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FISCAL DECENTRALIZATION: LESSONS FROM THE ASIAN EXPERIENCE

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FISCAL DECENTRALIZATION: LESSONS FROM THE ASIAN EXPERIENCE

Fiscal decentralization represents the transfer of resources from higher to lower levels of government, usually accompanied by an enhancement in responsibilities of the latter and ceding of influence over budgets and financial decisions of the latter by the former. The rising demand generally for decentralization in developing countries in recent years is a consequence of the broader process of liberalization and deregulation. Political imperatives for decentralization have been created by the urge for greater democraticization and the need to bring governments closer to the people for articulation of their needs and preferences. In a number of countries, the failure of national governments to adequately capture local preferences and provide basic services have strengthened the case for use of subnational governments as delivery agents, such that the production of services is carried down to the lowest unit of government capable of capturing the associated costs and benefits.

However, there are well defined pros and cons of decentralization. These are summarized aptly in the World Development Report [1997] as follows:

> *"Decentralization offers the chance to match public services more closely with local demands and preferences and to build more responsive and accountable government from below. But decentralization also has its pitfalls, including the possibility of increased disparity across regions, loss of macroeconomic stability, and institutional capture by local factions, especially in highly unequal societies."*

The objective of this paper is to describe the process of fiscal decentralization in a number of Asian countries. It covers areas of expenditure and service responsibility allocations, tax assignments, transfers to and access to borrowings by subnational governments. Best practices observed in these countries are highlighted alongwith any practices to avoid. The paper draws lessons regarding the consequences of fiscal decentralization on overall level of public expenditure, size of the fiscal deficit and effectiveness of service delivery.

TABLE 1.1
BASIC INDICATORS ON SAMPLE COUNTRIES

Country	*Population (in million, mid-1995)*	*GNP per Capita (US$)*
INDIA	929.4	340
INDONESIA	193.3	980
PAKISTAN	129.9	460
PHILIPPINES	68.6	1050

Four countries, viz., India, Indonesia, Pakistan and Philippines, have been included in the study. The first three countries are the largest countries of Asia (excluding China) in terms of population. India and Pakistan are federations while Indonesia and Philippines have unitary governments. Basic indicators of these countries are given in Table 1.1.

2. PARTICIPATION OF SUBNATIONAL GOVERNMENTS IN PUBLIC EXPENDITURE

2.1 Basic Principles of Expenditure Assignment

The fiscal federalism literature identifies the basic principles governing the demarcation of expenditure responsibilities among different levels of government in a federation or in a unitary state. The key determining factor is that a particular public service should be provided by that level of government which has a sufficiently large geographic jurisdiction to be able to internalize all the benefits and costs of provision of the service. This not only ensures efficiency in provision but also enables the decision making to be fully responsive to the beneficiaries who bear the costs of provision.

Involvement of higher levels of government in service provision is warranted, first, when there are spatial externalities. These arise when some of the benefits and costs are realized by non residents. In such a case, provision by local government is inefficient. If there are benefit spillovers, for example, to other jurisdictions then the service may be under provided. Alternatively, if there are cost spillovers then there could be some over provision. Some services like defence are truly national in scope and are best provided by the federal government.

TABLE 2.1
ALLOCATION OF FUNCTIONS BETWEEN NATIONAL (N) AND SUB-NATIONAL (S) GOVERNMENTS IN SAMPLE COUNTRIES

Function	India	Pakistan	Indonesia	Phillipines
Defence	N	N	N	N
Foreign Affairs	N	N	N	N
International Trade	N	N	N	N
Currency and Banking	N	N	N	N
Environment	N, S	N, S	N	N
Interstate Trade	N	N	N	N
Immigration	N	N, S	N	N
Air and Rail	N	N	N	N
Industry	N, S	N	N	N
Agriculture	N, S	N, S	N, S	N
Education	N, S	N, S	N, S	S
Health	S	N, S	N, S	N
Social Welfare	N, S	N, S	S	S
Police	S	S	S	S
Highways	N	N, S	N	N
Power	S	N	N	N
Tourism	N, S	N, S	N	N

N = National Government, S = Sub-National Governments (State and Local)

Second, if the provision of services is characterized by economies of scale or if administrative and compliance costs of centralized management are lower then the case for involvement of a higher level of government is stronger. Based on these considerations, the literature distinguishes between 'local' and 'national' public goods, with the former being supplied by subnational governments and the latter by the national government. Local public goods are characterized by variation in local tastes and there exists the potential for competition among jurisdictions in the provision of such goods. National public goods have significant spatial externalities and there is usually an equity concern in terms of a minimum standard of provision in all jurisdictions. In addition, there are economies of scale and cross-jurisdictional externalities.

2.2 Allocation of functions in Sample Countries

Table 2.1. highlights the actual allocation of functions in the sample countries. There is generally an adherence to the above principles, although some differences among the countries are observed. Services like defence, foreign affairs, regulation of international trade, currency and

banking are all provided by the national government in the sample countries. The role of national government is greater in the unitary states (Indonesia and Philippines) than in the federations (India and Pakistan). For example, the function of environmental regulation is performed by the national government in the former while it is shared between national and subnational governments in the latter. The provision of social services like education, health and social welfare is generally decentralized, with the notable exception of health being a national responsibility in Philippines. Other significant differences are the centralization of agricultural development functions in Philippines, exclusive responsibility for health and power generation with states in India and decentralization of social welfare functions to subnational governments in Indonesia and Philippines.

TABLE 2.2
SHARE OF SUBNATIONAL[a] GOVERNMENTS
IN TOTAL PUBLIC EXPENDITURE[b] IN SAMPLE COUNTRIES

Countries	Years	Share in Public Expenditure	Years	Share in Public Expenditure
INDIA[c]	1988-89	54	1995-96	59
PAKISTAN	1988-89	26	1995-96	30
INDONESIA	1989	14	1994	15
PHILIPPINES	1991	7	1996	11

[a] both state and local governments
[b] both current and capital expenditure
[c] including only that expenditure by local governments financed out of assignments to local governments by state governments.

Based on the allocation of functions in each sample country, the resulting share of subnational governments in total public expenditure is given in Table 2.2. The highest share of 59 percent is observed in the case of India. This is a substantially higher degree of decentralization than in most developing countries and is close to the level attained by developed countries like Canada and Australia. The share of subnational governments in Pakistan of 30 percent is close to the average for developing countries. The corresponding share, as expected, in unitary states like Indonesia and Philippines is much lower at 15 percent and 11 percent respectively.

Table 2.2 also indicates that there is a secular tendency for the share of subnational governments in public expenditure to rise over time. In all the four sample countries, this share has increased over the last decade. This is indicative not only of an enhancement in the functions of state governments but also of relatively high income elasticities of demand for services like health, education, etc., which are traditionally in the domain of responsibilities of subnational governments.

Table 2.3 constructs an index of subnational autonomy. This is measured as the extent of self-financing of public expenditure through own taxes and user charges by subnational governments. It is an important measure and highlights the degree of accountability in terms of the extent to which incremental expenditures are financed through additional taxation. It is interesting to note that India scores highly on this count also, with an index value of 0.63. Almost 63 percent of subnational expenditures in India are self-financed as compared to 16 percent in Pakistan, 19 percent in Indonesia and 8 percent in Philippines. It appears that, within the sample, India is an extreme case of decentralization with subnational governments in the country not only accounting for the major share of public expenditure but also possessing adequate fiscal powers to directly finance bulk of their expenditures.

TABLE 2.3
INDEX[a] OF SUB-NATIONAL AUTONOMY IN SAMPLE COUNTRIES

Countries	*Years*	*Share in Public Expenditure*	*Years*	*Share in Public Expenditure*
INDIA[b]	1988-89	0.56	1995-96	0.63
PAKISTAN[b]	1988-89	0.16	1995-96	0.16
INDONESIA			1991	0.19
PHILLIPINES			1994	0.08

[a] Index of Subnational Autonomy = $' \; 1 \; \& \left[\frac{ST \,\%\, G \,\%\, B}{EXP} \right]$

where ST = revenue from shared taxes, G = grants from central government,
B = Borrowings from national government, EXP = Total subnational expenditure

[b] only for state/provincial governments

3. ALLOCATION OF RESPONSIBILITIES FOR SERVICE DELIVERY AT SUBNATIONAL LEVEL

3.1 Allocation of Responsibilities

At the subnational level three types of agencies are responsible for service delivery in the sample countries. These are state/provincial line departments, local governments and specialized agencies, which are either in the nature of parastatal enterprises or semi autonomous bodies. Delineation of responsibilities vary between urban and rural areas, and within urban areas by city size. Functions typically performed in urban areas by local/municipal governments include basic functions like refuse collection and disposal, water supply and sanitation, fire fighting, street lighting and maintenance, etc. In metropolitan cities, municipal governments generally perform a more diversified set of functions including participation in public health, education and health services.

However, in many of the megacities of the sample countries specialized agencies have been established to perform particular functions. This includes development authorities which are responsible for urban planning, enforcement of zonal bye laws, building control, sites and services development and execution of major development schemes relating to the provision of trunk infrastructure. Water and sanitation agencies, transport corporations, mass transit authorities, etc., have also been created to perform designated functions.

Provincial/state governments are generally more active in the smaller cities and rural areas, where local governments usually have limited institutional and financial capacity to manage a wide range of services. In many areas like water supply and sanitation, roads, etc. provincial/state governments develop the infrastructure and transfer the facilities created for operations and maintenance by local governments. Delivery of social services is generally a shared function, with both state and local governments engaged jointly in the provision of education, health, social welfare, etc. Secondary and tertiary education and tertiary curative health are, however, more or less, in the exclusive domain of state governments with some involvement even by national governments.

3.2 Role of Local Governments

The role of local governments generally does not appear to be constrained by legislation relating to allocation of functions as much as by constraints imposed by lack of financial resources and adequate institutional capacity. By and large, local governments have tended to be dominated by state/provincial governments in federations like India and Pakistan while they have found more expression in unitary governments like Indonesia. Historically, in the former two countries, local governments were not even seen as an independent tier of government but more as an extension and subsidiaries of state governments. It is only in the early 90s that local governments have been given explicit constitutional recognition in India, although this remains yet to have operational implications. In Pakistan, local governments continue to function under special ordinances promulgated by provincial governments.

