasons include democratization of polity, advent of multi-party system, transition from plan to market economy and accommodating diverse ethnic, linguistic and religious identities (Litvack, Ahmad and Bird, 1998). The decentralizing trend is seen in countries with federal constitutions as with unitary systems; it has spanned across countries with different ideological spectrum and varying levels of development.

Designing and implementing policies and institutions to accelerate development and meet the requirements of transition to market are major challenges faced in both developing and transition economies. These tasks can be very well served by accommodating systems of sub-national finance. Prof. Bird’s own contribution to intergovernmental finance in both developing and transitional economies has been immense.1 In the same tradition, this paper attempts to relate universal principles to local applications in the context of developing and transitional Asian economies.

This paper analyzes decentralizing experiences of three large developing and transitional countries in Asia, namely, China, India and Vietnam. The paper begins with reviewing recent developments in fiscal

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decentralization in the three countries and identifyng the major issues in each of them. From this analysis, an attempt is made to identify the challenges faced in the process of transition. This is followed by a summary of major issues of fiscal decentralization in these economies.

The paper identifies a number of important challenges faced in setting up efficient systems of intergovernmental finance in the three Asian developing countries: 1. For making transition from plan to market, establishing property rights, instituting a legal system and regulations to ensure efficient competition calls for creation and strengthening decentralized institutions of governance. 2. The changing role of the State enhances the relative importance of the subnational fiscal system and extending fiscal decentralization up to the lowest level is a major challenge. 3. Effective fiscal decentralization requires assignment of significant powers to subnational governments (Bahl, 1999). This is necessary to ensure that at the margin there is linking of revenue and expenditure decisions. 4. The transition to market necessitates calibration of an efficient tax policy to replace revenue from public enterprises with taxes. It is also necessary to remove price and quantity controls. This necessitates reforms in budgetary systems to make them comprehensive to include all extra budget and off budget items. 5. It is necessary to develop a rational system of assignments and transfers, a proper legal and regulatory framework to conduct them and institutions to implement the system. 6. Capacity development of subnational institutions is also extremely important.

Within this broad set, the issues faced by individual countries vary widely. The differences can be due to economic, political, social and political diversities, history and traditions of individual countries, the extent of market penetration and the strength of decentralizing systems and institutions. Therefore, a uniform approach to meeting the challenges would be inappropriate. Nevertheless, it is useful to compare and contrast the decentralizing experiences to understand the challenges and evolve implementable approaches.

Fiscal Decentralization in China, India and Vietnam

There are important reasons for focusing on decentralization experiences in China, India and Vietnam. There are comparisons and contrasts in fiscal decentralization trends, policies and institutions in the three economies. All the three countries have initiated reforms towards achieving market-based development and embarked on initiating policies and setting up decentralized fiscal institutions to create a market-friendly environment.

The three countries represent different typologies of decentralization. Their varied experiences are useful to identify the challenges of fiscal decentralization during the process of transition. China
is a large unitary country, yet having a strong local government system. Although the tax powers rest mainly with the Centre, local governments have significant control over fiscal resources. China has a tradition of decentralization below the provincial level due to close government-enterprise interaction at country and township levels. India, on the other hand is a large federal democratic polity, but fiscal decentralization extends only up to the state level. The challenge here is one of extending fiscal decentralization below the state level. Vietnam, in contrast, is a unitary transitional country with local governments having little tax powers. Its decentralization may be characterized as 'deconcentration' in which subnational governments are merely agencies of the Centre.

An important common trend seen in all the three countries during the 1990s is the strong initiative taken to systematize their fiscal systems in recent years. In the case of China, fiscal reforms introduced in 1994 have attempted to re-centralize tax collection and reform the tax sharing system. However, these tax and intergovernmental finance reforms are not accompanied by corresponding changes in budgeting systems. Reforms in budget formulation, implementation and controls have been introduced only recently and are at various stages of implementation by different local governments. India has tried to evolve a three-tier federal system and strengthen the third level through Constitutional amendments and other institutional and policy initiatives since 1992. However, much of sub-state decentralization is a central initiative, though there are some notable exceptions in States such as Karnataka, Kerala and Madhya Pradesh. The process of local government reform is still under way in India. Similarly, Vietnam has implemented the new budget law in 1997 to place fiscal decentralization on a more systematic footing. In spite of this, much remains to be done to achieve decentralization from the present status of deconcentration.

Analysis of recent experiences of the three countries is useful to understand their strengths and weaknesses and to evolve strategies to deal with the fiscal decentralization problems of transition. In the following, the salient features of decentralization systems in the three countries are summarized:

1. China

China is a large country making a transition from Soviet-type planning to market-based development. Despite being unitary in structure, China's fiscal system is highly decentralized with five hierarchically ordered budget levels: centre, province, prefecture, county and township. The number of local government units add up to about 50,000 (Figure 1). These include: 31 provinces, 333 prefectures, 2148 counties, and 48697 townships. Although sub-national governments do not have powers to determine tax bases and rates, they have considerable maneuverability
with regard to spending decisions. Almost 70 per cent of expenditures are incurred at subnational levels. The fiscal arrangements over the years have been evolved according to the negotiated fiscal contract system. This has not only caused decline in governmental revenues but also reduced the ability of the central government to undertake macroeconomic stabilization and redistribution. Besides, the system encouraged the use of off-budget and extra budgetary funds with adverse consequences on accountability (World Bank, 2000). A comprehensive package of reforms was implemented in 1994 to arrest decline in revenues and restore central control over fiscal instruments. These reforms were directed also to define fiscal responsibilities, separate central and local fiscal systems, and ensure better macroeconomic control at the central level. However, the reforms are yet to address many issues at decentralized levels, particularly those relating to clarity in expenditure assignment and reforms in the budgetary process.

**Figure 1: Levels of Government in China**

![Levels of Government in China](image)

1/ Beijing, Tianjing, Shanghai, Chongging
2/ Under cities at all levels

*Source: World Bank (2000)*

**(a) Pre-reform intergovernmental finance system.** The system of intergovernmental finance in China has undergone several phases until a comprehensive package of reforms was introduced in 1994. There were at least three important reasons for the introduction of reforms: 1. secular fiscal decline or the decline in the 'two ratios' - the ratio of government revenue to GNP and central government share in total
expenditures - had to be arrested. The ratio of revenues to GNP fell from 35 per cent in 1978 to 12 per cent in 1996. Similarly, expenditure share of the Centre declined from about 51 per cent in 1979 to 27 per cent in 1994 (World Bank, 2000, Wong, 2000). Disincentives implicit in the fiscal contract system were an important reason for this outcome. The system also encouraged provision of public services, particularly at sub-national levels, outside the budgetary discipline through various types of fees and contributions. Another contributing factor was the introduction of greater competition with market-based reforms and falling profitability of public enterprises. While the contribution of public enterprise revenues declined steadily, the tax system did not change fast enough to exploit the expanding tax base arising from economic prosperity.

