OECD Fiscal Federalism Studies

Local Public Finance and Capacity Building in Asia

ISSUES AND CHALLENGES

Edited by Junghun Kim and Sean Dougherty



OECD

KOREA INSTITUTE OF PUBLIC FINANCE

OECD Fiscal Federalism Studies

Local Public Finance and Capacity Building in Asia

ISSUES AND CHALLENGES

Edited by
Junghun Kim and Sean Dougherty

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document, as well as any data and map included herein, are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Please cite this publication as:
Kim, J. and S. Dougherty (eds.) (2020), *Local Public Finance and Capacity Building in Asia: Issues and Challenges*, OECD Fiscal Federalism Studies, OECD Publishing, Paris, *https://doi.org/10.1787/a944b17e-en*.

ISBN 978-92-64-61206-8 (print)
ISBN 978-92-64-94300-1 (pdf)

OECD Fiscal Federalism Studies
ISSN 2225-403X (print)
ISSN 2225-4056 (online)

Photo credits: Cover © Enkophotography/iStockphoto.com.

Corrigenda to publications may be found on line at: *www.oecd.org/about/publishing/corrigenda.htm*.

© OECD 2020

The use of this work, whether digital or print, is governed by the Terms and Conditions to be found at *http://www.oecd.org/termsandconditions*.

Foreword

The rules and practices that govern fiscal relations among different levels of government, such as their responsibilities for taxation, spending and debt management, have a bearing on economic efficiency and ultimately growth. Recent volumes of the *Fiscal Federalism Studies* series have added to the evidence linking intergovernmental fiscal relations and inclusive growth. Since subnational governments are involved in so many aspects of policymaking, it is natural to investigate how these governments can promote inclusive growth. While all members of the OECD's Network on Fiscal Relations across Levels of Government seek to improve the performance of their own institutions, the design of fiscal decentralisation is perhaps even more important for many "newly decentralising" countries in Asia, Latin America and elsewhere. The Network has developed many broad lessons about "what works and what does not" in typical OECD economies, which it can share; at the same time, there are many country-specific factors that need to be taken into account.

The collection of analyses in this volume draw from the second meeting of the Roundtable of the Network on Fiscal Relations in Asia (RoNFRA), organised jointly with the Korea Institute of Public Finance (KIPF) and the Asian Development Bank (ADB) in 2019. The second RoNFRA focused on how local government capacity building and performance improvement can contribute to inclusive growth in the context of decentralisation. These drivers, in turn, depend on various factors such as local fiscal and human resources, the commitment of local politicians and public officials, intergovernmental fiscal relations, fiscal institutions, political environments and their interactions with each other.

Beyond all of the individual chapter authors, we would like to thank KIPF colleagues Hyun-A Kim and John M. Kim; OECD colleagues Luiz de Mello and Edwin Lau; and ADB colleagues Claudia Buentjen and Hanif Rahemtulla for their active roles in facilitating the workshop. In addition, we would like to acknowledge the country panellists: Niño Alvina (Philippines); Daovala Phommala (Lao PDR), Bondi Arifin (Indonesia), Win Win Myat (Myanmar), Imelda Laceras (Philippines); Anchidtha Roonguthai (Thailand), Lourenco Pinto (Timor-Leste); Suresh Balakrishnan (Nepal); Batsukh Tumurtulga (Mongolia); Mohammad Emdad Ullah Mian (Bangladesh); Chanthary Huy (Cambodia); Anna Bonagua (Philippines); Heru Wibowo (Indonesia); Preeta Lall (LOGIN Asia, India); Philipp Päcklar (Fiscal Network Bureau, Austria). Thanks are also due to Yunji Her (KIPF) and Lyora Raab (OECD) for their efficient help with administrative and logistical aspects of the workshop. For the publication, expert support was received from Julie Harris, who copy-edited the manuscript, as well as from Meral Gedik, who rapidly carried out the final typesetting. Finally, the workshop and publication were made possible through the generous financial support of the Korea Institute of Public Finance.

Table of Contents

Foreword **3**

Executive summary **11**

Chapter 1. Challenges of subnational capacity development **13**

Introduction 14
Some general considerations 15
The main weaknesses in subnational revenue capacities 16
The main weaknesses in subnational spending capacities 22
How central governments can help subnational governments improve their fiscal capacities 26
The role of horizontal intergovernmental co-operation in strengthening subnational fiscal capacities 27
Conclusion 28
References 29
Notes 31

Chapter 2. Political economy perspectives on intergovernmental fiscal system design and implementation in Asia **35**

Introduction 36
The scope and diversity of intergovernmental systems 36
Overlooked political and institutional dynamics 38
Overlooking implementation 42
Towards a more strategic approach to reform 44
Conclusion 49
References 51
Notes 57

Chapter 3. Finding the right balance in the use of conditional grants **59**

Introduction 60
Subnational debt and the role of intergovernmental relations 64
Vertical fiscal gap vs. vertical fiscal imbalance and the role of intergovernmental relations 66
Country cases 68
Conclusion 78
References 78
Notes 81

Chapter 4. Subnational capacity building: An international perspective of the Asia Pacific region **83**

Introduction 84
Current socio-economic and territorial organisation trends in Asia Pacific 86
Subnational government finance in Asia Pacific 92
Typical challenges in subnational capacities 99

Enabling conditions to foster subnational capacity building 106
Conclusion 117
Annex 4.A. Indicator tables for selected Asia-Pacific countries 118
References 120
Notes 123

Chapter 5. Fiscal transfers in Asia: Pitfalls and opportunities for achieving the Sustainable Development Goals 125

Introduction 126
Objectives and types of fiscal transfers in Asia 127
The equity effects of transfers in Asia 130
The unintended incentive effects of transfers 137
Leveraging incentive effects to promote better local performance 144
References 149
Notes 152

Chapter 6. Natural resource taxation and revenue sharing in Asia 155

Introduction 156
Natural resource revenue-sharing systems: Definitions and distinctions 158
Natural resource revenue-sharing systems 160
Addressing challenges with resource revenue-sharing systems 168
Conclusion 172
References 172
Notes 174

Chapter 7. Municipal finance and property taxation in China 175

Introduction 176
China's inter-governmental fiscal framework 176
Land-based finance for urban development 181
Emerging challenges in municipal finance 185
New sources of municipal revenues and finance 186
Conclusion 190
References 191
Notes 192

Chapter 8. Fiscal federalism in India 193

Introduction 194
Broad principles associated with fiscal federalism 196
The changing dynamism of fiscal federalism 196
Federalism in India, pre-independence 197
Federalism in India, post-independence 198
The role of the Finance Commission in India's federal architecture 199
Trends in fiscal transfers to the states over the years 200
Emerging challenges in India's fiscal federalism 202
Conclusion 206
References 208

Tables

Table 3.1. Share of tax revenue in selected OECD countries, 2017 70
Table 3.2. Budgeted revenue expenditure and financing in England, 2018/19 and 2019/20 71
Table 3.3. Central government revenue funding of local government in England, 2004-09 72
Table 4.1. Demographic and economic indicators for selected Asia-Pacific countries, 2017 88
Table 5.1. Mongolia: *Aimag* shared revenue and GLDF transfers, 2016 135
Table 5.2. The dominance of conditional transfers in India, 2014/15 138
Table 6.1. Mineral and petroleum tax collection by level of government, selected countries in Asia-Pacific 163
Table 6.2. *De jure* derivation-based inter-governmental transfer formulas in selected countries 164
Table 7.1. Government revenues in China, 2018 177
Table 7.2. Taxes by category under the tax-sharing system in China 179
Table 7.3. Tax revenues in China by year, 1995-2018 179
Table 7.4. Revenues from five taxes on real estate properties in China, 2013-18 182
Table 7.5. Individual tax revenues in China, 2013-18 186
Table 8.1. Unitary, federal and confederal systems of government 194
Table 8.2. Broad principles associated with fiscal federalism 196
Table 8.3. Views of earlier commissions and committees on centre-state relations in India 204

Annex Table 4.A.1. Demographic and economic indicators for selected Asia-Pacific countries, 2017 118
Annex Table 4.A.2. Fiscal decentralisation indicators for selected Asia-Pacific countries, 2016 119
Annex Table 4.A.3. Territorial organisation in selected Asia-Pacific countries, 2017/18 119

Figures

Figure 1.1. Subnational government own-tax revenue by type of taxes, 2019 19
Figure 1.2. Shared responsibilities across levels of government 23
Figure 2.1. Landscape and diversity of intergovernmental systems 42
Figure 2.2. Neglected factors in implementing reform and elements of strategic approaches 47
Figure 3.1. Percentage of total federal grants to state and local governments in the United States, by category, 1980–2018 68
Figure 3.2. The share of subnational debt in selected OECD countries, 2015 73
Figure 3.3. Government net debt relative to GDP, Canada, 2008-88 74
Figure 3.4. Shares of subnational expenditure and revenue in selected OECD countries, 2018 76
Figure 3.5. Grants as the share of municipalities' total revenues, Sweden, 1965-2003 77
Figure 4.1. Regionalisation in Europe, America and Asia since 1950 90
Figure 4.2. Average number of inhabitants per municipality by country 92
Figure 4.3. Subnational government expenditure as a percentage of GDP and total public expenditure by geographic area, 2016 93
Figure 4.4. Breakdown of subnational sources of revenue in Asia Pacific, 2016 94
Figure 4.5. Share of COFOG category in subnational public expenditure by geographic region, 2016 95
Figure 4.6. Share of COFOG category in subnational public expenditure by country, 2016 96
Figure 4.7. Public direct investment as a percentage of GDP and total public expenditure by geographic area, 2016 97
Figure 4.8. Public direct investment as a percentage of GDP and total public expenditure by country, 2016 97

Figure 4.9. Subnational direct investment as a percentage of GDP and public direct investment by country, 2016 98
Figure 4.10. GDP per capita and expenditure decentralisation by region, 2016 100
Figure 4.11. Human Development Index and expenditure decentralisation by region, 2016 100
Figure 4.12. Cumulative Governance Score in Asia-Pacific countries, 2016 101
Figure 4.13. Subnational government expenditure and tax revenue as a percentage of public expenditure and tax revenue, 2016 104
Figure 4.14. The tax revenue and recurrent property tax as a percentage of total subnational revenue in Asia Pacific, 2016 109
Figure 5.1. Selected SDGs and examples of public spending needed 126
Figure 5.2. The real funding gap 130
Figure 5.3. Fiscal equalising formulae: Varying scopes 132
Figure 5.4. Shared mining-related revenues 134
Figure 5.5. The equalising challenge 135
Figure 5.6. India: Differing spending patterns in the use of secondary education grants 2017/18 139
Figure 6.1. Types of natural resource revenue-sharing systems 158
Figure 6.2. Revenue sharing versus benefit sharing 160
Figure 6.3. *Blora* and *Bojonegoro*, Indonesia 165
Figure 7.1. General tax burden in China, 2009-17 178
Figure 7.2. Local general budgetary revenues and land concession revenues in China, 2001-18 184
Figure 8.1. Criteria for the distribution of income tax proceeds to states, First to Tenth Finance Commissions 201
Figure 8.2. Criteria for the distribution of union excise duties, First to Tenth Finance Commissions 201
Figure 8.3. Criteria for the distribution of states' share in all central taxes, Eleventh to Fourteenth Finance Commissions 202
Figure 8.4. Total outstanding liabilities of states and union territories in India, 2001-20 205
Figure 8.5. Cesses and surcharges in India, 2009-18 205
Figure 8.6. Challenges facing the development of fiscal federalism in India 206

Boxes

Box 4.1. The OECD/UCLG World Observatory on Subnational Finance and Investment 85
Box 4.2. COVID-19 crisis impact on economic development and multi-level governance 87
Box 4.3. Examples of decentralisation reforms in Asia Pacific 89
Box 4.4. Megacities in Asia Pacific and special status attributed to urban areas 91
Box 4.5. Subnational revenues in Asia-Pacific countries: A diversity of profiles 94
Box 4.6. Ten guidelines to make decentralisation systems work more effectively 106
Box 4.7. Guidelines 1 and 2: Clarify the responsibilities assigned to different government levels, and ensure that all responsibilities are sufficiently funded: some reforms' examples 107
Box 4.8. Guideline 3: Strengthen subnational fiscal autonomy to enhance accountability 108
Box 4.9. The property tax in Asia Pacific 109
Box 4.10. Guideline 4: Support subnational capacity building 110
Box 4.11. Guideline 5: Build adequate co-ordination mechanisms across levels of government 113
Box 4.12. Guideline 6: Support cross-jurisdictional co-operation 115
Box 4.13. Guideline 8: Allow and make the most of asymmetric decentralisation arrangements 116
Box 5.1. "Gap-filling" transfers and wish-list budgeting 141
Box 5.2. Performance-based multi-sectoral unconditional grants: Common features 145
Box 8.1. Article 280 of the Indian Constitution 199

Follow OECD Publications on:




http://twitter.com/OECD_Pubs


http://www.facebook.com/OECDPublications


http://www.linkedin.com/groups/OECD-Publications-4645871


http://www.youtube.com/oecdilibrary



http://www.oecd.org/oecddirect/

Executive summary

Subnational governments' capacity to effectively fund and deliver public services are crucial for the realisation of the benefits of decentralisation. However, subnational government capacities often suffer from significant weaknesses, ranging from inadequate assignments of own-revenues, through to flaws in tax administration, the design of intergovernmental transfers, spending assignments and various aspects of public financial management. The first chapter, by Teresa Ter-Minassian, gives an overview of these challenges, and discusses how central governments can contribute to easing the resource constraints on subnational capacity building as well as create appropriate incentives for these governments to improve their performance.

The second chapter, by Paul Smoke (New York University), gives a political economy perspective on intergovernmental fiscal system design and implementation. Although fiscal decentralisation has been a popular reform for decades, including in Asia, success with operationalising reform frameworks and the realisation of expected results have often been elusive, particularly in middle and lower-income countries. This chapter argues that a nuanced diagnosis of context, particularly of the political economy realities, is essential for improved system performance. While there is no universal remedy for increasing the effectiveness of fiscal decentralisation, better diagnostics and more strategic and flexible approaches to implementation have the potential to improve on the status quo.

The third chapter, by Junghun Kim (Network on Fiscal Relations), discusses how to find the right balance in the use of intergovernmental grants. Discussions on the design of intergovernmental fiscal relations often revolve around the premise that intergovernmental grants – especially earmarked grants – should be minimised, as they imply a vertical fiscal imbalance between central and subnational governments. However, almost all local governments provide certain essential public services, where earmarked grants play an important role in the provision of such services. Several country cases show the importance of intergovernmental relations in the role of co-ordinating across levels of government for the efficient and equitable provision of essential public services.

The fourth chapter, by Dorothée Allain-Dupré, Isabelle Chatry and Louise Phung (OECD) provides an overview of decentralisation trends and challenges in the Asia-Pacific region, based on a new database. The subnational landscape in the region is highly diverse when looking at territorial organisation, decentralisation patterns, subnational finances and capacities. Since the 1990s, decentralisation reforms have been carried out in many Asian countries, transferring responsibilities and fiscal resources to subnational governments. These reforms translated into high fiscal decentralisation indicators – above world averages – but several bottlenecks to effective multi-level governance and subnational capacity building remain. Unclear assignments of responsibility across levels of government and weak fiscal decentralisation are the most prominent challenges.

The fifth chapter, by Roger Shotton and Uyanga Gankhuyag (UNDP), examines how fiscal transfers in Asia can provide opportunities for attaining the Sustainable Development Goals (SDGs). Increased and better quality public spending is needed, with responsibility for a significant share of this spending mandated to subnational governments across Asia, which are primarily dependent on fiscal transfers to fulfil their mandates. Moreover, the allocation of these transfers may unintentionally shape progress towards reducing geographic inequality and also carry perverse incentives affecting the quality of spending. The chapter argues that there is also an increasing body of experience in explicitly attaching positive incentives to transfers, which hold promise for promoting better local service delivery performance and accountability, and hence for attaining the SDGs.

The sixth chapter, by Andrew Bauer and Uyanga Gankhuyag, looks at natural resource taxation and revenue sharing in Asia. More than 30 countries have put in place natural resource revenue-sharing systems – systems that allocate revenues from natural resources to subnational governments separately from other fiscal revenues. The main aim of such systems is to enable natural resource-producing regions of a country to benefit more from natural resource extraction, as well as to mitigate conflicts between national and sub-national governments. To work smoothly and enhance trust, natural resource revenue-sharing systems need to be well designed and implemented, as well as overseen by an adequate and transparent governance mechanism.

The seventh chapter, by Zhi Liu (Lincoln Institute of Land Policy), looks at municipal finance and property taxation in China. Chinese cities have relied heavily on the revenues from public land leasing to finance urban development. Recently, following China's recent amendment of its Land Administration Law, villages can supply rural land for urban development without going through land expropriation by local governments. This amendment will have a significant impact on the future of municipal finance. In the context of China's inter-governmental fiscal framework, this chapter discusses the current issues facing its municipal finance system, the new issues that would emerge as a result of the amendment and options to address them, notably through greater use of property taxation.

The eighth chapter, by N.K. Singh (Fifteenth Finance Commission), examines fiscal federalism in India over recent decades, and draws attention to the need to improve its principles and practices. The chapter argues that today's India, notably through its governance "matrix", economic development, institution-building and multilateral relations, is vastly different from the India that drafted its constitution in 1950. The country is going through a transition in its intergovernmental relations, with boundaries based on linguistic factors and administration blurring, given changes brought on by innovation and migration. Rapid socio-economic trends such as technological change, rising mobility and market integration will affect the future of fiscal federalism in India.

Chapter 1. Challenges of subnational capacity development

by Teresa Ter-Minassian

There is widespread consensus, both in the literature and among policy makers, that the capacity of subnational governments' to effectively and efficiently fund and deliver the public goods and services for which they are responsible is crucial for the realisation of the potential benefits of decentralisation. Unfortunately, there is also ample evidence that subnational capacities often suffer from significant weaknesses. This chapter provides an overview of such weaknesses, ranging from inadequate assignments of own revenues, to flaws in tax administration, in the design of intergovernmental transfers, in spending assignments, and in various aspects of public financial management. The chapter discusses how central governments can contribute to easing the resource constraints on subnational capacities and create appropriate incentives for subnational governments to improve them. It also reviews how intergovernmental co-operation can contribute to the development of subnational fiscal capacities.

This paper, prepared for the 2nd KIPF-OECD-ADB Roundtable of the Network on Fiscal Relations in Asia (RoNFRA), draws in part on an earlier presentation by the author to the third meeting of the IDB's Red de descentralización y gestión fiscal subnacional en América Latina y el Caribe.

Introduction

Traditional (first-generation) theories of fiscal federalism (Tiebout, 1956[1]; Musgrave, 1959[2]; Oates, 1972[3]) emphasised the potential welfare and efficiency gains from fiscal decentralisation.[1] Based on the key assumptions of benevolent governments, differences in preferences, and significant citizen mobility, they argued that expenditure functions should be assigned to the lowest level of government capable of internalising the benefits from those functions. This would improve preference matching and efficiency in the delivery of public services, because local governments were likely to know their citizens' preferences better than the central government, and because citizens unsatisfied with their local governments' performance could vote local officials out of office, or move to a different locality ("vote with their feet").

The restrictive assumptions underlying such theories were subsequently challenged by second-generation theories (Qian and Weingast, 1997[4]; Oates, 2005[5]; Weingast, 2009[6])[2] that emphasised political economy influences (including the risks of elite capture and governance failures) on the decentralisation process and its economic benefits.

More recently, both academics and policy makers have increasingly focused on the constraints that capacity limitations in subnational governments (SNGs) place on the effectiveness of decentralisation in ensuring a provision of public services that is more efficient and reflective of citizens' preferences, as well as addressing equity concerns.[3] This, in turn, raises several questions, including:

- What are the main weaknesses in subnational capacity that hinder SNGs' ability to efficiently and equitably deliver the goods and services for which they are responsible?
- What are the incentives and resource limitations that affect SNGs' willingness and ability to correct those weaknesses?
- How can central governments (CGs) promote sustained capacity development efforts by their SNGs?
- What role can horizontal intergovernmental co-operation play in improving subnational capacity?

This chapter explores such questions, drawing as much as possible on the (unfortunately limited) available empirical evidence from a range of countries at different levels of development. It also draws on the presentations made by representatives of a number of Asian countries at the Roundtable of the Network on Fiscal Relations in Asia (RoNFRA) for which this chapter was prepared, extending earlier work in OECD/KIPF (2019[7]).

The chapter is structured as follows. The next section defines subnational fiscal capacity and briefly discusses the limitations in available information on the state of such capacity. The third section explores the main weaknesses in subnational own revenue-raising capacity and in the design of intergovernmental transfers. The fourth section discusses weaknesses in SNGs' capacity to carry out their assigned spending responsibilities, including flaws in planning, budgeting and executing spending programmes and public investments. The fifth section discusses the role of CGs in subnational capacity building. The penultimate section focuses on how intergovernmental co-operation can help address subnational capacity weaknesses, and the last section presents some brief conclusions.

Some general considerations

As indicated above, increasing focus is now being placed in the literature and by policy makers worldwide on the fact that the effectiveness of decentralisation in promoting sustainable and inclusive growth depends on subnational fiscal capacity. The latter can be defined as subnational governments' ability to:

- secure own and transferred resources adequate to funding their assigned spending responsibilities in a reasonably efficient and fiscally sustainable manner
- provide their citizens access to services and infrastructure of adequate quality
- manage their budgets and financial and non-financial assets and liabilities responsibly and transparently.

Unfortunately, comprehensive, detailed, objective and internationally comparable information about subnational capacity needs is sorely lacking. The vast majority of systematic, indicators-based, international diagnostics about government capacities in revenue policy and administration (e.g. the International Monetary Fund's Revenue Administration Fiscal Information Tool [RA-FIT] and the Tax Administration Diagnostic Assessment Tool [TADAT][4]), and in expenditure and public financial management (e.g. Public Expenditure and Financial Accountability [PEFA][5] and Public Investment Management Assessment [PIMA][6]), relate to central governments.

For the most part, qualitative country-specific sources of information are the sources available, including surveys of opinions of national officials[7] and users of subnational services, and ad hoc studies covering one or more SNGs. Such studies can suffer from positive selection bias, as they focus more frequently on SNGs that provide better information (including performance indicators and/or cost data for spending programmes). These SNGs tend to be larger and richer jurisdictions in relatively more advanced countries and accordingly have comparatively more developed capacities.

Some countries (including the Philippines in Asia) have developed, or are in the process of developing, indicator-based systems of scoring financial and operational capacities of their SNGs, to identify major weaknesses, needs for support by the central government (CG), the appropriate pace of devolution of spending and revenue responsibilities, and subnational capacity to borrow responsibly.

Capacity needs vary not only across and among countries – reflecting, in particular, each country's level of development and size, as well as the urban or rural nature of its jurisdictions – but also over time, reflecting growing challenges posed to SNGs by trends in the socio-economic environment, such as:

- the dislocations caused by globalisation, and the related territorial shifts in demand and production, which affect both SNGs' revenue bases and spending needs
- migration flows, which can place increased burdens on social services (education, health and social assistance) provided by SNGs
- changes in technology, which require upgrading the skills of subnational employees, and changes in education services delivered by SNGs
- urbanisation and agglomeration trends, which lead to the emergence of mega metropolitan areas that include multiple jurisdictions, with related co-ordination challenges

- reduced societal tolerance for large disparities in access to, and quality of, public services.

These challenges make subnational capacity development an ongoing imperative, requiring recurrent use of appropriate diagnostic tools, and the right incentives to design and implement appropriate corrective strategies.

It must be recognised that a number of political economy and governance-related factors can weaken subnational governments' incentives to assess and improve their fiscal capacities, including:

- factors that weaken the accountability of SNGs' officials to their citizens, such as:
  - the capture of SNGs by local elites, which can hinder both their exploitation of own sources of revenues, such as property taxes, and their interest in providing quality services (e.g. primary health and education) to lower-income groups
  - limited involvement of the population in civic life
  - inadequate transparency of subnational budget operations
- extensive discretion in intergovernmental fiscal relations, which softens the subnational budget constraint, and often results in favouritism toward SNGs politically aligned with the central government
- a poorly functioning judiciary, which fosters impunity for tax evasion and corruption.

The effects of these and other governance–related weaknesses on subnational capacity are discussed in greater detail by Professor Paul Smoke in the next chapter of this volume.

The main weaknesses in subnational revenue capacities

Own revenues

Benefits of, and obstacles to, subnational tax autonomy

Both first and second-generation theories of fiscal federalism recognise the benefits of a significant degree of autonomy for SNGs in deciding the level and composition of their own revenues.[8] These benefits include:

1. the potential to increase overall national revenues by tapping sources (such as property taxes and user fees) that might be neglected or administered less effectively at the CG level
2. providing greater certainty to SNGs about their resource availability, thereby facilitating the preparation of more realistic budgets, and reducing volatility in the execution of spending programmes
3. promoting subnational fiscal responsibility, which tends to be undermined by SNGs' reliance on gap-filling transfers or other bailouts by the CG (the so-called soft budget constraint) (Eyraud and Lusinyan, 2011[8]; Ter-Minassian, 2015[9])
4. facilitating the alignment of tax structure and design with local preferences

5. making more visible to electorates the cost of subnational spending, thereby increasing local officials' political accountability and incentives to spend efficiently (provided that adequate transparency of their operations is ensured).

The literature also recognises, however, that there are significant economic, institutional and political obstacles to subnational own-revenue mobilisation. An important economic obstacle is the greater mobility of potential tax bases (goods and factors of production) within the national territory than across national borders, which increases the scope for tax evasion, and predatory tax competition (race to the bottom) among subnational jurisdictions. Another economic obstacle is the uneven distribution of the tax bases across the national territory, which implies that sole reliance on own revenues would result in excessive disparities in individual subnational governments' ability to finance the provision of adequate levels of public services in key areas such as health, education and basic infrastructure.

There are also important institutional obstacles to subnational own-revenue mobilisation, including the better capacity of central than of subnational tax administrations to exploit economies of scale in the collection and enforcement of taxes; their generally better endowments of financial and human resources; and the fact that compliance costs for taxpayers operating in multiple subnational jurisdictions are magnified by the existence of differences in subnational tax legislation and tax administration procedures.

Finally, there are important political economy constraints to revenue decentralisation, in particular, central governments' preference for maintaining control of the main tax bases, both to facilitate the conduct of revenue-based stabilisation policies, and to influence subnational spending decisions; and SNGs' frequent preference for CG transfers (especially unconditional ones), to avoid the political cost of raising own revenues.

The balance between the benefits and costs of revenue decentralisation varies both across countries and over time. Given the host of factors affecting the degree of revenue decentralisation, it is difficult to find robust empirical explanations of it. It does not appear to be clearly correlated with the (federal or unitary) form of government; the level of development; the composition of gross domestic product (GDP); the degree of dependence on revenues from non-renewable natural resources; or even the degree of spending decentralisation.

The Asia region is characterised by relatively low levels of subnational tax autonomy. Although the share of tax in total subnational revenues (around 46%) is higher in other regions of the world, the majority of tax revenues are shared taxes on the level of which SNGs have no control, since the CG determines their bases, rate structures, collection and enforcement.

Options for subnational own revenues

There is a vast literature discussing the criteria that should guide the assignment of specific forms of revenues to subnational (intermediate and local) governments [see, e.g. Ambrosanio and Bordignon (2006[10]); Bird (2010[11]); and Hagemann (2018[12])].

Theoretical considerations, as well as lessons from country experiences, suggest that desirable characteristics of such taxes include:

- relatively low mobility of the tax base
- the avoidance of distortions and risks of adverse spillovers on other jurisdictions, such as tax exporting, or predatory tax competition

- a relatively even distribution of the tax base across the national territory
- significant revenue-raising potential
- low sensitivity to cyclical fluctuations and other exogenous shocks
- the relative ease of administration
- low compliance costs.

Although no potential subnational revenue handle meets all these criteria, some are generally recognised to be more suitable than others. At the intermediate (state or region) level of government, the most suitable revenue handles are surcharges on the national personal income taxes (PIT),[9] retail sales taxes (RST) and excise taxes.

Surcharges on the PIT combine the advantages of taxing personal incomes (relatively low mobility of the tax base, and, if levied on a residence basis, conformity with benefit principle and low exportability) with reducing administration and compliance costs, and visibility (which are high in personal income taxation), a fact that increases their political acceptability. However, subnational PITs, or surcharges on the national PIT, are unlikely to produce substantial revenue in economies characterised by a high degree of labour informality, or by other weaknesses in the collection of the PIT at the national level. Therefore, they tend to be utilised mainly by advanced countries.

Compared to income taxes, subnational RSTs have the advantages of lesser cyclical sensitivity; more even distribution of the base; and possibly lesser visibility, which makes them more politically acceptable. However, they are difficult to enforce in countries (especially developing ones) where the retail sector is highly fragmented. They also tend to be regressive.

Turnover taxes (levied not only on sales to final consumers but also on inter-enterprise sales) tend to be favoured by SNGs for their high revenue potential, even at relatively low rates; relative ease of enforcement; and low visibility. Moreover, they tend to be more evenly distributed than is the case for income taxes and less cyclically sensitive. However, because of their cascading nature and exportability, these taxes entail high efficiency costs (Artana et al., 2012[13]).

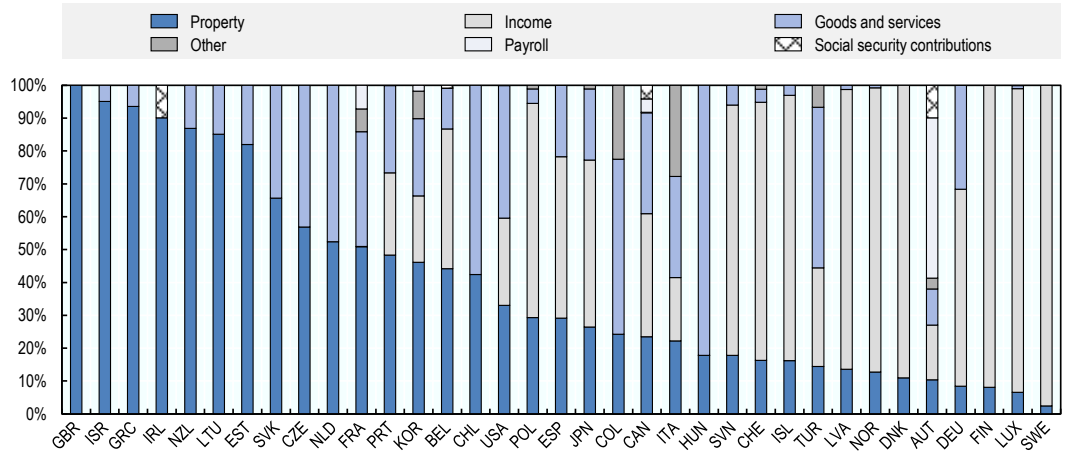
Regional value-added taxes (VATs) do not suffer from the shortcomings of turnover taxes but have significant costs. These include: 1) limited subnational capacities to administer a multi-stage tax, especially if levied with multiple rates and multiple exemptions; 2) high compliance costs for taxpayers (businesses) operating in multiple states, if the regional VATs are levied on differently defined tax bases, or with different administration procedures; and most importantly, 3) the difficulties connected with the taxation of interstate trade. These problems are quite evident in the case of the state VAT in Brazil.[10] Canada's successful operation of dual (national and provincial) VATs reflects the advanced capacities of its national and provincial tax administrations and a well-established tradition of co-operation among them.[11] India has only recently established a dual-type VAT (the goods and services tax [GST]); it is therefore too early to assess its performance.[12]

State-level taxes are also frequently levied on the consumption of specific (generally non-merit) goods and services, either on a stand-alone basis or, more frequently, as piggybacks on central government excises. Typical bases for subnational excises are gasoline, tobacco products, alcohol and soft drinks. Such taxes are increasingly also being levied, especially in metropolitan and/or touristic areas, on hotel occupancy and restaurant services. Their advantages are a reasonably good revenue-raising potential, low visibility and costs of

administration (especially when collected at the point of production). They can also fulfil environmental or health policy goals.

In the traditional fiscal federalism literature, taxes on immovable (urban and rural) properties are generally presented as the ideal source of own revenues for local governments. This is the case because they are levied on immobile bases, and therefore are not exportable; they conform to the benefit principle, as they typically finance the provision of local services used by the property owners (or their tenants); can be mildly progressive (if assessed property values are kept reasonably close to current market values); and are generally[13] less cyclically sensitive than income or consumption taxes. A limited number of local governments in OECD countries rely predominantly on property taxes (Figure 1.1).

Figure 1.1. Subnational government own-tax revenue by type of taxes, 2019



Note: As a share of total subnational own-tax revenue, from 2019 or closest available year.
Source: OECD Fiscal Decentralisation database.

However, economists like property taxes much more than taxpayers and politicians do (Bahl, Martinez-Vazquez and Youngman, 2010[14]). Their political unpopularity reflects several factors: the high visibility of the tax, which is typically paid in one or two annual instalments and may create liquidity difficulties for some taxpayers; the fact that the basis of the assessments is frequently not transparent, which opens scope for protracted judicial battles; and the fact that the difficulty of keeping property cadastres updated results in perceptions of horizontal inequities in the assessments.

Moreover, and importantly, property tax bases are typically very unevenly distributed across a national territory, with the bulk being concentrated in metropolitan areas; and property taxes are among the most challenging taxes to administer properly, especially in developing countries that are characterised by a high level of informality in real estate markets. Although technological advances have made the identification and registration of properties, and the updating of computerised property cadastres, easier than in the past, progress in these areas has been slow, especially in low-income countries, and in smaller municipalities. In addition, updating property assessments to reflect changing market values remains a challenge worldwide (Slack and Bird, 2014[15]). Moreover, the political economy factors mentioned above often discourage local officials from investing the resources necessary to keep property cadastres current.

A possible approach to addressing administrative challenges is assigning the responsibility for the administration of the cadastre to higher levels of government while maintaining local control over property tax rates and the enforcement of tax collections. This approach raises difficult issues of incentives (principal-agent relations between the levels of government involved), and empirical evidence on its effectiveness is not conclusive so far.

Various presentations at the Roundtable of the Network on Fiscal Relations in Asia confirmed that the above-mentioned weaknesses in the design and management of property taxes are common in Asian countries. Some, such as the Philippines, for example, are taking a range of steps to address such weaknesses, including tightening the enforcement of requirements for the updating of subnational property cadastres, and the approval of proposed subnational schedules of property market values by the national Finance Ministry.

Subnational governments also frequently levy taxes on movable properties, in particular automobiles. These are much easier to administer and are less controversial than real estate taxes. In setting rates, often there is a tension between environmental objectives (which argue for taxing less the more recent, less polluting models) and distributional ones (which support taxation based on the value of the car, implying lower taxes on older cars).

User charges are another suitable source of revenues for local governments. They can be levied to recover the cost of many services provided by these governments (e.g. water and sewerage, electricity, parking, garbage collection, urban public transport), and to contribute to the financing of other social services (such as education and health). They conform to the benefit principle and are largely non-exportable. Distributional concerns can be addressed by exempting – or levying the charge at reduced rates for – consumption levels below a minimum threshold. User charges can also help increase the accountability of local officials to their electorate for delivering public services of acceptable quality and minimising waste.

Many subnational governments, especially large cities, own assets (such as land, buildings and commercial enterprises) with significant revenue-earning potential (Detter and Fölster, 2017[16]), but relatively few (mostly in advanced countries) exploit such potential adequately. Most SNGs do not even have complete registers of such properties and reasonable estimates of their market values. Typically, realising their earning potential would require that their management be entrusted to independent, well-qualified agencies, and conducted on strictly commercial criteria.

Weak incentives and administrative limitations

It should be emphasised that even SNGs who have been assigned significant sources of own revenues may not have the right incentives to exploit them adequately, especially if they are subject to soft budget constraints, e.g. because of over-generous or highly discretionary transfers from the central government, or because of ineffective systems of borrowing controls.

They may then engage in predatory tax competition with other, especially neighbouring, jurisdictions through a proliferation of exemptions or other preferential treatments,[14] or by keeping tax rates or user charges too low (race to the bottom). A possible remedial approach would be for the CG to set floors on the rate structure of taxes assigned to SNGs, and/or to limit the scope for the latter to grant an exemption and special benefits under these taxes.

Furthermore, SNGs are frequently hampered in realising their revenue-raising potential by a variety of limitations in administrative capacities. These limitations include, in addition to the above-mentioned weaknesses in the management of property cadastres:

- cumbersome systems of tax collection, which raise taxpayers' compliance costs
- inadequate monitoring of, and slow reaction to, tax arrears
- a high degree of discretion in assessments (e.g. of property values) and in the resolution of tax disputes, which widens the scope for favouritism and corrupt practices
- low technical skills among tax officials
- limited use of modern information technology (IT) systems.

Some of these weaknesses tend to be more prevalent in less developed regions and small, rural communities. The disincentives mentioned above may also weaken SNGs' efforts to improve their tax administrations.

Intergovernmental transfers

In most countries, intergovernmental transfers constitute the backbone of subnational finances, accounting for the bulk of revenues, especially at the intermediate level of government. They fulfil different objectives: filling vertical gaps, equalising revenue capacities and spending needs among SNGs, and funding subnational spending programmes regarded as national priorities or as having positive externalities. Different types of transfers privilege one or another of these objectives: revenue sharing is the most commonly used instrument to fill vertical imbalances; equalisation transfers aim to reduce horizontal imbalances; and block and special-purpose grants seek to finance subnational spending in sectors and programmes considered of national priority, or with large spillovers to other jurisdictions.

The relative weights of these objectives vary from country to country, reflecting a range of economic, institutional and socio-political factors. Accordingly, intergovernmental transfer systems differ significantly across countries. For example, shared revenues are very important in Argentina, Australia, Austria, Belgium, Colombia, Germany, Mexico and Spain, which are all characterised by large vertical imbalances. In other countries (e.g. Canada, India and the United States), block or special purpose transfers play more important roles. Such transfers are the primary source of subnational revenues in Indonesia, and a major one in other Asian countries, including Korea, Mongolia, the Philippines and Thailand. The degree of conditionality attached to such transfers varies widely across countries, types of programme and over time.

Most countries, including in Asia, have equalisation transfers, but the criteria for their distribution vary significantly. For instance, the Canadian equalisation transfer system only equalises revenue capacities, the South African one only spending needs, and the Australian one both revenue capacities and spending needs. Equalisation systems also vary widely in terms of the complexity of formulas and indicators used, reflecting particular countries' preferences for transparency, popular acceptability of systems and the availability of relevant data.