The relative importance of local governments in unitary states is demonstrated by the fact that in Indonesia and Philippines these governments play a more active role in services like education, health, social welfare and police than their counterparts in India and Pakistan. The national governments in the former two countries have established elaborate revenue sharing or formula driven grant schemes which access directly to local governments. In India and Pakistan, most of the subnational taxes have been pre-empted by state/provincial governments and local governments have been compelled to rely on primitive and distortionary taxes like the *Octroi* (a tax on goods as they enter municipal limits for use, sale or consumption). Revenue sharing arrangements are minimal and access to grants very limited. In Pakistan, provincial governments only share the property tax with local governments, while in India these arrangements extend to include the motor vehicle tax and the entertainment tax. It is not surprising, therefore, that collectively local governments in the two countries incur expenditure equivalent to less than one sixths of the expenditure by state/local governments.

The lack of decentralization beyond the state/provincial governments level is attributable to a number of factors. First, local governments are seen as having limited institutional capacity, especially for performing development functions, and as being prone to capture (and corruption) by vested interest groups. This explains the overriding responsibility of state/local governments for provision of social and economic services in smaller cities and rural areas. Second, at the current stage of democratic evolution of India and Pakistan, political power has become concentrated at the state/provincial level and there is a reluctance to hand over greater patronage to local politicians who are seen as a potential threat. In many parts of India and Pakistan, the local/state dichotomy is indicative of the struggle between the traditional rural (feudal) elite which dominates at the state level and the rising urban middle class which is striving for greater expression through more active local governments.

The subordination of local governments by state/provincial governments is manifest in a number of ways. First, local councils can be dissolved without assigning any reasons. In Pakistan, for example, these councils were dissolved in 1993. Since then no elections have been held and interim arrangements of management by provincially appointed administrators continue. Second, appointments to key positions within local government administrations are made by the provincial/state governments and key functionaries belong to the state civil service. Third, taxation proposals and annual budgets are subject to approval by the higher level of government. Altogether, genuine decentralization down to the lowest level of government remains an elusive goal in India and Pakistan.

4. TAX ALLOCATIONS BETWEEN DIFFERENT LEVELS OF GOVERNMENT

4.1 Principles for Assignment of Taxes

Assignment of taxes among different levels of government is usually specified in the constitutions of most countries. Two considerations are important in determining the extent to which fiscal powers should be Decentralized. First, there has to be a link between expenditure and tax assignments so as to match expenditure needs with revenue means at different levels of government. Second, there are efficiency considerations with regard to the appropriate level of government for collecting a particular tax. The general principle is that taxes on relatively immobile tax bases should be levied by local authorities so as to minimize the excess burden associated with taxation. Also, residence-based taxes, such as excises, should be levied by states. The objective is to ensure that the costs of provision of local public goods are financed primarily by taxes the burden of which falls on local residents.

Beyond this, taxes on mobile factors of production should be centralized in order to maintain uniform tax rates across jurisdictions and prevent distortions in location of economic activity. Further, progressive redistributive taxes and taxes suitable for economic stabilization should be centralized. As far as benefit taxes and user charges are concerned these can be levied appropriately by all levels.

By and large, the efficiency consideration appears to more important in the assignment of taxes among different levels of government in developing countries. This is reinforced by the need for centralized tax administration which can effectively collect revenues and avoid fragmentation of the resource mobilization effort. However, this has created a tendency for over dependence of lower levels of government on intergovernmental transfers, which can distort local spending priorities. Therefore, there is a need in practice to balance the considerations of fiscal efficiency and responsibility.

TABLE 4.1
ASSIGNMENT OF TAXES BETWEEN NATIONAL AND SUB-NATIONAL GOVERNMENTS IN SAMPLE COUNTRIES

Tax	India	Pakistan	Indonesia	Philippines
Customs	N	N	N	N
Income	N, S[a]	N, S[a]	N	N
Corporate	N	N	N	N
Estates	N	)	)	)
Natural Resource	S	N	N	N
Sales	N, S	S[b]	)	N
VAT	)	N	N	N
Excises	N, S	N, S	N	N, S
Property	S	S	N	N, S
Fees	N, S	N, S	N, S	N, S
Others	S	N, S	S	S

N = National Government, S = Sub-National Governments (State and Local)

[a] primarily agricultural income and tax on professions, callings and trades
[b] primarily taxes which are in the nature of a scale tax on services like entertainment, electricity, etc.

4.2 Tax Assignment in Sample Countries

Tables 4.1 and 4.2 give the assignment of taxes between national and subnational governments in the sample countries. The tax system is more centralized in the unitary states than in federations. In Indonesia, for example, even a conventionally local tax like the property tax is collected by the national government. The high degree of centralization is largely a reflection of the concentration of expenditure responsibilities with the higher level of government. Customs duties on international trade and the corporate income tax are central responsibilities in all sample countries. There is an element of tax base sharing in the context of the personal income tax in India and Pakistan, where state/provincial governments levy a professions, trades and callings tax. Natural resource taxes are collected by the national government, except in India. Following the transition from a single-state sales tax to a multi-stage value added tax, Pakistan, Indonesia and Philippines have assigned the responsibility of collection of this tax to the national government. The sales tax continues to be collected at the state level in India, and this represents one of the big differences in tax assignments among the sample countries. Due to constitutional limitations whereby sales taxes can only be levied on goods by the federal governments in Pakistan, provincial governments have introduced taxes which are equivalent to sales taxes on services like electricity, hotels, entertainment, etc.

Excises are prevalent both at the national and subnational level, except for Indonesia where these are the exclusive responsibility of the national government. As highlighted earlier, the property tax generally lies within the ambit of fiscal powers of state/local governments in the sample countries, except for Indonesia. Altogether, there are significant differences in the assignment of taxes between national and subnational governments in the sample countries.

TABLE 4.2
MAJOR TAXES COLLECTED BY NATIONAL AND SUBNATIONAL [a] GOVERNMENTS IN SAMPLE COUNTRIES
[*Given generally in descending order of importance*]

Countries	National Taxes	Subnational Taxes
INDIA	Excise Duties Customs Duty Income and corporation Tax	Sales Tax Excises Stamp Duty Taxes on Vehicles Octroi Agricultural Income Tax/Land Revenue Property Tax
PAKISTAN	Customs Duty Income and Corporation Tax Sales Tax Excise Duties	Stamp Duty Octroi Tax on Motor Vehicles Property Tax
INDONESIA	Value Added Tax Income and Corporation Tax Customs Duty Excise Duties Property Tax	Taxes on Vehicles Taxes on Services Transfer Taxes
PHILLIPINES	Income and Corporation Tax Value Added Tax Customs Duty Excise Duties	Property Tax

[a] both state/provincial and local governments.

4.3 Share of Subnational Governments in Tax Revenues

Based on the tax assignments, the shares of subnational governments in total tax revenues in the sample countries are given in Table 4.3. There is some correlation between expenditure and revenue shares, with the notable exception of Pakistan where the share of provincial governments in tax collections is very low at 4 percent as compared to the expenditure share of 30 percent. This appears to be a reflection not only of the pattern of tax assignment, with most of the large and buoyant tax bases relating to international trade and domestic income, production and sales being pre-empted by the federal government, but also of limited exploitation of the fiscal powers available with the provincial governments. The corresponding share of states in India is substantially higher at 36 percent and has shown a tendency to rise over time. This is the consequence of a more balanced allocation of taxes in India with the States being endowed with greater fiscal powers including the collection of sales tax, excises and taxes on natural resources. In line with the limited expenditure responsibilities of subnational governments in Indonesia and Philippines, shares in tax revenues are relatively low at 7 and 2 percent respectively.

TABLE 4.3
SHARE OF SUBNATIONAL GOVERNMENTS IN TAX REVENUES IN SAMPLE COUNTRIES

Countries	*Years*	*Share in Tax Revenue*	*Years*	*Share in Tax Revenues*
INDIA[a]	1988-89	33	1995-96	36
PAKISTAN[a]	1990-91	4	1995-96	4
INDONESIA	1991	7	)	)
PHILLIPINES	)	)	1996	2

[a] only state/provincial governments.

4.4 *Issues in Tax Assignment*

A number of issues arise in the context of assignment of taxes between different levels of government in the sample countries. First, there is the problem of *fragmentation* of the tax bases which creates distortions and affects adversely both vertical and horizontal equity of the tax system. For example, in India and Pakistan, incomes accruing from agriculture have been subject to state/provincial taxation as a separate block of income while all other incomes are taxable at the central level. This has created loopholes for tax evasion and reduced the element of progressivity of the income tax system. Similarly, capital gains on physical assets (land and property) have been included in the tax base of provincial governments in Pakistan while capital gains on financial assets lie in the federal domain. The exemption granted to the former has probably increased significantly the relative return and led to overinvestment in real estate. An important distortion, also observed in Pakistan, is the bifurcation of the sales tax base, whereby the federal government levies this tax on goods and the provincial governments potentially have the option of imposing a corresponding sales tax on services. This bifurcation has created problems in introducing a neutral VAT, with tax invoicing features, on different sectors of the economy.

Second, *overlapping tax bases or tax base sharing* between different levels of government have increased tax payer compliance costs and led to spatial variations in effective tax rates, with the associated distortions. For example, in Pakistan, a stamp duty is charged by provincial governments on property transactions. In addition, local governments levy a tax on transfer of property and, more recently, the federal government has introduced a capital value tax on property sales. The consequence is that the overall incidence of taxes on property transactions is quite high, which has retarded the development of the property market and led to large scale under declaration of property values for tax purposes. The multiplicity of collection by agencies belonging to different levels of government has also increased compliance costs for tax payers.

Third, in the case of subnational taxes levied on mobile tax bases, problems have arisen due to *tax rate competition* among different jurisdictions. Clearly, there has to be some degree of autonomy in the fixation of tax rates so that subnational governments can select the optimal level of taxation and expenditure in line with the preferences of their residents. Therefore, in a multiple jurisdiction setting of the Tiebout type there will be some variation in tax rates. Voters can potentially vote with their feet and opt for the jurisdiction of their choice. But if tax bases are highly mobile among jurisdictions with respect to differential tax rates then competition among subnational governments can lead to sub-optimal tax collections with a tendency for the tax rates to be too low as a result of the motivation of each jurisdiction to attract economic activity within its boundaries.

This problem is perhaps most clearly visible in the context of the sales tax in India. States have resorted to undercutting each other in the matter of sales taxation in order to attract trade and industry to their territories. This has created distortions and in some states the sales tax rates on items like color televisions have gone down to levels below that applied to cereals. The net result has been that sales taxation in the states has virtually reached an impasse. The growth of the sales tax for the country has decelerated and it has become essential to rely on the central government to levy a central sales tax (CST) on interstate sales, with proceeds reverting to the states. At first, the CST was subject to ceiling of 1 percent, which has subsequently been raised to 4 percent. Also, excise duties have been increased by the central government on certain items in lieu of the state sales tax. The imposition of CST impedes inter-state trade and acts as a hindrance to the development of a national common market.