2. In the development of the tax system, cascading type turnover tax was the mainstay. This was replaced by an origin-based value added tax which created a source of invisible transfers in terms of inter-regional tax exportation. Such invisible transfers tend to be regressive, and undermine the progressivity of explicit intergovernmental transfers, even when they are progressive. Again, as the tax sharing arrangements are derivation based, this further contributed to regressivity.

3. The intergovernmental transfer system had serious disincentives. The Central Government determined all tax bases and tax rates, but the local tax administration collected the taxes and remitted them upwards according to negotiated arrangements. This provided independent revenues to local governments but there were also incentives for them to avoid remitting taxes upwards through a variety of means (Ma Jun, 1995, Wong, 1995). The differential sharing mechanism introduced in the fiscal contract system of 1988 only served to enhance the powers of more affluent provinces and reduced the central share in revenues.

Major consequences of the above may be summarized. 1. The Centre lost its ability to undertake redistribution and stabilization functions effectively. 2. Local governments in general, unlike other 'deconcentrated' systems, had a good deal of autonomy both in revenue and expenditure decisions as the collection of revenues by local tax administration meant that they could control effective tax rates and flow of funds to the Centre. The declining share of central revenues and overlapping expenditure assignments enabled the Centre to push down expenditure responsibilities to lower levels. The system of collecting taxes and remitting to higher levels by local governments and the tax sharing mechanism based on fiscal contract system created significant inequities in the spread of resources among local governments. The richer localities could also use the extra budgetary resources better to provide public services. This caused inequity in the access to public services and more importantly, constrained the ability to undertake macroeconomic control. As increasing
proportion of spending was done outside the budget discipline, the system encouraged poor accountability as well. Extra budgetary funds were estimated to be about 8-10 per cent of GDP in 1995 (World Bank, 2000).

(b) Intergovernmental fiscal system after fiscal reform (1994). Reforms in the fiscal system introduced in 1994 were intended to arrest the fiscal decline referred to above, make the budgeting system comprehensive, eliminate distortions in the tax system and revamp intergovernmental fiscal arrangements. The important measures introduced in 1994 comprised (i) reforms in the tax system including the introduction of value added tax (VAT); (ii) reassignment of taxes between central and local governments to have separate 'Centre fixed incomes', 'local fixed incomes' and shared revenues from VAT between central and local governments in the ratio (75:25); (iii) establishment of separate tax administrations for central and local governments; and (iv) establishment of earmarked transfer schemes to counter the dis-equalizing impact of the tax sharing system based on the principle of derivation.

An important feature of the reform in the tax sharing system is the new system of revenue assignment. 'Central fixed incomes' consist of customs duties, income taxes from central enterprises, VAT, customs and income taxes collected from central enterprises, banks, non-bank financial enterprises, railways, resource tax on offshore oil extraction, business taxes and urban maintenance and construction tax on railroads and profit remittances. 'Local fixed incomes' consist of business taxes excluding those assigned to the Centre, income taxes and profit remittances of local enterprises, urban land use taxes, personal income taxes, fixed asset investment orientation tax, urban construction and maintenance tax, real estate taxes, vehicle utilization tax, stamp tax, animal slaughter tax, agricultural taxes, title tax, inheritance and gift taxes, capital gains tax on land, state land sales revenues, and resource taxes on land-based resources.

The transfer system comprises shared taxes and earmarked grants from the Centre. Shared taxes consist of the VAT and the new securities trading tax. Centre and local governments share the VAT in the ratio of 75:25. Revenues from securities trading tax are shared equally between the Centre and local governments. Although the share of revenue in GDP remained broadly the same at about 12-13 per cent, the share of central government increased from less than 30 per cent in 1993 to over 50 per cent in 1999. Therefore, recentralization of revenues necessitated the central government to guarantee each province that revenues in 1994 at least equalled the base revenues of 1993. Thus, the central government had to institute grants equal to the difference between retained revenues of the provinces in 1993 and the revenue accruing to them according to the new arrangement. The sharing of increases in revenues was also modified to transfer 30 per cent of the increase in central revenues from
VAT and consumption taxes. Besides, the central government committed itself to give quota subsidies to poor and minority regions and make earmarked grants for specified purposes.

(c) Subprovincial revenue sharing arrangements. According to the Organic Budget Law implemented in the country since January 1995 the higher level government has discretionary powers to determine the fiscal assignment of the level immediately below it. The revenue sharing system is bilateral and for the five tiers of government, there are four layers of arrangements (Wong, 1996). Central-provincial arrangements do not touch arrangements below the provinces. Although there is no central guideline on the pattern of resource transfers to be done by provinces, there is no provincial guideline on the transfer system to the local governments below them; sub-provincial revenue sharing arrangements are broadly similar to the central-provincial revenue sharing system.

The result is to extend decentralization to all budget levels, though in some provinces, townships are used mainly as implementing agencies. Thus, in 1999, even in a poorer province such as Gansu, among sub-provincial governments countries received the highest share of revenues (34%). The share of revenues accruing to county and township levels in total sub-provincial revenues was 47 per cent.

As mentioned earlier, sub-provincial revenue sharing arrangement is similar to the centre-provincial revenue sharing arrangements. Similarity in revenue sharing arrangements at sub-provincial levels also implies that sub-provincial equalization reinforces the central-provincial equalization scheme. Bahl and Wallace (2000) show that in China, intra-provincial equalization achieved by provinces conforms to inter-provincial equalization achieved by central transfers.

(d) Intergovernmental transfers: Major Issues. Despite significant reforms in the intergovernmental transfer system, it remains complicated and non-transparent. Centralization of tax powers implied that the provinces could not gain from the growth of the 'lost' tax base. To make the package more acceptable to the provinces, a system of tax rebate had to be introduced to return revenues at enhanced rates from VAT and Consumption tax to provinces. With each layer making different types of remittances to both below and above, the system may be characterized as 'nested hierarchy' (Wong, 2000).