The design of transfers (in particular, equalisation transfers) should be incentive-compatible, i.e. it should not discourage recipient governments' efforts to exploit their own-revenue potentials nor their efforts to efficiently deliver the public services for which they are responsible. For this purpose, their horizontal distribution formulas should be based on indicators of revenue capacity and of spending needs (calculated assuming an appropriate level of spending efficiency), rather than on current or recent levels of revenues and expenditures. Accurately estimating such capacities and needs is, however, a complex task, requiring massive data availability. Most countries, including Asian ones, therefore, use more easily computable proxy indicators or focus only on revenue capacities (Chatry and Vincent, 2019[17]). Some delegate this task to independent bodies of technical experts, like the Australian Grants Commission (Ahmad and Searle, 2006[18]).

Several flaws in the design of intergovernmental transfers can adversely affect subnational capacities.[15] In particular:

- Transfers that are insufficient to cover the gap between revenue capacities and spending needs create unfunded spending mandates, undermining the capacity of subnational governments to carry out their assigned spending responsibilities adequately.
- Transfers with a high degree of discretion (or with complex and opaque distribution formulas) create unpredictability for subnational budgets, as well as weaken the subnational budget constraint.
- Revenue-sharing systems based on highly cyclical revenues (such as royalties from natural resources) impart excessive volatility to SNGs' revenues and thus hinder their capacity to deliver a reasonably stable stream of essential public services.

In practice, transfer systems frequently suffer from one or more such shortcomings, not least because their design or implementation is often shaped more by political economy considerations than by economic principles and fiscal soundness. They also tend to be the frequent object of reforms, and thus change over time, more than other aspects of intergovernmental fiscal systems. The roles that vertical and horizontal intergovernmental co-operation can play, and has played in many instances, in improving the design of intergovernmental transfers is discussed further below.

The main weaknesses in subnational spending capacities

Weaknesses in subnational governments' capacities for carrying out their spending responsibilities with adequate effectiveness and efficiency can have several roots, including a lack of clarity in spending assignments, excessive fragmentation of jurisdictions, significant flaws in subnational planning and budgeting systems, and human resource (HR) constraints. This section briefly discusses each of these shortcomings in turn.

Unclear concurrent spending responsibilities

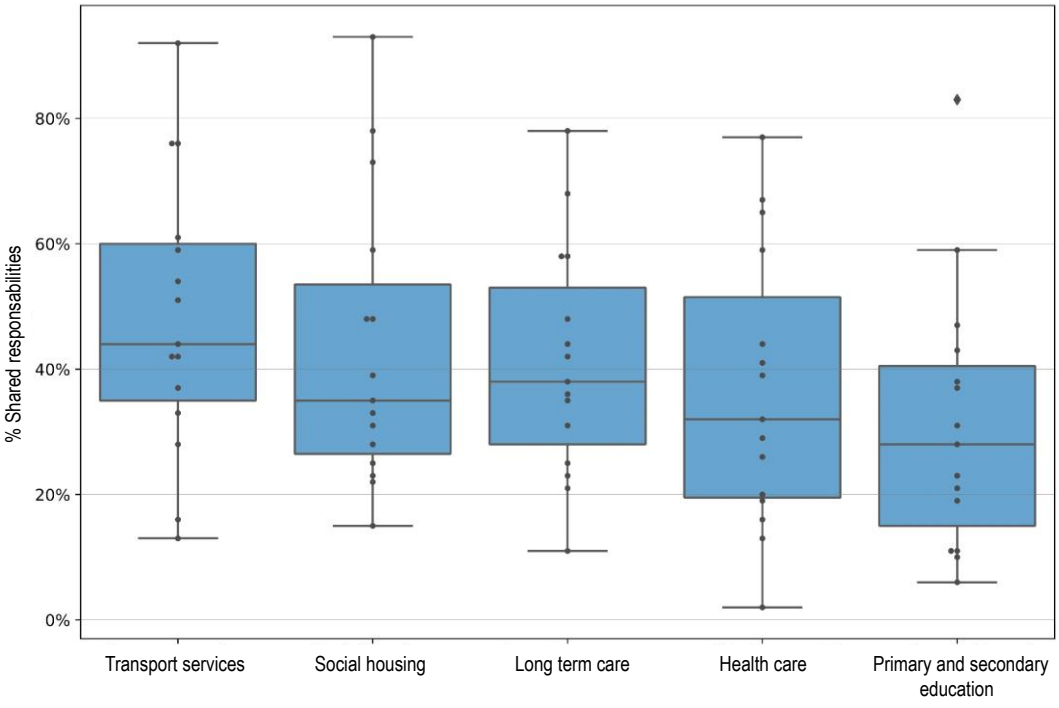
Most spending functions (except a few typically reserved to the central government, such as defence, foreign policy, border controls and the conduct of monetary policy) are shared among the different levels of government, although the respective shares of each vary significantly across countries and over time.

A recent OECD study (Dougherty and Phillips, 2019[19]), based on a survey of member countries, suggests that the national accounts-based shares of the CG, intermediate, and local governments in general government spending are not good indicators of their

respective spending responsibilities, because they do not measure the degree of autonomy of each level in deciding, planning and implementing the spending. A finer disaggregation of spending power into indicators of autonomy in policy, budget, input and output-related decisions shows a wide variation across OECD countries in major areas of spending, namely education, health and long-term care, transport, housing and social assistance (Figure 1.2).

Figure 1.2. Shared responsibilities across levels of government

Proportion of decisions where more than one level of government is involved



Note: The shaded area refers to the middle two quartiles around the mean, the brackets are minimum and maximums excluding outliers (diamonds), while each dot refers to a respondent country.
Source: OECD Fiscal Decentralisation database.

A comparison of a composite index of such indicators with spending shares suggests that there is limited correlation between the two, and that in general, subnational spending shares are significantly higher than their actual spending power in most areas.

Such an overlap of decision powers in all the main spending functions not reserved for the CG can give rise to inter-jurisdictional conflicts unless the respective responsibilities are clearly articulated in the relevant legislative and regulatory frameworks and are adhered to in practice. There are many examples in countries worldwide of such conflicts, occasionally escalating up to the constitutional courts.

A *de jure* or *de facto* lack of clarity in respective spending responsibilities can also weaken the political accountability of both national and subnational officials for the level, quality, and efficiency of public services, and/or lead to duplication of spending and wasteful use of public resources.

A number of presentations at the Roundtable of the Network on Fiscal Relations in Asia highlighted the pervasiveness and costs of unclear or overlapping spending responsibilities in Asian countries.

Excessive fragmentation of jurisdictions

Subnational governments' capacity to efficiently deliver goods and services for which they are responsible can also be adversely affected by excessive fragmentation of jurisdictions, especially at the local level. Municipalities with fewer than 5 000 inhabitants account for more than half of all local governments in the OECD area as a whole, although that proportion varies significantly across countries (de Mello, 2019[20]). In Asia, there is a vast dispersion of municipal sizes both across and within countries, mainly reflecting population size, geography and the degree of urbanisation. The average size of municipalities is particularly large in the People's Republic of China and Indonesia (around 500 000 inhabitants), Korea and Malaysia (over 200 000 inhabitants) and quite small in the Philippines and Mongolia (around 2 000 inhabitants).

Small jurisdictions cannot exploit the economies of scale that prevail in various types of public services, such as energy and water provision, waste collection and disposal, and hospital care. They are also typically less capable of funding and implementing technologically advanced public expenditure management systems. For these reasons, central governments have frequently provided incentives for the merging of small neighbouring municipalities or encouraged contractual arrangements for a joint provision of services (Ter-Minassian and de Mello, 2017[21]).

In the Asia-Pacific region, Australia, Japan, Korea and New Zealand have shown a trend towards the merging of small municipalities, while other countries, such as India, the Russian Federation and Kazakhstan have provided increased autonomy to small villages.

Even medium-sized neighbouring localities or regions can benefit from co-ordinating the provision of network infrastructures in such areas as:

- water resource management, to facilitate agreement on: the building of waterways from water-rich regions to more arid ones; the efficient utilisation of scarce water resources among different users; and the avoidance of upstream pollution[16]
- environmental management and conservation, given the substantial potential for regional and even national spillovers of local activities in this area
- energy management, distribution and conservation[17]
- inter-regional and intermodal transport infrastructures, to maximise synergies between transport projects undertaken at the local and regional level, to improve connectivity.

Co-ordination needs are especially significant in large metropolitan areas, which often include several municipalities. Indeed, most such areas have created joint institutions (including jointly owned enterprises in some cases) for the management of public transport, water and sanitation, and other major utilities in the area (Bahl, Linn and Wetzel, 2013[22]; de Mello and Lago-Peñas, 2013[23]). France and the United Kingdom provide good examples of inter-jurisdictional co-operation in metropolitan areas.[18]

Weaknesses in public financial management

There is significant evidence from the 2014 OECD survey cited in the section "Some general considerations" and from available public financial management (PFM) diagnostics in developing countries, including in Asian countries, that weaknesses in planning processes hinder the capacity of SNGs to choose and deliver effective spending programmes. Specifically:

- Subnational multi-year plans do not exist or, when they do, frequently they are not based on objective evidence of local needs or realistic estimates of resource availability.
- Subnational plans are not aligned with national ones, and effective mechanisms to reconcile differences are lacking, with adverse effects on subnational access to sustainable financing for investments.
- They frequently do not exploit the potential for synergies with those of neighbouring SNGs (e.g. in network infrastructure).
- Most SNGs lack medium-term expenditure frameworks (MTEFs)[19] to guide the annual budget process.

Most intermediate and medium-to-large local governments follow orderly and regular procedures for budget preparation, submission to the relevant legislature and monitoring and reporting budget execution. The evidence is more mixed for smaller, particularly rural, communities.

However, even in large and medium SNGs, budgeting processes often suffer from significant weaknesses:

- limited coverage of budgets (i.e. significant recourse to extra-budgetary accounts and operations)
- poor quality of forecasts of revenues and expenditures, partly reflecting uncertainties on intergovernmental transfers and on policy decisions by the central government that affect subnational spending, such as changes in civil servants' wages and employment regulations, or other regulatory measures
- little or no analysis of risks affecting revenue projections and spending needs, as well as of contingent liabilities, e.g. from the realisation of guarantees to enterprises owned by the SNGs
- inadequate monitoring and reporting of spending commitments and liquidations, and consequently of payment arrears
- lack, or limited coverage, of subnational treasury single accounts
- accounting rules and procedures not fully aligned with national and international standards
- fiscal reporting that is less timely than desirable, and does not adequately cover the operations of extra-budgetary units and subnational state-owned enterprises
- limited debt management capacities and systems.

Weaknesses are also endemic in the management of subnational investments, a fact that is of particular concern, given the fact that in many countries the latter accounts for more than half of total public investments. Such weaknesses include:

- only limited use of cost-benefit analysis in the evaluation of proposed investments
- frequent and substantial delays and cost overruns in project execution
- inadequate budgeting of operation and maintenance for new and existing infrastructure
- absence of systematic *ex post* evaluations of completed projects
- lacking access to affordable, long-term financing through capital markets, for most SNGs
- limited (or no) capacity to successfully manage public-private partnerships (PPPs).[20]

How central governments can help subnational governments improve their fiscal capacities

Central governments can support the development of subnational fiscal capacities[21] in several ways. The specific mix of desirable actions can be expected, of course, to vary both across countries and over time, reflecting the institutional characteristics of the intergovernmental fiscal relations system, economic and social conditions (in particular the extent of regional disparities) and the balance of political powers among levels government. CGs can both help subnational governments address resource constraints on their capacity and create incentives for them to do so.

Specifically, ways to ease resource constraints on subnational capacity include:

- Assigning SNGs appropriate sources of own revenues, along the lines discussed in the section "The main weaknesses in subnational revenue capacities".
- Setting a floor on the rates of taxes assigned to SNGs, to minimise the scope for a race to the bottom.[22]
- Sharing relevant taxpayers' information with subnational tax administrations and supporting the latter in adopting more effective procedures in the collection and enforcement of their assigned taxes.
- Avoiding unfunded expenditure mandates.
- Correcting regional disparities through well-designed equalisation transfers, to the extent allowed by its resources and by society's tolerance for such disparities.
- Modulating the pace of devolution of spending responsibilities to SNGs according to their capacities to fulfil those responsibilities. It should be recognised that the scope for asymmetric decentralisation is often constrained by legal provisions or even by SNGs' reluctance to accept a differentiation in spending responsibilities. There are, however successful examples of such an approach in various countries.[23]
- Adopting appropriate reforms to increase flexibility and improve incentives for the civil service, and encourage (or if feasible, require) SNGs to do the same.

- Supporting through technical assistance, and to the extent possible financially, improvements in subnational PFM systems.[24]

The central government can also create positive incentives for subnational capacity development through:

- A clear assignment of expenditure responsibilities, not only in legislation but also in practice. This involves specifying, and adhering to, the respective roles in concurrent spending functions, and creating effective vertical co-ordination mechanisms, e.g. forums including representatives of the CG and those of the other level(s) of government responsible for those functions.
- A design of equalisation transfers that does not discourage subnational own-revenue mobilisation efforts and rewards efficiency in spending, as discussed in the section "The main weaknesses in subnational revenue capacities". The equalisation formula may even include financial rewards for above-average SNGs' own-revenue efforts.
- The development and use of appropriate indicators to monitor the effectiveness and efficiency of subnational spending programmes financed or co-financed through conditional special-purpose grants.
- Well-designed and firmly enforced rules-based controls on subnational borrowing. The absence or ineffectiveness of such controls is a well-recognised source of subnational soft-budget constraints[25] and a significant disincentive to both own-revenue-raising efforts and efficiency in spending.
- Facilitating access to long-term financing for subnational investment projects, provided that they meet pre-specified quality standards.
- Legislating minimum subnational PFM standards, if necessary, differentiated by the size of SNGs. This is especially important in the areas of accounting and reporting of subnational fiscal operations. The absence of such requirements, by preventing timely and reliable monitoring of subnational finances can give rise to significant fiscal risks, reduce the political accountability of subnational officials, and open space for corruption. A number of countries worldwide have moved towards the adoption of uniform public accounting standards and fiscal transparency practices in recent years (Irwin and Moretti, 2020[24]).[26]

The role of horizontal intergovernmental co-operation in strengthening subnational fiscal capacities

As increasingly witnessed by international experiences, co-operation among subnational governments within each level of government can have beneficial effects on their respective capacities.

Horizontal co-operation forums can take different forms: they can involve SNGs' highest level of leadership (governors or state premiers and mayors), sectorial authorities (e.g. state ministers, state or city secretaries), or technical officials; they can have broad or narrower remits; and their decisions can be more-or-less binding.[27]

Such forums can help shape common positions that strengthen the "voice" of the relevant level of government in its dialogue with the central government, e.g. in vertical

co-operation forums and can facilitate agreement on important policy and institutional reforms.[28]

Horizontal co-operation can support the development of subnational fiscal capacities in several ways:

- By helping to reduce adverse spillovers from subnational actions, e.g. predatory competition through taxes and subsidies, effluent discharges, inadequate control of contagious diseases.
- By facilitating the exploitation of synergies in the delivery of services with economies of scale, and in network infrastructures, as discussed in "The main weaknesses in subnational spending capacities".
- Through the exchange of good practices, lessons from successes and failures, and positive demonstration effects.
- By promoting an exchange of information and know-how among subnational revenue administrations. A good example in this area is the forum for co-operation among state revenue administrations in Brazil, which was instrumental in the development and adoption of the electronic VAT invoices in Brazil.

Conclusion

There is widespread consensus, both in the literature and among policy makers, that subnational governments' capacities to effectively and efficiently fund and deliver the public goods and services for which they are responsible are crucial to realise the potential benefits of decentralisation. Although quantitative evidence of the state of such capacities across and within countries, as well as over time, is limited, there are sufficient qualitative bases for asserting that the vast majority of SNGs worldwide suffer from significant weaknesses in this respect.

This chapter has provided an overview of such weaknesses, ranging from inadequate assignments of own revenues, to flaws in tax administration, in the design of intergovernmental transfers, in spending assignments, and in various aspects of public financial management. The chapter has also discussed how central governments can contribute to easing the resource constraints on subnational capacities and can create appropriate incentives for SNGs to improve such capacities. Finally, it has briefly reviewed how intergovernmental co-operation can contribute to the development of subnational fiscal capacities.

There are no one-size-fits-all prescriptions in this area. Both the mix and the sequencing of actions by CGs and SNGs to improve the latter's fiscal capacities need to be chosen taking into account the economic, social, and political realities of each country, as well as the more or less binding nature of legal constraints on those actions, and of the fiscal space to accommodate them. Successful international experiences with subnational capacity building can point to promising approaches, but a careful analysis of their applicability to different contexts is needed before they are embraced.

The first step in designing a strategy for capacity-building reforms in any individual SNG should be a diagnostic of the main roots of the existing weaknesses. This should be followed by the identification of the likely stakeholders involved in the correction of those weaknesses, i.e. the winners and the losers from a reform effort, as well as the identification of the institutional powers (e.g. the CG's Executive or Parliament, or subnational own

institutions) whose consent would be needed for the reforms. This would facilitate a realistic assessment of the political and institutional obstacles to the reform effort, and of possible approaches to confronting them.

The design of the specific components of the reform, and their timetable and sequencing, should be based on conservative assumptions regarding both the human and financial resources needed to carry them out, and the extent and timing of their effects. A well-tailored blend of actions with relatively short payoffs and more fundamental reforms with longer-term benefits can be expected to sustain the reform momentum more than alternative strategies.

Development partners (both multilateral and bilateral) can support subnational capacity development efforts by providing the benefit of cross-country experiences, and by augmenting national resources for the efforts, but the reforms must be nationally "owned", both by the recipient subnational governments and by the central government when involved.

References

Ahmad, E. and G. Brosio (eds.) (2015), *Promoting Responsible and Sustainable Fiscal Decentralization*, Edgar Elgar, Cheltenham. [9]

Ahmad, E. and G. Brosio (eds.) (2006), *Handbook of Fiscal Federalism*, Edward Elgar, Cheltenham. [25]

Ahmad, E. and G. Brosio (eds.) (2006), *Normative versus Positive Theories of Revenue Assignments in Federations*. [10]

Ahmad, E. and G. Brosio (eds.) (2006), *On the Implementation of Transfers to Subnational Governments*, Edward Elgar, Cheltenham. [18]

Artana, D. et al. (2012), "Sub-national Revenue Mobilization in Latin American and Caribbean Countries: The Case of Argentina", *IDB Working Paper*, No. 297. [13]

Bahl, R., J. Linn and D. Wetzel (eds.) (2013), *Financing Metropolitan Governments in Developing Countries*, Lincoln Institute of Land Policy, Cambridge, Mass. [22]

Bahl, R., J. Martinez-Vazquez and J. Youngman (eds.) (2010), *Challenging the Conventional Wisdom on the Property Tax*, Lincoln Institute of Land Policy, Cambridge, Mass. [14]

Bird, R. (2010), "Subnational Taxation in Developing Countries: A Review of the Literature", *World Bank Policy Research Working Paper*, No. 5450, World Bank, Washington, DC. [11]

Bird, R. (2007), *The VAT in Developing and Transitional Economies*, Cambridge University Press, Cambridge. [29]

Boadway, R. and A. Shah (eds.) (2007), *Intergovernmental Transfers: Principles and Practice*, World Bank, Washington, DC. [30]

Chatry, I. and R. Vincent (2019), "A global view of sub-national governments in Asia: Structure and finance", in *Fiscal Decentralisation and Inclusive Growth in Asia*, OECD Publishing, Paris, https://dx.doi.org/10.1787/239e95db-en. [17]

de Mello, L. (2019), *Local Government Cooperation: Challenges, Trends and International Experience*. [20]

Detter, D. and S. Fölster (2017), *The Public Wealth of Cities*, Palgrave Macmillan. [16]

Dougherty, S. and L. Phillips (2019), "The spending power of sub-national decision makers across five policy sectors", *OECD Working Papers on Fiscal Federalism*, No. 25, OECD Publishing, Paris, https://dx.doi.org/10.1787/8955021f-en. [19]

Eyraud, L. and L. Lusinyan (2011), "Decentralizing Spending More than Revenue: Does It Hurt Fiscal Performance?", *IMF Working Paper*, No. 11/226. [8]

Hagemann, R. (2018), "Tax Policies for Inclusive Growth: Prescription versus Practice", *OECD Economic Policy Papers*, No. 24, OECD Publishing, Paris, https://dx.doi.org/10.1787/09ba747a-en. [12]

Irwin, T. and D. Moretti (2020), "Can subnational accounting give an early warning of fiscal risks?", *OECD Journal on Budgeting*, Vol. 20/2, https://dx.doi.org/10.1787/be73a937-en. [24]

Kim, J. and S. Dougherty (eds.) (2019), *Fiscal Decentralisation and Inclusive Growth in Asia*, OECD Fiscal Federalism Studies, OECD Publishing, Paris/Korea Institute of Public Finance, Seoul, https://dx.doi.org/10.1787/25cf7545-en. [7]

Kim, J. and S. Dougherty (eds.) (2018), *Fiscal Decentralisation and Inclusive Growth*, OECD Fiscal Federalism Studies, OECD Publishing, Paris/Korea Institute of Public Finance, Seoul, https://dx.doi.org/10.1787/9789264302488-en. [26]

Lago-Peñas, S. and J. Martinez-Vazquez (eds.) (2013), *Local Government Cooperation for Joint Provision: The Experiences of Brazil and Spain with Intermunicipal Consortia*, Edgar Elgar, Cheltenham. [23]

Mizell, L. and D. Allain-Dupré (2013), "Creating Conditions for Effective Public Investment: Sub-national Capacities in a Multi-level Governance Context", *OECD Regional Development Working Papers*, No. 2013/4, OECD Publishing, Paris, https://dx.doi.org/10.1787/5k49j2cjv5mq-en. [27]

Musgrave, R. (1959), *Theory of Public Finance*, McGraw-Hill, New York. [2]

Oates, W. (2005), "Towards a Second Generation Theory of Fiscal Federalism", *International Tax and Public Finance*, Vol. 12/4, pp. 349–373. [5]

Oates, W. (1972), *Fiscal Federalism*, Harcourt Brace, New York. [3]

OECD (2015), *The Metropolitan Century: Understanding Urbanisation and its Consequences*, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264228733-en. [31]

Qian, Y. and B. Weingast (1997), "Federalism as a Commitment to Preserving Market Incentives", *Journal ofEconomic Perspectives*, Vol. 11/Fall, pp. 83-92. [4]

Reyes-Tagle, G. (ed.) (2018), *Bringing PPPs into the Sunlight: Synergies Now and Pitfalls Later?*, IDB, Washington, DC. [33]

Slack, E. and R. Bird (2014), "The Political Economy of Property Tax Reform", *OECD Working Papers on Fiscal Federalism*, No. 18, OECD Publishing, Paris, https://dx.doi.org/10.1787/5jz5pzvzv6r7-en. [15]

Ter-Minassian, T. (2012), *Reform Priorities for Subnational Revenues in Brazil*. [28]

Ter-Minassian, T. and L. de Mello (2017), *Intergovernmental Fiscal Cooperation: International Experiences and Possible Lessons for Brazil*. [21]

Tiebout, C. (1956), "A Pure Theory of Local Expenditures", *The Journal of Political Economy*, Vol. 64/5. [1]

Weingast, B. (2009), "Second Generation Fiscal Federalism: The Implications of Fiscal Incentives", *Journal of Urban Economics*, Vol. 65/3. [6]

World Bank (2013), *Beyond the Annual Budget: Global Experience with Medium-Term Expenditure Frameworks*, World Bank, Washington, DC. [32]

Notes

1. Fiscal decentralisation refers to the transfer of revenue-raising powers and expenditure responsibilities from the national to the subnational levels of governments, and typically follows political decentralisation, which refers to the devolution of political powers to locally elected subnational authorities.
2. Ahmad and Brosio (2006[25]) provide a good review of such theories.
3. See Kim and Dougherty (2018[26]) for a selection of papers examining the role of fiscal decentralisation – or centralisation – in addressing the twin objectives of economic growth and reduced inequality.
4. The Revenue Administration Fiscal Information Tool (RA-FIT) is a web-based data-gathering tool to establish baselines of current revenue administration performance to improve comparative study and benchmarking. The Tax Administration Diagnostic Assessment Tool (TADAT) is a diagnostic tool to help governments gauge the performance of their tax administrations and identify priorities for reform. It focuses on nine key areas of performance of tax administrations worldwide. Additional details can be found at: www.imf.org/external/np/fad/news/fadtools.pdf.
5. Public Expenditure and Financial Accountability (PEFA) is a tool for assessing the status of public financial management (PFM). A PEFA assessment provides an analysis of the performance of country's PFM system at a specific point in time, based on internationally comparable criteria. The PEFA methodology can be reapplied in successive assessments to track changes over time. For more details, see https://pefa.org.
6. The Public Investment Management Assessment (PIMA) tool helps countries evaluate the strength of their public investment management practices. The PIMA evaluates the design and effectiveness of 15 institutions that shape decision making at three key stages of the public investment cycle, namely the planning, selection and implementation of investment projects. For more details: www.imf.org/external/np/fad/publicinvestment/pdf/PIMA.pdf.

7. The OECD conducted one such survey in 2013, focusing on subnational capacities in public investment management in OECD countries. The main results, reported in Mizell and Allain-Dupré (2013[27]) are discussed in the section, "The main weaknesses in subnational spending capacities".

8. Own revenues are defined here as those on which SNGs have autonomy in defining the base and/or the rate structure. Under this definition, revenues shared with higher levels of government are considered intergovernmental transfers, if the definition of their base and/or rate is a prerogative of those levels. Unfortunately, most comparative datasets on subnational revenues (including the recently released IMF dataset on fiscal decentralisation covering 75 countries) classify revenues shared on a formula basis as own revenues.

9. In contrast, a subnational corporate income tax (CIT) (or a surcharge on the national CIT) is generally not recommendable on efficiency grounds because it is exportable outside the taxing jurisdiction and can be used for predatory competition; it is highly sensitive to the cycle; its base tends to be concentrated in relatively few jurisdictions where most corporations are headquartered; and it entails substantial administration and compliance costs.

10. See Ter-Minassian (2012[28]) for a comprehensive discussion of the problems with a subnational VAT in Brazil.

11. Bird (2007[29]) provides a good analysis of the performance of the Canadian VAT.

12. Although the base and rate structure of the Indian GST are set for the whole country by a high-level committee of the federal and state ministers of finance (the GST Council), it is jointly administered by the federal government (the Union) and the states, who collect their respective portion of the tax for goods produced and consumed within each state. The tax on interstate transactions is collected by the Union and shared with the states on a destination basis.

13. However, as demonstrated by the impact of the global financial crisis of 2008-09 on local finances in a number of advanced countries, property tax revenues can be substantially affected by the build-up and subsequent collapse of real estate price bubbles.

14. An iconic example in this respect is provided by the so-called "tax war" among the states in Brazil, which has severely eroded the revenue of the state VAT in that country (Ter-Minassian, 2012[28]).

15. There is a vast literature on the desirable characteristics of intergovernmental transfer systems [e.g. Boadway and Shah (2007[30]); Ahmad and Brosio (2006[25])].

16. Notable examples in this area are the Australian Intergovernmental Agreement of 2004 on the National Water Initiative and one on the management of the Murray-Darling Basin of 2013. Other examples are the intergovernmental Pact for the Management of Water Resources in Brazil, and the Delta Program in the Netherlands.

17. Australia offers a good example in this area with its 2009 National Partnership Agreement on Energy Efficiency.

18. See OECD (2015[31]) for various other examples of intergovernmental co-operation in metropolitan areas.

19. See World Bank (2013[32]) for a discussion of global experiences with MTEFs, requisites for their successful implementation, and benefits in terms of fiscal performance.

20. Reyes-Tagle (2018[33]) provides a comprehensive discussion of the demanding conditions for a successful use of PPPs in public investments at all levels of government.

21. Many of the remarks in this section also apply to the support that intermediate governments can provide to local ones under their jurisdiction.

22. Uruguay provides an example of successful vertical intergovernmental fiscal cooperation in stemming predatory competition by municipalities in the motor vehicles tax.

23. For instance, in Colombia, the CG only devolves some spending responsibilities to municipalities when they have demonstrable capacity to assume them, according to various objective indicators.

24. A good example in this respect is provided by Brazil, where the CG has supported extensive modernisation of state and municipal revenue administration and PFM systems through multi-year programmes financed by the Inter-American Development Bank with guarantees by the national treasury.

25. Ter-Minassian (2015[9]) provides a comprehensive discussion of the causes and consequences of subnational soft-budget constraints.

26. For instance, the European Commission has been working since 2011 on developing European Public Accounting Standards (EPSAS), adapting the International Public Accounting Standards (IPSAS) to EU conditions. EPSAS are to be implemented by EU members by 2025. In the meantime, the Commission is encouraging member states to move towards implementing the existing IPSAS on a voluntary basis. Brazil pioneered the adoption of common accounting standards for all public sector entities in its 2000 Fiscal Responsibility Law (FRL). In subsequent years, the federal government devoted substantial efforts and resources to assisting states and municipalities in implementing the accounting and reporting requirements of the FRL.

27. Ter-Minassian and de Mello (2017[21]) present examples of horizontal co-operation forums in several advanced and emerging countries.

28. Australia provides a good example of the use of an intergovernmental high-level forum (the Council of Australian Governments, or COAG) to build consensus for a major tax reform (introduction of a VAT shared between the Commonwealth and the states). In Germany, proposed reforms of shared taxes are discussed in various co-operation forums, to minimise the risk of their being blocked by the Upper House of Parliament (the Bundesrat), whose members are designated by the states and which has veto power on reforms affecting the states. In Belgium, the IFC was instrumental in ensuring agreement on a substantial subnational tax reform in 2001 (the Lambermont Agreement). In Mexico, the 2013 proposed tax reform package was extensively discussed in two technical co-operation forums (the Reunión Nacional de Funcionarios Fiscales and the Comisión Permanente de Funcionarios Fiscales) to help secure the political consensus needed for its approval by the Congress.

Chapter 2. Political economy perspectives on intergovernmental fiscal system design and implementation in Asia

by Paul Smoke, New York University,
Robert F. Wagner Graduate School of Public Service

Although fiscal decentralisation has been a popular reform for decades, including in Asia, success with operationalising reform frameworks and the realisation of expected results have often been elusive, particularly in middle and lower-income countries. Progress occurs in many cases, but unevenly and not always sustainably. A common mantra in the literature is that decentralisation reform is context specific, but beyond some basic points, there is limited clarity about which aspects of context are important for good performance and how they matter. This chapter argues that context has been addressed in relatively superficial ways and that more nuanced diagnosis of context, particularly political economy realities, is essential for improved performance. Equally important, fiscal decentralisation policy makers have privileged the design phase of reform. Design is critical, and more can be done to better contextualise it, but many significant obstacles to better performance arise during the implementation process, and there is too little adaptation when potentially correctable issues emerge. There is no universal remedy for increasing the effectiveness of fiscal decentralisation, but better diagnostics and more strategic and flexible approaches to implementation have the potential to improve on the status quo.

This chapter, originally prepared for the 2nd KIPF-OECD-ADB Roundtable of the Network on Fiscal Relations in Asia (RoNFRA), builds on work done for the 1st RoNFRA (Smoke, 2019[1]) and on other work done by the author on the political economy of decentralisation. A special thanks to Pietro de Biase for help with the charts.

Introduction

Despite advances in many countries in Asia and beyond, public sector decentralisation has proven to be a defiantly stubborn reform in many countries during the several decades it has been widely pursued. Available empirical literature indicates that performance, more often than not, falls short of expectations to varying degrees.[1]

Perhaps most surprising is the uneven progress with fiscal decentralisation. There is a well-articulated set of public finance (fiscal federalism) principles for designing fiscal decentralisation and supporting reforms, and it is often used as an anchor for broader decentralisation. Yet even where these principles have been (or appear to have been) followed, performance is too often unexceptional or problematic. This chapter argues that this frustrating situation persists both because the conventional principles do not adequately consider certain key factors that inevitably shape fiscal decentralisation and because the principles are not strategically used. Underlying both of these problems is a set of multifaceted contextual political economy and implementation considerations that rarely get the level or quality of attention they deserve.

This chapter focuses on the nature of these neglected challenges to fiscal decentralisation and intergovernmental fiscal reform and their implications for how more successful reforms might be pursued. The relevant challenges are considerable, including the scope and diversity of public and intergovernmental structures and functions; the incentives faced by and the behaviours of national politicians and bureaucrats who shape rules of the intergovernmental fiscal system and how they are implemented; subnational political economy dynamics among elected local politicians, local government staff and citizens; and the persistent imbalance between reform design and reform implementation. These elements interact in a broader context that informs the choice of options for effective fiscal decentralisation. Insufficient inattention to these factors and dynamics can produce nontrivial shortcomings in reform design and/or implementation.

The next section provides an overview of the scope and diversity of intergovernmental systems. The chapter then turns to neglected political economy dynamics – in the national political and bureaucratic arenas, at the local level, and in the behaviour of international development agencies that may be central players in fiscal decentralisation reforms in aid-dependent countries. This is followed by a section arguing that insufficient attention is paid to implementation and another that taking better account of context and implementation challenges could facilitate crafting and executing more viable and sustainable reform. The closing section offers summary comments on how to better incorporate broader political thinking into fiscal decentralisation analysis.

The scope and diversity of intergovernmental systems

Although fiscal decentralisation has established norms, there is also general recognition that a broader array of legal and institutional factors require attention in pursuing reform. An adequate intergovernmental framework is indispensable if fiscal decentralisation is to be effective and sustainable, but the details of the framework may vary considerably across countries because the organisation and role of subnational governments are diverse.

The intergovernmental framework

All countries need an adequate intergovernmental framework to define the functional realms of different levels of government and other provisions that support fiscal

decentralisation. The basic framework typically covers principles and practices for sharing public functions and powers among levels of government, along with structures, processes, and resources that support their operation. These frameworks include administrative, fiscal and political dimensions of subnational governance, and they also specify relationships among and within different levels of government (e.g. inter-jurisdictional co-operation between intermediate and local tiers of government and among distinct jurisdictions within larger metropolitan areas).

The importance of blending administrative, fiscal and political reforms is well recognised since their failure to work together can limit their impact. Weak fiscal decentralisation, for example, can undercut the capacity of, and incentives for, subnational elected and appointed officials to perform. Robust fiscal powers alone are not likely to be used effectively, however, if they are not disciplined by proper administrative and political systems and processes. A substantial number of conceptual papers and empirical studies recognise institutional design as a key element affecting the ability of decentralisation and intergovernmental reforms to be effective.[2]

Regarding fiscal design, much of the literature is largely framed around the tenets of first-generation fiscal federalism regarding expenditure and revenue assignment to subnational governments, e.g. assigning public services with chiefly local benefits for provision and financing at the subnational level. Higher-level governments should provide, share in or oversee the services with wider effects and levy broad-based taxes that are fiscally or administratively inappropriate for subnational governments. The details and underlying logic for decentralising certain functions and resources are well documented in the fiscal federalism literature and are not repeated here.[3]

An important consideration that is sometimes not sufficiently recognised is the need for balance between upward and downward accountability in decentralised systems. Although much of the focus is on decentralising functions and developing downward accountability, upward accountability to ensure compliance with procedural and service delivery standards is also essential. Such regulatory and oversight functions are needed for an effective public sector, but they can create obstacles to good performance if they unduly limit the subnational discretion that is expected to generate benefits or are inconsistently or arbitrarily applied.

It should be noted that the relevant literature acknowledges that normative principles are not always followed in practice, as discussed in more detail below. There may be legitimate historical and contextual reasons why the principles cannot or should not be followed. In addition, even if principles are formalised, legal provisions may not provide clear operational details. Finally, whatever policies and procedures are formally adopted, there are often considerable challenges to effective implementation. Flaws in the overarching national framework and more detailed specification of design features and implementation approaches are often considered to be among the most critical constraints on effective fiscal decentralisation.[4]

Some weaknesses are attributed to the narrowly defined scope of traditional fiscal federalism. Second-generation approaches expanded the coverage of relevant concerns, but largely with respect to specific concerns, rather than holistically.[5] Other critical elements of the framework that are expected to affect performance, however, are even more extensive.[6] These include provisions for development planning, public financial management and fiscal responsibility, civil service and human resource management, sector-specific policy frameworks and government partnership with private sector actors in

performing public functions. Non-decentralisation-specific factors are also part of the framework. The nature of property rights, for example, affects local property taxation, and governance provisions (e.g. elections and non-electoral mechanisms) and civil society (e.g. the right to information and assembly) create space for citizen engagement that can help to shape subnational government behaviour and performance. Thus, although it is not sufficiently common in practice, the literature emphasises that the intergovernmental framework in principle should synthetically cover a broad, multi-dimensional constitutional, legal and administrative framework as well as the mechanisms required for its implementation and enforcement.

The diversity of intergovernmental organisation

The diversity of institutional arrangements for decentralisation and intergovernmental relations creates challenges for identifying best reform practices. Many countries have more than one level of subnational government, and these may use a mix of the forms of decentralisation (devolution, de-concentration, delegation) in varied ways.[7] One form may dominate, but forms may differ across levels, e.g. devolution at one and de-concentration at another. In some countries, such as India, intermediate tiers (states or provinces) have more power than lower tiers (municipalities, districts, etc.), but in other cases, such as Indonesia, the opposite is true. Dimensions may also vary across levels, e.g. provinces may receive more fiscal resources, but lower tiers may be more politically decentralised with directly elected local legislatures, as in Cambodia.

Although much of the literature on developing countries focuses on local level devolution, local governments are rarely the only (and may not be the main) service providers – there are relations among levels and/or joint responsibility. Levels may be more independent, as in the Philippines, or more hierarchical (e.g. higher tiers control lower tiers), as in Sri Lanka. There may be other government (at any level), parastatal and/or private entities with specific functional responsibilities, and these may or may not directly interact with elected subnational governments. Other governmental or nongovernmental actors may even overtly infringe on the legally defined functional territory of subnational governments.

Thus, subnational government performance must be understood in terms of the institutional framework in a particular country and the formal and informal relationships among differentially empowered levels and other governmental and non-governmental actors that are involved in various public functions. Without understanding such issues, reformers may try to pursue infeasible policies based on normative principles, and it may be difficult to explain the observed performance of subnational governments satisfactorily or to interpret the factors that shape it.

Overlooked political and institutional dynamics

As noted above, there has been broad recognition of the importance of context in shaping decentralisation reform, but the details and nuances of the political economy landscape rarely get the attention they deserve. This landscape incorporates electoral and legislative politics as well as bureaucratic politics. It also has national and subnational dimensions.