Some countries, like Pakistan, have attempted to resolve this problem by inter-provincial harmonization of tax rates. However, there is evidence that this may have gone too far, especially in the context of taxes levied on immobile tax bases, and retarded fiscal effort by provinces which had a preference for rasing expenditure levels through greater resource mobilization. In the context of the recently introduced agricultural income tax in Pakistan, residents of the province of Punjab, where the tax rates are currently the highest, have been agitating on the grounds of inter-regional equity that the rates should be brought down to the lower level prevailing in the other provinces.

Fourth, in countries characterized by large variations in the level of regional development there is the danger of *tax exporting*. Given regional disparities, especially in industrialization, relatively advanced states can export their taxes to residents of consuming states, assuming that these taxes are shifted forward, as is likely in the prevailing market conditions for several products. There is some evidence of this in the context of the sales tax in India. The transfer of the sales tax to provincial governments in Pakistan has been inhibited primarily by this factor. There is the concern that with the major concentration of industry (over 40 percent of value added) in Sindh province (with population share of 23 percent), levy of the sales at the provincial level will lead to a large quantum of tax exporting from this province to the three other provinces. The likelihood of tax exporting is also one of the justifications for assigning taxes on natural resources to central rather than subnational governments. Given the likely regional concentration of different natural resources (oil, gas, etc.), there is the danger that tax rates could be pitched at artificially levels if the power to tax is handed over to jurisdictions where these resources are located. However, it is of significance to note that while in three sample countries taxes on natural resources are levied by central governments, in India these taxes have been decentralized to state governments.

5. IMBALANCE BETWEEN EXPENDITURES AND COLLECTIONS

5.1 Vertical Imbalance

Given the allocation of taxes and expenditure functions, we are now in a position to quantify the extent of vertical imbalance between revenues and expenditures of national and subnational governments. This indicates the magnitude of transfers required from one level of government to the other in order to balance budgets. Table 5.1 indicates that in all four sample countries the allocation of taxes is such that national governments all have a surplus and, therefore, the direction of fiscal transfers is from the national to subnational governments. This is the pattern generally observed internationally.

TABLE 5.1
IMBALANCE BETWEEN REVENUES AND EXPENDITURES
IN SAMPLE COUNTRIES
(Before Transfers)

(%)

Heads	*Revenue Share*	*Expenditure Share*	*Surplus (+)/ Deficit (-)*
INDIA (1988-89)			
National Government	64	46	+18
Subnational Governments[a]	36	54	-18
All Levels	100	100	0
INDIA (1995-96)			
National Government	62	41	+21
Subnational Governments[a]	38	59	-21
All Levels	100	100	0
PAKISTAN (1988-89)			
National Government	96	74	+22
Subnational Governments[a]	4	26	-22
All Levels	100	100	0
PAKISTAN (1995-96)			
National Government	94	70	+24
Subnational Governments[b]	6	30	-24
All Levels	100	100	0
INDONESIA (1991)			
National Government	93	84	+9
Subnational Governments	7	16	-9
All Levels	100	100	0
PHILLIPINES (1996)			
National Government	98	89	+9
Subnational Governments	2	11	-9
All Levels	100	100	100

[a] only for state/provincial governments
[b] tax plus non-tax revenues

As highlighted earlier, the shares of subnational governments of India in tax revenues and expenditure are both large. In 1995-96 these are estimated at 38 and 59 percent respectively, implying an imbalance of about 21 percent of the overall expenditure. It appears that even though states of India have been endowed with substantial fiscal powers these are not adequate the meet their expenditure obligations and that almost one thirds of the revenues collected by the central government need to be transferred to enable subnational governments to balance their budgets.

The magnitude of the vertical balance is also pronounced in Pakistan. Even though the share of subnational governments is only half that of India, at 30 percent, the share of revenues directly collected is very small, at 6 percent. The resulting imbalance, equivalent to about 24 percent of total expenditure, has to be financed by transfers amounting to almost 80 percent of the expenditure by subnational governments. The magnitude of the vertical imbalance is the same in Indonesia and Philippines at about 9 per cent of total expenditure. The dependence, however, of subnational governments in Philippines on transfers is greater.

Table 5.1 also highlights the trend in the magnitude of the vertical imbalance in India and Pakistan. In the latter country, the imbalance has increased from 21 percent in 1988-89 to 24 percent in 1995-96, while in the former country it has risen from 18 per cent in 1988-89 to 21 per cent in 1995-96. Both revenue and expenditure shares of subnational governments in the two countries have increased over the period. But the rise in the vertical imbalance is due to the fact that the increase in the revenue share is less than the increase in the expenditure share.

TABLE 5.2
HORIZONTAL IMBALANCE BETWEEN REVENUE AND EXPENDITURE OF SELECTED STATES OF INDIA
1990-91

(Rs per Capita)

Rank	*State*	*Not State Domestic Product*	*Revenue Expendi-ture*	*Own Revenue*	*Imbala-nce i (%)*	*Rank*	*Imbala-nce i i*	*Rank*
1	Punjab	8373	1265	777	38	9	125	12
2	Haryana	7502	1205	986	18	14	-84	14
3	Maharashtra	7316	1131	893	21	13	9	13
4	Gujarat	5687	1005	691	31	11	211	11
5	West Bengal	4753	767	352	54	4	550	4
6	Andhra Pradesh	4728	850	531	38	8	371	7
7	Karnataka	4696	903	649	28	12	253	9
8	Tamil Nadu	4619	1038	650	37	10	252	10
9	Kerala	4207	983	539	45	6	363	8
10	Madhya Pradesh	4149	730	400	45	5	502	5
11	Rajasthan	4035	808	473	42	7	429	6
12	Uttar Pradesh	3516	698	288	59	3	614	3
13	Orissa	3077	704	280	60	2	622	2
14	Bihar	2655	550	189	66	1	713	1
Rank Correlation with net SDP					-0.79		-0.86	

5.2 Horizontal Imbalance

We turn now to an examination of the degree of horizontal imbalance in the sample countries. This relates to the variation among subnational governments in the gap between own revenues and expenditure. Data is available for individual state/provincial governments only in the case of India and Pakistan. As shown in Table 5.2 and 5.3, for India and Pakistan respectively, horizontal imbalance is measured in two ways. First, as the extent to which revenue/current expenditures are not covered by own revenues and, second, as the difference between average per capita expenditure by all subnational governments and own per capita revenue of a particular government. The latter represents one approach to the estimation of the quantum of fiscal equalization which is to be achieved through central transfers.

TABLE 5.3
HORIZONTAL IMBALANCE BETWEEN REVENUES AND EXPENDITURE OF PROVINCES OF PAKISTAN
1995-96

(Rs per Capita)

Rank	*Province*	*Per Capita GDP*	*Current Expendi-ture*	*Own Revenue*	*Imbala-nce i (%)*	*Rank*	*Imbala-nce*	*Rank*
1	Sindh	22973	1207	202	83	4	886	4
2	Punjab	14856	937	155	83	3	933	3
3	Balochistan	12915	1645	140	91	1	948	2
4	NWFP	12368	1347	131	90	2	957	1
Rank Correlation with per capita GDP					-0.80		-1.00	

A rank correlation is carried out between the state/provincial domestic product per capita and the two measures of imbalance respectively. In India, for 1990-91, the rank correlation with respect to the first measure is -0.79. This indicates that there is a high level of horizontal imbalance. States with lower per capita incomes generally have a relatively large resource gap. In fact, the extent to which revenues do not cover expenditures ranges from 18 percent in Haryana (third in terms to development ranking) to 66 percent in Bihar (lowest development ranking). The rank correlation with respect to the second measure is even higher at -0.86. The same pattern of results is obtained for Pakistan. The rank correlation coefficients are -0.80 and -1.00 respectively.

The degree of imbalance between expenditures and revenues is higher in relatively backward states in India primarily because even though per capita expenditures are relatively low in such states, own revenues are even lower because the taxable capacity of taxes assigned to subnational governments is smaller. The lower variation in per capita expenditure among states is attributable, first, to fixed costs of general administration and second, because certain minimum standards of provision have to be maintained spatially in services like primary education, basic preventive health, water supply and sanitation, etc. In Pakistan, the imbalance is magnified by the fact that per capita expenditure is actually higher in the two backward provinces, viz., Balochistan and North West Frontier Province, partly because of relatively high unit costs and partly because fixed costs of running the provincial government are spread over much smaller populations. Balochistan has a population share of 5 percent while that of NWFP is about 15 per cent as compared to 23 per cent and 57 per cent of the two larger provinces, Sind and Punjab, respectively.

The overall conclusions from the analysis of imbalance between expenditures are revenues are that the quantum of transfers required from central/national governments in all four sample countries to subnational governments are sizeable and that the quantum of support required by subnational governments in backward regions is even greater. We proceed now to describe the pattern of fiscal transfers in the sample countries.

6. TRANSFERS AND RULES FOR ALLOCATION

6.1 Types of Transfers

Given the large magnitude of required transfers, it is clear that the design of such transfers is crucial in determining the efficiency and equity in local service provision and the overall financial health of subnational governments. Fiscal transfers can be of various types. The first category is *general (unconditional) non-matching transfers*. These transfers augment the resources of subnational governments without imposing any conditionalities on the pattern of expenditure. Such transfers are prevalent in most countries and consist primarily of revenue sharing transfers (from the divisible pool of central taxes) and block grants. In micro theoretic terms, they have only an income effect and no substitution effect on expenditures, implying a parallel upward shift in the budget constraint faced by subnational grants.

The second type of transfers is *selective (conditional) non-matching transfers*. In this case, the central government makes a lumpsum grant for a particular purpose. Such grants are best suited for subsidizing activities considered high priority by a higher level government but low priority by local governments, and ensure a minimum level of provision of the particular service. The third category of transfers is *selective (conditional) matching grants*. In such cases, the central government requires that funds be spent for a particular purpose and that the recipient match the transfers to some degree. Therefore, these transfers have both income and substitution effects. There may be ceiling prescribed on the size of such grants.

Shah [....] has identified criteria for the design of intergovernmental fiscal arrangements. The first criterion is *autonomy*. Ideally transfers should honor the independence of subnational governments in setting their own expenditure priorities. General transfers score the highest on this criterion. The second criterion is *revenue adequacy*. Transfers should be adequate to cover both vertical and horizontal imbalances of subnational governments to the extent possible. The third requirement is of *equity*. Allocated funds should vary directly with fiscal need and inversely with the taxable capacity of each province. The fourth criterion is *predictability*. The quantum of flow of funds should be known in advance so that recipient governments can plan with a degree of certainty. A related criterion is that of *simplicity*. A subnational government's allocation should be based on objective factors over which individual units have little control. The last criterion is that the transfers should create appropriate *incentive* for sound fiscal management and, if possible, promote fiscal effort and control over expenditure. For example, there should be no transfers to finance deficits of subnational governments.