The 1994 reforms did not address a number of issues. Attempt to achieve comprehensiveness in the budget has not been very successful and a significant share of public services continue to be financed from extra budgetary sources. The problem is particularly severe at lower levels for, while revenues were recentralized, expenditure functions of
local governments continued. This has resulted in either underprovision of local public services or resorting to extra-budgetary sources by local governments to finance services or building arrears in meeting committed expenditures like wages or use a variety of other means to soften the local budget constraint. All these have had adverse consequences on efficiency and equity in spending.

Reforms have not also addressed the issue of equity in intergovernmental transfers. The tax sharing system does not address equity issue as revenues are distributed on origin principle and there are no equitable grants to offset this. Earmarked grants could address this to some extent, but it is pointed out that many of these grants are allocated in an arbitrary and non-transparent manner (Wong, 2000). With each level of local government deciding on the system of transfers to the level immediately below, there are problems of both vertical and horizontal coordination in public spending as well.

2. India

(a) Intergovernmental fiscal system. India is a democratic polity evolved as a two-tier classical federation with Constitutional demarcation of functions and finances between the Centre and the states with separate legislative, executive and judicial arms of government constituted at the two levels. The seventh schedule to the Constitution specifies legislative domains of the two layers of government in terms of union (central), state and concurrent lists. The Constitution also requires the President of India to appoint a Finance Commission every five years to review the finances of the Centre and the states and recommend devolution of taxes and grant-in-aid for the ensuing five years.

(b) Pre-reform fiscal arrangements. Though constitutionally a federal country, due to relatively high degree of centralization it is characterized as 'quasi-federal'. In shaping decentralization in India, both historical factors and the public sector dominated, heavy industry based import substituting industrialization strategy have played important roles. Centralization inherent in the constitution was accentuated by the autarchic economic regime, public sector domination in industry and financial sectors and state-engineered allocation of resources. Since 1991, market-oriented reforms have been introduced to liberalize the economy from the dirigisme.

In the pre-reform system, the Constitutional division of functions was only between the Centre and States. In the two-tier federal structure, local bodies below the state level in both urban and rural areas, were merely State government agencies. Although many states did have a third tier, elections to that level were infrequent, and supercession of the elected bodies in them was rather common. More importantly, the State
governments were reluctant to devolve fiscal responsibilities to the third level. Not surprisingly, fiscal decentralization was limited to the State level.

(c) Furthering fiscal decentralization through constitutional amendment. An important development in fiscal decentralization in India is the constitutional amendments in 1992 to accord statutory recognition to the third tier of government. With constitutional recognition, separate schedules listing of 29 subjects to rural local bodies and 18 to urban local bodies have been specified. Revenue and expenditure assignments of local governments are exercised concurrently with States' responsibilities. However, actual powers and functions exercised by the local bodies depend on the extent to which states are willing to devolve. Each state has its own pattern of devolution and in fact, there are wide variations in sub-state decentralization.

**Figure 2: Structure of Multilevel Government in India**

Thus, one billion people in the country are spread over 28 states. Below them there are over a quarter million local governments of which about 3000 are in urban areas and the remaining in rural areas. The rural local bodies or *panchayats*, in turn are at the district, taluk (block) and village levels (Figure 2). Urban local governments consist of municipal corporations in large cities and municipalities, nagar (town) panchayats or notified area councils in smaller towns. Each state government is required to devolve revenue and expenditure powers to local bodies. Elections to these local bodies have to be held every five years, and if the elected governments are superceded by states for any reason, elections must be held within six months of supercession. Each state has to appoint a State Finance Commission every five years to review local finances and recommend transfers to local bodies.
(d) Fiscal assignment. An important feature of the tax assignment is its fragmented nature. While the tax on non-agricultural incomes is assigned to the Centre, agricultural income tax is in the states' domain. Sales taxes on goods can be levied by the states but not the tax on services. Although the constitution is equivocal in stating that trade and commerce throughout the country should be free, the tax on inter-state sale of goods levied by the Centre and collected by the States impedes inter-state movement of goods. More importantly, the state list contains an item, 'tax on the entry of goods into a local area for consumption, use or sale'. This tax is called 'octroi' and has been assigned to urban local bodies in a number of States. The levy of this tax has caused serious impediments to internal trade and has created several tariff zones within the country.

In addition to the above, there are a number of regulatory measures introduced as a part of a planned regime that impedes free movement of goods and persons. Two examples to substantiate this. 1. to meet the contingencies of food scarcity, restrictions were placed on the movement of food grains under the Essential Commodities Act. 2. under the freight equalization scheme that existed for a long time, freight charges of many industrial raw materials such as coal, manganese and steel were subsidized to ensure supply at the same cost throughout the country. This has not only distorted industrial location but has also failed to strengthen forward and backward linkages in poorer, mineral rich regions of the country.

Assignment of taxes to the Centre and the States is guided by the principle of separation with considerable concurrency in the assignment of expenditures. This enables the higher level governments to push expenditure responsibilities downwards, particularly when faced with severe resource constraints. Another consequence of this has been to create overlapping expenditure systems with both the Centre and the states spending on concurrent functions. There are coordination costs, and institutions are still not fully developed to cope with the problems arising from them.

Although the federal constitution of the country has enabled a considerable degree of fiscal decentralization up to the regional level, the devolution of powers and functions to urban and rural local bodies has been abysmal. Information on the finances of urban and rural local governments is not available. However, based on the information for 1997-98 provided in the report of the Eleventh Finance Commission, it is seen that despite constitutional amendments, fiscal decentralization has not gone below the state level. States raise about 35 per cent of total revenues, and after transfers command almost 55 per cent of the revenues for spending. On the other hand, local governments at both urban and rural levels raise a mere 0.6 per cent of GDP or 3 per cent of total revenues.
raised in the country. At their disposal, they have command over resources of just 2.1 per cent of GDP or a little over 10 per cent of revenues. Revenue and spending powers of rural local bodies are particularly abysmal. The quarter million rural local governments representing over 65 per cent of population of the country raise 0.04 per cent of GDP or 0.3 per cent of total revenues. After receiving transfers from the states, they have command over only 1.3 per cent of GDP or 6.4 per cent of total revenues. In fact, history shows that except for a few states like Karnataka, Kerala and West Bengal, decentralization is a phenomenon that is imposed more from the Centre than initiated by the concerned states.