National political dynamics

The mainstream framework is premised on the assumption that decentralisation is undertaken for specific productive reasons: to increase efficiency in generating and using public resources, to improve public services, to enhance governance, and to alleviate

poverty, among others. It is widely accepted, however, that many countries adopt decentralisation reform as much or more for political reasons.[8] Some are reactions to economic or political emergencies, including conflict situations, as in Cambodia, Indonesia and Nepal, that generate pressure and opportunities for change. If reforms are hurriedly adopted to react to a crisis, there may be a limited analysis of or agreement on either the broad approach to power sharing or specific, related policies.

Such political motivations do not indicate that developmental goals are not also valued by the actors pushing reform, and such developmental advances can, of course, also promote political goals. Nevertheless, official developmental justifications may be less immediately significant than crisis alleviation, power consolidation or other political goals. The nature of these concerns influences the diversity noted above in terms of which levels of government are empowered (such as Indonesia's emphasis on local levels due to concerns about empowered provinces seeking to secede), the type and strength of autonomy granted to each level, and the nature and pace of the process through which reforms are rolled out and managed. Cambodia and the Philippines, for example, moved rather slowly with decentralisation compared to Indonesia.

Even if decentralisation is genuinely motivated by a perceived need to nurture political credibility or to mitigate conflicts, once formally adopted, implementation may be hindered by national actors seeking to preserve their powers (more below), and the forces underlying decentralisation can shift. Rapid changes in volatile political environments can alter reform momentum, as has occurred, for example, in Pakistan and Thailand. A crisis may pass, or a new crisis may arise, producing incentives to shift course. Even without major contextual or policy changes, reforms can stall or be reversed through formal actions or tacit modification of activities controlled by central actors who are threatened by decentralisation, as has occurred to some extent in many Asian countries. There are even documented instances of recentralisation.[9]

National bureaucratic dynamics and the role of development assistance

A range of diverse central government agencies is typically involved in detailed efforts to design and implement fiscal decentralisation and intergovernmental fiscal reforms.[10] These agencies, however, often have at least somewhat conflicting views of decentralisation and the appropriate role of subnational governments in public affairs. This may result in the pursuit of dissimilar approaches to how the intergovernmental system is organised and operated.

There is commonly a central agency in charge of regulating subnational governments, such as a ministry of local government, home affairs, interior, etc. Other agencies oversee specific aspects of public administration, such as planning, finance and the civil service, among others. Such agencies may be wary about or opposed to subnational government autonomy, often (officially) due to concerns about capacity that are framed as likely to result in misuse of public resources. In addition, sectoral agencies – for education, health, transport, water, etc. – prioritise service delivery over enabling subnational governance. Any of these national actors may have authority to weaken or impede subnational empowerment, perhaps with positive intentions related to their specific functional missions, but often at least in part to protect their own powers and funding.

This dissimilar set of institutional actors with conflicting perspectives and interests may adopt incompatible subnational government policies and procedures. For example, a local government ministry may pursue measures to strengthen subnational governments, while

a finance ministry, a civil service commission, or a sectoral/service delivery agency may develop policies that diminish the powers of subnational governments, perhaps even over responsibilities legally allocated to them. Such challenges have been documented in Cambodia, Indonesia and the Philippines, among others.[11] Some form of co-ordination is almost always officially endorsed to improve the compatibility of policies adopted by different agencies, but success in creating an effective instrument for this purpose has been elusive, including in many Asian countries.[12]

In some cases, central ministries may even directly provide public services that are legally subnational government functions, or they may assign such responsibility to special districts, parastatals or private sector actors. These measures may be justified to offer better service provision in the near term, but they may be inconsistent with provisions in the intergovernmental framework and may have adverse longer-term consequences. If these decisions violate legal requirements, their basis – legitimate criteria versus arbitrary or politicised decisions – and the role of subnational governments in the process of designing them should be documented.

Moving on to development assistance, when international agencies/donors support different national agencies pursuing decentralisation and intergovernmental reform, they may create challenges, particularly in aid-dependent countries.[13] Despite official assertions about pursuing aid effectiveness agendas – country ownership, alignment with national policies, building country institutions, harmonisation with other external actors, etc. – these agencies may privilege their own priorities/approaches and mandate use of their own accountability mechanisms, even creating parallel entities. Such practices can hinder unified system development and introduce significant administrative burdens on client governments. Meeting aid effectiveness principles is particularly challenging in an era that seems to favour rapid verified positive results more than reformed systems and processes that may be essential to sustain good performance.

Another consideration is that donors and their departments may have priorities just as diverse as government agencies. A finance ministry charged with ensuring effective public resource use will likely prioritise central oversight over subnational government autonomy. Similarly, sectoral agencies will tend to emphasise service delivery and deal with subnational governments only insofar as this promotes their goals. Some donors (or donor departments) may favour enabling community or private sector initiatives over improving subnational governments, regardless of official country policies. If donors pursue agreements with particular government agencies that share similar priorities but are not necessarily following national law, they can reinforce or aggravate the type of central government policy incoherence discussed above.[14]

Subnational political and institutional dynamics

There is considerable evidence – of uneven strength and quality – that how subnational governments use legal authorities depends on the relative power of local political actors – business leaders, ethnic groups, political factions, labour unions, civil society, etc. – as well as the incentives their influence generates for politicians and administrators.[15] Such local dynamics may create challenges for reform regardless of the normative quality of a national framework. Under some conditions, robust autonomy may allow elite capture or politicised access to services or enforcement of revenue compliance. Corruption may be more or less likely at the subnational level depending on local social and political relationships and the extent to which national upward accountability mechanisms can constrain problematic local political economy dynamics.

Mainstream fiscal federalism assumes a political mechanism that allows citizens to express their preferences on subnational government decisions.[16] Impartial competitive elections are framed as foundational in devolved systems. Many countries in Asia hold competitive (in varied ways and degrees) subnational elections, but there are systemic or contextual challenges. Subnational legislatures may be partly appointed or controlled by managers chosen by the national government. In addition, voters may have to choose candidates on closed party lists, or one political party may be strong enough to impede genuine competition. How subnational electoral processes operate affects accountability whatever the provisions of the framework, but electoral systems can vary in their effects on subnational service delivery, revenue generation and other aspects of subnational government. As is often the case, context matters, but not always in predictable ways.[17]

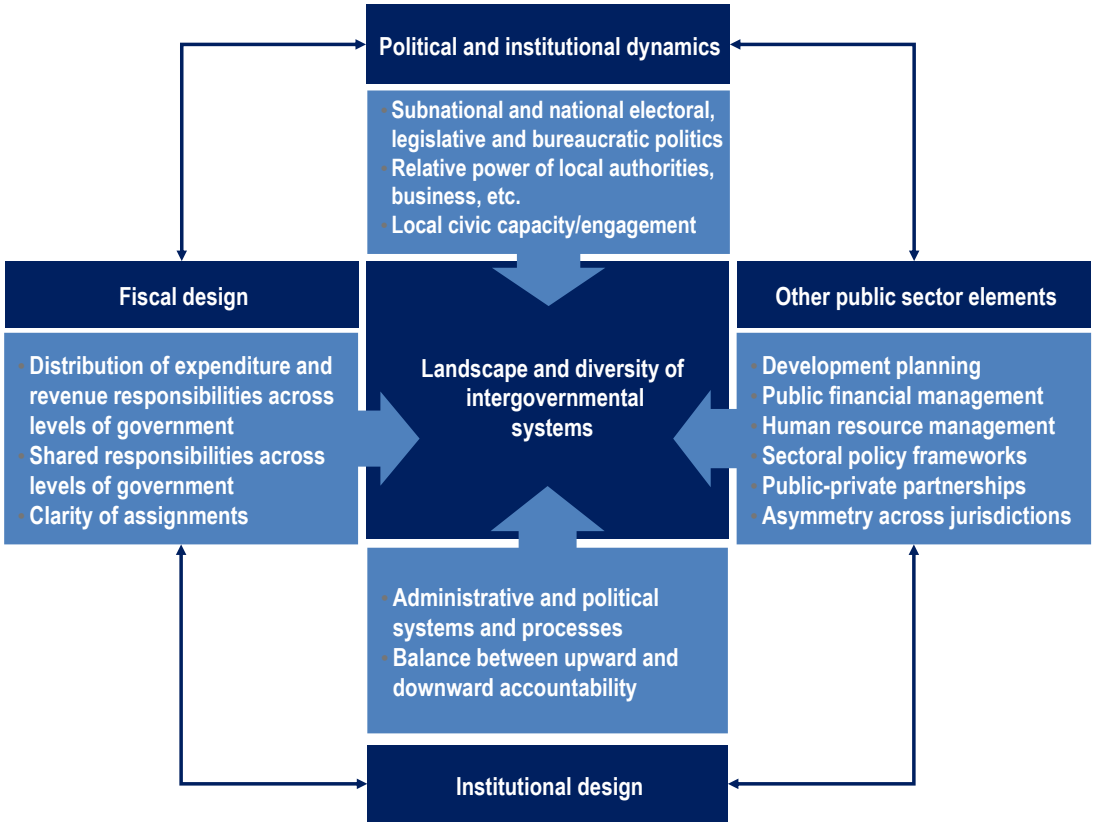
Another important consideration is that subnational elections are held only every few years at best, and so are a fairly inexact accountability instrument. Given this, the value of non-electoral accountability mechanisms is well recognised. These may include participatory planning and budgeting, public meetings, local public service oversight bodies, public service user committees, feedback bureaus, and social auditing of subnational government activities, among others. These civic engagement mechanisms, various forms of which are common across Asia, promote improved public knowledge and solicit input on how subnational resources are generated and expended. When they work as intended, they can encourage more effective and equitable use of funding, enhance service delivery performance, and augment local social capital.[18]

At the same time, there are nontrivial caveats. Civic engagement processes can be implemented superficially, and their potential advantages can also be undermined by political dynamics. Participatory budgeting, for example, can be organised to reflect normative principles but may be only incompletely adopted. Participation may be superficial or not taken seriously by local officials, thus having little effect on local decisions or outcomes. Civic engagement mechanisms can also be dominated by local elites, whether political parties, business interests, or civil society groups. Even specific policies to augment inclusivity, such as mandatory roles for under-represented groups (e.g. a fixed membership share for minority groups), need not generate much pressure on subnational government decisions or lead to results sought by participants.

An additional qualification is that meaningful use of non-electoral accountability instruments requires citizens to have the information, ability and motivation to use them productively. Subnational governments may make budget data available or offer consultative forums, but constituents must know how to access them and feel comfortable using them. Particularly in newly democratising environments, citizens or specific groups may encounter obstacles in using civic engagement mechanisms. These may include, for example, lack of awareness, limited access to guidance and assistance, or even explicit intimidation that limits the use or open expression of opinions.

A well-conceived national intergovernmental framework with appropriate upward accountability and incentives for subnational governments to behave responsibly can reduce unduly politicised behaviour, but subnational realities can overwhelm good policy.[19] How all of these factors interact (selectively summarised in Figure 2.1) to support or constrain service delivery, revenue generation, etc. will influence whether citizens feel fairly treated, and, therefore, whether they will be inclined to participate in subnational elections, to pay subnational taxes, to engage with participatory mechanisms and generally to be the active citizens required for the benefits of decentralisation to be realised.

Figure 2.1. Landscape and diversity of intergovernmental systems



Source: Author's depiction.

Overlooking implementation

Much of the decentralisation literature privileges system design consistent with mainstream principles noted above. Although systems must be adequately designed, even a normatively flawless system must be operationalised, and in a way that reflects political economy realities and other factors beyond fiscal concerns, as discussed above. Recently there has been some growing interest in the literature about how to implement and sequence decentralisation in a pragmatic and potentially more sustainable way, including capacity development.[20]

A pragmatic lens on the scope of design

Although intergovernmental fiscal system designs are usually fairly comprehensive, they are not necessarily well linked to the larger intergovernmental framework discussed above, and the detailed design and implementation of individual elements of fiscal decentralisation are often done separately. To a certain extent, fragmentation is inevitable given the different responsibilities and priorities of various parties and the fact that not everything can be done at once. Such challenges are well documented in Asia.[21] At the same time, more could often be done to frame the targeted efforts in the context of the larger system and according to a planned reform trajectory intended to eventually bring the interdependent elements of an intergovernmental system together.

Another commonly underappreciated consideration is the common asymmetry of subnational governments. Decentralisation design and implementation are often relatively standardised. There may be policies for distinct treatment of categories – for example, states/provinces versus local governments or urban versus rural governments. What is rarely taken into account, however, is that jurisdictions within an individual category often differ in capacity and performance. Thus, uniformly empowering all from the start may be counterproductive, and expecting them to implement reform at the same pace can generate poor performance.

The national vs. subnational perspective

There is obviously a role for both national and subnational governments in implementing decentralisation. Usually, the centre has a comprehensive legal framework, but the extent to which this framework is developed and how it is used can vary. On the one extreme, a framework adoption approach assumes the main task is done when the framework is issued because it is expected to incorporate incentives to encourage central and local actors to comply. Such an approach presumes that subnational governments will "sink or swim" in adopting legislated reforms. At the other extreme is a controlled gradualist approach, in which the centre may have a broad framework but makes all decisions about the order and pace of rolling out the elements of decentralisation reform. Without fair use of clear criteria, this process may lead to stalled reforms and could block even high-capacity local governments from meeting their potential. There have been calls to pursue a more strategic approach (more below) to implementation.

The scope a subnational government has for deciding on how to implement a reform will depend in part on what the national government allows and what type of support it provides, as well as local political and bureaucratic dynamics noted above. However, subnational governments face similar choices to the national government – they can try to do a lot at once if the legal framework empowers them to do so, or they can advance more gradually. Their specific approach will depend on what they feel they need to do, what they think local political conditions can support, what they think they have the capacity to handle. There is, however, also a case to be made for rolling out subnational implementation of decentralisation reforms in a more strategic manner.

Recognising the challenges of behavioural change

Perhaps most fundamental in considering strategy, the organisational and operational alterations involved in implementing decentralisation often require substantial modifications in the mindsets and conduct of all involved parties. Central agencies – perhaps contrary to their dispositions and interests – need to learn to relinquish certain powers and transition from primarily supervisory and control functions to oversight and support. Subnational governments must learn to assume new roles and collaborate (with other subnational governments and other actors). Subnational government staff and elected officials (under devolution) must learn to work together, and subnational officials (elected and appointed) must develop skills to engage with constituents. Citizens also need to develop an understanding of their rights and duties and learn how to hold subnational governments accountable. Donors, particularly in aid-dependent countries, must cultivate a measure of co-operation with each other – at some point if not immediately (so as to allow sufficient experimentation) – in order to responsibly support country systems and policies.

Such behavioural evolutions are politically and institutionally demanding and require time and effort to evolve. If too many changes are rolled out quickly without efforts to influence attitudes, to generate effective incentives and to develop appropriate capacity, decentralisation reform will be unlikely to be effectively established and institutionalised. On the other hand, if reform is too modest and gradual, it may produce little visible change and the key players may lose interest.

Capacity building

One other foundational aspect of implementation merits specific mention. Capacity building, which is covered elsewhere in this volume, is obviously essential to implement decentralisation reform. There is much literature on capacity building, but it is often embedded in treatments of specific aspects of subnational government reform, and for the most part, does not highlight particularly generalisable findings. Some critics have expressed concern about the dominant "supply-driven" (by national governments and international agencies) approach to capacity development. Detractors complain that it privileges a uniform and comprehensive technical approach and often fails to appreciate the fundamental underlying incentives and dynamics outlined in this chapter.[22]

Much subnational capacity development remains dominated by conventional classroom instruction. Initiatives to foster more "demand-driven" (requested by subnational governments for immediately needed skills) and "on the job" coaching are recommended but unevenly adopted. Both standardised and tailored approaches can serve a role, with broad overview training providing a foundational understanding of the system and basic skills, while efforts to respond to subnational requests for skills required for proximate commitments can serve a complementary role in targeting, refining and reinforcing capacity on the ground.

A further concern is that capacity development is often concentrated on developing the technical skills of subnational government civil servants. More consideration should be given to governance capacity that supports subnational politicians and civil society – beyond the often-mechanical participatory planning and budgeting exercises – which may help to promote more productive civic engagement.

Towards a more strategic approach to reform

So how can reformers pragmatically deal with the many issues raised above in ways that might approach reform? [23] As previously indicated, there are useful principles and tools and some evidence regarding fiscal decentralisation. There is, however, no comprehensive analytical framework to systematically guide policy makers in how to support viable decentralisation reform, so informed judgment and a sense of pragmatism are key.

Framing decentralisation challenges to inform implementation

As noted above, relatively narrow technical analyses to define decentralisation reforms have become pervasive in a world where expertise is increasingly specialised, and there are few incentives for more holistic diagnostics. Not all analyses to support intergovernmental reforms can comprehensively take into account the broad scope of decentralisation and all relevant country details. At the same time, it is productive to consider how to prioritise reforms in the context of the larger landscape. Enhanced appreciation of linkages among reforms and political economy dynamics could potentially promote more reflective, cohesive and practical application of basic reform principles and generate more robust

systems and results. Wider appreciation for the value of this type of analysis has surfaced more generally in recent years in the political economy analysis of development assistance and "doing development differently" literature.[24]

Crafting and executing strategic action

All implementation strategies need common elements to achieve their goals – a suitably defined entry point, an expected trajectory to roll out reforms over time, productive incentives for the uptake of reforms, capacity building/support structures and a managerially-oriented monitoring and feedback mechanism. When a central government agency managing decentralisation is considering implementation, developing a strategy will require attention to these elements.

Identifying initial steps and partners for a reform trajectory

Finding a starting point for action ideally involves both a broader vision in which to position reforms and the selection of attainable priorities. In cases where decentralisation is new or contentious, this may mean focusing on more basic reforms that don't unduly threaten current power bases, such as those examined in the political economy discussion above, or excessively strain existing capacity. At the same time, it is useful to select an undertaking that is adequately consequential and visible, and that can initiate movement in an appropriate direction on a potentially feasible trajectory. In Cambodia, for example, efforts began on a small scale at a lower level of government but incorporated important technical and political reforms.

A strategic approach also includes the identification of interested partners who are likely to take the effort seriously. Thus, if a particular ministry or agency is prepared to take some concrete steps to transfer powers to subnational governments or enhance their ability to collect or manage resources, it could make sense to begin the process with such partners, rather than with agencies that are not committed to supporting reform, such as a ministry that wants to retain control over their pre-decentralisation functions and resources.

As noted above, national reforms often assume that subnational governments have similar absorption capacity. Expecting those with limited capacity to bear major responsibilities invites failure, while excessively controlling the more capable governments squanders resources and undercuts subnational accountability. Asymmetric entry points can be beneficial, and some reforms may, to some extent, even be negotiated with individual subnational governments rather than framed as universal central dictates. Such negotiation places some responsibility on a specific subnational government unit to comply with what they consent to do.

In choosing and sequencing reforms, individual components would ideally be appropriately connected to the extent feasible, even if initially in a rudimentary manner. As noted above, a fragmented approach can generate reforms that superficially meet traditional normative values but in fact, may end up being deficient in their ability to yield desired results. Improved subnational revenue collection, for example, requires not only technical and managerial reforms but also governance outreach to those expected to pay.

Creating oversight structures and productive incentives

Positive and negative incentives (rewards and penalties) have the potential to motivate central and subnational governments to behave as intended under reforms. Where many actors with different but interdependent functions are involved, a co-ordinating mechanism

would ideally oversee and enforce implementation, compelling all parties to act according to legal mandates. As noted above, the political economy of such co-ordination mechanisms is often challenging, as with the National Committee for Subnational Democratic Development in Cambodia, the Decentralisation Support Facility in Indonesia, and the National Decentralisation Committee in Thailand. Their commonly deficient performance, however, also reflects unrealistic expectations and flawed design that can potentially be corrected if there is sufficient consensus about how to start and proceed with reforms, and there is the motivation or pressure to do so.

Creatively defined inducements may also help to facilitate subnational government adoption of decentralisation reforms. These include, for example, monitored accountability mechanisms (e.g. central government contracts with subnational governments to meet specific reform targets, a successful initiative in Rwanda); financial incentives for reform adoption/performance gains (e.g. compliance or performance-based grants that reward subnational government attainment of specific targets, which have been used in Bangladesh, Cambodia, Indonesia, Nepal and the Philippines, among others); and tournament-based approaches (e.g. competitive contests that bring recognition by rewarding notable achievements of particular subnational governments, which have been used in several countries, including the Philippines).[25]

Enabling capacity

Capacity building and technical assistance for both central and subnational actors are essential for reform given the new roles they will have to play under decentralisation, but as indicated earlier, they are often framed by central governments and international agencies in an excessively uniform and mechanical way. The above discussion of capacity building noted specific concerns – a preference for traditional classroom training and technical skills, with less emphasis on skills perceived as urgent by subnational governments (demand-driven) and more limited focus on governance capacity or relations between elected and appointed officials.

There is consensus – in principle if not in practice – on the need to nurture both subnational technical capacity (of government staff who will be executing public functions) and subnational governance capacity (of citizens, elected officials and staff to work together). But related efforts are rarely designed to facilitate such interaction in a meaningful way. Beyond conventional courses, "on the job" training can enhance skills and retention, but it is more challenging than classroom training and requires dedicated effort to develop and execute.

Consolidating a strategy, monitoring progress and adjusting as needed

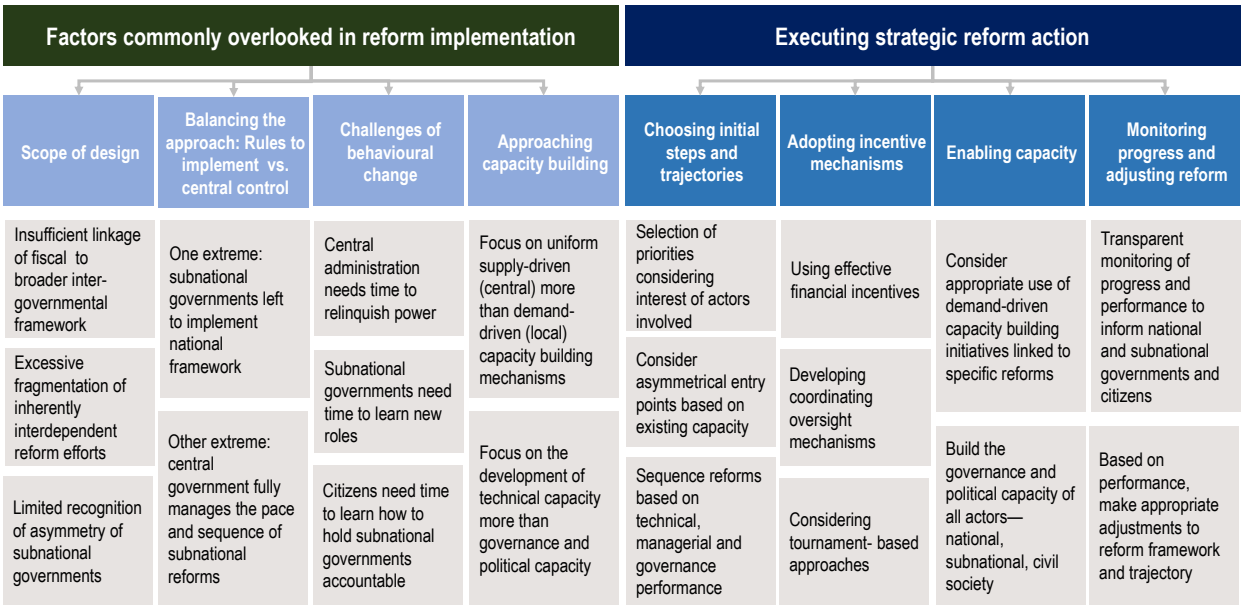
The reform path (asymmetric if appropriate), should ideally be directly linked to dedicated capacity and performance-enhancement efforts. Technical reforms can be tied to efforts that build capacity for particular functions being implemented during a specific time period. By using defined criteria, reforms can be sequenced in a transparent way so that they build on each other. This is demanding relative to conventional approaches. It is not easy to design such a scheme; it could become overly bureaucratic and be captured by politics. Nevertheless, there is a need to be more innovative in implementing decentralisation, and if approached carefully, this type of strategic approach could reduce arbitrary or politicised decisions and limit stalled reform.

For such an approach to work effectively, there must be transparent monitoring of progress and performance as new reforms are implemented. There have been many decentralisation

monitoring efforts, but they are often not assertively used to try to adjust general approaches or task/location-specific reforms. Even if they are, analysis often focuses on adopting a "symptom treating" type of reform that will not solve more fundamental obstacles to reform. Still, monitoring mechanisms have untapped potential as managerial tools, especially if linked to a sufficiently robust and integrated diagnosis of problems. Although the type of desired good information and its use for making policy changes is not well established in many countries, there have been positive steps taken to move in this direction. Indonesia, for example, has used performance information to make a number of changes in intergovernmental fiscal regulations.

Although it is difficult to neatly synthesise all of the relevant aspects of implementation, Figure 2.2 selectively summarises commonly neglected considerations. It also highlights elements of a more strategic approach to implementing intergovernmental fiscal reform.

Figure 2.2. Neglected factors in implementing reform and elements of strategic approaches



Source: Author's depiction.

Diagnosing specific problems: Looking beneath the surface

The above discussion of strategy is generic, and it is more focused on thinking about how to roll out broader fiscal decentralisation reform. In many countries, some fiscal decentralisation is already in place, but challenges with aspects of the system need to be addressed. If local revenue generation under-performs, for example, details are needed to pursue a strategic approach. Problems identified by reformers are often symptoms of underlying issues that also need to be addressed if the identified flaw is to be resolved. If, for example, a local tax is unproductive and the tax base is small and/or stagnant and the rate is low, common mainstream solutions might include expanding the base, improving assessment or increasing the rate. But if the more severe and immediate problem is collection, enhancing the base or raising the rate may have a limited effect on yield or even worsen the collection situation. Indonesia, for example, is known for its shift from assessment-based to collection-based property tax reform.

If low revenue yield is determined to be a priority, it is essential not only to document the nature and extent of the deficiency but also to determine the core causes. It would also be essential to understand if any remedial measures have already been attempted and by whom. If they have, analysts need to determine why they have not worked. If steps have not been taken, the reasons for inattention to the problem need to be established. Weak subnational revenue generation may result from a wide range of factors. These could include, for example, incomplete development of the details of a general policy mandated by enabling legislation; poorly designed policies (e.g. excessive exemptions to a revenue base, low tax rates or disincentives created by fiscal transfers); poorly structured revenue collection mechanisms; data deficiencies; insufficient legal revenue enforcement authority; and lack of citizen and business tax compliance, among others.

Beyond these basic determinations, a range of capacity and political economy considerations could be shaping observed deficiencies. Flaws in the national framework could result from an unintentional omission or error in design or overt political attempts to limit subnational government powers. Weak follow-up and implementation efforts may occur because national government agencies actively obstruct implementation of legally devolved revenues or do not provide subnational governments with needed training and technical support. Such behaviour could reflect limited central bureaucratic capacity, budgetary constraints, apathy or overt hostility to enhancing subnational revenue generation, among others.

If the tax policy is well designed and central support is solid, analysis might consider why subnational governments have not used available revenue authority and support mechanisms. Again, a range of factors could be relevant here, including staffing deficiencies, inadequate funding, a local political preference to rely on intergovernmental transfers, an aversion among constituents to pay subnational taxes, etc. If citizens and businesses are not complying with tax requirements, their behaviour may be rooted in affordability concerns, or they may be dissatisfied on various fronts – with service delivery, in their perception of how fairly revenues are assessed and collected, or with the overall performance and credibility of subnational governments.

Such meticulous investigations can be tiresome, but they can help to identify the main factors and dynamics underlying observed performance problems and to begin determining if and how they can be eased. Some potential concerns might be excluded swiftly, while others would need further examination. Additional investigations could focus in more detail on factors that may influence subnational government behaviour and performance: national ministry conduct (policy inconsistency, weak co-operation among executing agencies); relationships at subnational levels (interaction between intermediate and local tiers of government and among adjacent local governments); subnational electoral accountability (degree of competition, citizen perceptions of fairness); and non-electoral civic engagement processes that affect how residents perceive and interact with subnational governments (accessibility to processes, degree of genuine influence).

Fully exhaustive analysis of individual fiscal decentralisation elements is not practical, but there will often be room to improve on the status quo. The analysis can be selective but should be appropriately broad, inquisitive and adaptive. Even generating a broad feel for answers to basic issues can help to indicate types of further investigation required and to determine prospective remedies. A conversant analyst will learn to determine the boundaries of the evaluation so as to concentrate on factors that are most valuable for identifying tangible reforms.

Depending on who initiates the analysis and where it leads, concrete measures will involve different prime actors. Only the national government, for example, can address weak subnational empowerment or ministerial interference in subnational affairs (although subnational governments may be able to take steps within prevailing constraints). Motivated subnational governments can improve their own capacity, attempt innovative approaches and interact more intensely with constituents in defining and advancing reforms. Citizens themselves can pressure subnational governments to change how they do business. Such steps may generate support or rouse resistance, some of which can be expected, from others that may require further action. In some cases, the constraints identified may be insurmountable, such that the most logical avenues of reform are blocked, and less effective, but more promising, options may have to be considered.

Conclusion

It is hard to draw satisfying conclusions from the extensive and complex literature on, and experience with, fiscal decentralisation, and space constraints limited coverage of specific examples. A few observations, however, can be made. First, fiscal decentralisation is often more diverse and intricate than academics and practitioners may appreciate. There has been a resilient tendency – despite acknowledgement of the significance of context – to approach decentralisation as a predominantly technical reform based primarily on normative principles. There has also been a propensity to handle different aspects of reform as if they were isolated phenomena rather than part of an intrinsically integrated system.

Second, there are potent constraints on achieving sustainable decentralisation reform consistent with orthodox principles. Institutional arrangements that emerged in specific contexts may not respond to reforms based on normative conventions. Deficient attention to political economy dynamics (national, intergovernmental, subnational) and weak appreciation of the gap between official and genuine reform goals and its effects for effective reform are common. In addition, favouring design relative to implementation produces challenges for decentralisation reforms.

Third, empirical evidence on decentralisation is limited, fragmented and inconsistent, a reflection of the difficulty of systematically assessing such a complex reform that is of interest to a range of different actors with diverse views and interests. Some research does substantiate a variety of fundamental conceptual expectations about decentralisation (e.g. better governance and service delivery) to different degrees, but there is also evidence to document limited or negative impacts.

In the final analysis, there is no strong empirical basis for confident, detailed guidance about how to approach fiscal decentralisation beyond limited general prescriptions that are unsurprising and not operationally specific. The evidence does confirm the extent to which "context matters" in pursuing reform that may generate positive results. The literature offers instances of good performance, but also many examples of mainstream programmes inadequately tailored to specific circumstances or insufficiently cognisant of specific constraints that did not perform as expected.

Despite the inadequacy of empirical evidence, there are a few basic lessons to draw from experience. First, progress can be made in decentralisation reform if there is appropriately nuanced and pragmatically oriented contextual scrutiny. Examining the political economy and other contextual factors can contribute to a better understanding of why decentralisation reform has been or should be approached in a particular way. Political economy dynamics influence how policy is originally defined, how the entities involved

act in the course of implementation, the strength and evolving nature of intergovernmental relations, and how reforms perform in specific subnational jurisdictions facing their own political and bureaucratic dynamics.

Second, there can be value in integrating the elements of decentralisation reforms where feasible. The tendency to pursue fragmented reforms can produce inconsistencies in the structure and operation of intergovernmental systems. Some contradictions are a function of inherent tensions between technical/fiscal and governance reforms, but even specific aspects of technical reform can be inconsistent, such as intergovernmental transfers that create disincentives for subnational governments to meet their revenue generation and expenditure responsibilities. There is room for national governments to act more productively and strategically in defining decentralisation policies and constructing incentives to improve the performance of subnational governments.

Third, the somewhat limited attention to careful implementation of decentralisation is noteworthy. Where strategies exist, they are often perfunctory, disjointed across national agencies and not executed as planned. A suitably gradual, pragmatically sequenced, and contextually adapted process could allow subnational governments, national actors and citizens actors to gain the experience and competencies required to assume their evolving roles. Even limited progress in low-capacity environments can help to establish a foundation and facilitate momentum for deeper reforms with greater promise to be sustained. Of course, it is also crucial to guard against reforms stalling early on, so a strategic approach must be able to drive continued progress. This is not easy terrain to navigate, but proper preparation and monitoring could support a more pragmatic approach to rolling out (and adapting as needed) sustainable fiscal decentralisation reform in Asian countries.

References

Agrawal, A. and J. Ribot (2012), *Assessing the Effectiveness of Democratic Accountability Mechanisms in Local Governance*, USAID, Washington, DC. [57]

Ahmad, E. and G. Brosio (eds.) (2015), *Handbook of Multilevel Finance*, Edward Elgar, Cheltenham. [23]

Ahmad, E. and V. Tanzi (2002), *Managing Fiscal Decentralization*, Routledge, Oxford. [5]

Ahmad, J. et al. (2005), *Decentralization and Service Delivery*, World Bank, Washington, DC. [7]

Altunbas, Y. and J. Thornton (2012), "Fiscal Decentralization and Governance", *Public Finance Review*, Vol. 40/1, pp. 66-85. [45]

Andrews, M., L. Pritchett and M. Woolcock (2017), *Building State Capability: Evidence, Analysis, Action*, Oxford University Press, Oxford. [81]

Antwi, K. and F. Analoui (2008), "Challenges in Building the Capacity of Human Resource Development in Decentralized Local Governments", *Management Research News*, Vol. 31/7, pp. 504-517. [77]

Bahl, R. and R. Bird (2018), *Fiscal Decentralization and Local Finance in Developing Countries: Development from Below*, Edward Elgar, Cheltenham. [25]

Bahl, R., J. Linn and D. Wetzel (eds.) (2013), *Cities in the National Institutional and Fiscal Structure*, Lincoln Institute of Land Policy, Cambridge, MA. [40]

Bahl, R., J. Linn and D. Wetzel (eds.) (2013), *Financing Metropolitan Governments in Developing Countries*, Lincoln Institute of Land Policy, Cambridge, Mass. [20]

Bahl, R., J. Linn and D. Wetzel (eds.) (2013), *Grant Financing of Metropolitan Areas*, Lincoln Institute of Land Policy, Cambridge, MA. [89]

Bahl, R. and J. Martinez-Vazquez (2013), "Sequencing Fiscal Decentralization", *Annals of Economics and Finance*, Vol. 14/2, pp. 623-670. [72]

Baiocchi, G. and E. Ganuzza (2014), "Participatory Budgeting as if Emancipation Mattered", *Politics and Society*, Vol. 42/1, pp. 29-50. [66]

Bardhan, P. and D. Mookherjee (eds.) (2006), *Decentralization and Local Governance in Developing Countries: A Comparative Perspective*, MIT Press, Cambridge. [8]

Bird, R. and J. Martinez-Vazquez (eds.) (2014), *Why Theory and Practice Differ: The Gap Between Principles and Reality in Subnational Revenue Systems*, Edward Elgar, Cheltenham. [73]

Bird, R. and F. Vaillancourt (eds.) (1998), *Fiscal Decentralization in Developing Countries*, Cambridge University Press, Cambridge. [2]

Boadway, R. and L. Eyraud (2018), "Designing Sound Fiscal Relations Across Government Levels in Decentralized Countries", *IMF Working Paper*, No. 18/271. [27]

Boex, J. and S. Yilmaz (2010), *An Analytical Framework for Assessing Democratic Local Governance and the Local Public Sector*, The Urban Institute, Washington, DC. [30]

Booth, D. and S. Unsworth (2014), *Politically Smart, Locally Led Development*, Overseas Development Institute, London. [86]

Brinkerhoff, D. and P. Morgan (2010), "Capacity and Capacity Development: Coping with Complexity", *Public Administration and Development*, Vol. 30/1, pp. 2-10. [79]

Brosio, G. (2014), *Decentralization and Public Service Delivery in Asia*, Asian Development Bank, Manila. [36]

Cabbanes, Y. and B. Lipietz (2018), "Revisiting the Democratic Promise of Participatory Budgeting in Light of Competing Political, Good Governance and Technocratic Logic", *Environment and Urbanization*, Vol. 30/1, pp. 67-84. [92]

Chatry, I. and R. Vincent (2019), "A global view of sub-national governments in Asia: Structure and finance", in *Fiscal Decentralisation and Inclusive Growth in Asia*, OECD Publishing, Paris, https://dx.doi.org/10.1787/239e95db-en. [43]

Cheema, G. and D. Rondinelli (eds.) (2007), *Decentralized Governance: Emerging Concepts and Practices*, The Brookings Institution, Washington, DC. [10]

Connerley, E., K. Eaton and P. Smoke (eds.) (2010), *Decentralization and Community Empowerment*, Lynne Rienner, Boulder. [62]

Connerley, E., K. Eaton and P. Smoke (eds.) (2010), *Elections and the Development of Local Democracy*, Lynne Rienner, Boulder. [58]

Connerley, E., K. Eaton and P. Smoke (eds.) (2010), *Making Decentralization Work: Democracy, Development and Security*, Lynne Rienner Publishers, Boulder. [17]

Crawford, G. and C. Hartmann (2008), *Decentralization in Africa: A Pathway Out of Poverty and Conflict?*, Amsterdam University Press, Amsterdam. [15]

Dafflon, B. and T. Madies (2013), *The Political Economy of Decentralization in Sub-Saharan Africa: A New Implementation Model in Burkina Faso, Ghana, Kenya, and Senegal*, Agence Française de Développement, Paris and World Bank, Washington, DC. [35]

Development Partner Working Group on Decentralization and Local Governance (2011), *Busan and Beyond: Localizing Paris Principles for More Effective Support to Decentralization and Local Governance Reforms*, GIZ, Bonn. [53]

Dickovick, J. (2014), "Foreign Aid and Decentralization: Limitations on Impact in Autonomy and Responsiveness", *Public Administration and Development*, Vol. 34/2, pp. 194-206. [54]

Dickovick, J. (2011), *Decentralization and Recentralization in the Developing World: Comparative Studies from Africa and Latin America*, Penn State Press, University Park. [97]

Dickovick, J. and J. Wunsch (eds.) (2014), *Decentralization in Africa: A Comparative Perspective*, Lynne Rienner, Boulder. [21]

Eaton, K., K. Kaiser and P. Smoke (2011), *The Political Economy of Decentralization: Implications for Aid Effectiveness*, World Bank, Washington, DC. [44]

Ebel, R. and D. Weist (2006), *Sequencing Subnational Revenue Decentralization*, World Bank, Washington, DC. [71]

Faguet, J. (2014), "Decentralization and Governance", *World Development*, Vol. 53/1, pp. 2-13. [98]

Faguet, J. and C. Pöschl (2015), *Is Decentralization Good for Development? Perspectives from Academics and Policy Makers*, Oxford University Press, Oxford. [24]

Falleti, T. (2005), "A Sequential Theory of Decentralization: Latin American Cases in Comparative Perspective", *American Political Science Review*, Vol. 99/3, pp. 327-346. [70]

