FISCAL DECENTRALIZATION IN CHINA AND INDIA:
A COMPARATIVE PERSPECTIVE

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The paper analyses trends in fiscal decentralization in the two largest countries of the world – China and India. Both countries are in transition from a planned to a market system. The paper identifies the emerging challenges in achieving fiscal decentralization in the two countries. The challenges arise firstly from the transition to the market economy and secondly from the replacement of the old command and control systems with institutions developed to administer market-based policies and instruments. The paper argues that the approach to meet the emerging challenges has to be holistic and should deal with the sub-national budgeting system underpinning central fiscal control and not just the various components of the sub-national systems. The overall approach should ideally encompass all levels of government.

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

This paper analyses the decentralizing experiences of the two largest countries in the world namely, China and India. The paper begins with a review of recent developments in fiscal decentralization in the two countries and identifies the major issues in each of them. The analysis helps to identify the challenges faced in the process of transition. This is followed by a summary of major issues of fiscal decentralization in these economies.

The paper identifies a number of important challenges faced in setting up efficient systems of intergovernmental finance in the China and India. First, for making the transition from plan to market, establishing property rights, instituting

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a legal system and regulations to ensure efficient competition calls for the creation and strengthening of decentralized institutions of governance. Second, the changing role of the state enhances the relative importance of sub-national fiscal systems and extending fiscal decentralization up to the lowest level is a major challenge. Third, effective fiscal decentralization requires assignment of significant powers to sub-national governments (Bahl, 1999). This is necessary to ensure that at the margin, there is linking of revenue and expenditure decisions. Fourth, transition to market necessitates calibration of efficient tax policies to replace revenue from public enterprises with taxes. It is also necessary to remove price and quantity controls. This calls for reforms in budgetary systems to make them comprehensive to include all extra-budget and off budget items. Fifth, it is necessary to develop a rational system of assignments and transfers, a proper legal and regulatory framework to conduct them and institutions to implement the system. Finally, capacity development of sub-national institutions is also extremely important.

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

I. FISCAL DECENTRALIZATION IN CHINA AND INDIA

There are important reasons for focusing on the fiscal decentralization experiences of China and India. There are major contrasts in fiscal decentralization, the policies adopted and institutions set up in the two countries. Both have initiated reforms towards achieving market-based development and have embarked on initiating policies and setting up decentralized fiscal institutions to create a market friendly environment.

China and India present cases of different typologies of decentralization and their varied experiences are useful to identify the challenges of fiscal decentralization during the process of transition. China is a large unitary country, though with a strong local government system. Although the taxation powers rest mainly with the centre, local governments have significant control over fiscal resources. China has a tradition of decentralization below the provincial level owing to close government-enterprise interaction at the county and township levels. India, on the other hand, is a large federal democratic polity, but fiscal decentralization extends only up to the State level. The challenge here is one of extending fiscal decentralization below the State level.
An important common trend seen in both countries during the 1990s is the strong initiative taken to systematize their fiscal systems. In the case of China, fiscal reforms introduced in 1994 have attempted to re-centralize tax collection and reform the tax sharing system. However, the tax and intergovernmental finance reforms have not been accompanied by corresponding changes in budgeting systems. Reforms in budget formulation, implementation and controls have been introduced only recently and are at various stages of implementation by different local governments. India has tried to evolve a three tier federal system and strengthen the third level through constitutional amendments and other institutional and policy initiatives since 1992. However, much of the sub-State decentralization is at central initiative, though there are some notable exceptions in States such as Karnataka, Kerala and Madhya Pradesh. The process of local government reform is still under way in India.

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

**China**

China is a large country making a transition from Soviet type planning to market-based development. Despite being unitary in structure, China’s fiscal system is highly decentralized with five hierarchically ordered budget levels: centre, province, prefecture, county and township. The number of local government units add up to about 50,000 (see figure 1). These include: 31 provinces\(^1\), 333 prefectures, 2,148 counties, and 48,697 townships. Although sub-national governments do not have powers to determine tax bases and rates, they have considerable manoeuvrability in regard to spending decisions. Almost 70 per cent of expenditures are incurred at sub-national levels. The fiscal arrangements over the years have been evolved according to the negotiated fiscal contract system. This not only caused a decline in governmental revenues but also reduced the ability of the central government to undertake macroeconomic stabilization and redistribution. Besides, the system encouraged the use of off-budget and extrabudgetary funds with adverse consequences on accountability (World Bank, 2000). A comprehensive package of reforms was implemented in 1994 to arrest the decline in revenues and restore central control over fiscal instruments. These reforms were directed also to define fiscal responsibilities, separate central and local fiscal systems and ensure better macroeconomic control at the central level. However, reforms are yet to address many issues, particularly those relating to clarity in expenditure assignment and reforms in the budgetary process at the decentralized levels.