A related aspect of fiscal decentralization is the need to link revenue and expenditure assignments so that at the margin, the decision of the subnational governments to spend is matched by their own tax effort. This is necessary not only to impart efficiency and accountability to subnational spending but also to ensure macroeconomic stability. (Bahl, 1999). However, in the Indian context, state governments are able to finance their expenditure programmes by softening their budget constraints in a variety of ways. Borrowing from public accounts, floating 'autonomous' bodies to implement major projects and borrowing through them, borrowing through public enterprises and seeking overdrafts from the Reserve Bank of India are some of the important ways in which state governments have tried to soften their budget constraints.

Table 1: Fiscal Decentralization in India 1997-98

<table>
<thead>
<tr>
<th>Level of Government</th>
<th>Per Cent of GDP</th>
<th>Per Cent of Total</th>
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<tbody>
<tr>
<td></td>
<td>Revenue</td>
<td>Revenue</td>
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<tr>
<td></td>
<td>Collection</td>
<td>Accrual</td>
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<tr>
<td>Centre</td>
<td>11.4</td>
<td>6.8</td>
</tr>
<tr>
<td>States</td>
<td>6.3</td>
<td>10.9</td>
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<tr>
<td>Local Bodies</td>
<td>0.6</td>
<td>2.1</td>
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<tr>
<td>of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urban local bodies</td>
<td>0.5</td>
<td>0.8</td>
</tr>
<tr>
<td>Rural local bodies</td>
<td>0.04</td>
<td>1.3</td>
</tr>
<tr>
<td>Total</td>
<td>18.3</td>
<td>19.8</td>
</tr>
</tbody>
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In contrast, local governments have been facing hard budget constraints - in fact, they hardly have significant budgets. Their abysmal fiscal resources have resulted in poor service delivery. In the constitutional scheme, both revenue and expenditure powers have to be devolved to them by the states. However, in actual practice, as shown in the table, local governments have very little revenue powers. As regards expenditure functions, most states use them as implementing agencies. In effect, in many of the states, the functions of rural local governments consist of mainly implementing various schemes stipulated by either the Central or the State government. Thus, despite constitutional recognition, in effect, local governments hardly have independent fiscal powers.

**(e) Intergovernmental transfers.** A notable feature of intergovernmental transfers in India is the existence of multiple channels of transfer from the Centre to the states.\(^5\) The Constitution provides for the appointment of the Finance Commission by the President of India every five years to assess fiscal resources and needs of the Centre and individual states and recommend transfers. Finance commission transfers consist of mainly formula-based tax devolution and grants-in-aid given to fill the gap between projected revenues and expenditures on the non-plan accounts. The latest (11th) Finance Commission has recommended the transfer of 29.5 per cent of central taxes to states, the distribution of which is to be determined on the basis of a formula devised by the Commission.\(^6\) Grants are given to fill the post-devolution gaps. Transfers given by the Finance Commissions constitute 58 per cent of the total central transfers to states.

With development planning gaining emphasis, the scope of the Finance Commissions was restricted to meeting states' non-plan requirements in the current (revenue) account. The Planning Commission became a major dispenser of funds to the states by way of grants and loans to meet their plan requirements. These too are distributed according to a consensus formula\(^7\) evolved in the National Development Council (NDC).\(^8\) Transfers to state plan schemes constitute about 22 per cent of total transfers.

In addition to these two channels, various central ministries give specific purpose transfers to the central sector and centrally-sponsored schemes, with or without matching requirements. There are about 190 such schemes at present, but in terms of assistance, the programme on rural development and poverty alleviation, family welfare, primary education and nutritional supplement to schoolchildren are important. There is a good deal of discretionary element in these transfers. These transfers constitute 20 per cent of the total transfers.

Thus, although the Constitution provides for an impartial institution and objective mechanism to resolve fiscal imbalances between the Centre and the States, working of the system has brought in a great
deal of subjectivity. First, existence of multiple agencies making transfers has complicated the transfer system and has made it difficult to achieve the objectives of intergovernmental transfer policy. Although a significant portion of the transfers is formula based, the formulae themselves are not designed to offset revenue and cost disabilities of poorer states. In fact, the gap-filling approach of finance commissions has serious disincentives on fiscal management. The States indulging in lower tax effort and/or expenditure profligacy can show higher gaps and gain more grants. Moreover, despite the predominance of formula-based transfers, Central Government is able to exercise discretion through specific purpose transfers given for central schemes.

An important legacy of planning and the system of decentralization that has evolved over time is the existence of invisible transfers due to repressed interest rate regime, origin-based cascading type consumption tax system and subsidized loans given to 'priority' sectors (Rao, 2000). Invisible transfers in the Indian context also arise from the existence of inter-state tax exportation caused by the levy of cascading type origin-based sales taxes in the states. Another important source of such transfers is the allocation of 'market borrowings' and central loans to states at subsidized interest rates. Providing loans to 'priority' sectors at subsidized interest rates is another legacy of the planning regime that causes inter-regional resource transfers.

(f) Transfers below the state level. As mentioned earlier, in Indian fiscal federalism, decentralization below the state level is negligible. Local governments together raise only 0.6 per cent of GDP but spend about 2.1 per cent of GDP. In fact, a quarter million rural local governments together raise negligible amount of revenue. The state governments determine the system of assignments and the Constitution provides for the appointment of State Finance Commissions by the States. However, similarity with the Central transfer system ends here. In some states finance commissions are yet to be appointed, in some they are yet to submit their reports, while in the remaining the report has not been accepted, and the States have continued to make transfers on an ad hoc basis. In some states, transfers are made on the basis of the recommendations of the finance commissions, but, for want of information and data on indicators of fiscal capacities and needs, the recommendations are not based on scientific criteria. There are also significant inter-state variations in the functioning of sub-state fiscal decentralization.

Decentralization, particularly at village level, as envisaged in the constitutional amendment, also provides for empowerment of socially backward classes and women. A third of the seats in village panchayats are reserved for women. The village panchayats are required to organize 'gram sabha' or village assembly four times a year, in which schemes are prioritized and the accounts are approved. This is meant to ensure
provision of public services according to preferences of people. However, in actual practice, gram sabhas are not active. Instead, they are held less frequently and the participation in the sabhas is poor. Moreover, there are varying degrees of people's participation in different states, depending on a number of factors such as the distribution of landholdings, social stratification and educational levels of the people.