Based on the above, we can define some of the parameters of intergovernmental transfers. The first is the distribution of these transfers between allocations from a divisible pool of taxes based on certain revenue sharing formula, grants and borrowings from the central government. The last type can be distinguished on the basis that they impose debt servicing obligations, whereas other types of transfers do not. In the context of revenue sharing transfers there is need to identify, first, the taxes included in the divisible pool, second, the overall share of all subnational governments in the revenue from each tax in the divisible pool and, third, the basis for allocation to individual governments. Grants have to be distinguished between conditional and unconditional grants and whether there are any matching provisions or not. The formula (if any) for distribution of grants to individual governments also need to be identified.

TABLE 6.1
IMPORTANCE OF DIFFERENT TYPES OF TRANSFERS
FROM NATIONAL GOVERNMENTS TO SUBNATIONAL GOVERNMENTS[a]
IN SAMPLE COUNTRIES

(%)

Heads	*Revenue from Shared Taxes*	*Grants from National Government*	*Loans from National Government*	*Total Transfers from National Government*
INDIA				
1988-89	35	33	32	100
1995-96	42	30	28	100
PAKISTAN				
1988-89	45	46	9	100
1995-96	83	9	8	100
INDONESIA				
1988-89	10	89	1	100
1993-94	14	86	)	100

[a] In the case of Philippines, the predominant source is revenue from shared taxes.

6.2 Importance of Different Types of Transfers

Table 6.1 gives the overall importance of different types of transfers in the sample countries. There are marked differences among the four countries in the pattern of transfers, during the last year for which information is available. Revenue sharing transfers dominate in Pakistan and Philippines, while bulk of the transfers to subnational governments in Indonesia are in the form of grants. Transfers in India are more evenly distributed between revenues from shared taxes, grants and loans. There appears to be a tendency for the share of revenue sharing transfers to rise in the sample countries, with the most dramatic increase being observed in the case of Pakistan, where the share of such transfers has increased from 45 percent in 1988-89 to almost 83 percent in 1995-96. This has largely occurred at the expense of grants. It can be said, therefore, that to the extent that the grants are conditional in character, autonomy of subnational governments in the sample countries has increased with the greater reliance on revenue sharing transfers. This has probably also contributed to greater predictability and simplicity in the inter-governmental fiscal arrangements.

6.3 Revenue Sharing in Sample Countries

We proceed now to a description of the revenue sharing arrangements in each sample country. In India, the divisible pool of taxes consists of the personal income tax, union excise duties, additional excises in lieu of sales tax and estate duty on property, with the total subnational shares of 85 and 45 per cent respectively in the first two taxes and 100 per cent in the last two taxes (see Table 6.2). Revenues from the latter are reverted to the states on the basis of origin. The allocation formula among states of income tax and excise duties is quite complex. Different weights are attached to criteria like revenue contribution, population, different measures of backwardness and pre-devolution deficits. Additional excises on textiles, tobacco and sugar and distributed on the basis of proxies for consumption like the state domestic product and population. More recently, the Tenth finance Commission has recommended fundamental changes in the revenue sharing arrangements. The proposal now is to bring all central taxes into the divisible pool, with a collective share of subnational governments of 29 per cent. In addition, the suggested allocation formula will include new criteria like infrastructure, land area and fiscal effort.

The recent National Finance commission Award (implemented from 1997-98 onwards) in Pakistan has also implied fundamental changes in the bases for determination of revenue sharing transfers. All federal taxes are now included in the divisible pool, and the overall share of subnational governments has been fixed at 37.5 percent (three eighths). Beyond this, all revenues from royalty and development surcharge on natural gas, royalty on crude oil and profits from hydro-electricity are transferred to provinces on the basis of collection. Accordingly, these transfers are referred to as ‘straight’ transfers.

In Indonesia, the divisible pool of central taxes consist of royalties on oil and gas, motor vehicle tax, forestry royalty and the tax on land and buildings (equivalent to the property tax). All the revenues from the first two sources are handed over to subnational governments while the share of lower levels of government in the other two taxes are 35 and 81 per cent respectively. Allocation to individual subnational governments is on the basis of collection.

The divisible pool in Philippines consist of all inland revenues (that is, excluding customs duties). The collective share of subnational governments is 40 per cent of revenues lagged by three years. This lag has been introduced perhaps to increase certainty in the flow of revenues and to ensure that the immediate revenue gains from resource mobilization efforts are fully retained by the national government. Sharing among subnational governments is on the basis of 25 per cent linked to population, 25 percent to land area and the remainder, 50 per cent, on the basis of equal shares. In addition, 77 per cent of revenues from taxes on petroleum products and natural resources are handed over to subnational governments on the basis of collection.

TABLE 6.2

SHARED TAXES AND ALLOCATION FORMULAE IN SAMPLE COUNTRIES

Tax	*Share of Subnational Governments*	*Allocation Formulae Among Subnational Governments*	
INDIA			
Income Tax[a]	85%	Contribution	10%
		Population	22.5%
		Per Capita SDP	11.25%
		Inverse Formula	
		Distance Formula	45%
		Index of Backwardness	11.25%
Union Excise[a] Duties	45%	Population	25%
		Per Capita SDP	12.5%
		Inverse Formula	
		Distance Formula	33.5%
		Index of Backwardness	12.5%
		Per-Devolution Deficits	16.5%
Additional Excises instead of sales Tax (textiles, tobacco and sugar)	100%	State Domestic Product	50%
		State Population	50%
Estate Duty on Property	100%	Origin	100%
PAKISTAN			
All Federal Taxes	37.5%	Population	100%
Excise Duty and Royalty on Natural Gas, Gas Development Surcharge, Royalty on Crude Oil, Hydro-electricity Profits	100%	Origin	100%
INDONESIA			
Royalties on Oil and Gas	100%	Origin	100%
Forestry Royalty	35%	Origin	100%
Motor Vehicle Tax	100%	Origin	100%
Tax on Land and Buildings	81%	Origin	100%
PHILLIPINES			
All Inland Revenue (Three Years Lagged)	40%	Population	25%
		Land Area	25%
		Equal Shares	50%
Tax on Petroleum Products and Natural Resources	77%	Origin	100%

[a] The Tenth Finance Commission has suggested that the allocation formula be changed as follows: population, 20%; distance formula, 60%; infrastructure, 5%; land area, 5%; tax effort, 10%. Tax effort measured as (t/y^2)

Altogether, there are major differences among the sample countries in revenue sharing practices. In some countries (India and Phillippines) the divisible pool is relatively narrow and consists of a few central taxes while in the other two countries (Pakistan and Philippines) the coverage of shared taxes is broad and includes virtually all national taxes. Shares of subnational governments in individual taxes vary widely from 35 per cent to 100 per cent. The basis for allocation is also different ranging from the complex formula in India to the use of three criteria in Phillippines and at the other extreme, only one criterion, population, in Pakistan. Taxes on natural resources and property are generally, however, distributed among subnational governments on the basis of collection (origin).

6.4 Issues in Revenue Sharing

One of the key issues which arises in the context of revenue sharing is the impact these arrangements have on fiscal behaviour by subnational governments. Inter-governmental fiscal relations are periodically reviewed in most countries especially from the viewpoint of revenue adequacy of the transfers in removing vertical imbalances. In India and Pakistan, Finance Commissions are notified every five years by the President, as per constitutional provisions, to recommend the following:

- the distribution between the center/federation and the states/provinces of the proceeds of central taxes which are to be shared (as specified by the President) and determination of the share of each state/province

- the principles which should govern the grants-in-aid to states in need.

Finance Commissions have traditionally adopted the ‘gap-filling’ approach towards correcting the vertical imbalance, thereby virtually underwriting the deficits in the state/provincial budgets. There has generally been no incentive or reward for greater revenue effort or efficiency in expenditure management by subnational governments. This has had perverse consequences on behaviour. State/provincial governments have tried to inflate expenditure and limit own fiscal effort especially in the base year of the award in order to establish a higher benchmark of fiscal needs. In addition, efforts have been made during negotiations to understate future growth in revenues and overstate the required growth in expenditures in order to force a higher level and growth in transfers.

In recognition of this problem, terms of reference given to the last two Finance Commissions in India have suggested the adoption of a ‘normative’ approach in assessing the revenue capacity and expenditure needs for states. In addition, emphasis has been placed on adopting adequate incentives for better resource mobilization and financial discipline as well as on establishing a closer link between expenditure and revenue-rasing decisions. Consequently, the Ninth Finance Commission estimated the revenue base of each state by application of a modified representative tax system approach while for revenue expenditure the "average behaviour" of states was taken as the norm.

The 1996 National Finance Commission of Pakistan has gone one step further. Not only have the base revenue and expenditure been adjusted in the line with average behaviour, but a new approach has been developed for determining the overall provincial share from the divisible pool (consisting of all federal taxes). This approach involves projection of the 'national resource pool' consisting of all federal and provincial tax and non-tax revenues and resources which will become available through borrowings to finance target levels of the consolidated budget deficit. The national resource pool represents the limit of combined federal and provincial current and development expenditures. Within expenditures, future outlays on priority subjects like social development, defence and debt servicing are protected. The residual represents non-priority expenditures which are shared between the federal and provincial governments on the basis of shares in the base year. Following the determination of provincial priority and non-priority expenditures the resource gap is quantified by deducting own revenues. The residual is the required magnitude of transfers. Revenue-sharing transfers are estimated by excluding 'straight' transfers. The former as a percentage of projected federal tax revenues represents the provincial share from the divisible pool.

The national resource pool approach, adopted in Pakistan, has a number of merits. First, it ensures consistency of revenue sharing awards with macro economic stability in terms of the projected size of the fiscal deficits during the tenure of such awards. Second, it largely eliminates 'grantsmanship' by recipient governments in terms of overstatement of expenditure needs and understatement of revenue potential at the time of negotiations. The latter benefit needs to be clarified. If, for example, provincial governments insist on a lower growth rate of revenues from their own sources then under the old gap filling approach transfers to them have to be larger because the resource gap is greater. However, under the alternative approach, the size of the projected national resource pool is smaller. Consequently, the residual available for non-priority expenditure is smaller implying that projected provincial expenditures have to be lower. As a result, lower revenues do not translate on-to-one into higher transfers. Alternatively, if provincial governments demand a higher growth in their priority expenditures then, given the size of the national resource pool, less is available for non-priority expenditures. Therefore, overstatement of expenditure needs does not translate into a corresponding increase in fiscal transfers. In fact, it can be shown that at the limit if non-priority expenditures are all incurred at the provincial level then there is no gain (in terms of higher transfers) to such governments from either understating their ability to raise revenues or overstating their priority expenditure needs.