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\(^1\) Excluding Taiwan Province of China and Hong Kong, China.
(i) Pre-reform intergovernmental finance system

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

Second, in the development of the tax system, cascading type turnover taxes were the mainstay. This was replaced by an origin-based value added tax. This created a source of invisible transfers in terms of interregional tax exportation. Such invisible transfers tend to be regressive and undermine the progressivity of explicit

Figure 1. Levels of government in China

![Graph showing levels of government in China]

1 Beijing, Tianjing, Shanghai, Chongqing
2 Under cities at all levels.

intergovernmental transfers even when they are progressive. Again, as the tax sharing arrangements are derivation-based, this contributed further to regressivity.

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

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

(ii) Intergovernmental fiscal system after fiscal reform (1994)

Reforms in the fiscal system introduced in 1994 were intended to arrest the fiscal decline referred to above, make the budgeting system comprehensive, eliminate distortions in the tax system and revamp the intergovernmental fiscal arrangements. The important measures introduced in 1994 included (i) reforms in the tax system including the introduction of value added tax; (ii) reassignment of taxes between central and local governments to have separate “central fixed incomes”, “local fixed

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

3 In the deconcentrated system, the sub-national governments are merely administrative units carrying out expenditure functions devolved to them by the line ministries at the centre. See, Asher and Rondinelli (1999).
incomes” and shared revenues from VAT between the central and local governments in the ratio (75:25); (iii) establishment of separate tax administrations for the central and local governments; and (iv) establishment of earmarked transfer schemes to counter the dis-equalizing impact of the tax sharing system based on the principle of derivation.

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

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

(iii) Sub-provincial revenue sharing arrangements

According to the Organic Budget Law implemented in the country in January 1995 higher level government has discretion to determine the fiscal assignment of the level immediately below it. The revenue sharing system is bilateral and for the five tiers of government, there are four layers of arrangements (Wong, 1996). Central – provincial arrangements do not touch arrangements below the provinces. Although there are no central guidelines on the pattern of resource transfers to be done by provinces nor are there any provincial guidelines on the transfer system to the local
governments below them; sub-provincial revenue sharing arrangements are broadly similar to the central-provincial revenue sharing system.

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

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

(iv) Intergovernmental transfers: major issues

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

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

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

(i) Intergovernmental fiscal system

India, as a democratic polity, evolved as a two-tier classical federation with constitutional demarcation of functions and finances between the centre and the States with separate legislative, executive and judicial arms of government constituted at the two levels. The seventh schedule to the constitution specifies legislative domains of the two layers of government in terms of Union (central), State and concurrent lists. The constitution also requires the President of India to appoint a Finance Commission every five years to review the finances of the centre and the States and recommend devolution of taxes and grant in aid for the ensuing five years.

(ii) Pre-reform fiscal arrangements

Though constitutionally a federal country, owing to relatively high degree of centralization India is characterized as quasi-federal. In shaping decentralization in India, both historical factors and the public sector have dominated. In the latter, the heavy industry-based import substituting industrialization strategy has played an important role. Centralization inherent in the constitution was accentuated by an autarchic economic regime, public sector domination in industry and the financial sector and state engineered allocation of resources. Since 1991, market oriented reforms have been introduced to liberalize the economy from the dirigisme.

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

(iii) Furthering fiscal decentralization through constitutional amendment

An important development in fiscal decentralization in India consists of the constitutional amendments in 1992 to accord statutory recognition to the third tier of government. With constitutional recognition, separate schedules listing 29 subjects falling within the ambit of rural local bodies and 18 within the ambit of urban local bodies have been specified. Revenue and expenditure assignments of local governments are exercised concurrently with States’ responsibilities. However, the actual powers and functions exercised by the local bodies depend on the extent to which States are willing to devolve. Each State has its own pattern of devolution and, in fact, there are wide variations in sub-State decentralization.
Thus, one billion people in the country are spread over 28 States. Below them there are over a quarter million local governments of which about 3,000 are in urban areas and the rest in rural areas. The rural local bodies or panchayats, in turn are in three levels – district, taluk (block) and village (see figure 2). Urban local governments consist of municipal corporations in large cities and municipalities, nagar (town) panchayats or notified area councils in smaller towns. Each State government is required to devolve revenue and expenditure powers to local bodies. Elections to these local bodies have to be held every five years and if the elected governments are superseded by States for any reason, elections must be held within six months of supercession. Each State has to appoint a State finance commission every five years to review local finances and recommend transfers to local bodies.