The most important shortcoming of the sub-state decentralization is that both assignments and transfers to local governments do not constitute much to give them any meaningful role in delivering public services. As already mentioned, lower level governments hardly have any revenue handles. In the absence of even basic information, the rational system of transfers has not been evolved. Further, as the amount transferred is negligible, the panchayats are involved mainly in implementing the schemes formulated by the central and state governments.

3. Vietnam

(a) Pre-reform fiscal arrangements in Vietnam. Vietnam is a unified state deconcentrated into local governments. The local governments consist of provinces, districts and communes. Within the unitary system of government, authority to deliver public services is extended to local administrations in provinces, districts and communes. Local administrative units do not have autonomous decision-making authority, but implement central decisions. This is characterized as a 'de-concentrated' system (Asher and Rondinelli, 1999). In this system, the Centre under its supervision and control, assigns the responsibility of providing certain public services and implementing policies and programmes to subordinate local levels. Local administrations consist of 61 provinces, 598 districts and 8850 communes in Vietnam.

An essential complement of the 'de-concentrated' system in Vietnam is the 'unified' budget. The annual budget approved by the National Assembly includes revenues and expenditures of all levels of government. All policy decisions are taken by the People's Committee at the national level and implemented through line agencies at the Centre and local administrative agencies through their respective People's Committees.

Before the implementation of the Budget Law in 1997, fiscal arrangement between different levels of government in Vietnam were carried out on the basis of orders and decrees issued by the Prime Minister from time to time. The fiscal system was rigid and highly centralized with little room for local initiatives to provide public services. Hence, the Centre was unable to direct the delivery of public services to poorer districts and communes, with the provinces determining the allocation to districts and
communes and there being no guidelines to the provinces to make sub-provincial allocations. There was considerable ambiguity in the functions assigned to different levels of government. Often, delivery of services in communes was sustained by 'voluntary' contributions, and residents of poorer communes had to manage without services. Revenues were assigned afresh every year and this unstable system had adverse effects on incentives, rendering planning and implementation of expenditure decisions difficult. There was no institutional and legal framework for implementation, monitoring and control of budgetary decisions as well.

To provide a legal framework to conduct fiscal arrangements between the central and local governments and to place the formulation, implementation, monitoring and control of budgetary decision on a systematic footing, the government in Vietnam initiated budgetary reforms and promulgated the new budget law in 1997. The Law was amended and supplemented in May 1998 to deal with some of the identified problems and to take into account the new developments such as implementation of VAT. The important features of intergovernmental fiscal arrangement in Vietnam after the implementation of the New Budget Law are discussed in the following:

(b) Fiscal Assignment. The budget law implemented since 1998 provides the legal framework for the budgetary process and defines the roles of different governmental agencies. The law lays down the responsibilities of different agencies in the process of budget formulation, implementation, monitoring and control. The main responsibility of estimating revenues and expenditures of the state budget, coordination and negotiation of the estimates with the line ministries and provinces lies with the Ministry of Economy and Finance (MOEF). In finalizing the budget estimates, MOEF takes into account the overall borrowing estimates finalized in consultation with the State Bank of Vietnam and takes plan expenditure estimates from the Ministry of Planning and Investment (MPI). The line ministries and local departments prepare their recurrent and investment expenditures based on the guidelines received from the MOEF. The local budget estimates at each level are approved by the respective People's Councils and then submitted to the higher level finance department.

The starting point in budget formulation is the assignment of revenues and expenditures. The Law defines expenditure responsibilities and sources of revenue of different levels of the government. In the case of expenditures, there is a large area of concurrency and this provides scope for higher level governments to push expenditure responsibility to lower levels, particularly when revenue is stagnant. Expenditure assignment follows the principle of geographical spread of benefits, size of the projects and volume of spending but most public services are assigned concurrently to different administrative levels. The Centre
undertakes operation and maintenance of large projects; local governments implement projects benefiting their respective jurisdictions. Each local unit is responsible for its administration and internal security and it has some functions pertaining to national defence as well. Education and health are concurrent subjects with a functional division of responsibility. School education is a local responsibility and the Centre has to look after training (higher education). Large hospitals are in the central domain, the provinces administer provincial hospitals, the districts administer district hospitals, and communes look after the health centres.

The Law identifies the sources of revenue accruing entirely to the central and local governments and those shareable with higher levels of the government. All taxes are levied and collected by the Centre but the proceeds are assigned either to the Centre or to the states or shared between them. Although the General Taxation Department is a central agency, local governments are required to facilitate tax collections and hence are also the stakeholders. Also, they can retain revenues collected in excess of targets not only in the case of taxes assigned to the states but also the central and shared taxes in specified ratios.

The law, while ensuring stability for three to five years, also provides for adjustment of cash transfers to prices and GDP. The stability in the assignment system is expected to enhance local initiatives to plan the provision of public services. To take care of unforeseen contingencies, however, the Centre can give extra assistance to the local governments. The law also provides for readjustment of the assignments if national defence and security are in danger or if major changes in budget revenues and expenditures are expected.

(c) Expenditure Decentralization. Fiscal decentralization in Vietnam may be characterised as de-concentration. Local governments do not have independent powers to determine expenditure allocation, and they merely implement policies and programmes decided by the central government. Of course, in determining the budget, local governments negotiate their programmes, priorities and requirements. Local governments do not have much autonomy in changing expenditure allocations, as they do not have independent revenues. At the provincial level, flexibility is limited to the extent that actual revenue collections exceed targets and at the commune level, it is limited to voluntary contributions made by the people.

Yet, in terms of implementing expenditures, local governments have a significant role in Vietnam. Together, the local governments implement about 43 per cent of total expenditures and this share has shown a steady increase from about 33 per cent in 1993 to 43 per cent in 1998. Thus, while the total government expenditure in Vietnam in 1998 constituted 20.3 per cent of GDP, the share of expenditures implemented
by local governments formed about 8.8 per cent of GDP (Table 2). The share of local governments in implementing expenditures was 50.6 per cent in the case of social services and about 40 per cent in economic services. Their role is particularly important in education (73 per cent) and health (63 per cent).