Fan, V. et al. (2018), "Fiscal Transfers Based on Outputs or Outcomes: Lessons from the Twelfth and Thirteenth Finance Commission in India", *International Journal of Health Planning and Management*, Vol. 33, pp. e210–e227. [91]

Frank, J. and J. Martinez-Vazquez (eds.) (2016), *The Political Economy of Local Infrastructure Planning in Developing Countries*, Routledge, Oxford. [48]

Fritzen, S. (2007), "Linking Context and Strategy in Donor Support for Decentralization: A Diagnostic Framework", *Public Administration and Development*, Vol. 27/1, pp. 13-25. [52]

Goldfrank, B. (2012), "The World Bank and the Globalization of Participatory Budgeting", *Journal of Public Deliberation*, Article 7. [63]

Green, A. (2005), *Managing Human Resources in a Decentralized Context." In East Asia Decentralizes: Making Local Government Work*, World Bank, Washington, DC. [75]

Heller, P. and V. Rao (eds.) (2015), *But Who Will Speak for the People? The Travel and Translation of Participatory Budgeting*, World Bank, Washington, DC. [67]

Hope, K. (2009), "Capacity Development for Good Governance in Developing Societies: Lessons from the Field", *Development in Practice*, Vol. 19/1, pp. 79-86. [78]

Ichimura, S. and R. Bahl (2009), *Decentralization Policies in Asian Development*, World Scientific, Hackensack. [16]

Imansyah, H. (ed.) (2012), *Incentives for Local Service Delivery: International Experience and Options for Indonesia*, University of Indonesia Press, Jakarta. [88]

Khemani, S. (2019), "What is State Capacity?", *Policy Research Working Paper*, No. 8734, World Bank, Washington, DC. [82]

Kim, J. and S. Dougherty (eds.) (2019), *Fiscal Decentralisation and Inclusive Growth in Asia*, OECD Fiscal Federalism Studies, OECD Publishing, Paris/Korea Institute of Public Finance, Seoul, https://dx.doi.org/10.1787/25cf7545-en. [28]

Levy, B., V. Fritz and R. Ort (2014), *Problem-Driven Political Economy Analysis: The World Bank's Experience*, World Bank, Washington, DC. [83]

Litvack, J., J. Ahmad and R. Bird (1998), *Rethinking Decentralization in Developing Countries*, World Bank, Washington, DC. [3]

Lund, J. and M. Saito-Jensen (2013), "Revisiting the Issue of Elite Capture of Participatory Initiatives", *World Development*, Vol. 46, pp. 104-112. [65]

Malesky, E., C. Nguyen and A. Tran (2014), "The Impact of Recentralization on Public Services: A Difference-in-Differences Analysis of the Abolition of Elected Councils in Vietnam", *American Political Science Review*, Vol. 108/1, pp. 144-168. [50]

Martinez-Vazquez, J. (2011), *Fiscal Decentralization in Asia: Challenges and Opportunities*, Asian Development Bank, Manila. [18]

Martinez-Vazquez, J. and F. Vaillancourt (eds.) (2011), *Decentralization in Difficult Environments*, Edward Elgar, Cheltenham, UK and Northampton, MA. [19]

McGill, R. (2010), "Building Capacity for Local Government to Perform", *Commonwealth Journal of Local Governance*, Vol. 6, pp. 90-106. [80]

Mukherjee, A. (2014), *Fiscal Federalism and Intergovernmental Transfers for Financing Health in India*, Center for Global Development, Washington, DC. [90]

Oates, W. (2005), "Toward a Second-Generation Theory of Fiscal Federalism", *International Tax and Public Finance*, Vol. 12/4, pp. 349–373. [38]

Oates, W. (1972), *Fiscal Federalism*, Harcourt, Brace, Jovanovich, New York. [34]

OECD and UCLG (2019), *Subnational Governments Around the World: Structure and Finance*, OECD Publishing, Paris and United Cities and Local Governments, Barcelona. [42]

OECD and UCLG (2016), *Subnational Governments Around the World: Structure and Finance*, OECD Publishing, Paris and United Cities and Local Governments, Barcelona. [41]

Öjendal, J. and A. Dellnäs (eds.) (2013), *Decentralizing for Development: The Developmental Potential of Local Authorities and the Limits of Politics-Driven Decentralization Reforms*, United Nations University Press, Tokyo. [47]

Öjendal, J. and A. Dellnäs (eds.) (2013), *Participatory Budgeting and Local Governance*, United Nations University Press, Tokyo. [64]

Öjendal, J. and A. Dellnäs (eds.) (2013), *Recentralization in Developing Countries: Forms, Motivations and Consequences*, United Nations University Press, Tokyo. [49]

Öjendal, J. and A. Dellnäs (eds.) (2013), *Sanctions, Benefits and Rights: Three Faces of Accountability*, United Nations University Press, Tokyo. [68]

Öjendal, J. and A. Dellnäs (2013), *The Imperative of Good Local Governance: Challenges for the Next Decade of Decentralization*, United Nations University Press, Tokyo. [46]

Öjendal, J. and A. Dellnäs (eds.) (2013), *Understanding Decentralization: Key Issues for Successful Design*, United Nations University Press, Tokyo. [31]

Ponce-Rodríguez, R. et al. (2018), "Rethinking the Political Economy of Decentralization: How Elections and Parties Shape the Provision of Local Public Goods", *Publius: The Journal of Federalism*, Vol. 48/4, pp. 523–558. [93]

Rao, S., Z. Scott and M. Alam (2014), *Decentralisation and Local Government: Topic Guide*, GSDRC, University of Birmingham, Birmingham. [22]

Rocha Menocal, A. (2014), *Getting Real about Politics: From Thinking Politically to Working Differently*, Overseas Development Institute, London. [84]

Rodden, J. and E. Wibbels (eds.) (2019), *Decentralized Governance and Accountability: Academic Research and the Future of Donor Programming*, Cambridge University Press, Cambridge. [29]

Rodden, J. and E. Wibbels (eds.) (2019), *Leadership Selection Rules and Decentralized Governance*, Cambridge University Press, Cambridge. [60]

Rodden, J. and E. Wibbels (eds.) (2019), *Traditional Leaders, Service Delivery, and Electoral Accountability*, Cambridge University Press, Cambridge. [59]

Romeo, L. (2003), "The Role of External Assistance in Supporting Decentralization Reforms", *Public Administration and Development*, Vol. 23/1, pp. 89-96. [51]

Scott, Z. (2009), *Decentralization, Local Development and Social Cohesion: An Analytical Review*, University of Birmingham, GSDRC, Birmingham. [55]

Shah, A. (2010), *Sponsoring a Race to the Top: The Case for Results-Based Intergovernmental Finance for Merit Goods*, World Bank, Washington, DC. [85]

Shah, A. (ed.) (2007), *Participatory Budgeting*, World Bank, Washington, DC. [61]

Shah, A. and T. Thompson (2004), "Implementing Decentralized Local Governance: A Treacherous Road with Potholes, Detours, and Road Closures", *Policy Research Working Paper*, No. 3353, World Bank, Washington, DC. [69]

Smoke, P. (2019), "Fiscal decentralisation and inclusive growth: The role of institutional context in selected Asian economies", in *Fiscal Decentralisation and Inclusive Growth in Asia*, OECD Publishing, Paris, https://dx.doi.org/10.1787/67eca5ea-en. [1]

Smoke, P. (2015), "Managing Public Sector Decentralization in Developing Countries: Moving Beyond Conventional Recipes", *Public Administration and Development*, Vol. 35/4. [74]

Smoke, P. (2015), "Rethinking Decentralization: Assessing Challenges to a Popular Public Sector Reform", *Public Administration and Development*, Vol. 35/1, pp. 97-112. [37]

Smoke, P. (2001), *Fiscal Decentralization in Developing Countries: A Review of Current Concepts and Practice*, United Nations Research Institute for Social Development, Geneva. [4]

Smoke, P., E. Gomez and G. Peterson (eds.) (2006), *Decentralization in Asia and Latin America: Towards a Comparative Interdisciplinary Perspective*, Edward Elgar, Cheltenham. [9]

Sow, M. and I. Razafimahefa (2017), "Fiscal Decentralization and Fiscal Policy Performance", *IMF Working Paper*, No. 17/64, International Monetary Fund, Washington, DC. [33]

Steffensen, J. (2010), *Performance Based Grant Systems: Concept and International Experience*, United Nations Capital Development Fund, New York. [87]

UCLG (2016), *Co-Creating the Urban Future: Fourth Global Report on Decentralization and Local Governance*, United Cities and Local Governments, Barcelona. [14]

UCLG (2013), *Access to Basic Services. Third Global Report on Decentralization and Local Governance*, United Cities and Local Governments, Barcelona. [13]

UCLG (2010), *Financing Local Government: The Challenges of the 21st Century. Second Global Report on Decentralization and Local Governance*, United Cities and Local Governments, Barcelona. [12]

UCLG (2007), *Decentralization and Local Democracy in the World. First Global Report on Decentralization and Local Governance*, United Cities and Local Governments, Barcelona. [11]

UNCDF (2005), *Delivering the Goods: Building Local Government Capacity to Achieve the Millennium Development Goals*, UN Capital Development Fund, New York. [76]

UNDESA and UNCDF (2017), *Financing Sustainable Urban Development in the Least Developed Countries*, UN Department for Economic and Social Affairs Financing for Development Office and UN Capital Development Fund, New York. [26]

UN-Habitat (2015), *The Challenge of Local Government Financing in Developing Countries*, UN-Habitat, Nairobi. [32]

USAID (2013), *Evidence Review Paper: Responsiveness and Accountability in Local Governance and Service Delivery*, United States Agency for International Development, Washington, DC. [94]

Weingast, B. (2014), "Second Generation Fiscal Federalism: Political Aspects of Decentralization and Economic Development", *World Development*, Vol. 53/1, pp. 14-25. [39]

World Bank (2015), *East Asia's Changing Urban Landscape: Measuring a Decade of Spatial Growth*, The World Bank, Washington, DC, https://openknowledge.worldbank.org/handle/10986/21159. [96]

Wunsch, J. and D. Olowu (eds.) (2003), *Local Governance in Africa: The Challenge of Decentralization*, Lynne Rienner Publishers, Boulder. [6]

Yilmaz, S., Y. Beris and R. Serrano-Berthet (2010), "Linking Local Government Discretion and Accountability in Decentralization", *Development Policy Review*, Vol. 28/3. [56]

Yoshino, N. and P. Morgan (eds.) (2017), *Central and Local Government Relations in Asia: Achieving Fiscal Sustainability*, Edward Elgar, Cheltenham. [95]

Notes

1. Reviews of the extensive literature on decentralisation and intergovernmental relations from various perspectives include, for example: Bird and Vaillancourt (1998[2]); Litvack, Ahmad and Bird (1998[3]); Smoke (2001[4]); Ahmad and Tanzi (2002[5]); Wunsch and Olowu (2003[6]); Ahmad et al. (2005[7]); Bardhan and Mookherjee (2006[8]); Smoke, Gomez and Peterson (2006[9]); Cheema and Rondinelli (2007[10]); United Cities and Local Governments (2007[11]), (2010[12]), (2013[13]), (2016[14]); Crawford and Hartmann (2008[15]), Ichimura and Bahl (2009[16]); Connerley, Eaton and Smoke (2010[17]); Martinez-Vazquez (2011[18]); Martinez-Vazquez and Vaillancourt (2011[19]); Bahl, Linn and Wetzel (2013[20]); Faguet (2014[98]); Dickovick and Wunsch (2014[21]); Rao, Scott and Alam (2014[22]); Ahmad and Brosio (2015[23]); Faguet and Poschl (2015[24]); Bahl and Bird (2018[25]); UNDESA and UNCDF (2017[26]); Yoshino and Morgan (2017[95]); Boadway and Eyraud (2018[27]); Kim and Dougherty (2019[28]); and Rodden and Wibbels (2019[29]). More specific references to the substance of some of these diverse studies will be provided later.

2. Examples of synthetic frameworks (from varying perspectives) include: Bardhan and Mookherjee (2006[8]); Cheema and Rondinelli (2007[10]); Boex and Yilmaz (2010[30]); Connerley, Eaton and Smoke (2010[17]); Martinez-Vazquez and Vaillancourt (2011[19]); Bahl, Linn and Wetzel (2013[20]); Manor (2013[31]); Faguet (2014[98]); Ahmad and Brosio (2015[23]); UN-Habitat (2015[32]); Bahl and Bird (2018[25]); Sow and Razafemahefa (2017[33]); Boadway and Eyraud (2018[27]); and Rodden and Wibbels (2019[29]).

3. Fiscal federalism was originally framed by Oates (1972[34]), a cornerstone of the fiscal decentralisation literature.

4. See, for example, Martinez-Vazquez and Vaillancourt (2011[19]); Bahl, Linn and Wetzel (2013[20]); Dafflon and Madies (2013[35]); Brosio (2014[36]); Faguet and Pöschl (2015[24]); Smoke (2015[37]); Bahl and Bird (2018[25]); and Rodden and Wibbels (2019[29]).

5. See, for example, Oates (2005[38]) and Weingast (2014[39]) on second-generation fiscal federalism.

6. See, for example, Cheema and Rondinelli (2007[10]); Connerly, Eaton and Smoke (2010[17]); Manor (2013[31]); Öjendahl and Dellnäs (2013[46]); Smoke (2013[40]) and (2015[37]).

7. There are a few comparative overviews of diversity, such as OECD and UCLG (2016[41]) and (2019[42]), or attempts to compare selected countries on certain aspects, e.g. Chatry and Vincent (2019[43]); Smoke (2013[40]) and (2019[1]).

8. Examples of broader work on the political economy of decentralisation include Bardhan and Mookherjee (2006[8]); Smoke, Gomez and Peterson (2006[9]); Connerley, Eaton and Smoke (2010[17]); Eaton, Kaiser and Smoke (2011[44]); Altunbas and Thornton (2012[45]); Dafflon and Madies (2013[35]); Öjendahl and Dellnäs (2013[46]); Romeo (2013[47]); Faguet (2014[98]); Romeo and Smoke (2016[48]); and Ponce-Rodríguez et al. (2018[93]).

9. Some instances of recentralisation are covered in Dickovick (2011[97]); Smoke (2013[49]); Malesky, Nguyen and Tran (2014[50]).

10. Various aspects of the bureaucratic dynamics surrounding decentralisation are elaborated in Litvack, Ahmad, and Bird (1998[3]); Connerley, Eaton and Smoke (2010[17]); Eaton, Kaiser and Smoke (2011[44]); and Smoke (2015[37]).

11. See Smoke (2019[1]) for a summary of relevant literature.

12. Eaton, Kaiser and Smoke (2011[44]) discuss this problem.

13. Reviews of donor behaviour related to decentralisation are summarised in Romeo (2003[51]), Fritzen (2007[52]); Development Partner Working Group on Decentralization and Local Governance (2011[53]); Eaton, Kaiser and Smoke (2011[44]); and Dickovick (2014[54]).

14. See Eaton, Kaiser and Smoke (2011[44]); and Development Partner Working Group on Decentralization and Local Governance (2011[53]) for examples.

15. See, for example, Scott (2009[55]); Connerley, Eaton and Smoke (2010[17]); Yilmaz, Beris and Serrano-Berthet (2010[56]); Eaton, Kaiser and Smoke (2011[44]); Agrawal and Ribot (2012[57]); Öjendal and Dellnäs (2013[46]); and Rodden and Wibbels (2019[29]).

16. Politics are more explicit in second-generation fiscal federalism; see, for example, Oates (2005[38]) and Weingast (2014[39]).

17. See, for example, Bland (2010[58]); Ponce-Rodríguez et al. (2018[93]); Baldwin and Raffler (2019[59]); and Grossman (2019[60]).

18. Reviews of selected experiences with participatory mechanisms are found for example in: Shah (2007[61]); Brinkerhoff and Azfar (2010[62]); Goldfrank (2012[63]); Blair (2013[64]); Lund and Saito-Jensen (2013[65]), Baiocchi and Gannuza (2014[66]); Baiocchi (2015[67]); and Cabbanes and Lipietz (2018[92]).

19. Reviews of decentralised accountability and governance are found in Bardhan and Mookerjee (2006[8]); Cheema and Rondinelli (2007[10]); Boex and Yilmaz (2010[30]); Connerley, Eaton and Smoke (2010[17]); Yilmaz, Beris and Serrano-Berthet (2010[56]); Agrawal and Ribot (2012[57]); Grindle (2013[68]); Öjendal and Dellnäs (2013[46]); USAID (2013[94]); Faguet (2014[98]); Rodden and Wibbels (2019[29]).

20. How to approach the implementation of decentralisation is considered by Shah and Thompson (2004[69]); Falleti (2005[70]); Ebel and Weist (2006[71]); Martinez-Vazquez and Vaillancourt (2011[19]); Bahl and Martinez-Vazquez (2013[72]); Dafflon and Madies (2013[35]); Smoke (2014[73]) and (2015[74]); Sow and Razafimahefa (2017[33]); and Boadway and Eyraud (2018[27]).

21. See, for example, World Bank (2015[96]) and Smoke (2019[1]).

22. See, for example, some relevant discussions in Green (2005[75]); UNCDF (2005[76]); Antwi and Analoui (2008[77]); Hope (2009[78]); Brinkerhoff and Morgan (2010[79]); and McGill (2010[80]). Broader treatments of capacity and how to think about it are provided in Andrews, Pritchett and Woolcock (2017[81]); and Khemani (2019[82]).

23. This section is partly based on Smoke (2015[74]).

24. See, for example: Andrews, Pritchett and Woolcock (2017[81]); Booth and Unsworth (2014[86]); Levy, Fritz and Ort (2014[83]); and Rocha Menocal (2014[84]). See also http://doingdevelopmentdifferently.com.

25. See, for example, Shah (2010[85]); Steffensen (2010[87]); Lewis and Smoke (2012[88]); Shah (2013[89]); Mukherjee (2014[90]); and Fan et al. (2018[91]).

Chapter 3. Finding the right balance in the use of conditional grants

by Junghun Kim
Chair, OECD Network on Fiscal Relations across Levels of Government

Discussions on the design of intergovernmental fiscal relations often revolve around the premise that intergovernmental grants – especially earmarked grants – should be minimised. It is also often argued that intergovernmental grants imply a vertical fiscal imbalance between central and subnational governments. These arguments are based on the "benefit principle", and emphasise the importance of establishing a clear linkage between expenditure and revenue decisions of subnational governments. But in reality, almost all local governments worldwide provide, at least to some extent, essential (redistributive) public services such as health, education, and social services, which require substantial revenues. The four country cases examined in this chapter show the importance of intergovernmental relations in the role of co-ordinating across levels of government for the efficient and equitable provision of essential public services. They also show that, in many countries, earmarked grants play an important role in the provision of these services.

Introduction

In countries where the design of intergovernmental fiscal relations is evolving, the size and composition of local revenue are often subject to controversial debates.[1] As Wildasin (2004, p. 268[1]) notes, this is not the case of mature federations where "the institutions of federalism function relatively effectively, are relatively stable, and have developed over long historical periods." On the other hand, in countries where the history of decentralisation is relatively short, as in many developing countries and in some European countries such as Spain and Italy where fiscal decentralisation is still an ongoing process, the institutions of intergovernmental fiscal relations are not stable and changing them have significant political and economic implications. Among various issues regarding the design of intergovernmental fiscal relations, the most controversial ones are those related to the division of tax bases and revenues between central and subnational governments and the related choice between general grants and conditional grants (e.g. earmarked grants).[2]

Regarding these two issues, it is worth noting that the European Charter of Local Self-Government takes a very clear position: Article 9 of the European Charter stipulates that: 1) local authorities should have adequate fiscal resources of their own; and 2) transfers to subnational governments should be in the form of general-purpose grants (grants without conditionalities).[3,4] With its clear criteria on the design of intergovernmental fiscal relations, the European Charter provides an important guideline for European countries, as well as for those outside Europe, on policy discussions on the design of fiscal decentralisation.

In the policy debates that take place in many countries, it is indeed often observed that discussions on desirable properties of the composition of local revenue are based on a simple premise: local taxes are more desirable than general grants, and general grants are more desirable than conditional grants. However, this is a simplistic approach to the design of the structure of local revenue because it prevents proper recognition of the role of general and conditional grants. Moreover, so-called "local taxes" in many countries, in fact, do not represent local taxing power. For example, the revenues from personal income tax, corporate income tax, and value-added tax (VAT) in Germany are shared among levels of government by the rules stipulated in the German Basic Law (constitution). As discussed in, among others, McLure (2001[2]), Watts and Hobson (2000[3]) and Rodden (2002[4]), tax sharing or revenue sharing (tax sharing with horizontal redistribution) is a form of intergovernmental grant because local governments do not control the shared taxes at the margin. Indeed, as illustrated by Blöchliger and Petzold (2009[5]), the dividing line between tax sharing and grants is not very clear.

The fact that tax sharing and grants are similar in their nature has an important implication: the simplistic preference of local taxes over grants as a source of local revenue can mislead policy discussions on how to design the structure of local revenue. In particular, the main reason why local taxes are preferred to intergovernmental transfers as a source of local revenue is because of "transfer dependency" created by the latter: it softens local governments' budget constraint and weakens their fiscal accountability. However, since tax sharing and intergovernmental grants are similar in nature, the same is true for tax-sharing arrangements, as discussed in, among others, Rodden (2003[6]) and Stehn and Fedelino (2012[7]). While both tax sharing and intergovernmental grants share the problem of transfer dependency, the equalisation effect of tax sharing is not necessarily better than that of intergovernmental grants, because the main objective of the former is not fiscal equalisation across jurisdictions. Therefore, from both efficiency and equity points of view,

it is not clear whether local taxes are better than intergovernmental grants as a source of local revenue if "local taxes" are shared taxes.

In the same vein of local taxes and shared taxes, a simple premise that general grants are better than earmarked grants as a source of local revenue is not helpful in practice since both general grants and earmarked grants have their own merits and demerits in terms of efficiency and equity of fiscal resource allocation. In the case of health care, for example, many countries in Europe and elsewhere rely on a scheme of earmarked grants in one way or another. The same is also true for education. For example, the central government in England switched in 2006 from general grants to earmarked (ring-fenced) grants as a means of supporting schools.

Italy pushed for fiscal federalism with the constitutional reform in 2001 and sought to give regional and local governments greater fiscal autonomy with respect to revenue and expenditures. A noticeable aspect of the 2001 Italian constitution is that it introduced the concept of "essential level of services" for important public services such as health and education for which the central government calculates the standard cost corresponding to the essential level. In order to meet the requirement to guarantee the essential level of health and education, the Italian government has introduced a system of earmarked grants.[5] Thus, even after Italy pushed for fiscal decentralisation, the role of earmarked grants became, in a sense, even stronger depending on the nature of public services.

Korea is another case where earmarked grants play an important role in supporting essential public services. Elementary and secondary education in Korea, arguably the most successful policy of Korea, has long been strongly supported by the central government with a system of categorical block grants (earmarked grants). The Nordic countries (Denmark, Finland, Norway and Sweden) pushed for a large-scale fiscal reform in the early 1990s and consolidated many specific grants into a system of general grants. However, the amount of specific grants has steadily increased since the 1990s in these countries and is not negligible compared to that of general grants. A more detailed discussion on this is found in the section "Country cases".

In sum, when so-called local taxes are actually shared taxes, as in the case for many countries in Europe, Asia and Latin America, a simplistic premise (such as inferred from the European Charter) in designing the structure of local revenue needs careful consideration. In particular, the soft budget constraint problem pertains not only to intergovernmental grants but also to so-called local taxes in many countries. Similarly, as to the choice between general grants and earmarked grants as a desirable source of local revenue, a simplistic answer is not readily available. In this regard, Smart and Bird (2010[8]) note that "the limited role of matching grants to address spillovers from the Pigouvian perspective explains neither the number and importance of earmarked grants nor the changes observed over time in different countries in the importance of earmarking. Nor does it explain the extensive use of categorical block grants and closed-ended matching grants which do not as a rule affect spending choices directly, as the Pigouvian argument requires." Therefore, as Oates (2008[9]) emphasises, what needs to be focused on in the debates on intergovernmental fiscal relations is its "design and operation" in a country-specific policy environment rather than the application of simple rules.[6]

Among OECD countries, the case of the United States stands out in its overwhelming use of conditional or earmarked grants in transfers from the federal government, precisely the opposite of the premise of the European Charter. On the one hand, US evidence shows that conditions have been crucial in attaining the sought-after policy results when other instruments proved insufficient, such as with interstate transportation regulations. On the

other hand, numerous conditions have proved very difficult, most recently with education performance conditions for underperforming schools.

Additionally, although the European Union does not fit neatly into the fiscal federalism literature, its experience as a supra-national entity making conditional grants to national and subnational governments is relevant. Through its structural funding and reform support programmes, the European Commission seeks to enhance local capacity as well as promote national governments' structural reforms (Berkowitz, 2017[10]; OECD, 2018[11]; Dolls et al., 2019[12]). While the evidence on the grants' success remains controversial, the European Commission's role in making direct fiscal transfers is an important additional government actor to consider when addressing the design of grants.

In the next section, two prominent issues regarding intergovernmental fiscal relations will be discussed. First, the relationship between the size of subnational debt and the degree of local government autonomy (or the degree of fiscal decentralisation) will be examined. As previously discussed, it is often argued that the soft budget constraint problem is expected to occur more in countries where local governments are less independent and rely more on the central government's financial support. However, among OECD countries, federal countries where subnational governments are supposed to be more independent than those in unitary countries tend to have more serious subnational debt problems. This implies that the role of intergovernmental relations (a broader issue of institutions and political system) plays a critical role in the determination of subnational debt in comparison to the structure of local revenues (such as the size of local tax revenue or the degree of transfer dependency).

In the third section, the often-confused concepts of vertical fiscal gap (VFG) and vertical fiscal imbalance (VFI) are discussed. In much of the literature on fiscal decentralisation, the level of the VFG (intergovernmental transfers plus local borrowing) is often the metric that measures subnational revenue inadequacy. However, as recently discussed by Boadway and Eyraud (2018[13]), the VFG is a descriptive measure and does not in itself have any policy implications. On the other hand, the VFI refers to subnational revenue inadequacy, which causes such problems as inadequate public services, wasteful spending, persistent subnational debt, etc. However, as in the case of subnational debt, what is important to note in the case of the VFI is that it is created for various reasons that are in turn a function of the institutions of intergovernmental relations. In particular, almost every country has its own unique situation (via their constitution, laws, political system, informal traditions, etc.) that gives rise to the causes of VFI. Because of the complicated nature of the VFI, simply emphasising the importance of "own source local revenue" is often impractical and even counter-productive. In this regard, Watts's observation is worth noting: "Different combinations of interacting factors tend to require their own distinctive processes for adjusting intergovernmental financial relations. Technical, financial solutions that do not take account of how they interact with the social, economic, political and constitutional context have therefore, in practice, tended to be counter-productive." (Watts, 2000, p. 372[14]).

From a theoretical point of view, the reason why there is not a clear dividing line between different sources of local revenue, as well as the reason why the role of intergovernmental relations is an important factor in determining the level of subnational debt and the VFI is that, in many countries, local taxes are not local taxes in the sense of Tiebout (1956[15]), while the division of responsibilities among different levels of government is not consistent with the "decentralisation theorem" of Oates (1972[16]).

Regarding this point, Bird and Slack (2014, p. 43[17]) observe that "if one aim of policy is to ensure that the public sector operates efficiently, it is important to establish as clear a linkage between expenditure and revenue decisions as possible – to strengthen what Breton (1996[18]) calls the "Wicksellian Connection".[7] Having emphasised the importance of establishing the sound principle of local public finance implied by the models of Tiebout (1956[15]) and Oates (1972[16]), Bird and Slack then note that "theory and practice are far apart" (Bird and Slack, 2014, p. 45[17]). They further note that "in reality, decisions on the two sides of the local budget are usually made independently, often with relatively little local input, while both local expenditures and taxes often being largely determined by central authorities" (Bird and Slack, 2014[17]).

A key reason why the principle of the Wicksellian Connection does not hold in the area of local public finance is that, in many countries (both developed and developing), redistributive – "essential" as expressed in the Italian constitution – public services such as health, education, and social services are delivered by subnational governments. In this regard, the amount of revenue required to provide these redistributive services is much higher than that required for the types of local public goods considered by Tiebout (such as roads, parks, sewers, etc.). Given that there is a clear limit for "benefit taxes" to raise the significant amount of revenue required for redistributive public services (especially health and education), it is not surprising that, in many countries, shared taxes and intergovernmental transfers are an important source of subnational revenue. Recently, Boadway and Tremblay (2012[19]) reassessed the relevance of the Tiebout model as the theoretical framework used to explain the structure of local public finance, and made the following observation:

> *In the Tiebout–Musgrave–Oates tradition, expenditure assignment was based on the principle that state governments should be responsible for state public goods, and revenue assignment was based on the benefit principle. ... When we observe the reality of state fiscal structures – and local ones in unitary nations as well – these ideals are far from observed. While state governments do provide state public goods, by far their most important programs in most federations consist of quasi-private goods, social insurance and targeted transfers, including education, care for the elderly and children, health care, welfare and social services, and sometimes unemployment insurance. These programs are largely redistributive in nature. (Boadway and Tremblay, 2012, p. 1071[19])*

If we accept the premise that "subnational government expenditure-tax systems are an important part of the redistributive and social insurance fabric of the public sector", as Boadway and Tremblay (2012[19]) argue, what needs to be focused on in addressing the design of intergovernmental fiscal relations is not just the role of central-local fiscal arrangements, but also broader issues such as the political economy aspects of intergovernmental fiscal relations, and the role of co-ordination and co-operation among levels of government. These two issues are, of course, related. In their recent study of intergovernmental fiscal co-operation (IFC), Ter-Minassian and de Mello (2016[20]) emphasise that the effectiveness of IFC is affected by "economic, socio-political, and institutional factors, including constitutional provisions and power balances among different levels of government." In the same vein, Boadway and Tremblay (2012, p. 1077[19]) observe that "government decision making is inherently complex, involving political, historical and institutional factors." This view is easily confirmed when observing the impact of intergovernmental relations on the structure of local public finance in OECD countries.

In the fourth section of this chapter, how the system of intergovernmental transfers in selected countries evolves as per each country's political, historical and institutional factors will be examined. This will allow us to appreciate the importance of country-specific approaches to the design of intergovernmental fiscal relations and the importance of intergovernmental fiscal co-operation.

Subnational debt and the role of intergovernmental relations

As will be discussed in the next section, there is no clear theoretical reason why the role of intergovernmental transfers per se has to be negatively related to fiscal performance, such as the subnational debt level. This is because, in many unitary countries, the subnational debt level is tightly controlled by the central government. Yet many empirical studies find that there is a negative relationship between intergovernmental grants and fiscal performance. For example, Eyraud and Lusinyan (2013[21]) use the concept of "vertical fiscal imbalance" (VFI) as a measure of the gap between subnational governments' own revenue and spending, which is by definition intergovernmental transfers plus borrowing. Eyraud and Lusinyan's hypothesis is that large VFIs may relax fiscal discipline because "a *common view* in the normative literature is that a high reliance on intergovernmental transfers or borrowing 'softens' the budget constraint of subnational governments" (Eyraud and Lusinyan, 2013[21]). Using a sample of 28 OECD countries over 1969–2007, Eyraud and Lusinyan find that there is a statistically negative correlation between the VFI and fiscal performance (the primary balance of the general government). In another International Monetary Fund (IMF) study on vertical fiscal imbalances, Aldasoro and Seiferling (2014[22]) test whether deficit effect found by Eyraud and Lusinyan (2013[21]) will persist over time and translate into a higher level of general government debt. This study argues that, in the literature on fiscal federalism [such as Boadway and Tremblay (2006[23]) and Oates (2006[24])], VFI is identified as "transfer dependency".[8] They adopt the same definition of VFI as in Eyraud and Lusinyan (2013[21]) and find a statistically significant relationship between the levels of VFI and general government debt.

Besides these studies, there are many other studies on the effect of VFI ("transfer dependency") on economic and fiscal performance. Karpowicz (2012[25]) conducts country case studies on the institutional changes that induced a decline in the VFI – again defined as the share of subnational own spending not financed through own revenues – and finds that a declining VFI generally – not necessarily significantly – coincided with improved fiscal performance in countries such as Belgium, Italy, Norway and Spain. In an empirical study on the relationship between vertical fiscal imbalance and regional disparities, Bartolini, Stossberg and Blöchliger (2016[26]) find that the VFI is associated with larger regional disparities. In an early empirical study on the vertical fiscal imbalance, Rodden (2002[4]) defines VFI as "transfers as a percent of total subnational revenue" and finds that more transfer-dependent subnational sectors are likely to run larger long-term deficits. Another early study on the VFI, Rodden, Eskeland and Litvack (2003[27]), provides in-depth discussions of both theoretical and empirical aspects of the VFI. This study explains the problem of transfer dependency (VFI) by noting that "systems of transfers and revenue sharing cause inefficient responses that are not foreseen in textbooks", and that "transfer-dependent governments face weak incentives to be fiscally responsible, since it is more rewarding to position themselves for a bailout" (p. 14[27]). This negative assessment of intergovernmental transfers is also confirmed by Oates (2008[9]) in his discussion of second-generation fiscal federalism literature: "a kind of 'transfer dependency' can easily foster expectations of expanded central assistance in times of fiscal distress" (p. 320[9]). It is worth noting, however, that although Oates offers a negative assessment of transfers

in line with second-generation fiscal federalism literature, he also emphasises that there are roles for intergovernmental transfers and therefore what is most important is "the design and operation" of systems of intergovernmental grants (Oates, 2008, p. 326[9]).

While it is true that intergovernmental grants can create transfer dependency, the literature surveyed above does not pay enough attention to the actual institutions (e.g. constitutions, laws and fiscal rules) of intergovernmental fiscal relations under which intergovernmental transfers operate. For example, tax sharing found in many OECD member countries and non-member economies (Austria, Belgium, Germany and many other countries in Eastern Europe, Asia, and Latin America) is from a theoretical point of view (but not by government accounting standard), a type of intergovernmental transfer. This is, in fact, recognised in Eyraud and Lusinyan (2013[21]). They note that tax sharing should be excluded from the calculation of "own taxes" and admit that not doing so (due to data unavailability) is the paper's main shortcoming. From this point of view, it is worth noting that, in the study on the effect of local taxing power on government size, Rodden (2003, p. 718[28]) finds that, among 18 OECD countries used for the empirical analysis, only three highly decentralised federations – Canada, Switzerland and the United States – show non-negligible local taxing power. Obviously, it is too much of a simplification to assume that all the other 15 OECD countries with a high level of transfers or tax sharing are likely to suffer from the problem of transfer dependency.

In fact, contrary to the usual assumption of the literature on transfer dependency, the data of subnational debt shows that the subnational debt problem is confined to a few highly decentralised countries. Among the top four countries with a high level of subnational debt – Canada (67.2% of GDP), Germany (26.9% of GDP), Japan (34.0% of GDP), Spain (31.8% of GDP), and the United States (31.4% of GDP)[9] – four countries (Canada, Japan, Spain and the United States) are highly decentralised countries that have relatively low levels of transfers (VFI) among OECD countries. A particularly noteworthy case is Canada. According to the Parliamentary Budget Office (PBO) of Canada, its subnational debt is not sustainable in the long run (PBO, 2018[29]). On the other hand, many countries that rely on a high level of intergovernmental transfers or tax sharing show very low levels of local debt (usually less than 5% of GDP).

As previously discussed, in many OECD countries, a large amount of intergovernmental transfers or tax sharing is employed as a source of subnational revenue. The fact that subnational governments rely on common fiscal resources also implies that constitutions and laws in those countries make it possible for strong intergovernmental fiscal co-ordination mechanisms to exist. Therefore, it is easier for the central government in these countries to impose an effective fiscal rule (such as a balanced-budget rule or a debt brake rule) on subnational governments in order to constrain subnational deficit or debt. On the other hand, in highly decentralised countries such as Canada, Switzerland and the United States, the strong independent power of subnational governments makes it difficult for central government to impose a robust fiscal rule on state governments.

A similar situation exists in Spain. After a long period of fiscal devolution, regional governments in Spain are now responsible for their own budgets, with limited intervention from central governments in regional governments' fiscal behaviour. The level of subnational debt in Spain surged after the economic crisis in 2009 but has stabilised recently with the central government's intervention to control government debt at both the central and regional levels.

These episodes indicate that subnational debt is likely to be more of a problem in highly decentralised countries where subnational governments are responsible for a large share of national tax revenue rather than in countries where central government has a relatively stronger institutional influence on both fiscal resources and fiscal behaviour of subnational governments. Of course, subnational governments in a highly decentralised country can voluntarily impose fiscal rules on themselves, as in the case of Switzerland, as discussed by Kirchgässner (2013, p. 142[30]). However, judging from the level of subnational debts in OECD countries (see Figure 3.2, later in this chapter), the problem of high subnational debt is more likely to occur in countries where subnational governments enjoy a high level of own local taxes and independent fiscal power than in countries with a high level of transfers or tax sharing, which is usually subject to intergovernmental co-ordination by constitutions and laws.

Vertical fiscal gap vs. vertical fiscal imbalance and the role of intergovernmental relations

The concepts of the vertical fiscal gap (VFG) and vertical fiscal imbalance (VFI) are often confused, as discussed by Boadway (2004[31]; 2005[32]) and Sharma (2012[33]). More specifically, the term VFI is often used as the measurement of transfer dependency and used interchangeably with the size of intergovernmental transfers.[10] For example, Eyraud and Lusinyan (2013[21]) and Aldasoro and Seiferling (2014[22]) both do not differentiate the concept of VFG and VFI and argue that the size of intergovernmental transfers, or the share of intergovernmental transfers in total local revenue, measures the extent of transfer dependency. However, Boadway (2004[31]; 2005[32]) argues that it is helpful to distinguish the need for intergovernmental transfers and the problems created by inadequate central-subnational fiscal arrangement.[11] After all, there are theoretical and practical reasons for the existence of intergovernmental grants. At the same time, intergovernmental grants operate in an imperfect environment.

In a recent paper that attempts to clarify the concepts of VFG and VFI, Boadway and Eyraud (2018[13]) define vertical fiscal gap as "the financing structure of the decentralised system, and, more specifically, the degree to which subnational governments rely on their own revenues to finance their spending responsibilities." On the concept of VFG, Boadway and Eyraud further note that "the fiscal federalism literature refers to this shortfall of subnational own-revenues relative to subnational spending as a 'vertical fiscal gap,' a term that is meant to be descriptive rather than pejorative" (Boadway and Eyraud, 2018[13]). On the other hand, a vertical fiscal imbalance is associated with a normative assessment and is defined as the situation in which "transfers to subnational authorities combined with their own revenues (and borrowing) are insufficient to finance their expenditure responsibilities."