**Figure 2. Structure of multilevel government in India**

(iv) **Fiscal assignment**

An important feature of the tax assignment is its fragmented nature. While the tax on non-agricultural incomes is assigned to the centre, agricultural income tax is in the States’ domain. Sales taxes on goods can be levied by the States but not taxes on services. Although the constitution is equivocal in stating that trade and commerce throughout the country should be free, the tax on interstate sales of goods levied by the centre and collected by the States impedes the interstate movement of goods. More importantly, the State list contains an item, “tax on the entry of goods into a local area for consumption, use or sale”. This tax is called “octroi” and has been assigned to urban local bodies in a number of States. The levy of this tax has caused serious impediments to internal trade and has created several tariff zones within the country.
In addition to the above, there are a number of regulatory measures introduced as part of a planned regime that impede the free movement of goods and persons. Two examples will suffice to substantiate this: first, to meet the contingencies of food scarcity, restrictions were placed on the movement of foodgrains under the Essential Commodities Act; second, under the freight equalization scheme that existed for a long time, freight charges of many industrial raw materials such as coal, manganese and steel were subsidized to ensure supply at the same cost throughout the country. This has not only distorted industrial location but has also failed to strengthen forward and backward linkages in poorer, mineral rich regions of the country.

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

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

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

### Table 1. Fiscal decentralization in India 1997-1998

<table>
<thead>
<tr>
<th>Level of government</th>
<th>Percentage of GDP</th>
<th>Percentage of total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Revenue collection</td>
<td>Revenue accrual</td>
</tr>
<tr>
<td>Centre</td>
<td>11.4</td>
<td>6.8</td>
</tr>
<tr>
<td>States</td>
<td>6.3</td>
<td>10.9</td>
</tr>
<tr>
<td>Local bodies of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Urban local bodies</td>
<td>0.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Rural local bodies</td>
<td>0.04</td>
<td>1.3</td>
</tr>
<tr>
<td>Total</td>
<td>18.3</td>
<td>19.8</td>
</tr>
</tbody>
</table>

Source:  

In contrast, local governments have been facing hard budget constraints – in fact, they hardly have significant budgets. Their abysmal fiscal resources have resulted in poor service delivery. In the constitutional scheme, both revenue and expenditure powers have to be devolved to them by the States. However, in actual practice, as shown in the table, local governments have very few revenue powers. As regards expenditure functions, most States use them as implementing agencies. In effect, in many of the States, the functions of rural local governments consist of mainly implementing various schemes stipulated by either the central or the State government. Thus, despite constitutional recognition, in effect, local governments hardly have any independent fiscal powers.

(v) Intergovernmental transfers

A notable feature of intergovernmental transfers in India is the existence of multiple channels of transfer from the centre to the States\(^4\). The constitution provides for the appointment of the Finance Commission by the President of India every five years to assess fiscal resources and the needs of the centre and individual States and

\(^4\) For a detailed analysis of the transfer system, see Rao and Sen (1996).
recommend transfers. Finance commission transfers consist of mainly formula based
tax devolution and grants-in-aid given to fill the gap between projected revenues and
expenditures on the non-plan accounts. The latest, i.e. the Eleventh Finance
Commission has recommended the transfer of 29.5 per cent of central taxes to States
and the distribution is to be determined on the basis of a formula devised by the
Commission\(^5\). Grants are given to fill the post devolution gaps. Transfers given by
the Finance Commissions constitute 58 per cent of the total central transfers to States.

With development planning gaining emphasis, the scope of the Finance
Commissions was restricted to meeting States’ non-plan requirements in the current
(revenue) account. The Planning Commission became a major dispenser of funds to
the States by way of grants and loans to meet their plan requirements. These too are
distributed according to a consensus formula\(^6\) evolved in the National Development
Council (NDC)\(^7\). Transfers to State plan schemes constitute about 22 per cent of total
transfers.

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

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

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

\(^6\) The formula assigns 60 per cent weight to population, 25 per cent to income disability, 7.5 per cent
each to fiscal performance and special problems of states.

\(^7\) NDC is a body consisting of the cabinet ministers of the centre, Deputy Chairman and Members of
the Planning Commission and all the Chief Ministers of the States. The Prime Minister chairs the meetings
of the NDC.
An important legacy of planning and the system of decentralization that has evolved over time is the existence of invisible transfers due to a repressed interest rate regime, origin-based cascading type consumption tax system and subsidized loans given to priority sectors (Rao, 2000). Invisible transfers in the Indian context also arise from the existence of inter-State tax exportation caused by the levy of cascading type origin-based sales taxes in the States. Another important source of such transfers is the allocation of market borrowings and central loans to States at subsidized interest rates. Providing loans to priority sectors at subsidized interest rates is another legacy of the planning regime that causes interregional resource transfers.