Table 2: Expenditure Decentralization in Vietnam 1998

<table>
<thead>
<tr>
<th>Expenditure Item</th>
<th>Per Cent of GDP</th>
<th>Share of Local Exp in Total Exp (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Centre</td>
<td>Local</td>
</tr>
<tr>
<td>Agriculture and fisheries</td>
<td>0.8</td>
<td>0.6</td>
</tr>
<tr>
<td>Transport</td>
<td>1.3</td>
<td>0.9</td>
</tr>
<tr>
<td>Industry</td>
<td>0.5</td>
<td>0.3</td>
</tr>
<tr>
<td>All Economic Services</td>
<td>2.6</td>
<td>1.7</td>
</tr>
<tr>
<td>Education</td>
<td>0.9</td>
<td>2.6</td>
</tr>
<tr>
<td>Health</td>
<td>0.5</td>
<td>0.9</td>
</tr>
<tr>
<td>Pensions</td>
<td>2.2</td>
<td>0.2</td>
</tr>
<tr>
<td>All Social Services</td>
<td>4.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Other Expenditures</td>
<td>4.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>11.5</td>
<td>8.8</td>
</tr>
</tbody>
</table>

Source: Ministry of Economy and Finance, Vietnam.

(d) Intergovernmental Fiscal Arrangements in Vietnam: Salient Features. Despite the improvements brought about by the implementation of the new budget Law in 1998, the process of negotiating expenditures remains critical to determining the assignment of various taxes and cash transfers to provinces. Of course, the budgeting exercise by local governments is confined to determine the allocations to various sectors and units below them. Each province follows its own system in making assignments to the districts. Similarly, there are wide variations in the assignments made to the communes by the districts.

The limited local autonomy and the tendency to push down expenditure responsibility can create problems of inefficiency and inequity in public service provision. Lack of independent sources of revenue constrains local governments from influencing the allocation of public expenditures. When revenues are stagnant, either they have to reduce expenditures or community contributions will have to increase. In poorer communes and districts, the adverse effect of economic downturn on the service level could be severe.
An important characteristic of fiscal arrangements in Vietnam is the continuation of the negotiated system transfers. Determining expenditure levels of provinces is critical to determining tax assignments and cash transfers from the central government to provinces. In such a system, prevailing expenditure levels and bargaining skills of the provinces are the key determinants of transfers and not consideration of equity and efficiency. The negotiated system of transfers has perverse incentives, involves significant bargaining and transaction costs, is non-transparent and even when it is designed to be equalizing, it may not be seen to be so.

The transfer system has contradictory elements. While assignment and sharing of revenues are origin-based and hence, provides advantage to provinces with larger tax bases, cash transfers have to neutralize this regressivity. Proceeds from some taxes are assigned entirely to local governments and the revenues from value added tax is shared between central and local governments. The residual requirement of the provinces is met by giving them cash transfers. The origin-based system of taxation redistributes fiscal resources between different regions in unintended ways. Besides, the difference between point of revenue collection and final payment and the possibility of inter-provincial tax spillovers makes it difficult to assess the progressivity.

The new law gives some powers to charge fees and some user charges to local governments. This also makes it mandatory for the local governments to include all extra budgetary revenues in the budgets. However, actual progress in this regard has not been impressive for it is difficult to ascertain the amount of extra budgetary revenues of various line departments of the central government and different local governments. Revenue implications of interface between enterprises and governmental units are difficult to ascertain. Both local governments and line departments of the central government run a number of enterprises and these extra budgetary revenues are used by them outside the budget discipline. Thus, it is difficult to ensure efficiency and accountability in such expenditures.

Analysis of fiscal arrangement indicates that there is significant redistribution of tax collections in different provinces as shown by the difference between revenue collections and expenditures. While the cross-sectional elasticity of per capita revenue collections is 1.87, elasticity of per capita expenditures is 0.27 (Figure 3). However, this should not be taken as a measure of redistribution. The revenue is collected on the basis of origin and there can be significant inter-provincial tax exportation. This is particularly true of the turnover tax as well as income taxes. Therefore, it would be incorrect to conclude that the difference in the income elasticity between revenues and expenditures entirely represents the degree of equalization.
Figure 3: Redistribution of Revenues in Vietnam

![Graph showing the relationship between per capita revenues and expenditures against log per capita GDP.](image)

Note: the estimated equations are: 

\[ \ln \text{Rev} = -8.5916 + 1.8661 \ln \text{PGDP} \]
\[ \ln \text{Exp} = 3.7194 + 0.2683 \ln \text{PGDP} \]

Where Rev, EXP and PGDP represent revenue, expenditure and per capita GDP respectively. The coefficients are significant at 1% level.

Challenges of Fiscal Decentralization in Transition

The foregoing analysis of the three economies helps to identify important challenges in achieving efficient fiscal decentralization. The problems that need to be resolved include those relating to the development of the market, those pertaining to abandonment of command and control systems, designing multi-level fiscal systems and creating institutions to effectively manage them and their capacity development to ensure efficient public service delivery. Changing policies and developing institutions to deal with fiscal decentralization in the context of transition to market pose serious challenges.

The analysis of fiscal decentralization in the three developing economies of Asia provides useful insights. Within the set of countries
analyzed, there are comparisons and differences in the nature and content of fiscal decentralization. Vietnam is a unitary country and has a deconcentrated system. On the other hand, China, though a unitary country, has a considerable degree of fiscal decentralization, extending all the way up to the county and, in some cases, up to the township level. In contrast, despite being a federal country, fiscal decentralization in India does not extend beyond the state level.

Thus, significant differences in the characteristics of the three countries should not be ignored in drawing inferences and making generalizations on fiscal decentralization challenges faced by the three transitional economies in Asia. In China, the decentralized budgeting institutions extend all the way to townships, and the enterprise-government interface even at the township level has ensured adequate capacity building. The important challenges, however, relate to evolving fiscal instruments to replace the system of command and controls, instituting effective budgeting systems at all levels, developing the necessary institutions and loosening the government-enterprise interface at all levels as the economy makes a transition to the market. In contrast, in India the critical challenge is to develop effective decentralization below the state level and build capacity in it. Fiscal instruments and the budgeting system are reasonably well developed, but public enterprises continue to be a source of fiscal drain, causing macroeconomic difficulties in recent times. In Vietnam, on the other hand, the challenge is one of evolving a system of decentralization and building capacity in institutions from the deconcentrated system prevailing at present.