According to these definitions, the level of intergovernmental transfers (VFG), which are derived based on the concepts of efficiency and equity of resource allocation, is not a sign of inappropriate intergovernmental fiscal relations. Rather the problems of intergovernmental fiscal relations arise when its design and operation are neither efficient nor equitable. In other words, according to the definition of Boadway, the "vertical fiscal imbalance" describes the situation where the VFG is not adequately addressed in the design of intergovernmental fiscal relations. Although the consequences of the VFI are to be borne by both central and subnational governments, Boadway and Eyraud (2018[13]) focus on the fiscal behaviour of subnational governments and suggest that the problems associated with

the VFI can be assessed based on a scoreboard of indicators such as inadequate public services, wasteful spending, persistent deficits of subnational governments, etc.

As Boadway and Eyraud (2018[13]) argue, the two concepts of the vertical fiscal gap and the vertical fiscal imbalance provide a useful and simple conceptual framework for identifying key challenges in the design of intergovernmental fiscal relations. Yet what is not explicitly discussed in Boadway and Eyraud (2018[13]) is that the concepts of VFG and VFI need to be understood in a much broader context. More specifically, in almost all countries - both developed and developing - legal and fiscal institutions (e.g. constitutions, law, fiscal rules, etc.) as well as political economy considerations are closely intertwined with the vertical fiscal gap and vertical fiscal imbalance. In this context, every country has its own unique situation, as can be inferred from the above-mentioned cases of Canada, Spain and Switzerland, and also from the country case studies of Karpowicz (2012[25]).

A different but related issue to the importance of the relationship between institutions and VFG/VFI is the heterogeneity of the composition of general government revenue and expenditures across different countries. In many OECD countries, social security funds (for health and old age pension) are a separate sub-sector of the general government. However, there are countries where social security funds do not exist as a separate sub-sector of the general government. A notable example is Canada, where health care is the responsibility of subnational governments. The share of subnational tax revenue in total national tax revenue in Canada is among the highest in the OECD, and yet state governments in Canada are burdened with the highest government debt levels. Obviously, the level of subnational own tax revenue or the size of intergovernmental transfers does not show the whole picture of intergovernmental fiscal relations of a country unless the dynamics of expenditure assignment – very often country-specific – are also understood.

A key implication of these observations is that understanding institutional adjustment and evolution in relation to the vertical fiscal gap, and the vertical fiscal imbalance is as important as the measurement and metrics of the VFG and VFI. As another example, it took almost 20 years to transform the regional income tax ("ceded tax") in Spain from a kind of tax sharing (intergovernmental transfer) into an "own tax" of regional government. The central government of Spain ceded part of the income tax to regional governments in the early 1990s, but only in 2009 did central government abolish "default" tax rates of the regional income tax so that regional governments had to proactively decide on the level of tax rates of the regional income tax. This means that, although OECD Revenue Statistics shows that the size of own tax revenue of regional governments in Spain has significantly increased since the 1990s, the level of intergovernmental transfers in Spain had remained high – from a theoretical viewpoint – until 2009 when a real reform of intergovernmental fiscal relations took place.

In sum, in conducting comparative cross-country analysis on intergovernmental fiscal relations, it is important to understand the nature of country-specific institutions of VFG and VFI. This can be done in principle by including institutional characteristics variables in the regression analysis. Nevertheless, it is often elusive and challenging for regression analysis alone to fully account for the intricate and evolving nature of institutional characteristics of intergovernmental fiscal relations. If policy makers in a country are interested in drawing policy implications on its intergovernmental fiscal relations from comparative cross-country analysis, it is necessary and desirable to have an in-depth, country-specific understanding of why and how different countries adapt their institutions of intergovernmental fiscal relations to the changing policy environment they face.

Country cases

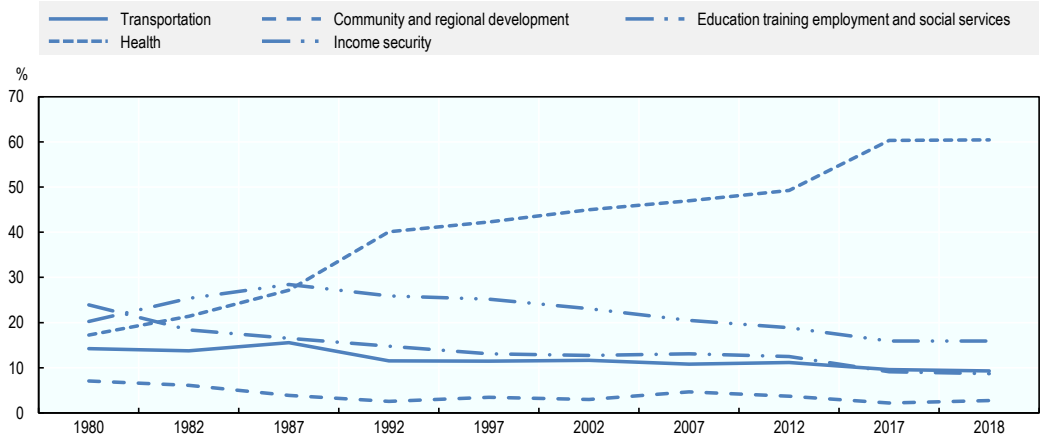
United States

As is well known in the local public finance literature, the United States does not have a system of general grants or tax sharing.[12] On the other hand, the federal government provides a wide range of specific-purpose grants to states and municipalities to financially support these governments. Therefore, the United States takes a position opposite to that of the European Charter with regard to the balance between general grants and earmarked grants [see Kim, Lotz and Mau (2010[34])].

The federal grants in the United States can be categorised broadly into two types: categorical grants and block grants. Categorical grants restrict funding to a narrow purpose (specific programmes or activities) and can be awarded either by formula or through a competitive application process. Medicaid, the National Highway Performance Program, the Children's Health Insurance Program are among the largest categorical grants. Block grants are allocated on a formula basis, are provided to a broad set of goals, and allow states and localities broad discretion in how they will meet those goals. Temporary Assistance for Needy Families (TANF), the Surface Transportation Program, and the Community Development Block Grant (CDBG) are among the largest block grants. There are almost 1 400 federal grants as of 2018, which grew from 653 in 2000 (Edwards, 2019, p. 2[35]).

The total amount of federal grants to states and municipalities in the United States was about USD 700 billion in 2018 (Office of Management and Budget, n.d.[36]). Among the various types of federal grants, grants for health care are by far the largest, occupying as much as 60% (USD 421 billion) of total grants. Income security (USD 110 billion), transportation (USD 64.8 billion) and education (USD 60.6 billion) are the next largest areas. The amount of intergovernmental grants in the United States provided for redistributive services (health, income security and education) is almost 88% of total intergovernmental grants (Figure 3.1).

Figure 3.1. Percentage of total federal grants to state and local governments in the United States, by category, 1980–2018



Source: Office of Management and Budget (n.d.[36]), "Table 12.2—Total Outlays for Grants to State and Local Governments, by Function and Fund Group: 1940–2024", Historical Tables, https://www.whitehouse.gov/omb/historical-tables/.

The structure of the US federal grants therefore confirms the previous discussion that the main purpose of intergovernmental grants is not to expand expenditures on local public goods that create spillover effects but to serve as a mechanism to effectively provide redistributive services such as health and education. Another point worth noting is the interaction between the system of intergovernmental grants and the institutions of intergovernmental relations such as mandates and legal constraints on subnational expenditures. This is documented in detail in Baicker, Clemens and Singhal (2012[37]). Their main finding is summarised in the abstract as follows:

> *We argue that the greater role of states cannot be easily explained by changes in Tiebout forces of fiscal competition, such as mobility and voting patterns, and are not accounted for by demographic or income trends. Rather, we demonstrate that much of the growth in state budgets has been driven by changes in intergovernmental interactions. Restricted federal grants to states have increased, and federal policy and legal constraints have also mandated or heavily incentivised state own-source spending, particularly in the areas of education, health and public welfare. These outside pressures moderate the forces of fiscal competition and must be taken into account when assessing the implications of observed revenue and spending patterns.*

United Kingdom

Among OECD countries, the United Kingdom is one of the most fiscally centralised countries. According to OECD Revenue Statistics, the UK share of subnational tax revenue in total tax revenue is 4.9%. This is among the lowest levels in the OECD, along with the Netherlands (3.0%) and Austria (4.6%). As can be seen in Table 3.1, in some federal countries (such as Canada, Germany, Switzerland and the United States), the subnational tax share is higher than 30%. For Australia, Spain, and three Nordic countries (Denmark, Finland, Sweden), it is above 20%. The United Kingdom has begun an ambitious reform to devolve certain taxes to its regions, in phases. If UK regions were considered to be subnational (contrary to national accounts definitions), the announced measures could eventually double the subnational revenue share, on a weighted basis.[13] Nevertheless, compared to other OECD countries, the subnational tax share in the United Kingdom remains very low.

Table 3.1. Share of tax revenue in selected OECD countries, 2017

Percentage of total revenue

Country	Federal	State/region	Local	Subnational[1]	Social security
Australia	79.5	16.9	3.6	20.5	0.0
Austria	65.8	1.6	3.0	4.6	29.2
Belgium	51.4	10.8	4.9	15.7	32.0
Canada	40.5	40.0	10.3	50.3	9.1
Germany	29.5	23.5	8.6	32.1	37.9
Spain	41.2	15.3	9.7	25.0	33.3
Switzerland	36.8	24.4	15.2	39.6	23.6
United States	44.6	18.4	13.9	32.3	23.1
Denmark	73.0		26.7	26.7	0.0
Finland	48.3		23.5	23.5	27.9
France	34.1		13.4	13.4	52.1
Italy	53.9		15.3	15.3	30.4
Japan	35.7		23.9	23.9	40.4
Korea	57.0		17.3	17.3	25.7
Netherlands	60.2		3.0	3.0	35.7
Norway	84.3		15.7	15.7	0.0
Sweden	52.1		35.4	35.4	12.1
United Kingdom	75.4		4.9	4.9	19.2

Note: 1. Following National Accounts definitions, UK regions are not considered subnational.
Source: OECD (2018[38]), *Revenue Statistics 2018*, OECD Publishing, https://doi.org/10.1787/rev_stats-2018-en.

Another aspect of local government finance in the United Kingdom is that the role of general-purpose grants is negligible. As can be seen in Table 3.2, the share of general-purpose grants (Revenue Support Grants) in total local government revenue in England is 0.66% of the 2019 budget. On the other hand, the share of specific grants in the local government revenue is 41%. Among the many specific grants provided by the central government in England, the specific grant for education – Dedicated Schools Grant (DSG) – is by far the largest, with its share close to 29%. The specific grant for police is the next largest at 7.5%.

Table 3.2. Budgeted revenue expenditure and financing in England, 2018/19 and 2019/20

GBP millions and %

	2018/19	2019/20	Percentage
Revenue expenditure	95 940	99 191	100
Financed by:			
Government grants	47 983	48 961	49.36
of which:			0.00
Specific grants inside AEF	39 406	40 827	41.16
of which:			0.00
Dedicated Schools Grant (DSG)	28 458	28 436	28.67
Pupil Premium Grant	1 364	1 282	1.29
Public Health Grant	2 991	2 933	2.96
New Homes Bonus	889	895	0.90
The Private Finance Initiative (PFI)	1 157	1 220	1.23
Other grants inside AEF	4 547	6 060	6.11
Revenue Support Grant	1 443	653	0.66
Police grant	7 120	7 481	7.54
Business rate retention	17 054	17 085	17.22
Appropriations (revenue reserves)	914	1 205	1.21
Other items	427	463	0.47
Council tax requirement	29 561	31 478	31.73

Note: AEF is Aggregate External Finance, which is the total amount of grant provided to finance all local government expenditure, excluding that subject to separate arrangements under statutory schemes, rent allowances and rebates and council tax benefit, which are funded by specific grants outside Aggregate External Finance.

Source: Ministry of Housing, Communities and Local Government (2019[39]), *Local Authority Revenue Expenditure and Financing: 2019-20 Budget, England*, UK Ministry of Housing, Communities and Local Government.

It should be noted that the currently low share of general grants in local government revenue in England is the result of the education finance reform that took place in 2006. As Table 3.3 shows, the share of general grants in local government revenue in England was about 42% (GBP 26.6 million out of total GBP 63.8 million) in 2005-06, much higher than the current level. Since the 2006-07 budget, however, the central government's support for local education changed from the system of general-purpose grants to a "ring-fenced" grant (Dedicated Schools Grant). This substantially reduced the size of general grants and increased that of specific grants in England.

Table 3.3. Central government revenue funding of local government in England, 2004-09

GBP millions

	2004-05	2005-06	2006-07	2007-08 (P)	2008-09 (B)
Revenue Support Grant[a]	**26 964**	**26 663**	**3 378**	**3 105**	**2 854**
Redistributed non-domestic rates[b]	15 004	18 004	17 506	18 506	20 506
Police Grant	4 168	4 353	3 936	4 028	4 136
Formula Grant	46 136	49 020	24 820	25 639	27 496
General Greater London Authority (GLA) Grant	36	37	38	38	48
Area Based Grant (ABG)[c]	-	-	-	-	2 731
Specific and special grants[a,c]	14 090	14 785	41 741	44 533	42 123
Of which the five largest for 2008-09: Dedicated Schools Grant (DSG)	-	-	26 321[d]	28 061	29 012
GLA Transport Grant	2 261	2 181	2 391[d]	2 521	2 663
Standards Fund[e]	2 041	2 490	3 076[d]	2 772	2 661
Supporting People Grant	1 654	1 600	1 544[d]	1 588	1 618
School Standards Grant (including Personalisation)	874	882	1 360[d]	1 428	1 459
Aggregate External Finance (AEF)	**60 262**	**63 842**	**66 599**	**70 210**	**72 398**

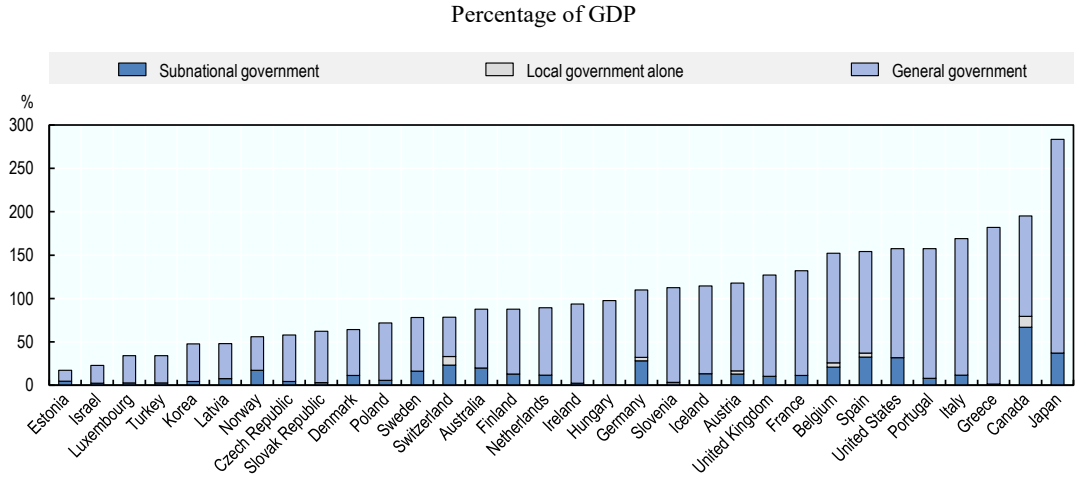
Notes:
a. Comparisons across years may not be valid due to changing local authority responsibilities and methods of funding. In particular, the large switch between the Revenue Support Grant and Specific and special grants in 2006-07 was largely due to the introduction of the Dedicated Schools Grant as a specific grant.
b. This includes the income that the City of London receives and retains from the use of its own multiplier.
c. The Area Based Grant is a new non-ring-fenced grant replacing a number of grants previously reported as specific grants inside AEF.
d. The statistical release of provisional out-turn figures for 2007-08 does not include the breakdown of individual grants, so budget figures are presented.
e. Previously called Standards Fund - Other. From 2008-09 excludes elements now in the Area Based Grant.
f. Figures are after any authorities were designated, requiring them to reset their budgets.
Source: Department for Communities and Local Government (2008[40]), *Local Government Finance Key Facts: England*, UK National Statistics Publication.

The evolution of local government finance in England shows that how to provide essential redistributive services is a key determinant of the structure of England's local government revenue. According to a document from the House of Commons Library (Jarrett, 2013[41]), which describes the background of introducing the Dedicated Schools Grant, the primary motivation for introducing earmarked education grants was the perceived failure of the school funding system before the introduction of the DSG. Before the introduction of the DSG, the Schools Formula Spending Share (SFSS) was part of a general-purpose grant (RSG) and was pooled with other public services (e.g. social services, roads) supported by RSG. In other words, local governments were free to decide how much of the general grant would be spent on education. In 2003, complaints from schools about funding shortages became a big political issue in England, and the then Secretary of State for Education promised to introduce "ring-fenced" or "dedicated" school funding. According to the White Paper that proposed the introduction of the DSG, the then Department for Education and Skills announced that "Local Authorities will not be able to divert this spending for other purposes [because of ring-fencing]" (Jarrett, 2013, p. 4[41]). As in the case of the United States, the evolution of local government finance in England also confirms that it is important to understand the importance of redistributive public services in affecting the structure of intergovernmental fiscal relations.

Canada

Canada is one of the most fiscally decentralised countries in the world. The share of subnational tax revenue in Canada is above 50%, which is the highest among OECD countries (Table 3.1). However, the size of subnational debt in Canada is also the highest among OECD countries. As seen in Figure 3.2, the size of subnational debt in federal/regional countries (Belgium, Germany, Spain, Switzerland, United States) and in some unitary countries (Japan, Norway) is relatively large. The size of subnational debt as a share of central government debt in Canada stands out.

Figure 3.2. The share of subnational debt in selected OECD countries, 2015



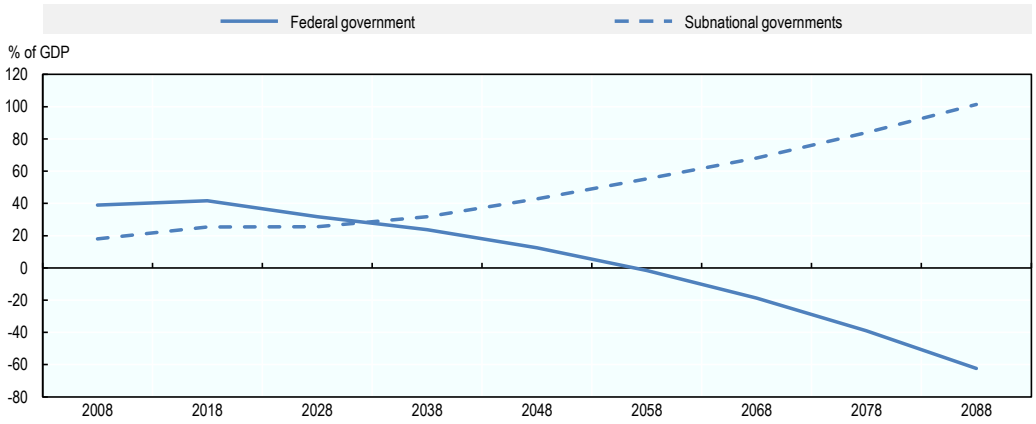
Note: The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.
Source: OECD (2017[42]), "9. SNG budget balance and debt", *OECD.Stat*, Regions and Cities, Subnational Government Structure and Finance, http://stats.oecd.org/.

The reason why subnational governments in Canada have accumulated such a large amount of debt is due to their high level of expenditure responsibilities. As seen in Figure 3.1, the share of subnational expenditure in Canada is by far the highest among OECD countries, at close to 75%. The vertical fiscal gap, which is about 25% of total subnational expenditure, is filled by three types of intergovernmental transfers: The Canada Health Transfer (CHT), the Canada Social Transfer (CST), and the Equalisation and Territorial Formula Financing. The CHT is an earmarked grant for health and is the second-largest federal budget item (about CAD 38. 6 billion in the 2018 budget), behind elderly benefits. The CST is a transfer to provinces in support of social services, early childhood development and post-secondary education. It was about CAD 14 billion in the 2018 budget. The amount of equalisation transfers was about CAD 19 billion.[14] While CHT is an earmarked grant for health, CST is a block grant that is distributed to provinces on a per capita cash basis.

Although the federal government in Canada provides a sizable amount of transfers to subnational governments – close to 22% of the federal budget in 2018 – subnational governments in Canada are still accumulating a large amount of debt. In fact, according to the Parliamentary Budget Office (PBO) of Canada, subnational governments' net debt relative to gross domestic product (GDP) is expected to continuously rise to the point of

unsustainability. This is in sharp contrast with the federal government fiscal situation, which is expected to continuously improve (Figure 3.3).

Figure 3.3. Government net debt relative to GDP, Canada, 2008-88



Source: PBO (2018[29]), *Fiscal Sustainability Report 2018*, Parliamentary Budget Office, Ottawa, Canada, https://www.pbo-dpb.gc.ca/en/blog/news/fsr_september_2018.

The large size of vertical fiscal gap and the contrasting fiscal situations of the federal government and subnational governments in Canada indicate that it is possible that the vertical fiscal gap is not adequately filled. Discussing the policy issues of the vertical fiscal gap and the vertical fiscal imbalance in Canada, Boadway (2004, p. 7[31]) remarks that "a VFI exists if the level of transfers is not consistent with the division of revenue raising, given expenditure responsibilities" and recommends that "the imbalance that exists between the federal government and the provinces should be addressed by an increase in transfers from the federal government to the provinces" (Boadway, 2004, p. 14[31]).

Boadway's recommendation dates back to 2004 but his view seems even more relevant now. As seen in Figure 3.3, the subnational net debt in Canada has been around 20-30% of GDP for the past decade but is forecast to steadily increase over the coming decades and reach almost 60% of GDP around 2050. The Canadian PBO indeed predicts that "for the subnational government sector as a whole, current fiscal policy is not sustainable over the long term" (PBO, 2018, p. 25[29]).

The main reason why the PBO of Canada forecasts an increasingly large subnational debt is two-fold. As in many other countries, the ageing process is putting increasing cost pressures on health care. In addition, according to the diagnosis of the Canadian PBO, the federal CHT contributions to provincial and territorial health care spending declines significantly over time since the federal CHT envelope is limited to growth in nominal GDP.

According to the Advisory Panel on Fiscal Imbalance (2006[43]), this situation was predicted a decade ago. At that time, the Advisory Panel forecast that health care spending would increase to 52.6% of provincial revenues in 2024-25 compared to 37.0% in 2005-06, due to ageing and a growing population, and higher inflation rates for health care costs (Advisory Panel on Fiscal Imbalance, 2006, p. 64[43]). To avoid the fiscal unsustainability of subnational debt, the Advisory Panel recommended measures such as a more transparent system of intergovernmental grants, an increase in the amount of CHT and CST, and greater

stability of CST transfer arrangements. However, it is worth noting that the Advisory Panel put a much stronger emphasis on the importance of intergovernmental process:

> *Above and beyond the equalisation program, or federal fiscal transfers to the provinces, or the territorial financing arrangements for Canada's three territories, there is an issue that is even more important for the long-term health of the federation – namely, the intergovernmental process by which these matters are decided. (Advisory Panel on Fiscal Imbalance, 2006, p. 89[43])*

In addition, although it should be borne in mind that the Advisory Panel represents the view of the Council of the Federation, its criticism of the intergovernmental relations in Canada is rather harsh: "It is the Panel's view that there is a flaw in the design of the Canadian federal system that this country's governments should take steps to correct. At its core, we have a governance problem: the institutions and processes we use to manage the fiscal arrangements of the Canadian federation are inadequate to the task, and they are a good deal weaker than those of almost every other modern federation in the world."

The challenges of intergovernmental fiscal relations Canada is faced with demonstrating that, as in the case of the United States and the United Kingdom, the provision of essential public services such as health, education and social services is a key obstacle in the design of intergovernmental fiscal relations. The case of Canada is particularly interesting because its subnational tax share is the largest among OECD countries, and its subnational debt burden is also the greatest. The size of earmarked grants in Canada also increased significantly in 2004 when Canada Health and Social Transfer (CHST) was split into an earmarked grant for health (CHT) and a block grant for education and social expenditure (CST) (as mentioned above). According to the Department of Finance Canada, the motivation for creating an earmarked health grant was to improve accountability and transparency for federal health funding.[15] As in the case of the Dedicated Schools Grants in England, the importance of earmarked grants has recently increased in Canada as well.

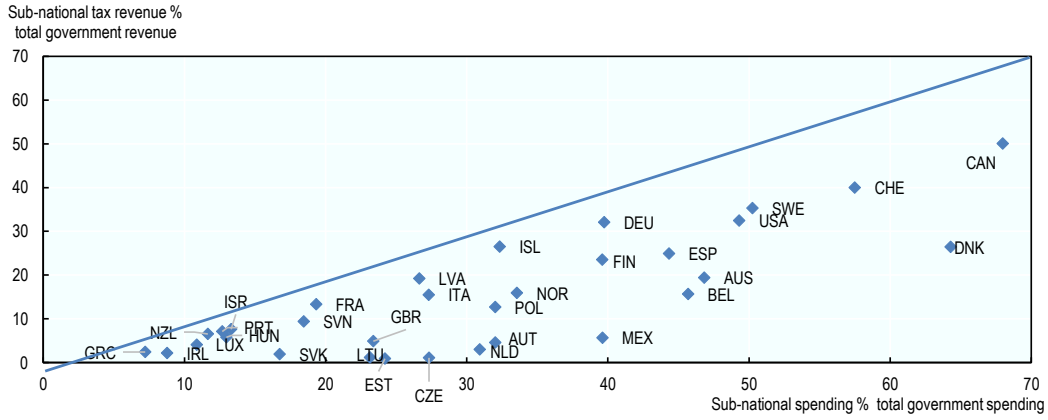
In sum, the combination of the high subnational tax share and subnational debt in Canada indicates that a high level of subnational tax share does not necessarily imply a high level of fiscal decentralisation, in the sense that subnational governments enjoy a high level of fiscal autonomy (i.e. independent decision making on subnational expenditures and corresponding subnational tax burden). Despite the high level of fiscal decentralisation, subnational governments in Canada are accumulating a large amount of debt, and the reason for this is that they are responsible for key redistributive public services such as health, education and social services. In turn, the reason why subnational governments in Canada are responsible for these key public services is political (constitutional), historical and institutional. Therefore, there is a clear limitation in finding the answers to the challenges of vertical fiscal imbalances in Canada through the Tiebout–Musgrave–Oates framework.

Sweden

Sweden is one of the most fiscally decentralised countries in the OECD. As shown in Table 3.1, the share of local tax revenue in Sweden is 35.4%, the highest among unitary OECD countries. Even among federal OECD countries, it is the third highest, following Canada (50%) and Switzerland (39. 6%). On the expenditure side, the local expenditure share in Sweden is around 50% (Figure 3.4). As of 2018, total local revenue (i.e. the total revenue of municipalities and county councils) was SEK 1.122 billion, which consists of operating revenue (SEK 228 billion), tax revenue (SEK 724 billion), economic equalisation and general grants from central government (SEK 154 billion), and financial revenue (SEK 17

billion).[16] Therefore the shares of local taxes, grants, financial revenue, and operating income in total local revenue were, respectively, 64.5%, 14%, 1.5%, and 20%.[17]

Figure 3.4. Shares of subnational expenditure and revenue in selected OECD countries, 2018



Source: OECD Fiscal Decentralisation database, http://oe.cd/FFdb.

Statistics Sweden does not publish the amount of specific grants received by local governments. According to alternative sources, general grants accounted for 12% of local revenue, and specific grants around 7%, as of 2014 (SKL International, 2014, p. 50[44]). These figures imply that the share of general grants in total grants is roughly 65%. Thus, compared to the United States, England and Canada, general grants in Sweden play a more important role than specific grants.

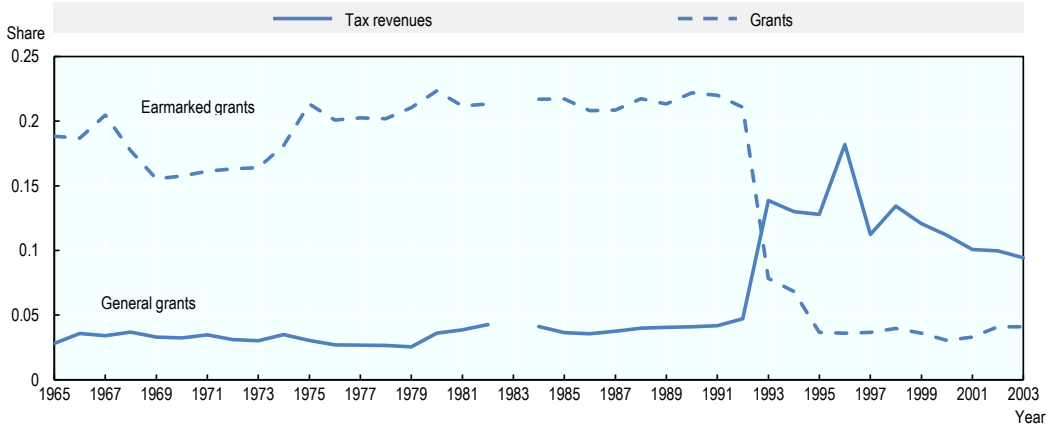
Given the fact that local taxes are the most important source of local government revenue, and intergovernmental grants are given in the form of general grants, it seems natural to argue that Sweden is one of the most fiscally decentralised countries, with strong local government fiscal autonomy. However, this interpretation should be made with caution. In particular, fiscal decentralisation in Sweden hardly fits into the Tiebout–Musgrave–Oates framework. There are two main reasons for this. First, from a constitutional point of view, Sweden is a unitary country, and all power rests in the central government.

Moreover, the Instrument of Government (the Swedish Constitution) stipulates that the principles of local self-government are laid down in law, e.g. enacted in the Parliament. With a large amount of fiscal resources provided by the central government, local governments in Sweden provide redistributive public services such as health, education, and social services, which account for more than 75% of local government expenditure there.[18] Yet under the constitutional rule, "a range of acts and regulations such as the Social Services Act, the Planning and Building Act, the Education Act and the Health and Medical Services Act set out the specific functions along with detailed regulations that local authorities must follow in exercising their responsibilities" (SKL International, 2014[44]). Thus, the large local expenditures in Sweden are not the result of the autonomous decision making of local governments. This is certainly not the role of local governments investigated in the tradition of Tiebout–Musgrave–Oates models.

Another aspect of intergovernmental fiscal relations in Sweden is the evolution of the intergovernmental grants system. When Sweden was struck by the economic crisis in the early 1990s, it pursued significant economic and fiscal reforms. One reform was to consolidate many specific grants. According to Dahlberg (2010[45]), the earmarked grants

made up about 20% of the municipalities' total revenues, and the corresponding figure for general grants was less than 5% between 1965 and 1992. However, specific grants were consolidated in a system of general grants in the 1993 fiscal reform. The result was a dramatic shift in the ratio of general and specific grants, as shown in Figure 3.5. This can be interpreted to follow the recommendation of the Article 9 of the EU Charter: "Transfers to subnational governments should be in the form of general-purpose grants." However, it should also be noted that the reform of the intergovernmental grants system in 1993 was accompanied by a dramatic reduction of total grants to local governments. As can be seen in Figure 3.5, total intergovernmental grants accounted for about 25% of local government revenue before 1993. However, it was reduced to around 20% in 1993 at the same time that the consolidation of specific grants took place. By 2003, the total amount of intergovernmental grants was reduced to 15% of local government revenue – a 10 percentage point decrease in local revenue in 10 years.

Figure 3.5. Grants as the share of municipalities' total revenues, Sweden, 1965-2003



Source: Dahlberg (2010[45]), "Local government in Sweden", in Moisio, Antti (ed.), *Local Public Sector in Transition: A Nordic perspective*, VATT (Government Institute for Economic Research), Helsinki, pp. 122-154.

The history of the intergovernmental grants reform in Sweden in the 1990s provides another example of the importance of understanding the institutional background of intergovernmental fiscal relations. Given that local governments in Sweden provide redistributive public services regulated by central government's laws and regulations, it cannot be simply said that the primary purpose of the consolidation of specific grants into a general grant system in Sweden was to enhance fiscal autonomy itself. After all, the constitution of Sweden clearly stipulates that local governments must follow laws (enacted by the central government) in exercising their responsibilities. Therefore, the shift of the balance between specific grants and general grants in Sweden after the 1993 reform has to be interpreted as the enhancement of local autonomy to meet the fiscal policy objective of enhancing the equity and efficiency of public services delivery. This view is supported by the fact that the local government fiscal reform took place in the nationwide response to the economic crisis in the early 1990s. On the other hand, this kind of co-ordinated response to an economic shock will not be easy for many countries to follow, as they do not have long-established institutions for intergovernmental co-ordination.

Conclusion

The central-local fiscal arrangement has important implications for the fiscal performance of a country. This is because subnational governments are responsible for the provision of essential redistributive public services such as health, education and social services. The challenges arising from the need to co-ordinate across levels of government for the provision of redistributive public services are not easily analysed with the traditional Tiebout–Musgrave–Oates framework. This is because the provision of essential public services is regulated by constitutions and laws, and is heavily influenced by national politics and the history of decentralisation. The international comparative studies and the benchmarking of best practices of other countries are helpful for appreciating the diversity of these challenges. However, it will be most beneficial when quantitative metrics such as the local tax share, the size of own revenue and the composition of intergovernmental grants are interpreted while understanding the institutions of intergovernmental relations in each country.

References

Advisory Panel on Fiscal Imbalance (2006), *Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance*, Council of the Federation, Ottawa. [43]

Aldasoro, I. and M. Seiferling (2014), "Vertical Fiscal Imbalances and the Accumulation of Government Debt", *IMF Working Paper*, No. 14/209, International Monetary Fund, Washington, DC. [22]

Baicker, K., J. Clemens and M. Singhal (2012), "The Rise of the States: US Fiscal Decentralization in the Postwar Period", *Journal of Public Economics*, Vol. 96/11-12, pp. 1079-1091. [37]

Bartolini, D., S. Stossberg and H. Blöchliger (2016), "Fiscal Decentralisation and Regional Disparities", *OECD Economics Department Working Papers*, No. 1330, OECD Publishing, Paris, https://dx.doi.org/10.1787/5jlpq7v3j237-en. [26]

Berkowitz, P. (2017), *Conditionalities for More Effective Public Investment*, https://www.oecd.org/cfe/regional-policy/Berkowitz_Conditionalities-for-More-Effective-Public.pdf. [10]

Blöchliger, H. and O. Petzold (2009), "Finding the Dividing Line Between Tax Sharing and Grants: A Statistical Investigation", *OECD Working Papers on Fiscal Federalism*, No. 10, OECD Publishing, Paris, https://dx.doi.org/10.1787/5k97b10vvbnw-en. [5]

Boadway, R. (2004), "Should the Canadian Federation be Rebalanced?", *Economic Policy Research Institute Working Papers*, No. 20041, University of Western Ontario, Ontario. [31]

Boadway, R. and L. Eyraud (2018), "Designing Sound Fiscal Relations Across Government Levels in Decentralized Countries", *IMF Working Paper*, No. 18/271. [13]

Boadway, R. and J. Tremblay (2012), "Reassessment of the Tiebout model", *Journal of Public Economics*, Vol. 96/11, pp. 1063-1078. [19]

Boadway, R. and J. Tremblay (2006), "A Theory of Vertical Fiscal Imbalance", *FinanzArchiv*, Vol. 62, pp. 1-27. [23]

Breton, A. (1996), *Competitive Governments Cambridge: An Economic Theory of Politics and Public Finance*, Cambridge University Press, Cambridge. [18]

Breton, A. and A. Fraschini (2007), "Competitive Governments, Globalization, and Equalization Grants", *Public Finance Review*, Vol. 35/4, pp. 463–479. [49]

Council of Europe (1988), *European Charter of Local Self-Government*, Council of Europe, Strasbourg, https://www.coe.int/en/web/congress/european-charter-of-local-self-government. [47]

Department for Communities and Local Government (2008), *Local Government Finance Key Facts: England, UK National Statistics Publication*. [40]

Dolls, M. et al. (2019), *Incentivising Structural Reforms in Europe? A Blueprint for the European Commission's Reform Support Programme*, European Network of Economic and Fiscal Policy Research, https://www.econpol.eu/sites/default/files/2019-02/EconPol_Policy_Brief_14.pdf. [12]

Edwards, C. (2019), *Restoring Responsible Government by Cutting Federal Aid to the States*, Cato Institute, Washington DC. [35]

Eyraud, L. and L. Lusinyan (2013), "Vertical Fiscal Imbalances and Fiscal Performance in Advanced Economies", *Journal of Monetary Economics*, Vol. 60, pp. 571-587. [21]

Jarrett, T. (2013), *School funding: 2006–2010 policy changes under the Labour Government*, House of Commons Library. [41]

Karpowicz, I. (2012), "Narrowing Vertical Fiscal Imbalances in Four European Countries", *IMF Working Paper*, International Monetary Fund, Washington, DC. [25]

Kim, J., J. Lotz and N. Mau (eds.) (2010), *Earmarked Grants and Accountability in Government*, KIPF Korea Institute of Public Finance, Seoul and Danish Ministry of Interior and Health, Copenhagen. [8]

Kim, J., J. Lotz and N. Mau (eds.) (2010), *General Grants Versus Earmarked Grants - Theory and Practice: The Copenhagen Workshop 2009*, Korea Institute of Public Finance, Seoul and Danish Ministry of Interior and Health, Copenhagen. [34]

Kim, Lotz and Mau (eds.) (2014), *Local Taxes And Local Expenditures: Strengthening the Wicksellian Connection*, Korea Institute of Public Finance, Seoul and the Danish Ministry of Economic Affairs and the Interior, Copenhagen. [17]

Kim, Lotz and Mau (eds.) (2010), *Conditional intergovernmental transfers in Italy after the constitutional reform of 2001*, Korea Institute of Public Finance, Seoul and the Danish Ministry of Interior and Health, Copenhagen. [48]

Kirchgässner, G. (2013), "Fiscal Institutions at the Cantonal Level in Switzerland", *Swiss Society of Economics and Statistics*, Vol. 149/2, pp. 139-166. [30]

Lazar, H. (ed.) (2005), *The Vertical Fiscal Gap: Conceptions and Misconceptions*, McGill-Queen's Press, Montreal. [32]

Lazar, H. (ed.) (2000), *Federal Financial Relations: A Comparative Perspective*, McGill-Queen's University Press, Montreal and Kingston. [14]

McLure, C. (2001), "The tax assignment problem: Ruminations on how theory and practice depend on history", *National Tax Journal*, Vol. 52, pp. 339-364. [2]

Ministry of Housing, Communities and Local Government (2019), *Local Authority Revenue Expenditure and Financing: 2019-20 Budget, England*, UK Ministry of Housing, Communities and Local Government. [39]

Moisio, A. (ed.) (2010), *Local government in Sweden*, VATT (Government Institute for Economic Research), Helsinki. [45]

Oates, W. (2008), "On the Evolution of Fiscal Federalism: Theory and Institutions", *National Tax Journal*, Vol. 61, pp. 313-334. [9]

Oates, W. (2006), "On the Theory and Practice of Fiscal Decentralization", *IFIR Working Papers* No. 2006–05. [24]

Oates, W. (1972), *Fiscal Federalism*, Harcourt, Brace, Jovanovich, New York. [16]

OECD (2018), *OECD Regions and Cities at a Glance 2018*, OECD Publishing, Paris, https://dx.doi.org/10.1787/reg_cit_glance-2018-en. [46]

OECD (2018), *Rethinking Regional Development Policy-making*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264293014-en. [11]

OECD (2018), *Revenue Statistics 2018*, OECD Publishing, Paris, https://dx.doi.org/10.1787/rev_stats-2018-en. [38]

OECD (2017), "9. SNG budget balance and debt", *OECD.Stat*, http://stats.oecd.org/ (accessed on 9 March 2020). [42]

Office of Management and Budget (n.d.), *Table 12.2—Total Outlays for Grants to State and Local Governments, by Function and Fund Group: 1940–2024*, https://www.whitehouse.gov/omb/historical-tables/. [36]

PBO (2018), *Fiscal Sustainability Report 2018*, Parliamentary Budget Office, Ottawa, Canada, https://www.pbo-dpb.gc.ca/en/blog/news/fsr_september_2018. [29]

Rodden, J. (2003), "Reviving Leviathan: Fiscal Federalism and the Growth of Government", *International Organization*, Vol. 57, pp. 695-729. [6]

Rodden, J. (2002), "The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World", *American Journal of Political Science*, Vol. 46/3, pp. 670–687. [4]

Rodden, J., G. Eskeland and J. Litvack (eds.) (2003), *Fiscal Decentralization and The Challenge of Hard Budget Constraints*, MIT Press, Cambridge, MA. [27]

Rodden, J., G. Eskeland and J. Litvack (eds.) (2003), *Soft Budget Constraints and German Federalism*, MIT Press, Cambridge, MA. [28]

Sharma, C. (2012), "Beyond Gaps and Imbalances: Restructuring the Debate on Intergovernmental Fiscal Relations", *Public Administration*, Vol. 90/1, pp. 99-128. [33]

SKL International (2014), *Local Government in the Nordic and Baltic Countries*. [44]

Stehn, S. and A. Fedelino (2012), *Fiscal Incentive Effects of the German Equalization System*, International Monetary Fund, Washington, DC. [7]

St-Hilaire, F. (2005), *Fiscal Gaps and Imbalances: The New Fundamentals of Canadian Federalism*, The Institute of Intergovernmental Relations, Queen's University. [50]

Ter-Minassian, T. and L. de Mello (2016), *Intergovernmental Fiscal Cooperation*, Inter-American Development Bank (IDB), Washington, DC. [20]

Tiebout, C. (1956), "A Pure Theory of Local Expenditures", *The Journal of Political Economy*, Vol. 64/5. [15]

Watts, R. and P. Hobson (2000), *Fiscal Federalism in Germany*, Institute of Intergovernmental Relations, Queen's University Kingston, Ontario. [3]

Wildasin, D. (2004), "The Institutions of Federalism: Toward an Analytical Framework", *National Tax Journal*, Vol. 57/2, pp. 247-72. [1]

Notes

1. In this chapter, the terms "local" and "subnational" are used interchangeably.
2. See Kim, Lotz and Mau (2010[34]) for an extensive discussion on grant types.
3. "Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers." (Council of Europe, 1988[47])
4. "As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction." Council of Europe (1988[47]), Article 9(7).
5. See Brosio and Piperno (2010[48]) for an explanation of Italy's system of education grants.
6. "[T]he design and operation of systems of intergovernmental grants in a political setting is an issue of the first priority in fiscal federalism; we need to devote more attention to it." (Oates, 2008, p. 326[9]).
7. Breton defines Wicksellian Connection as "a link between the quantity of a particular good or service supplied by centres of power and the tax price that citizens pay for that good or service." (Breton and Fraschini, 2007, p. 466[49])
8. As will be discussed below, Boadway and Tremblay (2006[23]) clearly differentiate the concepts of VFI and transfer dependency.
9. For more information, see OECD Regions and Cities at a Glance (OECD, 2018[46]).