The other related issue the context of revenue sharing is whether any explicit premium is placed on the level of fiscal effort in the sharing formula. This is a serious concern because one of the potential behavioural consequences of higher general unconditional transfers is that instead of raising expenditure correspondingly recipient governments may opt to give tax break to their residents and slacken their own fiscal effort. Therefore, an efficient revenue sharing arrangement must mitigate against this possibility. Historically, revenue sharing awards in most developing countries have seldom focused on the objective of sustaining local fiscal effort in the presence of transfers, but this is an important consideration in countries where the overall tax-to-GDP ratio is relatively low and fiscal deficits are large.

The last Finance Commission awards in India and Pakistan have recognized this objective for the first time and built in provisions in the awards to promote fiscal effort. In Pakistan, the 1996 NFC has introduced a matching grant from the federal government equal to the additional revenue mobilized from taxation proposals (involving rate increases, removal of exemptions or introduction of new taxes) in provincial budgets, subject to proper verification and attainment of a minimum growth rate (of 14.2 percent, equivalent to nominal GDP growth) during the year. It is of some significance to note that this provision has provided a major stimulus for resource mobilization to provinces in the first year of the award. Some of the provinces, like Punjab and NWFP, have announced substantive proposals relating to enhancement of rates and broad-basing of taxes. Matching grants for fiscal effort are in addition to normal revenue sharing transfers.

The Tenth Finance Commission of India has also included fiscal effort as one of the criteria for allocation of revenues from the divisible pool to individual states. Accordingly, 10 per cent of the transfers have been linked to tax effort, measured as the ratio of actual per capita tax revenues to taxable capacity, with the latter corresponding to the square of per capita state domestic product. This is a major step forward, although there could be some disagreement on the particular measure chosen of taxable capacity. It may have been more appropriate to relate actual per capita tax revenue to per capita domestic product in the base year for the cross section of state of India. This reveals that the taxable capacity is more closely linked to $y^{1.3}$ rather than y^2 (where y is the per capita state domestic product).

6.5 Design of Grants in Sample Countries

We turn now to the design of grants in each of the sample countries. It has been indicated earlier that grants play a major role in India and constitute about 30 percent of total central transfers to the states. Bulk of these grants are ‘plan’ grants, determined by the Planning commission of India, and meant for development purposes. These grants fall into the broad category of general unconditional non-matching transfers although they are meant to finance projects which have been through the planning process and obtained formal approval. Since 1969 plan grants have been subject to an agreed rule called the Gadgil formula. The motivation behind development of the rule is to minimize the scope for subjective or political elements influencing the transfers. Introduction of the Gadgil formula has enhanced the equity, predictability and simplicity of transfers in India. The latest version of the formula is as follows:

In addition to plan grants, there are specific purpose transfers associated with the central plan and centrally sponsored development schemes, some of which are fully centrally funded. Others may require matching allocations by the states. Specific matching transfers have had some adverse equity and efficiency implications. Richer states have been able to participate more actively in such schemes. Efforts to get matching funds have also tended to distort provincial expenditure priorities.

THE GADGIL FORMULA IN INDIA

Criteria	*Weight (%)*
Population	60
Measure of Backwardness '	25
Special Problems	7.5
Performance in terms of fiscal management	7.5
TOTAL	100.0

' assistance going to states with per capita income below national average

Grants have largely been substituted by revenue sharing transfers in Pakistan following the 1991 NFC award. As part of the award the two backward provinces, Balochistan and NWFP, have been given special grants, which are indexed annually to inflation with the benchmark figure for the first year being specified in the award. These grants are in the nature of general, unconditional transfers and are expected to play a fiscal equalization role. In addition, the federal government makes development grants which, unlike the India case, are not formula driven and are largely discretionary in character. Annual development plan allocations do, however, reflect a concern for regional disparities. Out of the total plan allocation to provincial government, a share of 5 per cent each is first given to the two backward provinces, Balochistan and NWFP and then the remainder, 90 per cent, is distributed among the four provinces or the basic of population. During the 80s, as a substitute for the failure to evolve a consensus in the NFC, the federal government started a scheme of deficit grants linked to the size of the revenue deficits of the provinces. This practice was discontinued after the announcement of the 1991 NFC award.

As highlighted earlier, grants play a major role in Indonesia and have gradually emerged as the primary vehicle of decentralization by substituting in-kind subsidies (through expenditures by national line departments) with cash transfers to subnational governments. These grants are of two types and are targeted both to provincial and local (urban and rural) governments. The first type is *general purpose transfers* aimed at promoting national development and policy aims. These transfers are formula based and were introduced in the early 70s through presidential instructions (INPRES). Provincial development grants are distributed on the basic of equal share to each province (85 per cent) and land area (15 per cent). District development grants have two components: a minimum grant for each government and a per capita grant. Village development grants of an equal amount are given to each village, while villages in less developed areas get an additional per capita grant.

The second type of transfers is *specific purpose transfers* of the non-matching variety. Such grants to provincial governments are for three purposes: establishment costs, road improvement and reforestation or conservation. Similar grants to local governments are meant to cover establishment costs, road improvement, expenditures on primary schools and health services. Each type of grant is formula based. For example, road improvement grants are linked to length and condition of roads, road density and unit costs.

The trend in recent years is for the share of general purpose transfers to increase and for local governments to get a larger portion of the funding than provincial governments. Altogether, the Indonesian system of grants is transparent and formula driven according to stated objectives. The system is simple since the number of grants and the criteria used for distribution are objective in nature and not too many. As indicated earlier, the role of grants in Phillippines is very limited and primary reliance has been placed on revenue sharing transfers.

6.6 Equalization Role of Transfers

Given the nature of transfers in the four sample countries, we analyze their role in fiscal equalization and removal of horizontal imbalances. Table 6.3 gives the rank correlation coefficients of components of per capita revenue and expenditure with per capita state/provincial domestic products in Pakistan and India. It is striking to observe that in Pakistan the process of fiscal equalization has been carried to the point where per capita expenditure by the provincial governments in relatively backward areas is actually higher. The rank correlation coefficient of per capita expenditure with per capita income is -0.6. Own revenues are positively correlated with income but both shared taxes and grants have a strong negative correlation. In the case of shared taxes this is due to the fact that ‘straight’ transfers (on oil, gas and hydro-electricity) primarily accrue to the two backward provinces, Balochistan and NWFP. These transfers play a strong equalization role while transfers from the divisible pool are largely neutral in character (being based only on population). Grants are primarily given to the two backward provinces and, therefore, also play an equalization role. It may, however, be noted that although per capita expenditure is significantly higher in the two backward provinces, this do not translate into corresponding differentials in the level of provision of services because of backlogs in access and higher unit costs.

TABLE 6.3
RANK CORRELATION COEFFICIENT OF PER CAPITA REVENUE AND EXPENDITURE WITH STATE/PROVINCIAL DOMESTIC PRODUCT IN PAKISTAN AND INDIA

Heads	*1972-73*	*1985-86*	*1995-96*	*1997-98 (B)*
PAKISTAN				
Per Capita:				
Current Expenditure	***0.8***	***-0.6***	***-0.6***	***-0.6***
Own Revenue	***0.4***	***0.4***	***1.0***	***0.8***
Shared Taxes	-0.4	1.0	-0.6	-0.6
Grants	0.0	-0.8	0.2	-0.6
Total Revenue	***0.4***	***-0.6***	***-0.6***	***-0.6***
Total Transfers	***0.0***	***-0.8***	***-0.6***	***-0.6***
INDIA				
	1974-75	*1979-80*	*1984-85*	*1990-91*
Per Capita:				
Current Expenditure	***0.74***	***0.87***	***0.93***	***0.87***
Own Revenue	***0.82***	***0.90***	***0.90***	***0.88***
Shared Taxes	0.18	-0.63	-0.53	-0.82
Grants	-0.38	-0.59	-0.02	-0.42
Total Revenue	***0.81***	***0.82***	***0.89***	***0.76***
Total Transfers	***-0.46***	***-0.45***	***0.34***	***-0.27***
INDONESIA				
				1992-93
Total Transfers	)	)	)	***-0.08***

Results of a more conventional nature are obtained in the context of India. There is a positive correlation between current expenditure and level of development of states. As expected, own revenues are higher in richer states. Both shared taxes and grants are fiscally equalizing in character, with rank correlation coefficients of -0.82 and 0.42 respectively in 1990-91, the last year for which information is available. This is not surprising since both the Finance commission's formula for revenue sharing and the Planning Commission's formula for grants explicitly include criteria reflecting backwardness. It is of significance to note that over time the fiscal equalization nature of transfers has got somewhat diluted.

Transfers in Indonesia a appear to have a mild equalization impact, with a rank correlation coefficient of only -0.08 in 1992-93. The grant distribution formula, as described above, do not explicitly incorporate considerations of backwardness except in the case of village development grants, which are relatively small in magnitude. Specific purpose transfers may even perpetuate inequalities as they are linked to the existing network of services. Analysis in the context of Philippines could not be undertaken due to lack of regionally disaggregated information.

7. INDEBTEDNESS REGULATIONS AND PROCEDURES

Access to borrowings by subnational governments is one of the key elements of fiscal decentralization, and indicates whether these governments face a relatively hard budget constraint or not. It is important also in determining whether the process of decentralization is likely to preserve macroeconomic instability or not, depending upon the magnitude of unregulated borrowings by state/provincial governments.

7.1 Indebtedness Regulations in Sample Countries

Within the four sample countries we observe a spread of indebtedness regulations and procedures which is largely consistent with the extent of fiscal decentralization. State governments in India appear to have the greatest access to diversified sources of finance, followed by Pakistan and at the other extreme there is little or no access to external finance in Indonesia and Phillippines. We describe the individual country arrangements.