Despite these differences, there are important issues of common concern in the three transitional developing countries. The challenges of developing an efficient fiscal system and budgeting process, replacement of command and control systems with market-based instruments, and evolving a responsive intergovernmental fiscal arrangement are all common to these countries. The major challenges of transition in these countries can be summarized as:

(i) Extending fiscal decentralization below provincial (state) level. Fiscal decentralization should extend all the way to the lowest budget level to ensure efficient provision of public services, information and transaction costs. This is particularly necessary in countries in which provincial governments are too large to allow meaningful citizen participation or accountability in public service delivery (Bahl, 1999). However, to extend fiscal decentralization below the state level, it is important to develop decentralized institutions and systems, build capacity in these institutions and ensure accountability at all levels.

Merely legislating changes to establish decentralized institutions does not lead to effective fiscal decentralization as has been demonstrated by Indian experience. Despite constitutional recognition, sub-state fiscal
decentralization in India is negligible. The same is the case with Vietnam. The new budget Law has not done much to further the cause of fiscal decentralization and the system continues to be de-concentrated. In contrast, demand-driven decentralization can be successful as seen in the Chinese case and its system of sub-provincial intergovernmental finance reinforces the centre-provincial arrangements (Bahl and Wallace, 2001). Local governments in China up to the township level have traditionally enjoyed economic power due to their hold over enterprises, and this nexus has helped to develop administrative and fiscal capacity in local governments. In spite of the fact that local governments did not have the right to determine the tax bases and rates, and centralization of tax collection arrangements in 1994, the sub-provincial local governments in China have been much more effective in providing public services than both India and Vietnam.

The demand-driven decentralization also has its impact on the size of the lowest budget level in China. There are about 48,000 townships in China with an average population size of about 25,000. At this economically viable size, capacity to deliver public services is better. In fact, in many provinces, even townships are implementing agencies and fiscal decisions are taken at the county level where the average population size is about 500,000. In contrast, in India, the lowest budget level - the village panchayat - has an average population size of only 3000. With negligible assignment of independent revenues, these units are no more than implementing agencies for Central and State government programmes.

Thus, of the three countries, China has the most decentralized system as almost 50 per cent of the subnational spending is undertaken below the county level. In contrast, decentralization stops at the state level in India. The system in Vietnam is best described as deconcentrated.

**(ii) Developing subnational tax system.** Designing and implementing an efficient tax system is an important component of fiscal decentralization. In China, local governments do not have powers to determine tax bases and rates and can only collect the taxes assigned to them. As public enterprises lose their importance in raising revenues, the local governments will have to develop their tax systems. This will not only bring in the extra-budgetary funds into the budget discipline, but will help to link revenue-expenditure decisions at the margin. In Vietnam, both assigning tax powers to local governments and bringing in extra-budgetary funds within the budget discipline are important. In India too, local governments below the state level need to be empowered by assigning independent revenues.

The most important local tax that needs to be developed to strengthen fiscal decentralization is the local property tax in all the three countries. In order to develop property tax as a significant contributor to
local revenues, it is important to institute clear property rights and develop legal and regulatory systems. In both Vietnam and China, assignment of property rights and development of a legal system are still in transition. In India, property rights have been assigned and legal institutions exist. But often, the records are not properly maintained and vestiges of a planned regime—price and quantity controls—continue to plague rationalization of the property tax system. Also, the property owning class as a pressure group in a local government can be a hindrance in the development of a modern property tax system in these countries.

Meaningful fiscal decentralization requires significant subnational taxing powers. Linking tax and expenditure decisions at the margin is critical to ensuring expenditure efficiency and accountability. At present, in Vietnam and China local governments do not have significant tax powers, though in the latter, local tax departments collect the taxes assigned to them. The major issue in China is to convert public enterprise contribution to revenues with taxes. In India, decentralization in tax powers is only upto the State level. Even in urban areas, as property tax is not well developed, the local governments have resorted to inefficient taxes such as the tax on the entry of goods (octroi) into local areas.

(iii) Substituting physical controls with market-based instruments. An important feature characterizing the three transitional economies is the prevalence of price and quantity controls. With the development of the market and opening up of the economy for international trade, price (including interest rate) and quantity controls will have to give way to monetary and fiscal policy instruments. Disbanding the vestiges of command and control systems associated with the Soviet style planning, and replacing them with fiscal and regulatory instruments, calls for changes in the decentralization system as well.

There are a number of other controls and regulations introduced at various levels that hinder the development of a common market. The impediments have been erected to serve the requirements of planning or the rationing strategy to meet the scarcity situations. These have imposed several types of hindrances to the movement of factors of production and products across the country.

Despite reduced emphasis on the plan and change in scarcity conditions over the years, a number of fiscal and regulatory impediments have continued in all the three countries in varying degrees. Besides physical controls, there are also fiscal impediments with unintended allocative consequences. Removal of impediments to ensure free movement of factors and products throughout the country is essential to improve competitiveness. This will be an important challenge in the transitional economies of Asia.

(iv) Making budgets comprehensive. An important challenge of transitional economies is to make the budgets comprehensive
by including spending from extra-budgetary sources of revenue. There are various types of extra budgetary revenues collected to finance public services in transitional countries. In China for example, decline in the share of taxes to GDP has coincided with extra-budgetary financing of expenditures. Besides various types of charges and fees collected outside the budgetary system, local governments have mandated the public enterprises to provide some public services. In addition, there are 'voluntary' contributions in cash and kind made by the community at county and township levels for services such as education, health and rural roads. In Vietnam too, extra-budgetary financing of public services is prevalent. Many line ministries including the Defence Ministry (within this Army) and local governments have profit making enterprises (hotels). Revenues from these activities are not included in the budget. This adversely affects efficiency in public spending, makes spending decisions opaque and creates poor accountability in the fiscal system.

In India, extra-budgetary financing is resorted to soften the budget constraint at the state level. As states’ borrowing is determined by the Central government, they use extra-budgetary means to borrow funds in various ways. A major consequence of this has been to slacken central control over macroeconomic stability. In fact, they have been fairly successful in softening their budget constraints by borrowing from public accounts, borrowing through public enterprises and by floating autonomous bodies and borrowing from them. Developing a proper debt market to improve market discipline to sub-national borrowing and accounting for all contingent liabilities and risks at subnational levels are important challenges faced in these transitional economies.