10. Boadway (2005[32]) notes, "the terms 'vertical fiscal gap' (VFG) and 'vertical fiscal imbalance' (VFI) have been used in various contexts, often interchangeably. They seem to mean different things to different persons. For our purposes, it is useful to refer to them as distinct concepts. The traditional meaning of a VFG comes from the fiscal federalism literature."

11. See also St-Hilaire (2005[50]) and Advisory Panel on Fiscal Imbalance (2006[43]).

12. General grants (General Revenue Sharing) existed in the United States from 1972 through 1986. They were provided to states and localities to support "priority expenditures" such as public safety, environmental protection, public transportation, health, recreation, libraries, social services for the poor or aged and financial administration.

13. A summary of announced measures is at www.instituteforgovernment.org.uk/explainers/tax-and-devolution.

14. For more information, see Department of Finance Canada, Federal Support to Provinces and Territories (www.fin.gc.ca).

15. "The 2003 First Ministers' Accord established an enhanced accountability framework under which all governments committed to provide comprehensive and regular reports to Canadians based on comparable indicators relating to health status, health outcomes, and quality of service"; for more information, see https://www.fin.gc.ca/fedprov/fihc-ifass-eng.asp.

16. For more information, see Statistics Sweden (https://www.scb.se/en/).

17. The operating income of the Swedish local governments consists of charges and fees for local services provided such as child, elderly and health care, rents, site leaseholds, etc. It also includes certain kinds of government grants (for example, grants for refugees).

18. Social protection accounted for 27.6%, health for 26.7%, and education for 21.0%. For more information, see World Observatory on Subnational Government Finance and Investment (www.sng-wofi.org).

Chapter 4. Subnational capacity building: An international perspective of the Asia Pacific region

by Dorothée Allain-Dupré, Isabelle Chatry and Louise Phung

This chapter provides an overview of decentralisation trends and challenges in the Asia-Pacific region, and the enabling conditions that support subnational capacity building. The subnational landscape in the Asia-Pacific region is highly diverse when looking at territorial organisation, decentralisation patterns, subnational finances and capacities. Since the 1990s, decentralisation reforms have been carried out in many Asia-Pacific countries, transferring responsibilities and fiscal resources to subnational governments. These reforms translated into high fiscal decentralisation indicators – above world averages – but several bottlenecks to effective multi-level governance remain. Unclear assignments of responsibilities across levels of government and weak fiscal decentralisation are the most prominent challenges. The chapter provides an international perspective on the enabling conditions that support subnational capacity building, a key condition for decentralisation systems to work more effectively.

This chapter was prepared for the 2nd KIPF-OECD-ADB Roundtable of the Network on Fiscal Relations in Asia (RoNFRA). It builds on the OECD work *Making Decentralisation Work: a Handbook for Policy-Makers* and on data from the OECD/UCLG World Observatory on Subnational Finance and Investment.

Introduction

Decentralisation has increased around the world in recent decades, according to fiscal and institutional indicators (OECD/UCLG, 2019[1]). Decentralisation refers to the transfer of powers and responsibilities from the central government level to elected authorities at the subnational level, having some degree of autonomy. Decentralisation is also about reconfiguring the relationships between the central government and subnational governments towards more co-operation and a more strategic role for national/federal governments. Decentralisation is a multi-dimensional concept, covering three distinct but inter-related dimensions: the fiscal, administrative and political.

In Asia, many countries started to decentralise after the 1990s and decentralisation started to figure among the most prominent public reforms. Like in all regions of the world, there is considerable heterogeneity among countries in Asia Pacific in terms of the level and types of decentralisation. There are also common features, linked to some common characteristics of the region in terms of fast urbanisation, megacities, high population growth and diverse territorial organisation. These dimensions have an impact on the way decentralisation is shaped, with many asymmetric or differentiated systems within countries (OECD/KIPF, 2019[2]).

With such decentralisation trends in Asia and around the world, subnational governments have gained additional responsibilities in key areas linked to transportation, economic development, energy, education, health, social protection, housing, water and sanitation, for example. They play a key role for public service delivery and investment. Therefore, subnational governments need to develop financial, institutional, administrative and strategic capacities to manage these expanding responsibilities. It is thus essential to understand the enabling conditions, incentives and intergovernmental mechanisms that can support subnational capacity building. Building adequate capacities is a gradual process that takes time and requires long-term involvement and commitment from both central and subnational governments (OECD, 2019[3]).

The current COVID-19 crisis might contribute to redefine current multi-level governance arrangements. governments at all levels must act on all fronts simultaneously and in synchrony, requiring high degree of coordination and clear responsibility allocation while adopting a place-based approach to adjust for local/regional specificities. This need – for flexibility and adaptability – may lead governments to reconsider their multi-level governance systems, to revaluate their policy tools, and to reassess their regional development priorities (OECD, 2020[4]).

Decentralisation reforms are and have been implemented for a wide variety of political, historical, and economic reasons, which vary significantly across countries. Several moves towards decentralisation around the world have been mainly motivated by the quest for more local democratic control, as well as by the desire for greater efficiency in public service delivery and accountability for regional and local development policies. Megatrends linked to the information revolution or digitalisation, the globalisation of economic activity and urbanisation also play an important role in the strengthened role of subnational governments.

The outcomes of decentralisation have been debated for decades. According to the OECD (2019[3]), the question is not whether decentralisation is good or bad in itself; rather, it is a question of under which conditions decentralisation can support local democracy, efficient public service delivery and regional development. The outcomes of decentralisation depend

on how it is designed and implemented, and several pre-conditions need to be in place for decentralisation to be successful. The OECD has identified ten preconditions for effective design and implementation of decentralisation reforms (OECD, 2019[3]).

This chapter provides a snapshot of subnational governments' organisation and finance in the Asia-Pacific region, and focuses and enabling conditions to support subnational capacity building. The first section provides an overview of current trends occurring in Asia Pacific, compared to other regions in the world, in terms of territorial organisation and decentralisation. The second section provides some highlights on subnational government finance in Asia Pacific, compared to other regions of the world and OECD countries. The third section addresses the typical challenges in subnational government capacities, and the fourth section focuses on OECD guidelines for to help policy makers make decentralisation systems work more effectively, in particular by developing adequate capacities at subnational level. The chapter uses the new data and information from the 2019 OECD-UCLG World Observatory on Subnational Government Finance and Investment, notably from the sample of 16 countries of the Asia-Pacific region covered in the Observatory (Box 4.1).

Box 4.1. The OECD/UCLG World Observatory on Subnational Finance and Investment

The 2019 update of the World Observatory on Subnational Finance and Investment provides a relatively clear picture of the decentralisation frameworks in the world and in Asia Pacific. It identifies the current context and challenges linked to decentralisation, thanks to thorough qualitative and quantitative data collections that lasted two years. This World Observatory is the largest international database on subnational government structure and finance ever produced. It covers dozens of indicators for more than 120 countries, accounting for 86% of the world population and 89% of the world gross domestic product (GDP). The database is complemented by country profiles that provide quantitative and qualitative information on multi-level governance systems around the world. The synthesis report provides analysis by geographical areas, including Asia-Pacific, country income groups and institutional forms (federal or unitary countries).

In the World Observatory, 16 countries in the Asia-Pacific region are covered, including Australia, Bangladesh, Cambodia, the People's Republic of China (hereafter "China"), India, Indonesia, Japan, Korea, Malaysia, Mongolia, Nepal, New Zealand, the Philippines, Sri Lanka, Thailand and Viet Nam.

Hereafter, in this chapter, when "Asia-Pacific countries" or the "Asia-Pacific region" or "Asia Pacific" are mentioned, this refers to the 16 countries mentioned above. The year of reference of fiscal indicators is 2016 but can vary country to country according to data availability.

Source: OECD/UCLG (2019[1]). More information can be found on the World Observatory website (including country profiles and data): www.sng-wofi.org.

Current socio-economic and territorial organisation trends in Asia Pacific

Fast urbanisation and diverse levels of development

Although great disparities exist among Asia-Pacific countries in terms of levels of development (see Annex Table 4.A.1), there are also common drivers in terms of urbanisation and economic growth. On average, urbanisation growth is high among Asia-Pacific countries, with an annual rate of 2.1% in 2017, slightly higher than the world average of 1.9%, which is driven by Africa (3.7%), and higher than the Latin America and European averages (1.6% and 0.6%, respectively). This can reflect a catch-up trend as, on average, only 53.9% of the Asia-Pacific population lives in urban areas compared to 71.4% in Europe and 72.1% in Latin America (OECD/UCLG, 2019[1]). This catch-up trend, i.e. relatively low urbanisation rate and high urbanisation growth, is the most acute in Cambodia, Nepal, Bangladesh and Viet Nam. More precisely for ASEAN countries, the population in cities is expected to reach 51% by 2050, i.e. 379 million people, with the largest metropolitan areas grow twice as fast as other urban cities. Comparatively, in the world, city populations have doubled over the last 40 years and will increase from 48% to 55% by 2050.

Among Asia-Pacific countries, the average annual population growth of 1% between 2010 and 2015 was close to the world average of 1.2%.[1] By 2030, average annual population growth is forecasted to be slightly below 1.0% in Asia Pacific (United Nations, 2019[5]). While the average annual population growth between 2010 and 2015 is negative in Japan, and is below 0.5% in Korea, Thailand, China and Sri Lanka; it is above the world average in Indonesia, Malaysia, Australia, Cambodia, the Philippines and Mongolia, the average annual population growth is above the world average (Table 4.1).

Economic development and impact of COVID-19 crisis

The average real GDP growth in Asia Pacific is the highest regional average in the world, reaching 5.1% in 2017, compared to 3.9% in the world, 4.2% in Africa, 4.1% in Eurasia, 3.4% in Europe and 3.0% in Latin America. In 2017, in ten Asia-Pacific countries, the real GDP growth was more than 5%, the highest growth rates being 7.5% in Nepal and 7.3% in Bangladesh. In Thailand, Sri Lanka, Korea and New Zealand, the real GDP growth is between 3.0% and 3.9%, while it is 2.3% in Australia and 1.7% in Japan. The COVID-19 crisis has however put a halt to this strong economic growth (see Box 4.2). The Asia-Pacific region concentrates 5% of all cases reported at global level and 19% of deaths as of 2 December 2020. Within Asia-Pacific, India registered 60% of cases and 50% of deaths related to the COVID-19. Most other affected countries are Indonesia, Bangladesh and Philippines (ECDC, 2020[6]). The impact of the COVID-19 health crisis differs markedly not only across countries, but also across regions and municipalities within countries (see Box 4.2).

Box 4.2. COVID-19 crisis impact on economic development and multi-level governance

The World Bank estimates a contraction to -0.9% of economic growth in 2020 for the East Asia and Pacific region[2], with long-lasting effects if the COVID-19 economic consequences remain unremedied (World Bank, 2020[7]). Korea has been the least affected country among OECD countries and is expected to register the smallest decline in GDP, just over 1% in 2020, due to effective measures to contain the spread of the COVID-19 in spring. Australia and New Zealand have also so far been less affected by the COVID-19 crisis, compared to other OECD countries. Real GDP is expected to contract by 3.8% and 4.8% respectively in 2020 with a rebound around 3.2% and 2.7% respectively in 2021. In Japan, however, the COVID-19 shock in early 2020 triggered a major recession and real GDP is projected to shrink by around 5.2% this year (OECD, 2020[8]). Within Emerging Asian countries[3], the OECD forecasted that Thailand will be the worst affected, with an estimated GDP decline of 6.7% in 2020, and that Cambodia's GDP growth will also turn negative in 2020. In China and India, economic output is expected to contract for the first time in decades before returning to a positive growth trajectory in 2021. On the contrary, Viet Nam will outperform its ASEAN-5 counterparts, posting a positive GDP growth for 2020 and the strongest growth in 2021 for the region (OECD, 2020[9]).

Territorial impact of the COVID-19

The COVID-19 crisis has a strong territorial dimension. For instance, the health of populations in some regions is more affected than in others. In India for example, the State of Maharashtra registered 19% of Indian confirmed cases as of end of November 2020, followed by Karnataka (9%) and Andhra Pradesh (8%). In the People's Republic of China (hereafter 'China') 73% of confirmed cases were concentrated in Hubei province as of end of November 2020. Tokyo concentrated 31% of national cases by the end of October 2020. Large urban areas have been hard hit, but within them deprived areas are more strongly affected (OECD, 2020[4]).

Subnational governments – regions and municipalities – are at the frontline of the crisis management and recovery, and confronted by COVID-19's asymmetric health, economic, social and fiscal impact – within countries but also among regions and local areas. The impact of the COVID-19 crisis and related policy responses (e.g. public health measures, lockdowns, emergency economic and social measures) on subnational government finance is significant. This observation is supported by the results from a survey jointly conducted by the OECD and the European Committee of the Regions (CoR) during the summer 2020 with 300 representatives of regional and local governments in 24 countries of the European Union. The results indicate that in the short and medium terms most subnational governments expect the socio-economic crisis linked to COVID-19 to have a negative impact on their finances, with a dangerous "scissors effect" of rising expenditure and falling revenues (OECD, 2020[4]).

The current crisis requires all levels of government to act in a context of great uncertainty and under heavy economic, fiscal and social pressures. In addition, governments cannot sequence their policy actions as they need to manage the crisis, notably the second wave of pandemic, design exit strategies and support the recovery all at once. The need – for flexibility and adaptability – may lead governments to reconsider their multi-level governance systems, to revaluate their policy tools, and to reassess their regional development priorities (OECD, 2020[4]).

Human development is very heterogeneous in Asia Pacific. Regarding the Human Development Index (HDI), six Asia-Pacific countries have a world rank below 100 and 12 below 50. Cambodia, Nepal, Bangladesh, India, Indonesia, Viet Nam and the Philippines have the lowest ranks in the Asia-Pacific region. On the opposite end, Australia, New Zealand, Japan and Korea rank among the best countries in terms of HDI. Five Asia-Pacific countries have a GDP per capita higher than the world average: the GDP per capita is more than double the world average in Australia, Japan and New Zealand and close to double the world average in Korea, while it is almost one and a half the world average in Malaysia.

Table 4.1. Demographic and economic indicators for selected Asia-Pacific countries, 2017

	Urban population growth	Urban population	Population growth	GDP per capita	HDI	Real GDP growth
	Annual %	% of total population	Average annual %	USD PPP	World rank	Annual %
Australia	1.7%	85.9%	1.5%	48 460.0	3	2.3%
Bangladesh	3.2%	35.9%	1.2%	3 868.8	136	7.3%
Cambodia	3.3%	23.0%	1.6%	4 009.0	146	6.8%
China	2.7%	58.0%	0.5%	16 806.7	86	6.9%
India	2.4%	33.6%	1.2%	7 059.3	130	6.7%
Indonesia	2.3%	54.7%	1.3%	12 283.6	116	5.1%
Japan	-0.1%	91.5%	-0.1%	43 279.0	19	1.7%
Korea	0.4%	81.5%	0.4%	38 350.3	22	3.1%
Malaysia	2.2%	75.4%	1.4%	29 448.9	57	5.9%
Mongolia	1.7%	68.4%	1.9%	12 918.4	92	5.3%
Nepal	3.2%	19.3%	1.2%	2 696.7	144	7.5%
New Zealand	2.2%	86.5%	1.1%	41 109.0	16	3.0%
Philippines	2.0%	46.7%	1.6%	8 342.8	113	6.7%
Sri Lanka	1.5%	18.4%	0.5%	12 826.6	76	3.3%
Thailand	1.8%	49.2%	0.4%	17 872.2	83	3.9%
Viet Nam	3.0%	35.2%	1.1%	6 775.8	116	6.8%

Notes: GFCF: Gross Fixed Capital Formation. The year of reference is 2017 but can vary country by country according to data availability. More information can be found on the database. The annual average population growth rate is calculated over the period 2010-15.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

Trends in decentralisation and territorial organisation

A number of countries have implemented decentralisation reforms in the Asia-Pacific region, mostly since the late 1980s and 1990s, as in the case of Australia, India, Japan and New Zealand. In countries like Korea or the Philippines, decentralisation policies have been conducted over the past three decades and are still high on the agenda (Box 4.3). For Bangladesh, decentralisation gained momentum in the 2000s, while in Indonesia it has been more recent, around the 2010s. In many Asia-Pacific countries, decentralisation reforms continue to be on the agenda, but there are some exceptions, such as Thailand, where local elections have been suspended since 2014 (OECD/KIPF, 2019[2]; Smoke, 2019[10]) and will be held for the first time since in December 2020. Elections will be held at several levels – for provincial administration organisations (PAOs) first, then for tambon administration organisations (TAOs), municipalities and special administration areas (Bangkok Metropolitan Administration (BMA) and Pattaya City) (Government of Thailand, 2020[11]).

Box 4.3. Examples of decentralisation reforms in Asia Pacific

Indonesia engaged in a strong decentralisation process, together with the democratic transition in 1998. The Asian economic crisis participated in speeding up this decentralisation process, which led to two "big bang" decentralisation reforms in 2001 and 2005that granted subnational governments greater political autonomy and transferred to them substantial responsibilities, personnel, assets and resources. The laws 22/1999 on local government – also often referred to as the Regional Autonomy Law – and law 25/1999 on revenue sharing between the central and the regional governments were revised in 2004. Law 32/2004 introduced local direct elections and granted additional powers and responsibilities to subnational governments, giving provinces supervisory powers and strengthening their role as representatives of the central government, particularly in the area of planning and budgeting. Law 28/2009 specifies subnational government revenues, local taxation and charges. In September 2014, the Indonesian government enacted a new Local Government Law which aimed to restructure decentralisation to make the public sector more effective. The same year, the "Village Law" recognised the villages as self-governing entities and allocated them with more authority and resources.

In Japan**,** the decentralisation process was carried out through several steps over a long period, with the support of a Decentralisation Promotion Committee set up in 1995.The first "Decentralisation Promotion Reform" of 1995 led to the adoption of the Omnibus Decentralisation Law in 2000. This law was followed by the Trinity Reform in 2004-06, which laid out the financial component of the decentralisation reform. The "Decentralisation Promotion Reform" of 2006, granted further authority to local governments, rationalised their functions as well as the power of central government on local authorities and consolidated local administrative systems through municipal mergers.

In Korea, decentralisation started in 1987 with the "Decentralisation for Democratisation" and was followed in 1988 by the Local Autonomy Act and the Local Finance Act. Decentralisation gained further momentum in 1991 with the first election of local councillors and in 1995 with the first election of local governments' chief executives. The "Special Act on Decentralisation", enacted in 2004, clarified the principles and methods for decentralisation, transferred new functions to local governments and abolished special administrative agencies. It was followed by a fiscal reform in 2005 and then changed in 2008 for the "Special Act on the Promotion of Decentralisation". The "Special Act on Decentralization and Restructuring of Local Administrative Systems" enacted in 2013 and revised in 2018 sets up the Presidential Committee on Autonomy and Decentralization, which developed a comprehensive the country's plan for autonomous decentralisation, included a transfer of additional fiscal authority to local governments and included a devolution of centralised administrative powers to local governments effective from 1 January 2021. The goal of the reform is to enable local governments to autonomously establish and enforce polices tailored to their regional needs.

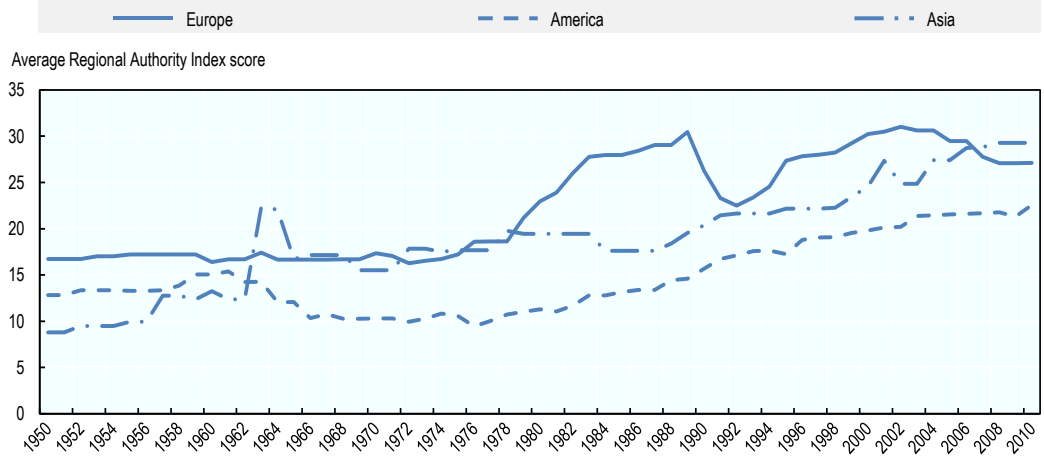
In the Philippines**,** the 1987 Constitution established the notions of decentralisation, local autonomy and popular participation. In 1991, a Local Government Code was set up to define the legal and regulatory framework of local governments. A "Master Plan for the Sustained Implementation" was developed in three stages of decentralization reform: (a) formal transfer of functions (1992–93) (b) adjustment by local governments (1994–96) (c) institutionalisation of the decentralised system (1997 onwards). The current political

debate in the country is heading towards the acknowledgement of a more explicitly federal form of government. In December 2016, the presidency signed an executive order to prompt a consultative committee tasked with reviewing the 1987 Constitution. A draft Constitution was presented to the President in July 2018. It is proposed to establish 17 federated regions and the National Capital Region. The reform has not yet been adopted.

Source: OECD/KIPF (2019[2]); OECD/UCLG (2019[1]); OECD (forthcoming[12]).

According to the Regional Authority Index (RAI) (Hooghe et al., 2016[13]), an institutional indicator that aims to measure the degree of autonomy of regional governments (defined as states, regions, provinces, *Länders*, for example), 52 countries out of 81 of the world sample became more regionalised since the 1970s. This trend occurred in all regions of the world, including Asia. During the period 1950-2010, according to the RAI, reforms to strengthen the intermediary level of government (regions, states) have intensified since the 1990s in Asia, corresponding to the bulk of decentralisation reforms in the region (Figure 4.1). Australia, Japan, Korea and the Philippines experienced a significant increase in their RAI scores in the 1990s, while in Indonesia,[4] regionalisation started in the 2010s.

Figure 4.1. Regionalisation in Europe, America and Asia since 1950



Notes: 1. Shown are the average Regional Authority Index (RAI) scores for 41 European countries and economies, 29 American ones and 11 Asian ones.
Source: OECD (2019[3]), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/g2g9faa7-en.

Levels of government

In Asia Pacific[5], nine countries have two-tiered subnational governments[6] and seven have three-tiered subnational governments[7] (see Annex Table 4.A.3). As previously mentioned, the particularity of China is that its constitution states only three tiers of subnational government, while in practice, four layers exist. Usually, a hierarchical link exists between the different tiers. However, in Japan and Korea, where the subnational governments are two-tiered, there is no hierarchical link. Korea is characterised by a complex architecture with a diversity of organisations within each level. In Bangladesh, there is also no hierarchical link between the three tiers in the rural areas and the single tier in urban ones.

Many countries in Asia Pacific are also characterised by a territorial organisation that differentiates between rural and urban areas. This is also the case in many other countries in Europe or Latin America. This differentiation often exists at the municipal level and is often stated in legal texts or the constitution itself. This is the case in Bangladesh, India, Indonesia, Malaysia, Sri Lanka and Viet Nam. In New Zealand, a distinction is made according to the population size, and in Nepal, the distinction is made according to the population size and the subnational government's resources. In Cambodia, Mongolia and Thailand, a distinction is made between the capital city and the rest.

As mentioned above, in Bangladesh, while the rural areas are organised in non-hierarchical three tiers, the urban areas are single tiers. In India, there is a differentiation between the 262 771 *panchayat*, the rural local bodies, and the 4 657 municipalities, the urban local bodies. In most Indian states, the *panchayat* are organised in three levels, the village, the "development block" and the district level, while the urban areas are classified in three categories according to their population size. In Malaysia, there are 12 city councils, 38 municipal councils (urban) and 98 district councils (rural). In Sri Lanka, there are 24 municipal councils, 41 urban councils and 276 rural councils.

In Viet Nam, the differentiation between rural and urban areas is made at the intermediate level of subnational governments. There are 8 978 communes, 1 581 wards and 603 commune-level towns at the municipal level. At the intermediate level, there are 546 rural districts, 49 urban districts, 51 district-level towns and 67 provincial cities, and at the regional level, there are 58 provinces and 5 centrally run cities (Can Tho, Da Nang, Ha Noi, Hai Phong and Ho Chi Minh City). In 2018 in Viet Nam, Ho Chi Minh City reached a population of 8.1 million inhabitants, and Ha Noi is projected to reach 6.4 million inhabitants by 2030 (United Nations, 2018[14]).

The high concentration of megacities in Asia Pacific can partially explain the special status attributed to urban areas and specific cities (Box 4.4). In 2018, out of the 33 megacities of 10 million or more inhabitants, more than half were in Asia (19). Besides, seven of the world's ten largest urban agglomerations in 2018 were in Asia Pacific: Tokyo (37 million inhabitants), Delhi (29 million), Shanghai (26 million), Mumbai, Beijing, Dhaka and Kinki Major Metropolitan Area (Osaka) (these last four megacities have close to 20 million inhabitants each).

Box 4.4. Megacities in Asia Pacific and special status attributed to urban areas

Because of the large size of Tokyo, the municipal level in Japan is broken down into 1 718 municipalities (*shichouson*) and 23 special wards within Tokyo.

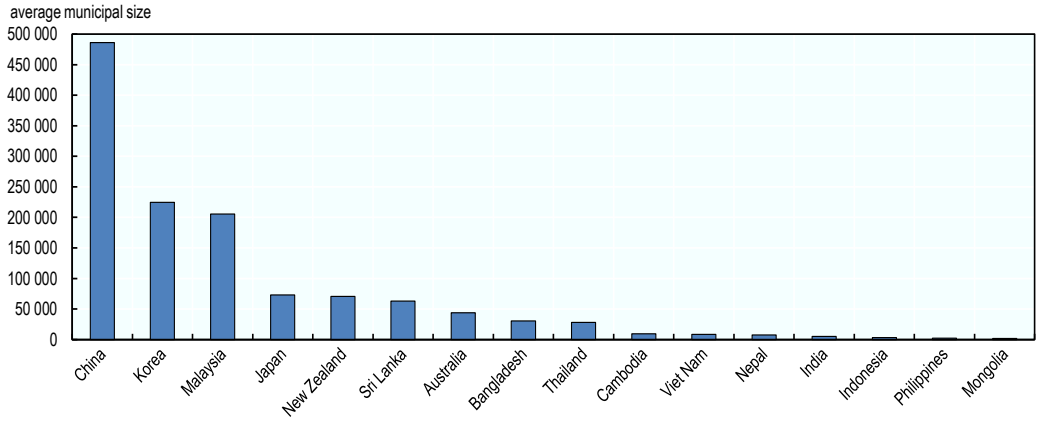
In Mongolia, Thailand and Cambodia, a special status is attributed to the capital city. In Mongolia, Ulan Bator (Ulaanbaatar) is at the regional level, its nine districts (*duureg*) are at the intermediate level, and the 152 neighbourhoods (*khoroo*) are at the local level. Ulan Bator had a population of 1.5 million in 2018, representing 71% of the urban population and 49% of the total population of Mongolia. Similarly, in Thailand, the Metropolitan City of Bangkok is erected at the regional level. The City of Bangkok reached 12.1 million inhabitants in 2018, representing 17% of the country's population. In Cambodia, Phnom Penh, the capital city, is at the regional level, the *khans* are districts of Phnom Penh and are at the intermediate level, and the 236 *Sangkats* are the lowest tier of government in the capital city. In 2018, Phnom Penh had 1.9 million inhabitants, representing 51% of the urban population and 12% of the total population of Cambodia (United Nations, 2019[15]; United Nations, 2018[14]; OECD/UCLG, 2019[1]).

Number and size of municipalities

Although there is diversity across countries, a common trend across Asia-Pacific is that the number of municipalities per country is high, on average 26 366, and over five times the world average of 5 116 municipal-level governments. If this high number of municipal-level governments is mainly driven by India (267 428), then by Indonesia (83 344), the Philippines (42 045) and Viet Nam (11 162), the median number of municipal-level governments remains high (1 730) and is five times higher than the world median (340).

The size of municipalities, and their fragmentation, vary a lot among Asia-Pacific countries. In India, Indonesia, Philippines and Viet Nam, the municipal landscape is very fragmented with an average municipal size of fewer than 5 000 inhabitants and a total number of municipalities ranging from 11 000 in Viet Nam to over 260 000 in India. On the contrary, the municipal landscape is highly concentrated in China, Korea and Malaysia with an average municipal size over 200 000 inhabitants and fewer than 3 000 municipalities (see Figure 4.2). One explanation for the subnational fragmentation at the municipal level, among others, is geography as several Asia-Pacific countries are composed of islands. This specific geography must be taken into account to understand the territorial organisation and decentralisation systems in Asia-Pacific countries.

Figure 4.2. Average number of inhabitants per municipality by country



Note: average municipal size as per number of inhabitants
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org

In 2018, out of the 33 megacities of 10 million or more inhabitants, more than half were in Asia (19). Besides, seven of the world's ten largest urban agglomerations in 2018 were in Asia Pacific: Tokyo (37 million inhabitants), Delhi (29 million), Shanghai (26 million), Mumbai, Beijing, Dhaka and Kinki Major Metropolitan Area (Osaka) (these last four megacities have close to 20 million inhabitants each).

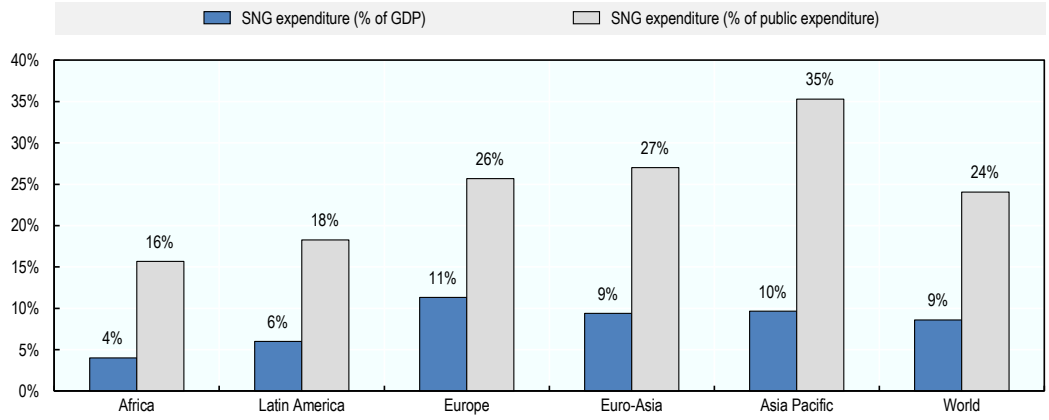
Subnational government finance in Asia Pacific

Subnational spending and revenue

Compared to other regions in the world, the Asia-Pacific region has – overall – higher indicators of fiscal decentralisation. Of the 16 countries in the Asia-Pacific region covered by the World Observatory on Subnational Government Finance and Investment, the share

of subnational public spending represents on average 9.6% of GDP and 35.4% of public spending,[8] which is higher than the world averages of 8.6% of GDP and 24.1% of public spending (Figure 4.3).[9] The share of public investment undertaken by subnational governments (40%) is also higher than the world average (36%). This public investment represents 1.8% of GDP (compared to 1.3% on average in the world). Subnational revenue represents on average 9.0% of GDP (world: 8.5%) and 36.0% of public revenue (world: 24.4%), 41.4% coming from taxes (world: 33.0%). Subnational debt reaches on average 9.1% of GDP and 12.4% of the total public debt; it is at 69.3%, on average, of financial debt.

Figure 4.3. Subnational government expenditure as a percentage of GDP and total public expenditure by geographic area, 2016



Note: In the World Observatory, 34 African countries are covered, including 19 with subnational expenditure data; 14 out of 16 Asia-Pacific countries have subnational expenditure data; 18 Latin America, 37 European and 11 Euro-Asia countries are covered, all with subnational expenditure data. Out of the 122 countries of the World Observatory, 105 have subnational expenditure data. The Northern American and the Middle East and Western Asian regions are not displayed because they are only composed of, respectively, two and four countries in the World Observatory database, but they all have subnational expenditure data, and their countries are included in the world average.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

However, large disparities exist among the 16 Asia-Pacific countries for these fiscal indicators (see Annex Table 4.A.2). For instance, half of the countries in the Asia-Pacific sample[10] have subnational expenditure that reached more than one-third of public expenditure, and for four of them, subnational expenditure reached more than 50% of public expenditure in 2016 (Figure 4.3)). However, among the other half, subnational expenditure as a percentage of public expenditure is below the world average, reaching from 19.1% in Thailand to below 10% in Malaysia and Cambodia. In terms of tax revenue, there is also a large diversity of profiles (Box 4.1). Subnational tax revenue in China, India and Japan represents between 40% and 60% of public tax revenue, more than twice the world average (14.7%). In contrast, in New Zealand, the Philippines and Sri Lanka, subnational tax revenue as a share of public tax revenue represents less than half the world average.

A large diversity also exists within the Asia-Pacific region regarding subnational revenue. Taxes are the primary sources of revenue for subnational governments in Cambodia, India and New Zealand (over 50%), while grants and subsidies are the main sources of subnational revenues in many Asia-Pacific countries, including Indonesia, Sri Lanka and the Philippines (over 65%) (Box 4.5). Tariffs and fees, and property income, are relatively low compared to world averages, except in New Zealand and Australia (Figure 4.4).

Box 4.5. Subnational revenues in Asia-Pacific countries: A diversity of profiles

In 2016, less than 20% of subnational revenue came from taxes in Indonesia, while in New Zealand, India and Cambodia, they topped 50%. In Japan and China, taxes almost represent 50% of total subnational revenue.