State governments in India have access to various sources of borrowing. First, they undertake borrowings from the central government at interest rates which are, more or less, close to market rates and with maturities of twenty years for development projects and centrally sponsored schemes. Second, official external development finance, usually at concessional terms, is passed on by the central government to the states. Third, states can borrow from the central government up to an amount equal to 75 per cent of the increase in savings deposits with the postal system in a particular state. Fourth, states have the option to place their bonds with commercial banks (as part of their statutory liquidity reserve requirements), insurance companies and non-government pension and provident funds (which are mandated to invest part of their portfolio in government securities). The central government allocates among states the SLR securities, while states are allowed to compete for other forms of borrowing. Fifth, states can engage in short term borrowings from the Reserve Bank of India. Finally, states can access to the capital market if granted permission (which is seldom given) by the central government. Such consent is required if a state is indebted to the center. Major portion of the debt, 60 per cent, of the states is with the central government. About 23 per cent is with insurance companies, private sector provident and pension funds. Bulk of the remainder, 16 per cent, is in the form of securities held by the commercial banks.

Altogether, although state governments have diversified sources of borrowing in India, a relatively hard budget constraint has ben imposed on them by regulation of such borrowings by the central government and severe limitations placed on direct access to the capital markets, both domestic and external. This has spared the country upto now from the moral hazard and macroeconomic crises witnessed in some federated states of Latin America, many of which were triggered by excessive state borrowings with implicit central government guarantees.

Provincial governments in Pakistan essentially borrow on a long term basis, at near market rates, from the federal government. In practice, these governments have access to running overdraft facilities with the State Bank of Pakistan. Although there are well-defined limits imposed on the use of cash balances with the central bank these are frequently violated in the event of delays in releases of transfers from the central government or because of underlying structural problems of particular provincial governments. Market borrowings are extremely limited and, as in India, require prior permission from the federal government. Almost 95 per cent of the outstanding debt is with the federal government.

In Indonesia, resort to borrowings by subnational governments is generally discouraged. Many local governments actually carry budgetary surpluses. There are limited flows of funds from the central government for donor assisted projects. In recent years, attempts have been made for establishment of a regional development fund in the center for subnational governments. In Philippines also access to borrowings is nominal.

7.2 Level of Indebtedness

Table 7.1 tracks the evolution of the state/provincial debt to GDP ratio in India and Pakistan. Since the mid-80s this ratio has declined marginally, from 21 per cent not 19 per cent in India and from 10 to 9 per cent in Pakistan. Therefore, there has been no explosion in the process of debt accumulation in the sub-continent. However, in absolute terms the stock of state debt in India is fairly large at about $ 59 billion (in 1994-95) and in equivalent to about 25 per cent of the total public debt. The corresponding figure for Pakistan is about $ 5 billion, which represents about 12 per cent of the outstanding public debt in the country. Table 7.2 quantifies the size of annual borrowings of subnational governments. This is a measure of the contribution by such governments to the overall fiscal deficit. During the last decade this has remained at about 3 per cent of the GDP in

TABLE 7.1
LEVEL OF INDEBTEDNESS OF SUB-NATIONAL GOVERNMENTS IN INDIA AND PAKISTAN

Years	Outstanding Debt (Rs in Billion)	Debt as % of GDP	Outstanding Debt (Rs in Billion)	Debt as Percent of GDP
	INDIA		PAKISTAN	
1986-87	607	21	60	10
1987-88	700	21	65	10
1988-89	810	20	70	9
1989-90	942	21	81	9
1990-91	1103	21	94	9
1991-92	1263	20	111	9
1992-93	1428	20	126	9
1993-94	1601	29	146	9
1994-95	1845[a]	19	163[b]	9

[a] Equivalent to $ 59 Billion
[b] Equivalent to $ 5 Billion

India while in Pakistan it was just above 1 per cent of the GDP in the early 90s and has since declined to about 0.5 per cent of the GDP.

8. PRACTICES TO AVOID

Based on the above description of the parameters of fiscal decentralization in the four Asian countries, we are now in a position to draw lessons from their experience which are potentially relevant for developing countries at large. These are identified separately as practices to avoid and as best practices.

The former are summarized below:

TABLE 7.2
ANNUAL BORROWINGS BY STATE/ PROVINCIAL GOVERNMENTS IN INDIA AND PAKISTAN

(% of GDP)

Years	*India*	*Pakistan*
1988-89	2.9	0.6
1989-90	2.9	1.3
1990-91	3.3	1.3
1991-92	2.9	1.3
1992-93	3.0	1.1
1993-94	2.6	1.3
1994-95	2.9	0.9
1995-96	3.4	0.6
1996-97	N.A	0.5

8.1 Expenditure Assignment

- Concurrent expenditure responsibilities have been allocated to national and subnational governments in India and Pakistan. This has led to a shirking of responsibility and transferring of the burden from one government to the other. The consequence has been both ineffective and under provision. An example of this are university education, flood protection and population control in Pakistan, which are financed by the federal government and managed by provincial governments. The consequence has been a woeful neglect of these areas. The lesson is that wherever possible there should be a clear delineation of service functions between different levels of government.

- In some of the sample countries, especially those with unitary governments or with an underdeveloped bottom tier of local governments, the tendency to centralize the provision of essentially local services like primary education, primary health care, water supply and sanitation, etc, has had adverse consequences. Quality of service provision has suffered due to lack of proper outreach and decentralized management and lack of accountability to beneficiaries. Local preferences have not been adequately reflected. The approach to provision has been primarily supply and not demand driven. In this respect a wrong allocation of functions among different levels of government has had significant negative consequences on the cost effectiveness and quality of provision. Clearly, one of the major lessons is that local services must be locally provided and this is the minimum degree of decentralization that must be achieved generally. For this, local governments need to empowered, possibly through clear constitutional provisions.

8.2 Responsibilities of Service Delivery

- There is evidence of overregulation and excessive control of local governments by provincial/state governments in India and Pakistan. This has stunted the growth of local government and limited their involvement int he provision of services. Direct physical controls need to be replaced by mechanisms which induced desired changes in behaviour of local governments like the use of specific conditional or unconditional grants and support mechanisms like training in project preparation, accounting practices, etc., which augment the institutional capacity of local governments.

- A multiplicity of service providing agencies are observed, especially in metropolitan cities of the sample countries. This has led to duplication, wastage and lack of coordination in service provision. The resulting fragmentation of institutional capacity has impaired the process of planning and execution of projects. In addition, the practice observed, especially in India and Pakistan, of development works by state/provincial governments with subsequent transfers to local governments for operations and maintenance in areas like water supply and sanitation, roads, etc., has created problems of sustainability of provision due to transfers problems and inadequate funding of operations and maintenance. The answer lies in the involvement of local government at all stages starting from project identification, planning and execution, in order to create a greater sense of ownership. Also, strong umbrella metropolitan governments with overall responsibility of coordinating the provision of services by specialized agencies need to be put in place in mega cities.

8.3 Tax Allocations

- In all sample countries, except India, there appears to be a very high level of dependence of subnational governments on transfers to finance their expenditure. This is primarily because large and buoyant sources of tax revenue have been pre-empted by national governments. As a result, the tax machinery of lower levels of government remains underdeveloped and the state of dependency has reduced accountability in service provision. There is a need to link more closely expenditure and revenue raising decisions of subnational governments. This argues for a more balanced allocation of taxes among different levels of government and the scope for tax base sharing through ‘piggybacking’ arrangements.

- Cases have been observed where essentially local taxes have been assigned to national governments. Perhaps the best example is the property tax n Indonesia which is collected by the national government. This has led to ineffective and inadequate tax collection with substantial tax evasion due to lack of local knowledge of the tax base. The national government has inevitably attached low priority to a relatively small tax. As a principle, local taxes must be collected by subnational governments.

- The possibility of unhealthy completion in the setting of tax rates among subnational jurisdictions has been identified. Individual jurisdictions may reduce their tax rates below that observed in other jurisdictions so as to attract economic activity. There is clear evidence that this happened in the context of the sales tax in India. In such cases, central regulation of subnational tax rates may be warranted which limits the possibility of downward movements in these rates or at the extreme such taxes may be taken over by national governments.

- A multiplicity of small, subnational taxes is observed in countries like Indonesia and Pakistan. This had led to a fragmentation of tax collection efforts and implied higher costs of collection. There is a case for elimination for most of the small taxes so that resources could be concentrated on developing the most promising sources of revenue.

- The lack of fiscal powers with local governments, due to pre-emption of conventional local taxes like the property tax and the motor vehicle tax by state/provincial governments and absence of proper transfer arrangements, in India and Pakistan has led to resort to distortionary local taxes. The best example of this is the heavy reliance on octroi by a large proportion of local governments in the two countries. This has created distortions in allocation of resources and in the location of economic activity, while imposing impediments to the operation of a national common market. This again demonstrates the need for a more balanced allocation of taxes between different levels of government.

- In the process of allocation of taxes, there has been a fragmentation of revenues source between national and subnational governments. Prime examples of this are in the area of income taxation, whereby special blocs of income like agricultural income and capital gains on physical assets have been handed over to state/provincial governments in India and Pakistan. This has implied loss of progressivity in the tax system, creation of loopholes for tax evasion and distortion in investment choices. There is a case here for global taxation by the national government coupled with adequate revenue sharing arrangements.

- We have also come across cases of exporting of taxes among jurisdictions, like the sales and natural resources taxes in India. This has created a situation where the tax burden is not correlated with expenditure benefits. The solution may lie in regulation of maximum tax rates by the central government or a transfer of such taxes to the central government with revenues being reverted back to state governments on the basis of collection.

8.4 Revenue Sharing and Allocation Rules

- The use of the gap filling approach to revenue sharing awards by successive Finance Commission in India and Pakistan has created a tendency for subnational governments to raise expenditure and reduce fiscal effort as a means of qualifying for larger transfers. This tendency can be avoided by adopting a representative tax system approach to determine the potential level of state revenues and averaging out per capita expenditures (adjusted for variation in unit costs) across states. This rewards states with above average fiscal effort or greater control over expenditures. Alternatively, the innovative approach of sharing from a given 'national resource pool,' adopted by the last NFC in Pakistan, has the potential of largely eliminating 'grantmanshp' by recipient governments.

- In some countries, like Pakistan and Indonesia, there is over reliance on population as basis of allocation of transfers among subnational governments. This precludes possibilities of fiscal equalization, creates a tendency for overstatement of population and at the extreme (as in Pakistan) imposes severe restrictions on the carrying out periodically of population censuses. The way out is to use multiple criteria, thereby reducing the population weight, and incorporate backwardness as a criterion in the absence of an explicit fiscal equalization program.

- We have observed cases of uncoordinated tax base sharing in the sample countries. For example, different levels of government separately levy and collect taxes on essentially the same tax base like services and property transactions in Pakistan. This leads to higher compliance costs for tax payers and over taxation in some cases causing severe tax base contraction. In such cases, there is need for rationalization of the process of tax collection whereby this responsibility is given to the particular level of government which is best equipped to perform this function and revenue generated is shared according to a pre-determined formula.