(v) **Incentives and Accountability.** A legacy of planned regime is the lack of accountability and incentives. Public sector in all the three economies are characterized by over-employment and/or high wages, lack of incentive in payment of wages, recruitment and promotion policy. The position of sub-national governments is not different. Attempts have been to equalize emoluments at all levels of government both horizontally and vertically. At subnational levels, when intergovernmental transfers are determined on the basis of actual/projected expenditures, this can lead to over employment. Equating wage rates of employees of local governments with those of the central government enhances the cost of providing public services particularly in poorer regions. This can also cause segmentation of the labour market and create distortions in unintended ways. Interestingly, the socialist economies of China and Vietnam have greater flexibility in the labour market than in India. In all the three economies, human resource development in the government sector, reduction in over-employment in government and state enterprises, providing performance-based wages and career advancement are the key issues of reform.
(vi) Intergovernmental Finance. Evolving a responsive intergovernmental transfer mechanism is critical to efficient fiscal decentralization system in developing economies. The prevailing transfer systems in all the three countries have perverse incentives. In China and Vietnam, transfer systems are predominantly negotiated. In India, although the institutions have been provided in the Constitution to objectively determine transfers to the states, ways have been found to exercise discretion in intergovernmental transfers. Besides, perverse incentives exist in the design of the formula-based transfers.

In all the three economies, transfer system has a combination of both general and specific purpose transfers. While there is a legitimate role for specific purpose transfers in fiscal decentralization in developing countries, it is necessary that the objectives of such transfers are clear and their design, appropriate. It is important to ensure that this is not used to exercise political influence and discretion by the Centre. The case in point is the system in India in which there are as many as 190 specific purpose transfer programmes. De-politicization of intergovernmental finance is difficult in developing and transitional economies but this is an objective that has to be pursued.

An important implementation rule is that the design of the transfer system should match objectives of the decentralization reform (Bahl, 1999). The challenge is to design general purpose transfers to offset revenue and cost disabilities of subnational governments and specific purpose transfers should be designed to ensure normatively given standards of specified services. However, evolving appropriate transfer system requires significant effort to collect the necessary information, creation of database and measurement of fiscal parameters for designing and implementing transfer systems. In all the three economies, lack of data and information is a major constraint in evolving scientific approaches to implementing intergovernmental transfer systems. Fiscal data at subnational levels in China and Vietnam are difficult to obtain. In India, budgets at state level are published but significant efforts are needed to collect information at local levels.

(vii) Invisible Transfers. In planned economies, besides explicit transfers, various price and quantity controls can cause significant implicit transfers across regions. An important source of implicit transfers in the three transitional economies is inter-regional tax exportation. Origin-based tax system and cascading type of taxes can cause significant inter-regional resource transfers. These economies are characterised by oligopolistic markets. The tax levied by a producing state in many cases could be shifted to consumers in consuming states. Thus, such transfers can be regressive and can significantly offset progressivity of equalizing transfers.
Besides inter-state tax exportation, there can be other sources of inter-regional transfers in planned economies. Important sources of such transfers include targeting investments in specific locations by the central government (regional policies), lending to the subnational governments at below market rates of interest and allowing them to borrow from the market under financially repressive regime, and influencing the allocation of the financial system, including distribution of seigniorage and preemption of the resources of the banking system for priority sectors (Rao, 1997).

**(viii) Institutional Development.** Another important precondition for the success of decentralization in developing countries is the creation of necessary institutions to implement and monitor the fiscal arrangements. A fair degree of intergovernmental competition can be efficiency enhancing. However, it is important to ensure competitive equality and cost-benefit appropriability among competition governmental units (Breton, 1996). Besides, competition can not only be horizontal but also vertical units. Creating institutions and systems to monitor competition is an essential prerequisite for successful fiscal decentralization. Such institutions are necessary to minimize co-ordination costs and to monitor competition. Competitive federalism is successful when the information is available at low costs. In a democratic polity, this is done by political parties and media. Information asymmetry in governments is a major problem when there is no political opposition and media is inactive.

**Concluding Remarks**

This paper has attempted to identify important challenges faced by developing and transitional countries in Asia in achieving efficient fiscal decentralization. Accelerating development and making a transition from plan to market economy pose challenges of evolving market-based instruments, policies and institutions. The challenges identified in this paper, by no means are exhaustive nor are they specific to Asian countries. They can apply in varying measures to other developing and transitional economies as well.

The challenges of fiscal decentralization should not be looked at from the narrow perspective of developing intergovernmental finance. This should be seen as a part of developing a comprehensive and coordinated budgeting and fiscal system. Evolving a transparent and programme-based budgeting system involves the development of an efficient tax, expenditure, and intergovernmental finance systems at the central and local levels. Systemic approach to fiscal decentralization requires instituting policies and institutions on the one hand and capacity building of various institutions to implement them on the other.
Thus, in evolving a decentralized delivery of public services, the developing and transitional economies in Asia will have to face the challenges of developing the market, removing infirmities and impediments to the functioning market and also make a transition from plan to market. Rediscovering the role of decentralized governmental units in the context of the changed role of the government, severing the nexus between governments and state enterprises, removal of price and quantity controls, restoring market incentives, developing institutions to administer market-based instruments and policies and bringing in expenditures from all sources into the budgetary discipline, are the major challenges which need to be met to ensure equity and efficiency in delivering public services in these economies.

Notes


2. Excluding Taiwan and Hong Kong.

3. See Rao (1997). Bahl and Wallace (2000) find that the transfer system in China is progressive. This is true with regard to not only inter-provincial transfers but also intra-provincial transfers.

4. In the de-concentrated system, the sub-national governments are merely administrative units carrying out expenditure functions devolved to them by the line ministries at the centre. See, Asher and Rondinelli (1999).

5. For detailed analysis of the transfer system, see Rao and Sen (1996).

6. The latest tax devolution formula recommended by the Eleventh Finance Commission gives 10% weight to population, 62.5% weight to income disability (distance from the highest per capita income), 7.5% each to area, infrastructure shortfall and fiscal discipline, and 5% to tax effort.

7. The formula assigns 60% weight to population, 25% to income disability, 7.5% each to fiscal performance and special problems of states.

8. NDC is a body consisting of the cabinet ministers of the Centre, Deputy Chairman and Members of the Planning Commission and all the Chief Ministers of the States. The Prime Minister chairs the meetings of the NDC.

9. For a detailed discussion of evolving property tax systems in transitional countries, see Malme and Youngman (2001).
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