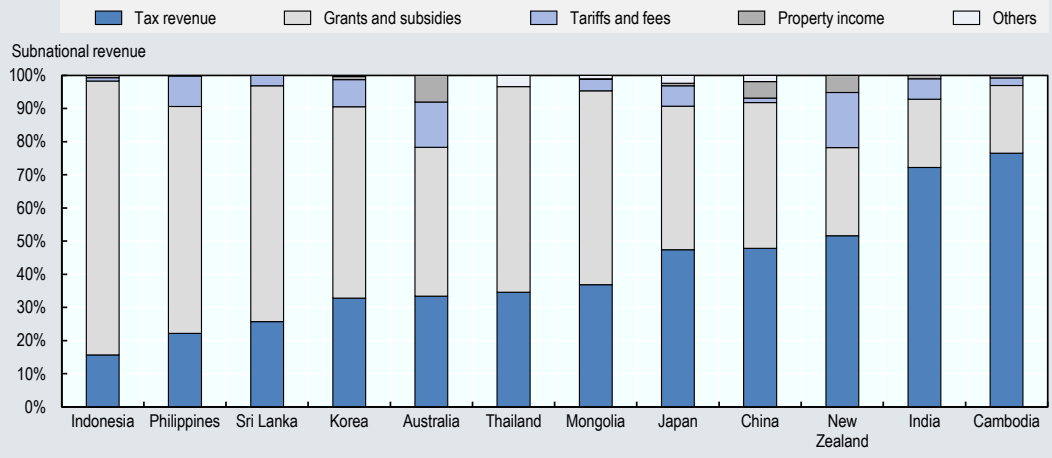
Symmetrically, grants and subsidies represent less than 30% of total subnational revenue in New Zealand, India and Cambodia, while they represent more than 50% in Korea, Mongolia, Thailand, the Philippines Sri Lanka and Indonesia.

Tariffs and fees represent more than 9% of total subnational revenue (the world average) in only three countries, New Zealand, Australia and the Philippines. For the remaining nine countries in the Asia-Pacific region, the sample average is 3.5%, less than half of the world average.

The share of property income is also low in Asia Pacific, reaching on average 1.9% of total subnational revenue, compared to 2.3% for the world average. However, this Asia-Pacific average is driven by Australia, New Zealand and China. In Australia and Viet Nam, subnational governments benefit from royalties from mineral exploitation. In New Zealand, subnational governments' revenues are diverse and come to a higher degree from service charges and fees as well as permits and licences. In China, the sale of land-use rights is a powerful subnational tool. When these three countries are removed from the sample, the sub-sample average drops to 0.5%.

Finally, for all Asia-Pacific countries, the share of other revenues, including social contributions, are below the world average of 4.7%.

Figure 4.4. Breakdown of subnational sources of revenue in Asia Pacific, 2016

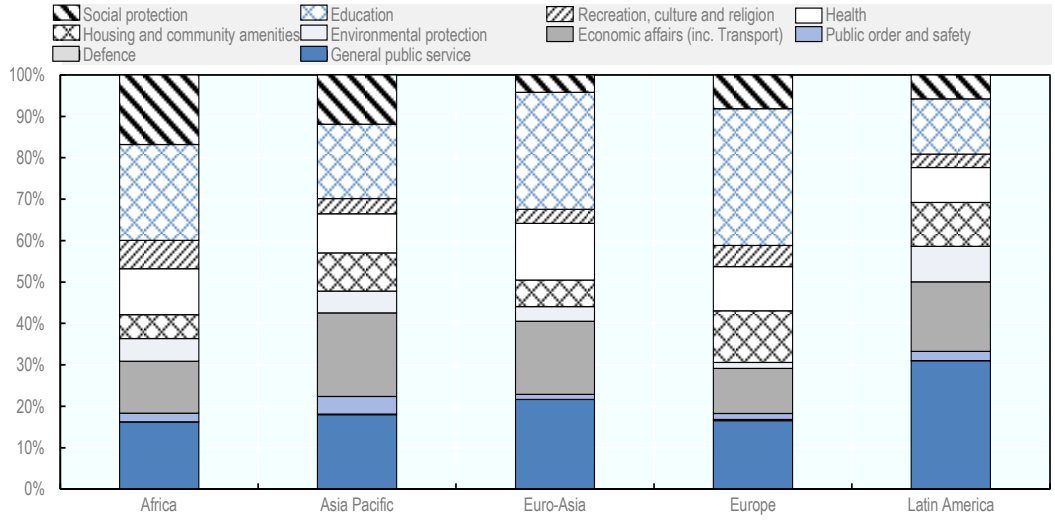


Note: The World Observatory does not have subnational revenue data for Bangladesh, Malaysia, Nepal and Viet Nam.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.
Source: World Observatory on Subnational Government Finance and Investment (2019[16]), "Country profiles", www.sng-wofi.org/country-profiles/.

Subnational spending responsibilities

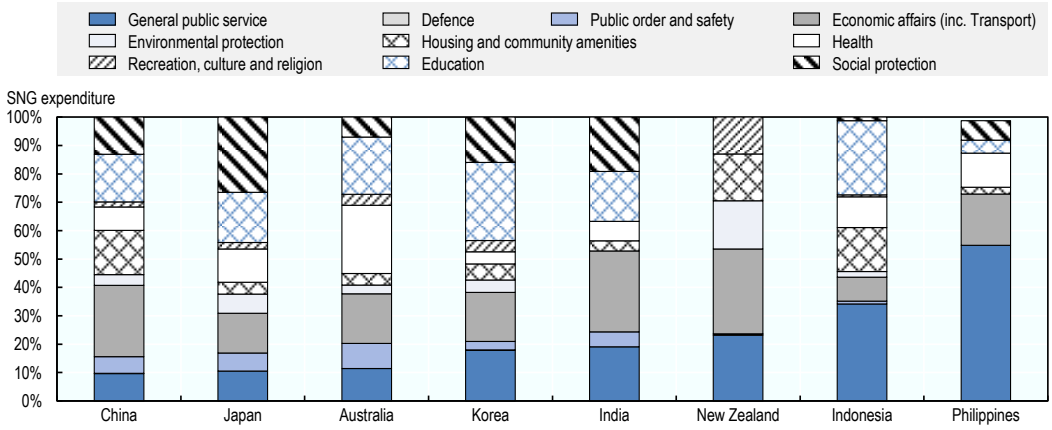
The bulk of subnational expenditure in Asia-Pacific countries went to economic affairs and transport (20.1% of subnational expenditure on average), general public services (18.0%) and education (18.0%). Figure 4.5 shows that these three categories are the main subnational spending categories in every global region. Interestingly, the importance of economic affairs and transport in subnational spending is higher in Asia Pacific than anywhere else in the world, indicating that subnational governments play a more prominent role in economic development in many countries of this region.

Figure 4.5. Share of COFOG category in subnational public expenditure by geographic region, 2016



Note: In the World Observatory, 34 African countries are covered, including 5 with Classification of Function of Government (COFOG) data; 7/16 Asia-Pacific countries, 11/11 Eurasian countries, 34/37 European countries and 5/18 Latin America countries have subnational COFOG data. The Northern American and the Middle East and Western Asian regions are not displayed because they are only composed of two and four countries, respectively, in the World Observatory database.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

Figure 4.6. Share of COFOG category in subnational public expenditure by country, 2016



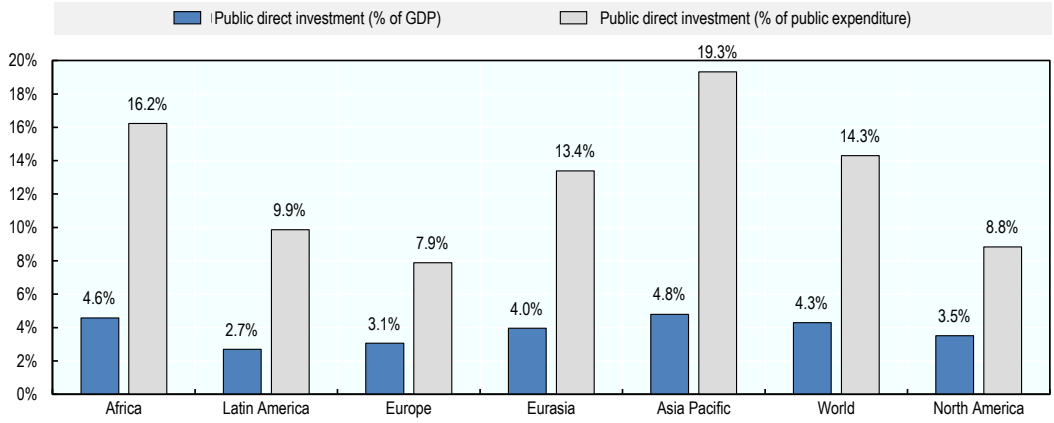
Note: incomplete or missing information for Bangladesh, Cambodia, Malaysia, Mongolia, Nepal, Philippines, Thailand, Sri Lanka and Vietnam.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

Public investment at national and subnational levels

One specificity of Asia Pacific compared to other regions of the world is the high level of public investment at national and subnational level.

At national level, in 2016, in Asia Pacific, 19.3% of the total public expenditure was allocated to direct investment on average, compared to 14.3% on average in the world, accounting for 4.8% of GDP versus 4.3% at global level (Figure 4.7). This high share of direct public investment is more than double the Latin American and European averages.

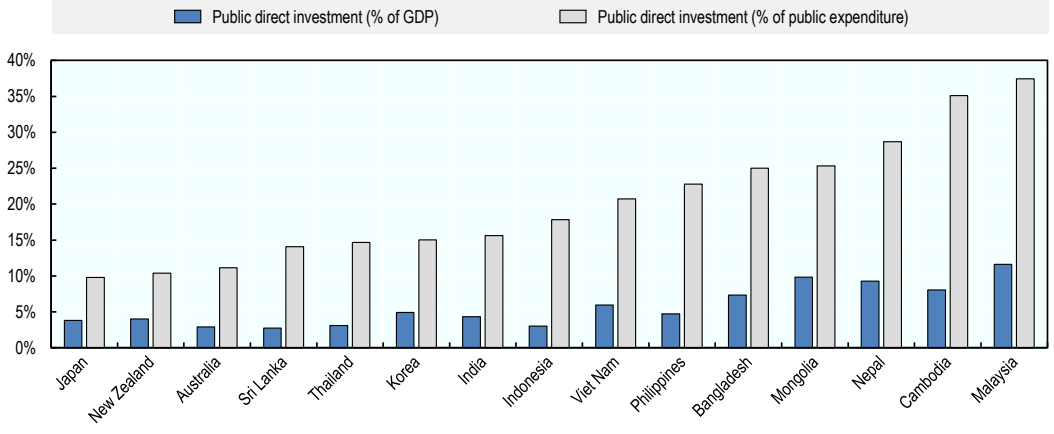
Figure 4.7. Public direct investment as a percentage of GDP and total public expenditure by geographic area, 2016



Note: In the World Observatory, 34 African countries are covered, including 22 with investment data; 15 out of 16 Asia-Pacific data have investment data; 18 Latin America, 37 European and 11 Euro-Asia countries are covered, all with subnational investment data. Out of the 122 countries of the World Observatory, 108 have subnational expenditure data. The Northern American and the Middle East and Western Asian regions are not displayed because they are only composed of two and four countries, respectively, in the World Observatory database, but they all have investment data (except one, Jordan) and their countries are included in the world average.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

By countries, in 2016, direct public investment ranges from 2.8% in Sri Lanka to 11.6% in Malaysia. For almost three-fourth of the Asia-Pacific countries, the share of their public expenditure allocated towards direct investment is higher than the world average. While seven countries allocate between 20% and 40% of their total public expenditure to direct investment, five countries allocate between 14% and 18%. Australia, New Zealand and Japan are the only countries with a share below the world average, around 10.5%. In terms of percentage of GDP, while Mongolia and Malaysia allocate around 10% to direct investment; Sri Lanka, Australia, Indonesia allocate less than 3% (Figure 4.8).

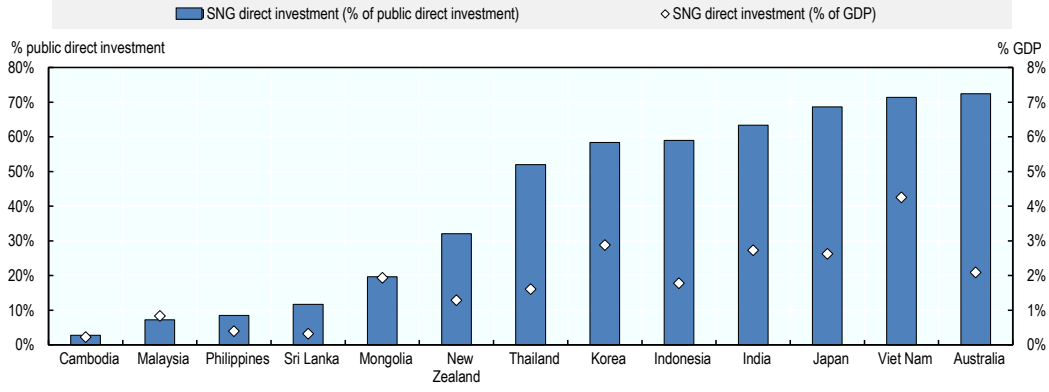
Figure 4.8. Public direct investment as a percentage of GDP and total public expenditure by country, 2016



Note: Only 15 out of the 16 sample-countries are presented because no data were available for China.
Source: Authors' elaboration based on the *2019 World Observatory on Subnational Government Finance and Investment database,* found at www.sng-wofi.org.

At subnational level, public investment is also high. Asia-Pacific subnational governments are key public investors. In 2016, 40.6% of public direct investment was carried out at the subnational level in Asia Pacific, compared to the world average of 36.6%. The subnational direct investment represents a higher share of GDP, at 1.8% in 2016 in Asia Pacific, compared to 1.5% in Latin America, 1.3% in Europe and Euro-Asia, and 0.9% in Africa. High disparities exist among Asia-Pacific countries regarding subnational direct investment (Figure 4.9). Subnational direct investment represented more than 50% of public direct investment in 7 out of 13 countries, and more than 60% in Australia, India, Japan, and Viet Nam. In terms of share of GDP, subnational direct investment exceeded 4% of GDP only in Viet Nam; in Australia, India, Japan and Korea, it ranged between 2% and 3%. Subnational direct investment was the lowest in Cambodia, Malaysia and Philippines, both as a share of public direct investment, below 10%, and as a share of GDP, below 1%; closely followed by Sri Lanka.

Figure 4.9. Subnational direct investment as a percentage of GDP and public direct investment by country, 2016



Note: Only 13 out of the 16 sample-countries are presented because no data were available for Bangladesh, China and Nepal.
Source: Authors' elaboration based on the *2019 World Observatory on Subnational Government Finance and Investment database,* found at www.sng-wofi.org.

Real degree of autonomy more limited than what fiscal indicators indicate

When taking into account other dimensions of subnational autonomy, many countries in Asia Pacific are more centralised than what fiscal indicators indicate, as subnational responsibilities are highly regulated by the central government and resources are often shared with the central government. This is, for example, the case in countries like China, India, Indonesia, Korea, Malaysia, Mongolia, Thailand, and Viet Nam; China and Viet Nam represent a special case of centralised countries since they have a one-party political system. Fiscal indicators tend to over-estimate the real autonomy of subnational governments because spending allocations to subnational governments can be mandated and controlled by the central government. For instance, subnational governments can act as "paying agents" for the central government (OECD, 2019[3]; Musgrave, 1959[17]). As an example, public spending is highly decentralised in China, but the central government maintains high control over it. On the contrary, a relatively large degree of subnational autonomy exists in Australia, Indonesia, Japan, New Zealand and the Philippines.

In some countries such as India, Malaysia and Sri Lanka, a concurrent list of competencies exists between the central government and the highest tier of subnational governments. In India, for instance, the union list describes the 97 exclusive competencies of the central government; the concurrent list covers the 47 items shared between the central government and the states, and the state list describes the 66 states' competencies. In Cambodia, Korea, Sri Lanka and Thailand, the central government has the power to intervene directly in subnational affairs. Finally, central governments' control over subnational governments can be exerted through the appointment of subnational leaders, as in China, Malaysia, Mongolia and Sri Lanka.

Typical challenges in subnational capacities

Decentralising can bring various positive outcomes, but they are not given, and several pre-conditions are essential for subnational governments to have adequate capacities that enable them to fulfil their responsibilities effectively. Subnational government capacities are strongly associated with the degree of institutional quality in the country, the level of economic development, the level of human development indicators, the level of regional disparities within the country and the scale of the jurisdictions (see Chapter 1). The literature suggests that decentralisation might foster convergence when institutional quality is high but tend to exacerbate disparities in a low-quality environment, fuelling local capture (OECD, 2019[3]). The levels of economic and human development are also an important dimension because the higher the development of the country is, the higher the subnational governments' abilities to raise revenue and to build strong capacities are. The level of regional disparities and the scale of subnational jurisdictions also matter for subnational capacity building. Up to a certain point, the larger the jurisdiction, the larger the tax base is, and the larger the economies of scale are, thus enabling larger capacities (Ter-Minassian, forthcoming[18]).

In its 2019 publication *Making Decentralisation Work*, the OECD highlights the main challenges related to decentralisation, notably for subnational capacity building. They encompass the unclear assignment of responsibilities, the weakness of fiscal decentralisation, poor horizontal and vertical co-ordination, and the lack of administrative capacities, especially in terms of human resources regarding adequate staff and expertise (OECD, 2019[3]; OECD/CoR, 2015[19]). Some challenges, like the unclear assignment of responsibilities and weak fiscal decentralisation, regarding unfunded and/or under-funded mandates, are more frequent in countries with recent decentralisation reforms, as in several Asia-Pacific countries.

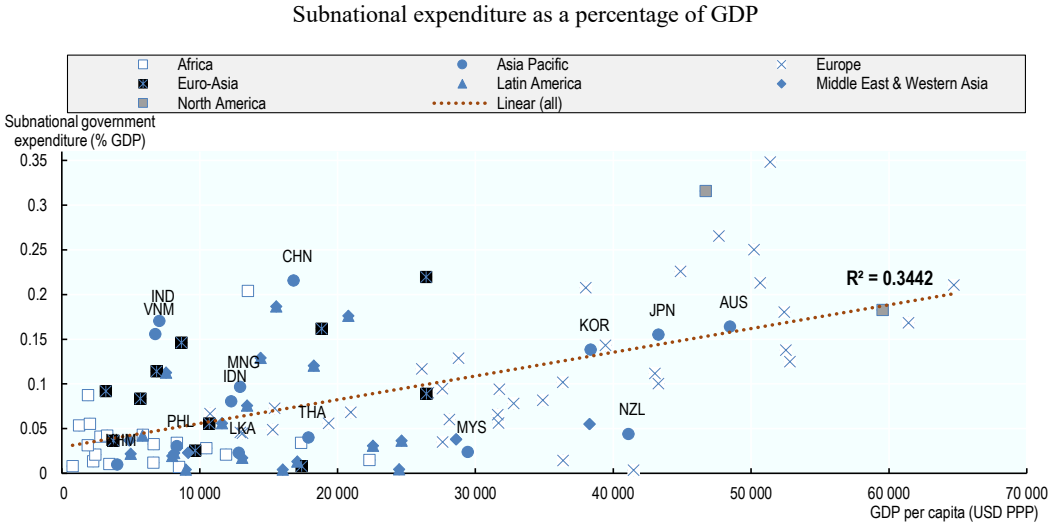
Broader enabling environment: Institutional quality

The broader institutional environment matters significantly for decentralisation to produce positive outcomes and for subnational governments to have the ability to build their capacities (OECD, 2019[3]). Empirical studies have found that the positive impacts of decentralisation are less significant in developing countries compared to developed ones, suggesting that the context matters, including the institutional quality that is traditionally higher in more developed countries (Martinez-Vazquez and McNab, 2006[20]; Baskaran, Feld and Schnellenbach, 2016[21]).

Figure 4.10 supports this finding. The linear relation between expenditure decentralisation and the level of GDP per capita[11] is strong for European countries (R^2=0.45) while it is relatively weak for Euro-Asia countries (R^2=0.17); this relation does not exist for Asia-Pacific, African and Latin American countries (R^2<0.05). This finding is further supported

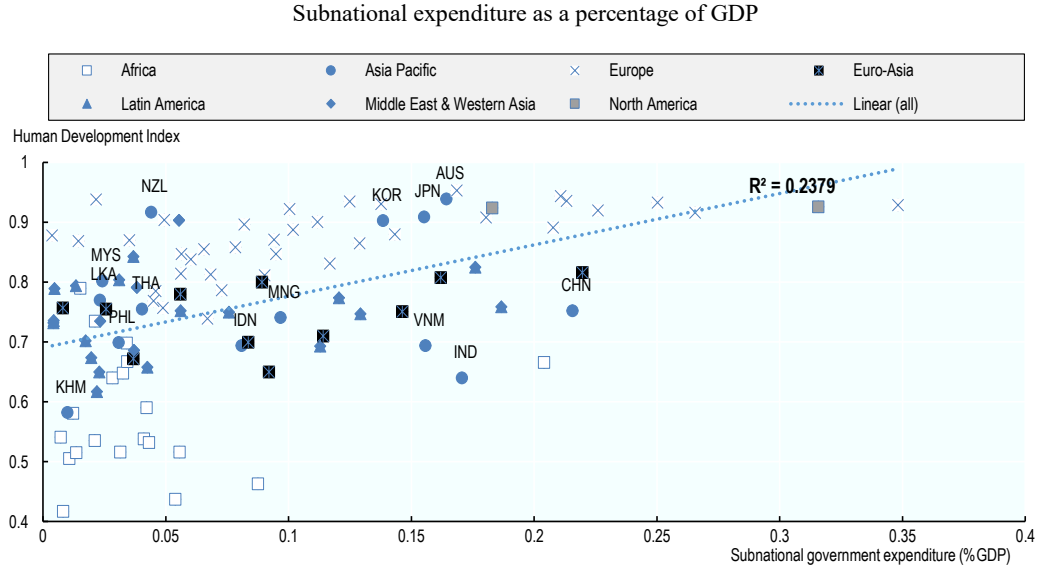
by the existence of a positive relationship at the world level between expenditure decentralisation and the Human Development Index (UNDP, 2019[22]) while it is relatively weak among the Asia-Pacific group, as shown in Figure 4.11.

Figure 4.10. GDP per capita and expenditure decentralisation by region, 2016



Note: Ireland and Luxembourg are not represented in the figure as they are extreme cases due to their high GDP per capita (USD 75 648 PPP and USD 104 175 PPP, respectively).
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

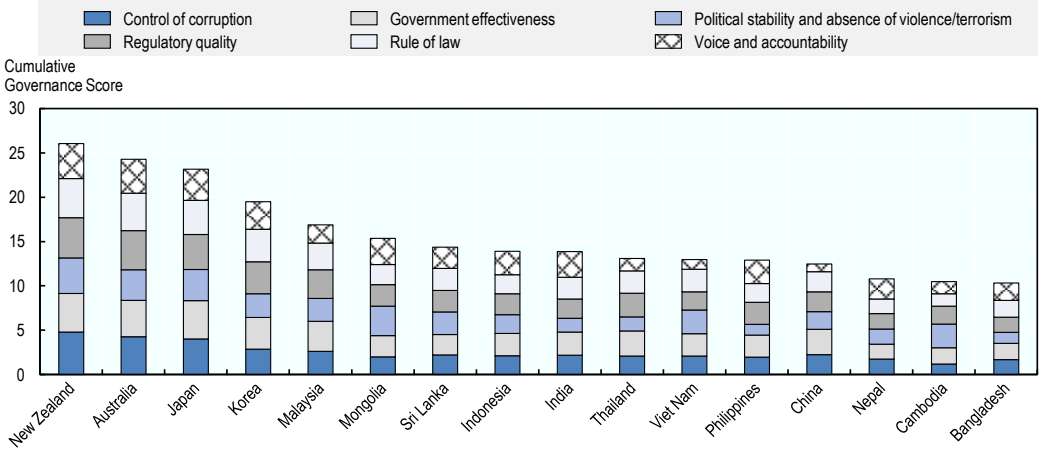
Figure 4.11. Human Development Index and expenditure decentralisation by region, 2016



Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

Figure 4.12 shows the quality of governance in the Asia-Pacific region in 2016, according to the 2017 version of the World Governance Indicators (Kaufmann, Kraay and Mastruzzi, 2011[23]). These indicators encompass six dimensions: government effectiveness, control of corruption, political stability, regulatory quality, rule of law, and voice and accountability. In 2016, in Asia Pacific, the average cumulative governance score reached 15.7 out of 30, similar to the world average (15.8).[12] This is above the African and Latin American averages (12.1 and 14.5, respectively), but below the European average (20.3). Heterogeneity in Asia is high, with New Zealand, Australia, Japan and Korea scoring above 19 and a majority of countries scoring below 15, such as Bangladesh, Cambodia, Nepal, China, the Philippines, Viet Nam and Thailand. The lowest averages are for political stability, and voice and accountability, two indicators for which one-third of the countries score below two out of five. In 2016, the level of political stability was the lowest in Bangladesh, the Philippines, Thailand and India, and the level of voice and accountability was the lowest in China, Cambodia, Viet Nam and Thailand.

Figure 4.12. Cumulative Governance Score in Asia-Pacific countries, 2016



Note: Each of the six indicators ranges from -2.5 to 2.5 and has been rescaled from 0 to 5, to create a cumulative indicator.

Source: Authors' elaboration based on the 2017 version of Kaufmann, Kraay and Mastruzzi (2011[23]), "The worldwide governance indicators: Methodology and analytical issues", *Hague Journal on the Rule of Law*, 3(2), http://info.worldbank.org/governance/wgi/index.aspx#home.

The implications for decentralisation policies are important: when the capabilities and framework conditions are not in place, implementing decentralisation policies can produce adverse outcomes. The economic aspect of development, which allows for financial flexibility and revenue delegation to subnational governments, is as important as the human aspect of development, which encompasses the technical and administrative capacities of the central government. The lack of human development, especially in terms of education, hinders the ability of the central government to design and implement decentralisation reforms, which are among the most complex, and limits the pool of skilled workers who can be hired as public servants at the subnational level. Blöchliger (2016[24]) considers that good governance is complementary to decentralisation and enables it to produce positive outcomes in terms of economic development, well-being and political stability. Acemoglu and Johnson (2005[25]) find that high-quality institutions are often related to better design and implementation of public policies, such as decentralisation reforms. Besides, high-quality institutions enable a more efficient provision of public goods and services,

translating into economic development. Additionally, Rodríguez-Pose and Di Cataldo (2014[26]) find that the capability to design and implement effective policies as well as keep corruption at bay, both characteristics of good governance, are conducive to innovation and efficiency. If these framework conditions are not met, decentralisation reforms might lead to unbalanced and/or partial decentralisation and can be more harmful than a centralised architecture, since subnational governments would lack the concrete means to fulfil their responsibilities, leading to the under-provision or low-quality provision of public goods and services (Enikolopov and Zhuravskaya, 2007[27]).

Size and scale

The size of subnational jurisdictions matters significantly for the ability of subnational governments to deliver their public goods and services efficiently. A significant variation in demographic size of municipalities is observed around the world. In the Asia-Pacific region, data from the World Observatory on Subnational Finance and Investment show that there are significant differences across countries concerning the average size of municipalities. Size can range from a highly fragmented municipal landscape with fewer than 2 000 inhabitants on average in Mongolia to highly populated municipalities with over 200 000 inhabitants on average, as in the case of China, Korea and Malaysia (see above).

Determining the optimal subnational unit size is a context-specific task; it varies not only by region or country but by policy area, as well. The efficient size differs between waste disposal, schools or hospitals. In Finland, research on scale benefits of expanding the size of local governments found that large municipalities were less efficient at service delivery and the optimal size was between 20 000 and 40 000 inhabitants (OECD, 2017[28]; Moisio, Loikkanen and Oulasvirta, 2010[29]). Yet in Japan, unit costs of public services bottomed out at about 120 000 inhabitants and increased at both higher and lower municipal sizes (OECD, 2017[28]; OECD, 2019[3]). In New Zealand, for instance, the government decided to align the regional boundaries with the limits of the drainage systems (OECD/UCLG, 2019[1]).

In practice, subnational governments are often too small to deliver public services or invest at the relevant scale. Besides, the lack of co-ordination across jurisdictions prevent them from taking advantage of economies of scale and from overcoming the limitations their insufficient scale represents (see Box 4.6). In the European Union, the 2015 OECD/Committee of Regions (CoR) survey highlighted horizontal co-ordination as a major challenge for most subnational governments. More than three-quarters of the subnational governments surveyed reported that they had no joint investment strategy with neighbouring cities or regions. In addition, the same percentage of subnational governments reported that the lack of incentives – including financial – to co-operate across jurisdictions was a problem (OECD/CoR, 2015[19]; Allain-Dupré, 2018[30]).

Challenges linked to fiscal decentralisation

The fiscal dimension is very often the weak or even missing link of decentralisation. One of the most frequent challenges, particularly in countries at an early stage of decentralisation, is the misalignment between responsibilities allocated to subnational governments and the resources available to them. Unbalanced decentralisation, when subnational governments have little fiscal autonomy and rely heavily on grants and/or shared taxes, is also common (OECD, 2019[3]). Several countries like China, India and Viet Nam, have a high degree of subnational government expenditure and revenue.

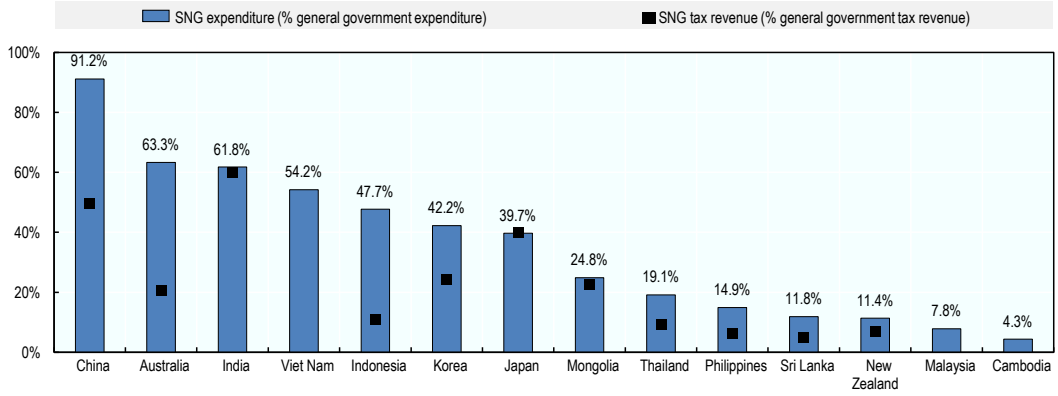
However, in practice, their subnational governments have little autonomy as expenditures and revenues are highly constrained from the national level.

A high proportion of the revenue in subnational governments in most Asia-Pacific countries come from taxes, unlike in the rest of the world, but like Eurasia. However, the high proportion of taxes can be a misleading indication of fiscal autonomy since taxes can be shared with the central government or higher levels of governments, leading to limited decision power for subnational governments. In addition, like the rest of the world, the share of grants and subsidies in total subnational revenue remains high, reaching 50% on average for Asia-Pacific countries.

Most Asia-Pacific countries are characterised by a high degree of shared taxation. Shared taxes, often encompassing personal income tax (PIT), value-added tax (VAT), corporate income tax (CIT) or excise tax, are national taxes that are redistributed to subnational governments either discretionarily or according to allocative criteria. In China, four taxes are shared uniformly between the central government and the provinces: the VAT, CIT, PIT and the securities trading tax. Each province then decides how to distribute it among its lower tiers. In addition, local governments have no discretionary power over their own-source revenue as the central government determines the legislation and rate for each tax. In Mongolia, subnational governments also have little tax autonomy as any changes in tax base or rate must be approved by central authorities. In Korea, subnational taxes, even after the 2011 tax reform, are highly determined by the central government. This is also the case in Viet Nam. It must also be noted that in many Asia-Pacific countries, tax autonomy on local taxes is restricted; even the local own-source taxes are significantly controlled by the central government through various regulations, such as the imposition of minimal or maximal rates and obligations to apply certain exemptions, resulting in significant fiscal imbalances (OECD/UCLG, 2019[1]).

There are great fiscal imbalances across countries between the level of subnational expenditure and the level of subnational tax revenue, higher than in OECD countries, because of the low level of tax (OECD/KIPF, 2019[2])]. For instance, the subnational shares of public expenditure and tax revenue (shared and own-source taxes) are almost equivalent in India, Japan and Mongolia, while in Australia, Indonesia and Sri Lanka, the subnational share of public expenditure is more than double the subnational share of public tax revenue (Box 4.5).

Figure 4.13. Subnational government expenditure and tax revenue as a percentage of public expenditure and tax revenue, 2016



Note: In the World Observatory, 13 out of 16 Asia-Pacific countries have subnational expenditure and tax revenue data. Data are missing for Bangladesh and Nepal. For tax revenue, data are also missing for Cambodia, Mongolia and Viet Nam. Percentage of GG means as a percentage of the general government's, or public, total expenditure and tax revenue respectively.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

A certain degree of fiscal autonomy is needed for the accountability mechanism to thrive. Indeed, relying on own-source revenue, such as taxes, rather than grants and subsidies from the central government, improves the quality and efficiency of spending, targeted more at local needs. It also improves budget management and allows for longer-term planning since own-source revenue can be a reliable and foreseeable source of revenue compared to grants and subsidies, especially when they are allocated discretionarily by the central government (OECD/KIPF, 2019[2]).

Challenges linked to administrative decentralisation

In many countries around the world, the lack of clarity in the assignment of responsibilities and the overlap in the way functions are performed are the most important obstacles to effective decentralisation (OECD, 2019[3]). Unclear and overlapping responsibilities lead to costlier service delivery and policy making. They also hinder subnational capacity building (OECD, 2019[3]). Nevertheless, a certain degree of shared responsibilities among levels of government, especially for distributive functions and those with economies of scale or spillovers, is necessary to enable co-operation between the various levels and improve public service delivery. Since shared responsibilities bring a higher degree of complexity in the administrative structure, they require very clear assignments, however, such as level A and level B share a function, but level A is in charge of maintenance, and level B is in charge of service delivery. This need for clarity is even more relevant when uneven responsibilities are attributed across governments at the same level, bringing another degree of administrative complexity.

Unclear and/or overlapping assignment of responsibilities is an issue that affects both centralised and decentralised countries. For example:

- In China, most transfers of responsibilities are not in the law.
- In Australia, there are significant overlaps in mandates between the federal government and the states, even after the creation of the 2008 Intergovernmental Agreement on Federal Financial Relations (IGAFFR), which aims to clarify responsibilities between the federal government and the states. However, the risk of overlap is relatively low between the state and municipal levels.
- In Indonesia, provinces should, in theory, take care of services that require horizontal co-ordination and/or cannot be taken at the local level. However, in practice, there are several overlaps and not clear-cut delimitation between the provinces' and local governments' assignments. Also, the 2014 Village Law that recognises villages as self-governing bodies does not assign them clear responsibilities.
- In the Philippines, the 1991 decentralisation reform brings several challenges. First, the 1991 Local Government Codes provide some specifications of the new responsibilities for each level of government, but the responsibilities of provinces, cities, municipalities and *barangays* overlap. Also, the various public agencies provide public services and public work at the local level, creating another layer of overlaps. In addition, the codes do not delegate the funds required for Local Government Units (LGUs) to carry out their new responsibilities.

Another major challenge linked to administrative decentralisation is the ability of subnational governments to hire enough staff with adequate competencies to provide public services effectively. There are many variations within countries in terms of capacities, as well as in developed ones (Tselios et al., 2012[31]; OECD, 2019[3]). For example, according to a survey of the OECD and the EU Committee of the Regions, two-thirds of the subnational governments (65%) reported that the capacity to design adequate infrastructure strategies is lacking in their city/region and more than half of the subnational governments (56%) reported a lack of adequate own expertise in infrastructure (OECD, 2019[3]).

Challenges linked to political decentralisation

In theory, decentralisation and accountability mechanisms both reinforce each other. Indeed, if accountability mechanisms are needed for decentralisation to yield positive outcomes, decentralisation can also improve accountability. A first requirement for the accountability mechanism to work is the election of subnational representatives. Then, a certain degree of citizen participation, open, transparent and accessible information regarding one's jurisdiction's planning, finance and projects, and a certain degree of own-resource revenue's dependency are essential for local/subnational representatives to build trust. The capacity to build trust among its residents is fundamental for a subnational government to obtain the support of its local citizens, to develop long-term projects and to implement them when being re-elected. A well-functioning accountability mechanism also stimulates citizens' public participation and helps subnational governments collect information about residents' preferences that, in turn, help improve public service. In sum, subnational elected representatives are more aware of their residents' preferences and can better build the government's capacities accordingly, that is reinforced by the fact that these representatives answer to the residents and not to the central government. In some countries

of Asia-Pacific, local representatives may be appointed by the central/federal government, instead of being elected. Local elections have sometimes been suspended.

Enabling conditions to foster subnational capacity building

The OECD has identified ten guidelines to help policy makers make decentralisation systems work more effectively (Box 4.6) and to enable subnational governments to build their capacities to function well. These guidelines apply mainly at the national government level since they encompass some preconditions regarding legal and constitutional frameworks, which concerns the prerogatives of the national government (OECD, 2019[3]). National governments are also in charge of delegating appropriate resources, financial, administrative and human, to subnational governments, and of supporting co-operation. In fact, a well-functioning decentralisation system implies a renewed role for the central government directed more towards strategic planning, co-ordination and support to subnational capacity building.

Box 4.6. Ten guidelines to make decentralisation systems work more effectively

1. Clarify the responsibilities assigned to different government levels.
2. Ensure that all responsibilities are sufficiently funded.
3. Strengthen subnational fiscal autonomy to enhance accountability.
4. Support subnational capacity building.
5. Build adequate co-ordination mechanisms across levels of government.
6. Support cross-jurisdictional co-operation.
7. Strengthen innovative and experimental governance and promote citizen engagement.
8. Allow and make the most of asymmetric decentralisation arrangements.
9. Consistently improve transparency, enhance data collection and strengthen performance monitoring.
10. Strengthen national, regional development policies and equalisation systems and reduce territorial disparities.

Source: OECD (2019[3]), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/g2g9faa7-en.

Clarify the responsibilities assigned to different government levels, and ensure that all responsibilities are sufficiently funded

Clear and principled assignment of responsibilities across levels of government is crucial for governments to deliver on their mandates, to be held accountable by citizens and to build instituting mechanisms for intergovernmental, as well as beyond government, partnership and co-ordination. Clarity in the division of powers can prevent overlapping or inefficient provision of public services since each governing body knows what its prerogatives are (Box 4.7). Clarity in the division of powers can also encourage citizen engagement and prevent the development of democratic deficits since citizens know to

which governing bodies they can address their requests or claims. Responsibility assignments should not only be clear and codified, but there should be clarity in the division of spending powers to ensure that revenue means are aligned with expenditure needs and other national objectives (Allain-Dupré, 2018[30]; OECD, 2019[3]).