- In many cases, the subnational share in shared taxes is very high, in excess of 80 per cent. Examples are the income tax in India and the property tax in Indonesia. The consequence frequently is underdevelopment of such taxes because of the limited direct yield from reforms and an over reliance on taxes which are not shared. In Pakistan, prior to the last NFC award, income and sales taxes were in the divisible pool while revenues from customs duties and excise duties (except for tobacco and sugar) were retained fully by the federal government. Tax rates in the latter two taxes were relatively high, and trade liberalization through tariff reforms had to be postponed because of the likelihood of substantial revenue losses and the consequential impact on the fiscal deficit. It is of significance to note that in the immediate aftermath of the 1996 NFC Award, which neutralized the divisible pool by expanding it to include all federal taxes and reduced the subnational share to 37.5 per cent, the federal government has announced steep tariff reforms involving a cascading down of the structure from a maximum of 65 per cent to 45 per cent. Therefore, it is important to realize that there are potentially important incentive efforts of revenue sharing arrangements on the pace and direction of tax reforms. There appears to be a tendency now in the sample countries to have as broad a coverage of divisible pool of taxes and specify the same percentage share of subnational governments in all taxes.

8.5 Grant Design

- Revenue deficit grants to provincial governments in Pakistan during the 80s represent one of the most striking examples of inter-governmental fiscal relations with adverse consequences on the level of public expenditure and the size of the fiscal deficit. The prospect of such grants encouraged provincial governments to slacken their fiscal effort and raise expenditure, frequently in wasteful forms. It is not surprising that during the period when these grants were operative the consolidated fiscal deficit approached 10 per cent of the GDP in Pakistan. The basic lesson is that transfers should not be linked to parameters which can be influenced to their advantage by subnational governments.

- In India, the Planning Commission operates a scheme of specific matching grants for centrally sponsored development schemes. These matching grants appear to have adverse equity and efficiency implications. Given the greater ability to generate funds, this scheme favours richer subnational governments. It also creates biases in the selection of projects and distorts allocation of public expenditure away from operations and maintenance of existing infrastructure to capital expenditure. As will be demonstrated later, the matching grants scheme also tends to raise public expenditure and increase the fiscal deficit. Therefore, if particular development programs are to be promoted by the central government in important areas like social development, poverty alleviation, environment, etc., it is perhaps better to set up a scheme of specific non-matching grants.

- Distortions can also be created by selective grants for particular inputs. In Indonesia, specific (SDO) grants are given to cover the costs of establishment of subnational governments. This has created a tendency towards over-employment and diversion of expenditure away from non-salary inputs, which may be more effective in improving quality of service provision. In such cases, general unconditional grants ought to be preferred.

8.6 Indebtedness Regulations

- Finance Commission in India and Pakistan have periodically allowed debt write-offs by state/provincial governments. This encourages profligacy in borrowing and lack of proper project appraisal. Such a practice needs to be avoided in the interest of financial discipline and proper investment programming, which takes into account the cost of capital.

- Overdraft limits have been prescribed for provincial governments in Pakistan by the Central Bank. As indicated earlier, these limits have seldom been observed and some provincial governments have borrowed over ten times these limits. The Central Bank has found it difficult to dishonour cheques issued by provincial governments, which generally involve payment of salaries of government employees, due to the fear of political agitation by the large number of people employed by provincial governments. Knowledge of this has been used to their advantage by these governments. The prospect of an inevitable 'bail out' has created a kind of moral hazard problem. Clearly, the Central Bank has to make its overdraft limits more credible by revising them upwards to reflect the underlying position of different governments and then strictly enforcing them.

9. BEST PRACTICES IN SAMPLE COUNTRIES

Some practices are observed in the sample countries which have promoted efficient and equitable fiscal decentralization. These practices can be replicated in other developing countries, and are described below.

9.1 Expenditure Assignment

- For any successful program of fiscal decentralization, there has to be a strong and explicit political and policy level commitment to this objective. This has been manifest for a long time in India in terms of the strong political aspirations for autonomy of the states spanning ethnically, culturally and linguistically diverse populations. More recently, there has been a commitment to carrying this process further through empowerment of local governments by enacting explicit constitutional provisions highlighting the role of the third tier of government. In Indonesia and Phillippines, one of the primary motivations for decentralization and impetus from the top (the President) is the need to reduce regional disparities in relation to living standards in the megacities of Jakarta and Metro Manila. In Pakistan, the commitment to decentralization has not been so strong particularly during periods of military rule. Decentralization is largely the incidental consequence of a recent change in intersectoral priorities, whereby greater emphasis is now being placed on social development (through the Social Action Programs) which is primarily the responsibility of subnational governments. However, the lack of emphasis on decentralization is evident from the, more or less, complete neglect of local governments. The general lesson is that for fiscal decentralization to filter down to the grass roots level and be sustainable there has to be a strong political commitment to this process.

9.2 Tax Allocations

- We have highlighted the fact that vertical imbalances are large in the sample countries, with the possible exception of India, due to skewed allocation of fiscal powers between national and subnational governments. India comes closest to fiscal autonomy of state in terms of self-financing of expenditure. This autonomy of subnational governments is essential to introduce accountability to tax payers, by establishing a closer link between expenditure and revenue raising decisions.

- Pakistan has been successful in harmonizing tax rates in different jurisdictions through inter-provincial coordination and central regulation. This has avoided unhealthy competition for economic activity through reductions in tax rates leading to sub-optimal allocations to public expenditure. Such harmonization is essential especially in sub-national taxes which have mobile tax bases.

9.3 Revenue Sharing and Allocation Rules

- The larger share of transfers in the form of revenues from shared taxes rather than grants in Pakistan and Philippines is a desirable practice from the viewpoint of autonomy of sub-national governments and greater certainty in the availability of resources (thereby promoting better planning). Even if grants are unconditional and formula driven in character, there is greater uncertainty usually about the overall quantum of these grants. Therefore, in terms of desirability, revenue sharing transfers should represent as large a portion of transfers as possible.

- The relatively large divisible pool of taxes and a relatively small share of subnational governments from this pool can be classified as the best practice in inter- governmental fiscal arrangements. The latest NFC provisions in Pakistan, the proposals of the TFC of India and the existing practice in Philippines come closest to satisfying this ideal. Neutrality of the divisible pool and, more or less, identical sharing in different taxes removes distortions and expedites the process of tax reforms. The recent spurt of tax reforms in Pakistan amply demonstrates this point.

- In terms of best practice in the area of allocation rules of transfers to subnational governments, India and Philippines score the highest. In these countries use of multiple criteria reflects on the one hand taxable capacity like backwardness and per capita income and in other hand higher unit costs of provision by use of a criterion like land area. This builds fiscal need and equalization objectives into revenue sharing transfers. In a first best world, the preference would be to set up a regime of fiscal equalization grants of the type described by Shah [....]. However, given information constraints and lack of consensus on the fiscal equalization standard, a more pragmatic approach, as followed in India and Phillippines, is to incorporate criteria in the revenue sharing formula which lead to a degree of fiscal equalization. Transfers in Pakistan, in fact, perform the best in terms of the resulting extent of fiscal equalization but this is largely the incidental consequence of straight transfers and not due to the revenue sharing formula, which has only one criterion (population). Therefore, despite its success Pakistan does not represent a model of revenue sharing which can be replicated elsewhere.

9.4 Grant Design

- We have already highlighted the merits of the grants system in Indonesia. This has enabled the process of fiscal decentralization, whereby the emphasis has shifted gradually from subsidies in-kind through expenditures by national line departments to cash grants to finance direct provision by subnational governments. Indonesia has developed a simple, transparent and formula-driven grants system which ensures minimum standards of quality of provision at all locations within national boundaries. Subject to some further refinement like an increase in the proportion of general unconditional transfers and incorporation of fiscal equalization criteria, this system of grants can readily be replicated especially in countries where service responsibilities are gradually being transferred from national or state governments to local governments.

- A good practice which has evolved in some of the sample countries is the incorporation of incentives for higher fiscal effort into revenue sharing or grants allocation formula. This is the product of the realization that higher transfers could be absorbed by subnational governments by a reduction in their own resource mobilization. Therefore, if fiscal decentralization is not to be accompanied by an overall deterioration in the fiscal position then the fiscal effort by subnational governments must be sustained. Pakistan has attempted this in the latest NFC award by introducing a matching grants scheme whereby the federal government has committed to make an additional transfer equal to the revenues generated from taxation proposals by provincial governments in their budgets, subject to a minimum growth rate of revenues being attained. The TFC of India has adopted the alternative approach of including a measure of fiscal effort in the revenue sharing formula. Either of the two approaches are recommended to countries which are keen to promote higher resource mobilization by subnational governments.

- Fiscal equalization concerns need to be reflected not only in revenue sharing or grant transfers to finance current/revenue expenditure of subnational governments but also in development transfers. Both India (through the Gadgill formula) and Pakistan have developed allocation formulae for development transfers which ensure higher per capita allocations to the backward regions. Similar allocation formula could be developed by other countries.

9.5 Indebtedness Regulations

- Within the four sample countries, regulations defining access to borrowing by state governments in India appear to represent the best practice. On the one hand, they are not too restrictive (as in the other countries) and provide a limited opportunity for the more credit worthy states to mobilize borrowings from private sector pension and provident funds they are, on the other hand, sufficiently regulated by the central government to impose a relatively hard budget constraint on state governments. The Indian experience is relevant for countries in the Latin American region and elsewhere which are trying to curb the excessive borrowing powers of states or for countries which want to gradually remove the existing restrictions on borrowing by subnational governments.

- India has also introduced an innovative scheme for providing incentive to state governments to obtain debt relief from the central government. Accordingly, debt relief has been linked to the quantum of proceeds from the privatization of state enterprises. This can promote the process of privatisation and reduce debt servicing burden of state governments. Similar arrangements can also be put in place by other countries which are contemplating a downsizing of subnational governments by greater involvement of the private sector.

10. CONSEQUENCES OF FISCAL DECENTRALIZATION

10.1 A Theoretical Framework

We take up finally the issue of the consequences of fiscal decentralization on the overall (consolidated) public expenditure and fiscal deficit as well as on the effectiveness of service delivery. At the outset it can be stated that fiscal decentralization, involving a transfer of additional resources to subnational governments, is neutral with respect to macro economic magnitudes like public expenditure and fiscal deficit under the following conditions:

(i) alongwith the transfer of resources there is also a transfer of functions to sub-national governments involving expenditure of, more or less, the same magnitude

(ii) the additional transfer of resources has no impact on the existing level of resource mobilization by state governments

(iii) there is a hard budget constraint imposed on subnational governments such that the existing level of borrowing cannot be exceeded.