(vi) Transfers below the State level

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

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

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

**Challenges of fiscal decentralization in transition**

The foregoing analysis of the two economies helps to identify important challenges in achieving efficient fiscal decentralization. The problems that need to be resolved include those relating to the development of the market, those pertaining to the ending of the previous command and control systems, designing multilevel fiscal systems and the creation of institutions to manage them effectively, and above all, their capacity development to ensure efficient public service delivery. Changing policies and developing institutions to deal with fiscal decentralization in the context of transition to market thus pose serious challenges.

An analysis of fiscal decentralization in the two countries provides useful insights. Within the context of the issues highlighted, there are comparisons and differences in the nature and content of fiscal decentralization. China, has a unitary system and yet has a considerable degree of fiscal decentralization, extending all the way up to the county and in some cases township level. In contrast, despite having a market based environment and a federal constitution, fiscal decentralization in India does not extend beyond the State level.

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

Despite these differences, there are, however, important issues of common concern in the transitional developing countries. The challenges of developing an efficient fiscal system and budgeting process, replacement of command and control systems with market-based instruments, and evolving responsive intergovernmental fiscal arrangements are all common to these countries. The major challenges of transition are summarized below:
(i) Extending fiscal decentralization below the provincial/State level

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

Merely legislating changes to establish decentralized institutions does not lead to effective fiscal decentralization as has been demonstrated by the Indian experience. Despite constitutional recognition, sub-State fiscal decentralization in India is negligible. In contrast, demand driven decentralization can be successful as seen in the Chinese case and its system of sub-provincial intergovernmental finance reinforces the centre-provincial arrangements (Bahl and Wallace, 2001). Local government in China up to the township level has traditionally enjoyed economic power due to its hold over enterprises, and the government – enterprise nexus has helped to develop administrative and fiscal capacity in local governments. In spite of the fact that local governments do not have the right to determine the tax base and rates, and the centralization of tax collection arrangements instituted in 1994, the sub-provincial local governments in China have been much more effective in providing public services than in India.

The demand driven decentralization also has its impact on the size of the lowest budget level in China. There are about 48,000 townships in China with an average population size of about 25,000. At this economically viable size, capacity to deliver public services is better. In fact, in many provinces, even townships are implementing agencies and fiscal decisions are taken at the county level where the average population size is about 500,000. In contrast, in India, the lowest budget level – the village panchayat, has an average population size of only 3,000. With negligible assignment of independent revenues, these units are no more than implementing agencies for the central and State government programmes.

Thus, of the two countries, China has the more decentralized system as almost 50 per cent of the sub-national spending is undertaken below the county level. In contrast, decentralization stops at the State level in India.

(ii) Developing a sub-national tax system

Designing and implementing an efficient tax system is an important component of fiscal decentralization. In China, local government does not have powers to determine tax bases and rates and can only collect the taxes assigned to them. As
public enterprises lose their importance in raising revenues, the local governments will have to develop their tax systems. This will not only bring in extrabudgetary funds into the budget discipline, but will help to link revenue-expenditure decisions at the margin. In India, too, local government below the State level needs to be empowered by assigning it independent revenue-raising authority.

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

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

(iii) Substituting physical controls with market based instruments

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

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

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8 For a detailed discussion of evolving property tax systems in transitional countries, see Malme and Youngman (2001).
Despite reduced emphasis on the plan and change in scarcity conditions over the years, a number of fiscal and regulatory impediments have continued in the two countries in varying degrees. Besides physical controls, there are also fiscal impediments with unintended allocative consequences. Removal of impediments to ensure free movement of factors and products throughout the country is necessary to improve competitiveness and this will be an important challenge generally in the transitional economies of Asia.

(iv) Making budgets comprehensive

An important challenge for transitional economies is to make the budgets comprehensive by including spending from extrabudgetary sources of revenue. There are various types of extrabudgetary revenues collected to finance public services in transitional countries. In China for example, decline in the share of taxes to GDP has coincided with extrabudgetary financing of expenditures. Besides various types of charges and fees collected outside the budgetary system, local governments have mandated public enterprises to provide some public services. In addition, there are “voluntary” contributions in cash and kind made by the community at the county and township levels for services such as education, health and rural roads.

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

(v) Incentives and accountability

A legacy of the planned regime is the lack of accountability and incentives. The public sector in both China and India is characterized by overemployment and/or high wages, lack of incentives in the payment of wages and in the recruitment and promotion policy. In this regard, the position of sub-national governments is not different. Attempts have been made to equalize emoluments at all levels of government both horizontally and vertically. At the sub-national level, when intergovernmental transfers are determined on the basis of actual/projected expenditures, this can lead to overemployment. Equating the wage rates of employees of local governments with those of the central government enhances the cost of providing public services,
particularly in poorer regions. This can also cause segmentation of the labour market and create distortions in unintended ways. Interestingly, China, which ironically has a strong socialist tradition, has greater flexibility in the labour market than India. In both economies, human resource development in the government sector, reduction in overemployment in government and State enterprises, providing performance-based wages and career advancement are the key issues of reform.

(vi) Intergovernmental finance

Evolving a responsive intergovernmental transfer mechanism is critical to an efficient system of fiscal decentralization in developing economies. The prevailing transfer systems in both countries have perverse incentives. In China, the transfer system is predominantly negotiated. In India, although the institutions have been provided in the constitution to objectively determine transfers to States, ways have been found to exercise discretion in intergovernmental transfers. Besides, perverse incentives can exist even in the design of formula-based transfers.

In both countries the transfer system is a combination of general and specific purpose transfers. While there is a legitimate role for specific purpose transfers in fiscal decentralization in developing countries, it is necessary that the objectives of such transfers are clear and their design appropriate. It is important to ensure that the transfer system is not used to exercise political influence and discretion by the centre. The case in point is the system in India in which there are as many as 220 specific purpose transfer programmes. Depoliticization of intergovernmental finance is difficult in developing economies but this is an objective that has to be pursued.

An important criterion for the design of any transfer system is that should match the objectives of decentralization reform (Bahl, 1999). The challenge is to design general purpose transfers to offset revenue and cost disabilities of sub-national governments and specific purpose transfers should be designed to ensure normatively given standards of specified services. However, evolving an appropriate transfer system requires significant effort at collecting the necessary information, creation of a database and measurement of the right fiscal parameters for designing and implementing transfer systems. In both economies, the lack of data and information are a major constraint in devising objective policy approaches to implementing intergovernmental transfer systems. Fiscal data at the sub-national levels in China are difficult to obtain. In India, budgets at the State level are published but significant efforts are needed to collect information below the State level.

(vii) Invisible transfers

In planned economies, besides explicit transfers, various price and quantity controls can cause significant implicit transfers across regions. An important source
of implicit transfers in the two countries is interregional tax exportation. Origin-based tax system and cascading-type taxes can cause significant interregional resource transfers. These economies are characterised by oligopolistic markets and the tax levied by a producing State in many cases could be shifted to consumers in other States. Thus, such transfers can be regressive and can significantly offset the progressivity of equalizing transfers.

Besides interstate tax exportation, there can be other sources of interregional transfers in planned or quasi-planned economies. Important sources of such transfers include targeting investments in specific locations by the central government (regional policies), lending to the sub-national governments at below market rates of interest and allowing them to borrow from the market under a financially repressive regime, and influencing the allocation of the financial system including distribution of seignorage and preemption of the resources of the banking system for priority sectors (Rao, 1997).

(viii) Institutional development

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

III. CONCLUDING REMARKS

The paper has attempted to identify important challenges of fiscal decentralization faced by the two largest countries in the world. Interestingly, both are also developing countries and both are making a transition from a planned to a market system. Accelerating development and making a transition from plan to market pose major challenges of creating/developing market based instruments, policies and institutions. The challenges identified in the paper are by no means exhaustive nor are they specific to Asian countries. They can apply in varying measures to other developing and transitional economies as well.
The challenges of fiscal decentralization should not be looked at from the narrow perspective of developing intergovernmental finance. This should be seen as part of developing a comprehensive and coordinated budgeting and fiscal system. Evolving a transparent and programme based budgeting system involves the development of an efficient tax, expenditure and intergovernmental finance system at the central and local levels. A systemic approach to fiscal decentralization also requires policies and institutions, on the one hand, and capacity-building of various institutions to implement them on the other.

Thus, in evolving the decentralized delivery of public services, the case study of the two countries highlights the challenges of developing the right framework for the purpose, specifically removing the infirmities and impediments to the efficient functioning of a market-based system and of making a relatively smooth transition from plan to market. Rediscovering the role of decentralized governmental units in the context of a changed role for the government, severing the nexus between governments and State enterprises, removal of price and quantity controls, restoring market incentives, developing institutions to administer market-based instruments and policies and bringing in expenditures from all sources into budgetary discipline, are the major issues which need to be confronted to ensure equity and efficiency in delivering public services in the two economies.
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