In this case, fiscal decentralization merely leads to a redistribution of public expenditure between national and subnational governments. Consolidated public expenditure and revenues respectively remain unchanged implying no impact on the fiscal deficit.

Within this framework, it is now possible to identify situations where one or more of the above conditions is not satisfied and there is consequently some impact on consolidated public expenditure and the fiscal deficit, as follows:

(i) Alongwith the transfer of resources there is no well-defined reallocation of functions. As such, public expenditure by the national government tends to remain unchanged while that of subnational governments tends to rise (unless the additional resources are used to bring down borrowings). In this situation, both consolidated public expenditure and fiscal deficit tend to increase following greater fiscal decentralization.

(ii) The greater transfer of resources leads to some slackening of fiscal effort by subnational governments. Consolidated revenues fall while public expenditure may remain largely unchanged. The fiscal deficit increases by the extent to which sub-national revenues fall.

(iii) Even in the absence of greater transfer of resources, a slackening in the budget constraint faced by subnational governments through increased access to borrowings leads to an increase both in the overall level of public expenditure and fiscal deficit.

The World Development Report [1997] highlights the case of Brazil in the 80s when democratization and constitutional revisions increased the amount of resources under subnational control and the degree of local autonomy in their use. Although decentralization shifted resources downward, there was no expansion in local functions. Therefore, as identified above, this alone would have contributed to an increase in the fiscal deficit, since subnational governments increased their expenditure accordingly by raising their employment and launching questionable projects. Beyond this, large states used their improved political autonomy to increase borrowings. This exacerbated further the problem of the fiscal deficit. By the mid-1990s nearly a third of the growing federal deficit was due to subnational debt.

10.2 Consequences of Fiscal Decentralization in Sample Countries

Other situations are observed in the context of the sample countries when it is likely that fiscal decentralization contributed to a worsening of the fiscal deficit. In India, the central government has been operating a scheme of matching development grants to states for centrally sponsored schemes. This has probably had some impact on public expenditure and the fiscal deficit, although the magnitude of the effects may no be too large. The matching grants scheme tends to increase expenditure by state governments which is partially financed by larger transfers. It is possible that simultaneously the states may mobilise more resources to qualify for the matching grants. But since part of the expenditure is financed by a higher transfer, this tends to worsen the budgetary position of the central government while leaving the budget deficit of subnational governments largely unchanged. Consequently, the overall deficit tends to rise.

The scheme of revenue deficit grants operated by the government of Pakistan the 80s probably contributed to significantly higher public expenditure and fiscal deficits. In the presence of such a scheme, provincial governments had a strong incentive to reduce their own level of resource mobilization and raise their expenditure. Consequently, consolidated revenues were lower and consolidated expenditures higher, implying a higher fiscal deficit.

Beyond these particular circumstances, we analyse the macroeconomic consequences of fiscal decentralization in the sample countries. Time series data is available of public finance magnitudes only for India and Pakistan. Fiscal trends for the states of India are presented in Table 10.1. Prior to the economic liberalization in the early 90s, fiscal transfers remained, more or less, constant as a percentage of the GDP from 1988-89 to 1993-94. During this period, the access to borrowing also remained largely unchanged at about 3 per cent of the GDP. Therefore, there is no evidence of any substantial increase in transfers to or runaway borrowings by the states of India.

TABLE 10.1
FISCAL TRENDS OF STATES OF INDIA

(% of GDP)

Years	Own Revenues	Fiscal Transfers	Total Revenues	Revenue Expenditures	Revenue Surplus (+)/ Deficit	Borrowing	Capital Expenditure	Overall Fiscal Deficit
1988-89	7.6	5.2	12.8	13.2	-0.4	2.9	2.5	8.8
1989-90	7.6	5.2	12.8	13.2	-0.4	3.0	2.6	9.5
1990-91	7.4	5.2	12.6	13.4	-0.8	3.3	2.5	9.8
1991-92	7.9	5.3	13.2	14.0	-0.8	3.0	2.2	7.2
1992-93	7.5	5.4	12.9	13.6	-0.7	2.9	2.2	7.5
1993-94	7.7	5.3	13.0	13.5	-0.5	2.6	2.1	8.8
1994-95	8.1	4.7	12.8	13.5	-0.7	3.0	2.3	7.5
1995-96	7.8	4.6	12.4	13.5	-1.1	3.4	2.3	7.6
1996-97 (B)	7.0	4.6	11.6	12.8	-1.2	3.3	2.1	6.8

Data for the provincial governments of Pakistan is given in Table 10.2. There was a quantum jump (over 1 per cent of the GDP) in fiscal transfers in 1991-92 in the immediate aftermath of the 1991 NFC award, implying a corresponding worsening in the federal deficit. This ought to have raised current expenditure, which did not happen. Simultaneously, the federal government reduced the quantum of lending to the provincial governments by almost the same amount as the increase in transfers. Consequently, provincial governments were compelled to restrain their current expenditure and generate revenue surpluses to finance their development expenditure. As a result of these adjustments, fiscal decentralization did not have any adverse impact on the overall fiscal deficit. The increase in the federal deficit was compensated by a corresponding reduction in the combined provincial deficit. It is also likely that the overall level of public expenditure was largely unaffected. Beyond 1991-92, upto 1995-96, we observe broadly the same negative correlation between an increase in transfers and a decrease in borrowings. It is interesting to observe that in the last two years transfers have fallen sharply. The nature of the adjustment now appears to be more in terms of a decline in expenditure (especially development expenditure) rather than by increased borrowings. It is expected that during the current fiscal year the overall budget deficit will fall sharply as part of the structural adjustment program agreed with the IMF.

TABLE 10.2
FISCAL TRENDS OF PROVINCES OF PAKISTAN

(% of GDP)

Years	Own Revenues	Fiscal Transfers	Total Revenues	Revenue Expenditures	Revenue Surplus (+)/ Deficit (-)	Borrowing	Development Expenditure	Overall Fiscal Deficit
1990-91	1.3	4.9	6.2	6.2	0.0	2.3	2.3	8.7
1991-92	1.2	6.0	7.2	6.2	1.0	1.3	2.3	7.4
1992-93	1.0	6.0	7.0	6.5	0.5	1.5	2.0	8.0
1993-94	1.0	6.0	7.0	6.4	0.6	0.9	1.5	5.9
1994-95	0.9	6.3	7.2	6.2	1.0	1.1	2.1	5.6
1995-96	1.0	6.6	7.6	6.5	1.1	0.9	2.0	6.3
1996-97	1.1	5.7	6.8	6.0	0.8	0.4	1.2	6.2
1997-98 (B)	1.0	5.0	6.0	5.8	0.2	1.0	1.2	5.0

The overall conclusion from the experience of India and Pakistan is that fiscal decentralization need not necessarily raise public expenditure and exacerbate the problem of the size of the fiscal deficit. Central governments in these two countries have handled the process of fiscal decentralization judiciously. In the event larger transfers have been made to subnational governments, there has been a, more or less, corresponding downward adjustment in the quantum of loans made available to these governments. The lesson is that adverse consequences of fiscal decentralization can largely be avoided if alongwith the larger transfers there is simultaneously a hardening of the budget constraint faced by subnational governments. This forces subnational governments to increase their revenue surpluses to finance their capital expenditure and thereby limits the rate of accumulation of debt.

10.3 Effectiveness in Service Delivery of Subnational Governments

The problem with states of India is not of uncontrollable deficits and rapid debt accumulation but more a problem of expenditure composition, and the resulting decline in the effectiveness of service delivery. Overhead costs, represented by the costs of general administration, have tended to increase disproportionately. As shown in Table 10.3, the share of general administration in revenue expenditure has increased from 15 per cent in 1988-89 to 17 per cent in 1995-96. Also, a larger part of the budget is being devoted to debt servicing (due primarily to rising interest rates). Therefore, the portion of the recurring budget devoted to the operations and maintenance of social and economic services has fallen from 69 per cent to 62 per cent. Simultaneously, the share of capital expenditure in total expenditure has also fallen from 16 to 14 per cent. Clearly, the Indian states are not making adequate provisions for expansion of public infrastructure, which is vitally needed for future economic growth.

TABLE 10.3
EXPENDITURE COMPOSITION OF SUBNATIONAL - GOVERNMENTS IN INDIA, PAKISTAN AND INDONESIA

(%)

Heads	INDIA [i]		PAKISTAN [i]		INDONESIA	
	1988-89	1995-96	1988-89	1995-96	1985-86	1993-94
Revenue/Current Expenditure	84	86	76	77	77	59
Capital/Development Expenditure	16	14	24	23	23	41
TOTAL	***100***	***100***	***100***	***100***	***100***	***100***

COMPOSITION OF CURRENT / REVENUE EXPENDITURE

Heads	INDIA		PAKISTAN	
	1988-89	1995-96	1988-89	1995-96
General Administration[a]	15	17	20	21
Debt Servicing	11	15	26	19
Social Services	39	37	33	39
Economic Services	30	25	16	16
Other	5	6	5	5
TOTAL	***100***	***100***	***100***	***100***

[i] only state/provincial governments
[a] including expenditures on law and order

The corresponding numbers for the provincial governments of Pakistan look better. The share of general administration in current expenditure has remained, mor or less, constant while the burden of debt servicing has declined sharply (due largely to decreased borrowings). Consequently, the outlays on services have expanded rapidly. The share, in particular, of social services has increased dramatically from 33 to 39 per cent, coinciding with the greater emphasis on social development (through the Social Action Programme). Also, the share of development expenditure is higher than in India and has remained, more or less, unchanged. From the scanty data available over time for subnational governments of Indonesia, there also appears to major improvement in expenditure composition, with the share of capital expenditure rising from 23 per cent in 1985-86 to 41 per cent in 1993-94. Therefore, it appears from the sample of countries that the relationship between fiscal decentralization and effectiveness in service delivery is ambiguous.

CONCLUSIONS

The paper has studied the experience of fiscal decentralization in four Asian countries, viz., India, Pakistan, Indonesia and Philippines. It has covered areas of expenditure and service responsibility allocations, tax assignments, transfers to and access to borrowings by subnational governments. A wide range of practices is observed, some which need to be avoided and others which can be classified as best practices and recommended for replication in other countries. The paper has also analyzed the consequences of fiscal decentralization on the overall level of public expenditure and fiscal deficit. It appears that, in the setting of the sample countries, fiscal decentralization has had no significant adverse macro economic consequences while the impact on effectiveness of service delivery remains ambiguous.

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