Some countries of the Asia-Pacific region have tried to address this issue and conducted reforms towards greater clarification of responsibilities and functions, including China, Indonesia, Japan and New Zealand (Box 4.7).

Box 4.7. Guidelines 1 and 2: Clarify the responsibilities assigned to different government levels, and ensure that all responsibilities are sufficiently funded: some reforms' examples

The way responsibilities are shared should be explicit, mutually understood and clear for all actors. Equally important is clarity in the different functions that are assigned within policy areas – financing, regulating, implementing or monitoring. Since multi-level governance systems are constantly evolving, a periodic review of jurisdictional assignments should be made to ensure flexibility in the system.

The way different responsibilities across policy areas are decentralised should be balanced, i.e. when the various policy functions are decentralised to a similar extent.

In China, the intergovernmental fiscal reform launched in 2016 addressed the long-standing misalignment of revenue and spending across levels of government. The core part of the reform provided guidelines that included a review of expenditure responsibilities, clarifying responsibility assignments that were traditionally not mentioned in the law. The State Council plan outlined three broad categories of spending allocation (Wingender, 2018[32]).

In Indonesia, following Law 32/2004, local governments gained broad responsibilities, making Indonesia one of the largest decentralised countries in the world. In 2014, the government enacted a new Local Government Law in (no. 23/2014) to replace 2004 law, which aimed to restructure decentralisation to make the public sector more effective. The new law aims to provide clearer guidance related to the distribution of governmental functions between the central and subnational governments. It has redefined the distribution of responsibilities across all levels of government, defining exclusive responsibilities for the central government, concurrent responsibilities and general affairs. It also established a list of obligatory and discretionary functions (OECD/UCLG, 2019[1]).

In Japan, the 1988 Municipal Government Act provides a reference framework for the distribution of responsibilities across levels of government, making a distinction between mandatory responsibilities (including some which are shared with central government or delegated) and optional responsibilities. The 1999 decentralization law eliminated opaque central decision-making on local responsibilities and clarified competences more generally. Subsequent waves of reform have continued to develop the goals of greater municipal autonomy, clearer delineation of responsibilities, and proper financing (OECD, 2017[28]; Allain-Dupré, 2018[30]).

In New Zealand, the Local Government Act 2002 redefined subnational government responsibilities and increased their autonomy regarding the activities they undertake. The LGA 2002 separated policy making from policy implementation and provided subnational governments with a general power of competence. This 2002 Act was amended in 2010

and 2014, in line with the Better Local Government New Zealand reform with the aim, among others, to clarify responsibilities between regional councils and territorial authorities (OECD, 2017[28]). The division of responsibilities between, regional councils and regional and territorial authorities follows the principle of separation between responsibilities related to planning and those which are related to service provision. Regional councils have generally no direct responsibilities for service delivery (except for Auckland and Wellington) and are primarily responsible in sectors related to environmental protection and natural environment, transport, green areas and water management. Territorial authorities generally have responsibilities related to local development and service delivery, local infrastructure and community development and amenities. There is a high degree of co-operation between regional and territorial councils, which have complementary roles (OECD/UCLG, 2019[1]).

Strengthen subnational fiscal autonomy to enhance accountability

In addition to the clear assignment of responsibilities, subnational governments need adequate revenue allocation that matches their spending responsibilities to deliver public services effectively and to support the accountability mechanism. Different empirical studies consistently show that revenue decentralisation is more conducive to regional development than spending decentralisation. A balanced basket of revenues and a large share of own-source revenues enable subnational governments to have more reliable and forecastable revenue streams and to better design long-term development plans (Box 4.8).

In addition, the more subnational governments have fiscal autonomy over their revenue, the more enhanced the accountability mechanism is. Indeed, local residents must have incentives to monitor and evaluate the efficiency of their local administrations for the accountability mechanism to work properly. The literature identifies two requirements to trigger resident incentives: subnational governments depend on own-resource financing, meaning that local residents pay taxes that are directly used by their local representatives; and residents have open access to information about their own jurisdiction's outcomes as well as those of other jurisdictions (Weingast, 2014[33]; Faguet, 2014[34]).

Box 4.8. Guideline 3: Strengthen subnational fiscal autonomy to enhance accountability

Subnational governments should have a certain degree of autonomy in the design and delivery of their public service responsibilities within the limits set by normative regulations, such as minimum service standards.

Subnational governments need own-source revenues beyond shared tax revenues – and they need to develop other sources of revenue to have a balanced basket of revenues.

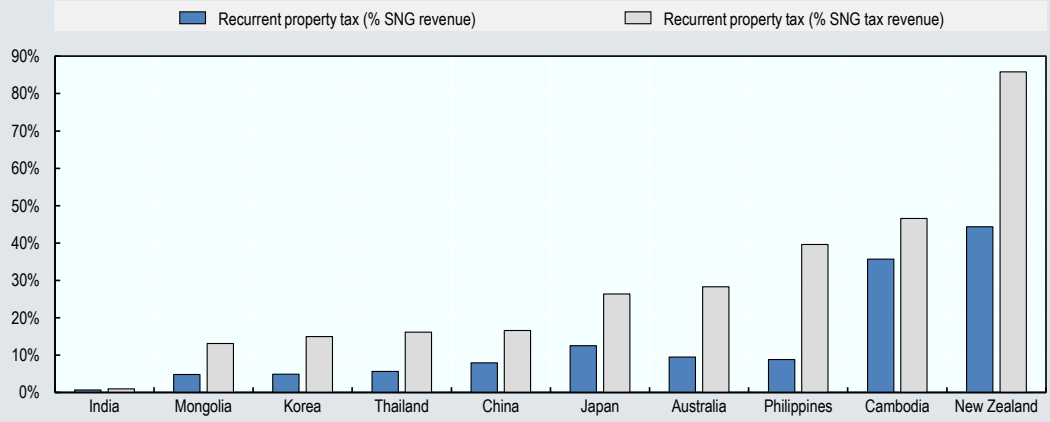
Source: OECD (2019[3]), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/g2g9faa7-en.

Several fiscal instruments are well suited at various subnational levels and can be enhanced to strengthen subnational own-source revenues. The property tax is a local tax by nature and is widespread in Asia Pacific and in the world (see Box 4.9). However, in many Asia-Pacific countries, the central government keeps tight control over the definition of the tax base and rate and often oversees its collection and administration. Some exceptions exist, such as in New Zealand, where the subnational autonomy in property tax is large (OECD/KIPF, 2019[2]).

Box 4.9. The property tax in Asia Pacific

Box 4.13 displays the share of the recurrent property tax in subnational total revenue and tax revenue in 2016. In 2016, in New Zealand, the recurrent property tax represented more than three-quarters of subnational tax revenue (85.8%), and 44% of total subnational revenue. In Cambodia and the Philippines, the recurrent property tax represented respectively 46.6% and 39.6% of their subnational tax revenue, but while it represented 36% of Cambodia's total subnational revenue, it represented only 9% of the Philippines' total subnational revenue. In Australia and Japan, it represented between 25% and 30% of subnational tax revenue and less than 15% of total subnational revenue. The recurrent property tax only represents 17% to 13% of subnational tax revenue in China, Thailand, Korea and Mongolia; it represents less than 1% in India.

Figure 4.14. The tax revenue and recurrent property tax as a percentage of total subnational revenue in Asia Pacific, 2016



Note: In the World Observatory, no data on subnational tax revenue and/or subnational property tax are available for Bangladesh, Indonesia, Malaysia, Nepal, Sri Lanka or Viet Nam.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

The other common tax instruments at subnational level are motor vehicle taxes (e.g. Australia, India, Indonesia, Japan and Korea), excise taxes, in particular on fuel or domestic goods and services (Indonesia, Malaysia, New Zealand, Russia, Thailand, Viet Nam), local business taxes, licences, tax on payrolls and professional tax (Australia, India, Japan, Korea, Mongolia, Philippines, Viet Nam), local consumption taxes (Japan, Korea), land use taxes (China, Viet Nam), taxes on natural resources (Indonesia, Viet Nam) and other minor taxes such as an education tax (Korea, Philippines), or taxes on touristic activities and entertainment. Other countries also have specific taxes targeted specifically at cities (city planning tax in Japan) metropolitan cities (Korea) or even a special tax for the capital Ulaanbaatar in Mongolia (OECD/KIPF, 2019[2]).

This large diversity of tax experiences in Asia-Pacific countries presents an opportunity to further strengthen the autonomy of subnational governments over these fiscal instruments since the taxation structures already exist and do not need to be created from scratch.

The high degree of informality in some countries, such as Bangladesh, India, Nepal and Sri Lanka, and/or the lack of a sound tax-collection system can be however a significant barrier

to sustaining subnational finance with taxation. However, in Cambodia, major improvements to address informality in the economy came with a significant tax revenue increase, from 9.6% of GDP in 2009 to 15.3% in 2016. In the Philippines, locally collected revenue grew by 37% between 2013 and 2016 thanks to capacity-training programmes supported by the central government and international donor agencies.

In addition to make the most of taxation at subnational level, other sources of revenue, such as user charges and fees, licences and permits, can be valuable fiscal tools to finance subnational public services. . There is an opportunity to diversify and develop other sources of revenue, especially since alternative means of finance are currently low in Asia Pacific, including property income, tariffs and fees, and other types of revenue. Examples of other types of revenue in Asia-Pacific countries are mentioned in Box 4.5.

Support subnational capacity building

Subnational capacities in terms of quantity of staff, level of expertise and scale of actions are key to addressing complex issues such as strategic planning, infrastructure investment, oversight of public goods and services procurement or production and delivery, etc. (Box 4.10). It entails subnational governments first having the constitutional/legal/traditional empowerment to effectively hire, fire and set terms of employment of own employees; that they can co-ordinate or co-deliver policies and programmes with other governments (horizontally and vertically) and beyond government stakeholders; they can carry out fiscal and financial management; and they can audit and evaluate own services. In addition to these institutional abilities to perform this range of actions, subnational governments require resources, competencies, skills, and organisation to deliver high-quality services effectively, efficiently and sustainably. Governments should seek to reinforce the capacities of public officials and institutions with a systemic approach, rather than adopting a narrow focus on technical assistance only. For instance, staff training on local public financial management should be established and mandatory for all staff covering these functions. Governments should also institute mandatory training for budgeting department staff in budget methods, budget formulation, budget execution, revenue analysis and strategic planning (OECD, 2019[3]).

Box 4.10. Guideline 4: Support subnational capacity building

Central government should assess capacity challenges in the different regions on a regular basis. Policies to strengthen capacities should be adapted to the various needs of territories. Governments should seek to reinforce the capacities of public officials and institutions in a systemic approach, rather than adopting a narrow focus on technical assistance.

Staff training in the basics of local public financial management should be established. Open, competitive hiring and merit-based promotion should be ensured.

Special public agencies accessible to multiple jurisdictions should be encouraged in areas of needed expertise (e.g. regional development agencies, PPP units).

Source: OECD (2019[3]), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/g2g9faa7-en.

When subnational governments have limited financial and human-resource capacities or when no co-ordination among various levels of governments has been possible to deal with externalities or economies of scale, outsourcing can be a solution. As an example, in India, municipalities are relying more and more on the private sector to fund infrastructure improvements and to deliver basic services. However, for a service to be outsourced, it must be intrinsically profitable while fulfilling the principle of equality in public service access. Another alternative to outsourcing is the development of public-private partnerships (PPPs). However, a limitation of PPPs is their administrative and judiciary complexity, which requires sound administrative capacities at the subnational level or support from strong central government or a higher subnational level.

Building adequate capacities takes time and requires the long-term involvement and commitment of both subnational – and central – governments. Indeed, central governments are in charge of ensuring that subnational governments have enough capacities. In Indonesia, for example, the two major reforms of 2001 and 2005 induced significant delegation to subnational governments of political autonomy, important responsibilities and capacities. Two-thirds of the central government's workforce has been transferred to subnational governments together with several assets and resources.

Equally, central governments should assess on a regular basis the capacity challenges of their subnational governments and adapt their policies to strengthen capacities according to their territories' specific needs. They can also issue standardised guidance documents in key areas, such as planning, project appraisal, procurement, monitoring and evaluation, to disseminate to subnational governments. This practice is highly cost-effective; it helps subnational governments structure their work and save time and money since they do not have to allocate staff for these tasks. This practice can also lead to harmonised procedures across a national territory, which can, in turn, support horizontal co-ordination.

In addition, central governments can create or support the creation of special public agencies accessible to multiple jurisdictions in areas of needed expertise to help support subnational capacities (e.g. PPP units, regional development agencies) (OECD, 2019[3]). In Korea, for example, the Public and Private Infrastructure Investment Management Centre (PIMAC) established a Public-Private Partnership Unit that provides technical assistance to subnational governments. There is also a PPP centre in the Philippines, but the support provided to local government units is currently limited, and these units are not yet ready to engage in PPP.

The megatrend regarding digitalisation could also be an opportunity. A central government might produce online courses to train subnational public servants on various matters (town planning, budget management, PPPs, infrastructure investment, development planning, etc.) and could organise regular meetings with web conference tools. An online platform could also be designed to report subnational governments' progress on their various projects. This type of platform could also be an opportunity to share cross-jurisdiction experiences with the support of the central government.

In countries with regional layers of governments, states governments, often in charge of overseeing several local governments, also have the administrative expertise to support local governments. Various forms of co-ordination mechanisms exist, such as having a regional public servant dispatched in local governments for specific projects; cyclical meetings to discuss the various functions and projects under the local governments' responsibilities; mixed teams of regional and municipal public servants working on a specific service delivery; consulting services available for local governments, establishing local government training institutes, etc.

- In 2007, Chile created the Academia de Capacitación Municipal y Regional to strengthen subnational capacities. It aims to be a technical reference for subnational staff and to strengthen human resources in municipal and regional governments to support a broad spectrum of knowledge of use in various territorial situations. It provides free training, in-person and online training for public servants. In addition, a Fund for the Training of Municipal Public Servants was created in 2014, financing technical and professional studies for municipal personnel (OECD, 2017[35]).
- In Korea, the Ministry of the Interior and Safety host the Local Government Officials Development Institute (LOGODI) since its creation in 1965. The institute contributes to the development of local administration through strengthening the capacity of Korean and foreign local government officials thanks to various education and training programs. With a strong focus on international cooperation, the institute, for instance, provided training on capacity building for local administration the third week of November 2020 to more than 100 Ugandan Officials (Korean Ministry of the Interior and Safety, 2020[36]).
- In the Indian state of Kerala, the Kerala Institute of Local Administration (KILA) is an autonomous institution constituted under the Ministry of Local Self Government, government of Kerala, with the mandate of facilitating and accelerating the socio-economic development of the State through strengthening the Local Self Government Institutions (LSGIs). KILA is a training, research and consultancy institution providing capacity-building intervention on local governance and decentralisation through training programmes of local elected representatives and officials, facilitation and strengthening of decentralised planning processes, documentation of local governance best practices for dissemination, etc. It is organised around 6 regional centres, each focusing on various topics such as tribal development and natural resource management, human resource development and good governance (KILA, 2020[37]).
- In Philippines, the University of the Philippines and the Congress established the Centre for Local and Regional Governance (CLRG) in 1965. The CLRG is affiliated to the University of Philippines as its research, training and consulting centre for local governments and is a constituent unit of the national College of Public Administration and Governance. The CLRG is responsible for developing and contributing to responsive knowledge on local and regional governance, providing consulting services in local and regional governance systems, effectively developing competencies of local governance participants and nurturing a community of practice on local and regional governance (CLRG, 2020[38]).
- In the United States, the National League of Cities (NLC), a voluntary organisation of municipalities, has established an NLC University to impart online and face-to-face training in municipal governance. It also produces toolkits and other training materials of use to municipal leaders and officials.

Build adequate co-ordination mechanisms across levels of government

Vertical and horizontal co-ordination across levels of government is crucial for any decentralised system to function well, and for subnational governments to be able to build capacity. Vertical co-ordination helps to both align policies at all government levels and enable higher levels of government to support lower levels in capacity building and in fulfilling their mandates (Box 4.11). Especially in the context of shared rules, a dense

network of national/regional/local political and bureaucratic interactions is necessary to deliver public services effectively and efficiently. Indeed, delivery methods must be consistent across all levels of government and should not overlap. Specific instruments and platforms exist to foster vertical co-ordination, from consultation mechanisms to joint decision-making processes; they include dialogue platforms, fiscal councils, standing commissions and intergovernmental consultation boards, and contractual arrangements (OECD, 2019[3]).

Box 4.11. Guideline 5: Build adequate co-ordination mechanisms across levels of government

Since most responsibilities are shared, it is crucial to establish governance mechanisms to manage joint responsibilities. Creating a culture of co-operation and regular communication is essential for effective multi-level governance and successful long-term reform. Tools for vertical co-ordination include, for example, dialogue platforms, fiscal councils, standing commissions and intergovernmental consultation boards, and contractual arrangements.

It is important to avoid multiplying co-ordination mechanisms with no clear role in the decision-making process.

Source: OECD (2019[3]), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/g2g9faa7-en.

Examples from countries who have worked in this area include:

- In Italy, inter-governmental coordination mechanisms are well developed. Italy has three levels of "conferences" between the central and subnational governments, serving as fora for intergovernmental coordination: a Conference of State-Regions, a Conference of State-Municipalities and other Local Authorities and a Unified Conference of State-Regions-Municipalities and Local Authorities, which includes all the members of the two other conferences (OECD, 2017[28]).
- In Spain, vertical coordination between the central government and the autonomous communities is conducted, on a voluntary basis, through the Conference of Presidents (*Conferencia de Presidentes*), created in 2004. Vertical coordination also takes place through sectoral conferences such as the Council of Fiscal and Financial Policy (*Consejo de politica fiscal y financiera,* CPFF) for economic, fiscal and financial matters. Vertical coordination between the central government and local governments takes place through the National Commission for Local Administration (*Comisiòn Nacional de Administracion Local*), which was created in 1985. Autonomous communities have their own fora for coordinating with local governments under their jurisdiction.
- In Australia, the new National Federation Reform Council (NFRC) replaces the Council of Australian Governments (COAG) since June 2020, following an agreement between the Prime Minister of Australia and the Premiers and Chief Ministers. The NFRC, which has the National Cabinet at its core, also comprises the Council on Federal Financial Relations (CFFR) and the Australian Local Government Association (ALGA). The NFRC meets once a year to focus on national priority issues. It is intended that the new model will streamline processes, enabling improved collaboration, communication and effectiveness. Under the new

structure, the National Cabinet will oversee seven ministerial reform sub-committees in select areas, consolidating the work of 19 ministerial forums and nine regulatory councils. These areas include rural and regional; skills; energy; housing; transport and infrastructure; population and migration; and health (OECD, Implementation Handbook for Quality Infrastructure Investment, Forthcoming).

- In India, the government is currently promoting a new federalism paradigm consisting of co-operative and competitive federalism. The idea is to shift from a top-down/planning approach to a bottom-up approach that promotes experimentation, benchmarking and the sharing of experience across states. Several examples of vertical co-ordination arrangements already exist: the Inter-State Council (ISC); the National Institution for Transforming India, also called NITI Aayog; and the Finance Commission of India. The ISC, in particular, is specified in the Constitution as a platform for strengthening Centre-State and Inter-State relations. The NITI Aayog, which replaces the Planning Commission instituted in 1950, was established in 2015 to foster co-operative federalism (OECD/UCLG, 2019[1]).

During the COVID-19 pandemic, the countries most successful in addressing the crisis have had strong coordination mechanisms across levels of government (OECD, 2020[14]). For instance, the Korean government has strengthened the "whole-of-government approach" in the fight against COVID-19. The Prime Minister chairs the Central Crisis Management Committee, on which are represented all relevant central government ministries, as well as Korea's seventeen provinces and major cities. As many Asian countries, South Korea draws on its experience with the SARS epidemic in 2003. In Australia, the central government has introduced a National Cabinet to address health and economic issues related to managing the COVID-19 crisis and recovery, gathering the Prime Minister and the First Ministers of each Australian State and Territory. The Australian Health Protection Principal Committee, a parallel group composed of all state and territory Chief Health Officers and chaired by the national Australian Chief Medical Officer, advises the National Cabinet (OECD, 2020[4]; Institut Montaigne, 2020[39]).

Reaching the right scale by merging and/or cooperating

A central government can decide to delegate a function to a certain level of government, but it cannot ensure that the jurisdiction boundaries match the "benefit area" and enable the subnational government to exercise the function in the most efficient way. In order to overcome this limitation, several options exist (Box 4.12). If few subnational functions produce externalities and/or would benefit from economies of scale, subnational governments can co-operate on these few specific functions, such as inter-municipal transports and energy power plants, or can create cross-jurisdiction local enterprises.

Box 4.12. Guideline 6: Support cross-jurisdictional co-operation

Horizontal co-ordination can be carried out using specific matching grants, and by promoting inter-municipal and interregional co-operation. Metropolitan governance should be promoted as well. The legal system should allow such tools.

Rural-urban partnerships should be promoted as a form of cross-jurisdiction collaboration to enhance inclusive growth by bringing multiple benefits, such as expanding the benefits of agglomeration economies, to overcome co-ordination failures and strengthen capacity.

Source: OECD (2019[3]), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/g2g9faa7-en.

National governments – as well as state governments – may promote inter-municipal cooperation by improving legal frameworks, spreading the values and benefits of cooperation amongst local elected, and providing financial (grants and other financial incentives) and technical incentives for cross-jurisdiction co-operation.

Some countries have made headway in this area, including:

- In New Zealand, the Local Government Act (LGA) 2002 Amendment Bill encourages inter-municipal co-operation and shared services between local governments. In 2014, in line with the "Better Local Government New Zealand" the LGA was amended in particular to further encourage inter-municipal co-operation and shared services.
- In Australia, policies fostering inter-municipal cooperation are under states' responsibility. Various types of inter-municipal co-operation exist depending on the state: Regional Local governments (Western Australia), Regional Subsidiaries (South Australia), County Councils (NSW), etc. Shared services arrangements are promoted at both state and local levels throughout Australia (OECD/UCLG, 2019[1]). In France, inter-municipal co-operative units can also have their own sources of tax revenue.
- In India, federated states have established "urban development authorities" to address the lack of horizontal co-ordination among municipalities.
- In Mongolia, cooperation between territorial units has been encouraged by development agencies active in the country. Inter-soum models have been developed in health management, and Habitat III's national report mentions other various inter-soum experiments in the provision of other services (OECD/UCLG, 2019[1]).
- In Japan, inter-municipal cooperation is increasingly promoted, in particular through voluntary partnership agreements that are established under the Local Autonomy Act.
- In Germany, inter-municipal co-operation is strongly encouraged by the Länder, which decide independently on the rules of establishing such bodies. There are around 4 530 municipal associations (Gemeindeverband), which have different forms and status: offices, joint municipalities, association of communities and syndicates. Syndicates in particular are special-purpose associations created to

deliver standard local services such as waste management, water and wastewater or transport. They are widespread throughout Germany and are one of the most common and oldest forms of inter-municipal co-operation in the country.

Local public companies are another alternative to improve the efficiency of service delivery due to cost-effectiveness requirements and to foster expertise. Japan, a decentralised country, has a network of 8 398 local public companies active in public service delivery, especially in sewerage (43.2% of all local public companies), water supply (22.9%) and hospitals (7.5%). Likewise, Indonesia relies on local public enterprises with around 650 local public enterprises owned and managed by regencies and cities, and 108 local public enterprises owned and managed by provinces, as of 2014. The local enterprises include drinking water companies and marketplaces.

Allow and make the most of asymmetric decentralisation arrangements

In most Asia-Pacific countries, certain subnational bodies have different self-governing statuses. Some regions are more autonomous than others (e.g. China, India, Malaysia and the Philippines). Some large cities have the status of an intermediate or regional government (in, for example, Cambodia, China, Japan, Korea, Mongolia, Thailand and Viet Nam) and some urban areas have a different status than rural ones (for example in Bangladesh, India, Malaysia, Nepal, New Zealand, Sri Lanka and Viet Nam). These asymmetric decentralised arrangements are more common in Asia Pacific than in other regions of the world (OECD/KIPF, 2019[2]). These asymmetric arrangements are both an opportunity to address geographic, ethnic and socio-economic heterogeneity and allow some degree of differentiation, and a challenge, as it creates additional complexity in terms of territorial organisation and can result in unclear definitions of responsibilities across levels of government and overlap in public service provision.

To make the most out of asymmetric arrangements, several conditions must be met (Box 4.13). They should be considered as experimental and evolving and should be monitored on a regular basis to highlight good practices and enable modifications. Finally, the number of asymmetric arrangements within a country must be kept within reason to limit co-ordination costs and complexity (Allain-Dupré, Chatry and Moisio, forthcoming[40]).

Box 4.13. Guideline 8: Allow and make the most of asymmetric decentralisation arrangements

Asymmetric decentralisation should be supported by effective vertical and horizontal co-ordination mechanisms and needs to go hand-in-hand with an effective equalisation system. An asymmetric decentralisation approach should be based on dialogue, transparency and agreements between all main stakeholders, and be part of a broader strategy of territorial development.

The way asymmetric responsibilities are allocated should be explicit, mutually understood and clear for all actors. To the greatest extent possible, participation in an asymmetric arrangement should remain voluntary.

Source: OECD (2019[3]), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/g2g9faa7-en.

Conclusion

This chapter provides an overview of the diversity of institutional and fiscal arrangements for subnational governments in the Asia-Pacific region. It provides an international perspective on subnational capacity building, with concrete guidelines from the OECD publication *Making Decentralisation Work: A Handbook for Policy-Makers*. In all types of systems, for decentralisation to be the most effective, national governments need to support subnational governments in their effort to build sound capacities. National governments should embrace a renewed role, directed more towards strategic planning, providing adequate enabling conditions and co-ordination, to ensure a well-functioning decentralisation system.

Annex 4.A. Indicator tables for selected Asia-Pacific countries

Annex Table 4.A.1. Demographic and economic indicators for selected Asia-Pacific countries, 2017

	Area	Population	Population growth	Urban population	Urban population growth	Density	Population of capital city	GDP per capita	Real GDP growth	GFCF	HDI	Unemployment rate
	km²	Thousand inhabitants	Average annual %	% of total population	Annual %	Inhabitants /km²	% of total population	USD PPP	Annual %	% GDP	World rank	% labour force
Australia	7 741 220	24 598	1.5%	85.9%	1.7%	3.2	1.8%	48 460.0	2.3%	24.0%	3	5.6%
Bangladesh	147 630	164 670	1.2%	35.9%	3.2%	1 115.4	11.9%	3 868.8	7.3%	30.5%	136	4.4%
Cambodia	181 040	16 005	1.6%	23.0%	3.3%	88.4	12.2%	4 009.0	6.8%	21.9%	146	0.2%
China	9 634 057	1 386 395	0.5%	58.0%	2.7%	145.0	1.4%	16 806.7	6.9%	41.9%	86	4.1%
India	3 287 259	1 339 180	1.2%	33.6%	2.4%	407.4	2.1%	7 059.3	6.7%	28.5%	130	3.5%
Indonesia	1 910 931	263 991	1.3%	54.7%	2.3%	138.1	4.0%	12 283.6	5.1%	32.2%	116	4.2%
Japan	377 962	126 728	-0.1%	91.5%	-0.1%	335.4	29.6%	43 279.0	1.7%	23.5%	19	2.8%
Korea	99 461	51 446	0.4%	81.5%	0.4%	517.2	19.4%	38 350.3	3.1%	31.1%	22	3.7%
Malaysia	330 345	31 624	1.4%	75.4%	2.2%	95.7	23.9%	29 448.9	5.9%	25.0%	57	3.4%
Mongolia	1 564 120	3 076	1.9%	68.4%	1.7%	2.0	49.4%	12 918.4	5.3%	24.7%	92	6.4%
Nepal	147 180	29 305	1.2%	19.3%	3.2%	199.1	4.5%	2 696.7	7.5%	34.0%	144	2.7%
New Zealand	267 710	4 820	1.1%	86.5%	2.2%	18.0	8.5%	41 109.0	3.0%	24.0%	16	4.7%
Philippines	300 000	104 918	1.6%	46.7%	2.0%	349.7	12.8%	8 342.8	6.7%	25.0%	113	2.4%
Sri Lanka	65 610	21 444	0.5%	18.4%	1.5%	326.8	2.8%	12 826.6	3.3%	26.3%	76	4.2%
Thailand	513 120	69 038	0.4%	49.2%	1.8%	134.5	13.7%	17 872.2	3.9%	23.2%	83	0.9%
Viet Nam	330 967	95 541	1.1%	35.2%	3.0%	288.7	4.5%	6 775.8	6.8%	23.0%	116	2.1%

Notes: GFCF: Gross Fixed Capital Formation. The year of reference is 2017 but can vary country by country according to data availability. More information can be found on the database. The annual average population growth rate is calculated over the period 2010-15.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

Annex Table 4.A.2. Fiscal decentralisation indicators for selected Asia-Pacific countries, 2016

	Total expenditure		Direct investment		Total revenue		Tax revenue		Total debt		Financial debt	
	% GDP	% CG	% GDP	% CG	% GDP	% CG	% GDP	% CG	% GDP	% CG	% GDP	% CG
Australia	16.4%	63.3%	2.1%	72.5%	16.3%	49.6%	5.5%	20.6%	19.8%	29.1%	8.5%	22.6%
Bangladesh	..	..	..	..	..	..	..	..	0.1%	0.3%	..	..
Cambodia	1.0%	4.3%	0.2%	2.8%	1.2%	7.9%	0.9%	..	..	..	..	..
China	21.6%	91.2%	..	..	18.2%	72.0%	8.7%	49.6%	20.6%	46.6%	..	..
India	17.1%	61.8%	2.7%	63.4%	14.6%	70.8%	10.6%	60.1%	21.3%	29.9%	21.3%	35.0%
Indonesia	8.1%	47.7%	1.8%	59.0%	8.1%	55.9%	1.3%	10.9%	0.3%	1.1%	0.0%	0.1%
Japan	15.5%	39.7%	2.6%	68.7%	15.5%	43.5%	7.4%	39.9%	33.9%	15.3%	32.2%	14.9%
Korea	13.8%	42.2%	2.9%	58.4%	14.3%	41.4%	4.7%	24.1%	4.2%	7.6%	2.1%	4.3%
Malaysia	2.4%	7.8%	0.8%	7.2%	2.4%	13.4%	..	..	0.5%	0.6%	0.5%	0.6%
Mongolia	9.7%	24.8%	1.9%	19.6%	9.1%	35.9%	3.3%	22.7%	..	..	..	..
Nepal	..	..	..	..	..	..	..	..	..	..	..	..
New Zealand	4.4%	11.4%	1.3%	32.1%	4.3%	10.8%	2.2%	7.1%	5.8%	11.5%	4.8%	13.1%
Philippines	3.1%	14.9%	0.4%	8.5%	4.0%	20.8%	0.9%	6.1%	0.6%	1.4%	0.6%	..
Sri Lanka	2.3%	11.8%	0.3%	11.7%	2.3%	16.4%	0.6%	4.8%	..	..	..	..
Thailand	4.0%	19.1%	1.6%	52.0%	4.1%	19.3%	1.4%	9.3%	1.0%	2.4%	0.1%	0.3%
Viet Nam	15.6%	54.2%	4.3%	71.4%	11.2%	45.8%	..	..	1.5%	2.3%	1.5%	2.3%
Regional average	9.6%	35.3%	1.8%	40.6%	9.0%	36.0%	4.0%	23.2%	9.1%	12.4%	..	..

Notes: CG: Central Government. Each category is the share of subnational governments within the general government for this category. For instance, Total expenditure (% CG) means subnational expenditure as a percentage of total public expenditure; Tax revenue (% CG) means subnational tax revenue as a percentage of total public tax revenue. The year of reference is 2016 but can vary country by country according to data availability. More information can be found on the database.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

Annex Table 4.A.3. Territorial organisation in selected Asia-Pacific countries, 2017/18

	System	Municipal level	Intermediate level	Regional or state level	Total number of SNGs
Australia	Federal	562 local government areas		6 states + 2 federal territories	570
Bangladesh	Unitary	**Rural**: 4 553 union of villages **Urban**: 11 city corporations + 324 municipalities	**Rural**: 489 sub-districts	**Rural**: 64 districts	5 441
Cambodia	Unitary	1 410 communes + 236 *Sangkats*	159 districts + 26 municipalities	24 provinces + 1 capital city	1 856
China	Unitary	2 851 counties	334 prefectures	31 provinces	3 216
India	Federal	262 771 rural local bodies + 4 657 urban local bodies		29 states + 7 union territories	267 464
Indonesia	Unitary	83 344 villages	416 regencies + 98 cities	34 provinces	83 892
Japan	Unitary	1 718 municipalities + 23 special wards within Tokyo		47 prefectures	1 788
Korea	Unitary	226 municipalities		17 regional entities	243
Malaysia	Federal	**Rural**: 98 district councils **Urban**: 12 city councils + 38 municipal councils		13 states	167
Mongolia	Unitary	1 568 communities + 152 neighbourhoods	330 regions + 9 districts	21 provinces + 1 capital city	2 081
Nepal	Federal	276 urban municipalities + 460 rural municipalities +		7 provinces	760

	System	Municipal level	Intermediate level	Regional or state level	Total number of SNGs
		6 metropolitan cities + 11 sub-metropolitan cities			
New Zealand	Unitary	67 territorial authorities		11 regional councils	78
Philippines	Unitary	42 045 villages	145 cities + 1 489 municipalities	81 provinces + 1 autonomous region	43 761
Sri Lanka	Unitary	24 municipal councils + 41 urban councils + 276 rural councils		9 provincial councils	350
Thailand	Unitary	Pattaya City + 30 city municipalities + 178 town municipalities + 2 232 sub-district municipalities		75 Provincial Administrative Organisations (PAOs) + Metropolitan City of Bangkok	2 517
Viet Nam	Unitary	8 978 communes + 1 581 wards + 603 commune-level towns	546 rural districts + 46 urban districts + 51 district-level towns + 67 provincial cities	58 provinces + 5 centrally run cities	11 938

Notes: SNGs: Subnational governments. The year of reference is 2017/18 but can vary country by country according to data availability. More information can be found on the database.
Source: Authors' elaboration based on the 2019 World Observatory on Subnational Government Finance and Investment database, found at www.sng-wofi.org.

References

Acemoglu, D. and S. Johnson (2005), "Unbundling institutions", *Journal of Political Economy*, Vol. 113/5, pp. 949-995. [25]

Allain-Dupré, D. (2018), "Assigning responsibilities across levels of government: Trends, challenges and guiding principles for policy-makers", *OECD Working Papers on Fiscal Federalism*, No. 24, OECD Publishing, Paris, https://doi.org/10.1787/f0944eae-en. [30]

Allain-Dupré, D., I. Chatry and A. Moisio (forthcoming), *Asymmetric decentralisation: Trends, challenges and policy implications*, OECD Publishing, Paris. [40]

Baskaran, T., L. Feld and J. Schnellenbach (2016), "Fiscal Federalism, Decentralization, and Economic Growth: A Meta-Analysis", *Economic Inquiry*, pp. 1445-1463. [21]

CLRG (2020), *Centre for Local and Regional Governance*, https://localgov.up.edu.ph/ (accessed on 7 December 2020). [38]

ECDC (2020), *COVID-19 situation update worldwide, as of 2 December 2020*, https://www.ecdc.europa.eu/en/geographical-distribution-2019-ncov-cases. [6]

Enikolopov, R. and E. Zhuravskaya (2007), "Decentralisation and Political Institutions", *Journal of Public Economics*, Vol. 91, pp. 2261-90. [27]

Faguet, J. (2014), "Decentralization and Governance", *World Development*, Vol. 53, pp. 2-13, http://dx.doi.org/10.1016/j.worlddev.2013.01.002. [34]

Government of Thailand (2020), *Cabinet Approves the Holding of Elections of PAO Members*, https://thailand.prd.go.th/ewt_news.php?nid=10194&filename=index (accessed on 4 december 2020). [11]

Hooghe, L. et al. (2016), *Measuring Regional Authority: A Postfunctionalist Theory of Governance (Vol. 1)*, Oxford University Press. [13]

Institut Montaigne (2020), *COVID-19: L'Asie oriental face à la pandémie*, https://www.institutmontaigne.org/ressources/pdfs/publications/covid-19-lasie-orientale-face-la-pandemie-note1.pdf. [39]

Kaufmann, D., A. Kraay and M. Mastruzzi (2011), *The worldwide governance indicators: Methodology and analytical issues*, pp. 220-246, http://info.worldbank.org/governance/wgi/index.aspx#home. [23]

KILA (2020), *Kerala Institute of Local Administration: About Us*, https://www.kila.ac.in/about-us/ (accessed on 7 December 2020). [37]

Korean Ministry of the Interior and Safety (2020), *Local Government Officials Development Institute*, https://logodi.go.kr/en/ (accessed on 7 December 2020). [36]

Martinez-Vazquez, J. and R. McNab (2006), "Fiscal decentralization, macrostability, and growth". [20]

Moisio, A., H. Loikkanen and L. Oulasvirta (2010), *Public services at the local level - The Finnish way*. [29]

Musgrave, R. (1959), *The Theory of Public Finance, A Study in Public Economy*, McGraw-Hill. [17]

OECD (2020), *Economic Outlook for Southeast Asia, China and India 2020 – Update: Meeting the Challenges of COVID-19*, OECD Publishing, Paris, https://dx.doi.org/10.1787/e8c90b68-en. [9]

OECD (2020), *OECD Economic Outlook, Volume 2020 Issue 2: Preliminary version*, OECD Publishing, Paris, https://dx.doi.org/10.1787/39a88ab1-en. [8]

OECD (2020), *The Territorial Impact of COVID-19: managing the crisis across levels of government*, OECD Publishing, https://read.oecd-ilibrary.org/view/?ref=128_128287-5agkkojaaa&title=The-territorial-impact-of-covid-19-managing-the-crisis-across-levels-of-government. [4]

OECD (2019), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://dx.doi.org/10.1787/g2g9faa7-en. [3]

OECD (2017), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264279049-en. [35]

OECD (2017), *Multi-level Governance Reforms: Overview of OECD Country Experiences*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264272866-en. [28]

OECD (2016), *Decentralisation and Quality of Public Finance: Intermediate Report*, OECD Publishing. [24]

OECD (forthcoming), *OECD Rural Policy Reviews: Korea*. [12]

OECD/CoR (2015), *Infrastructure Planning and Investment across Levels of Government: Current Challenges and Possible Solutions*, OECD Publishing. [19]

OECD/KIPF (2019), *Fiscal Decentralisation and Inclusive Growth in Asia edited by Kim, Junghun; Dougherty, Sean*, OECD Fiscal Federalism Studies, OECD Publishing, Paris/Korea Institute of Public Finance, Seoul, https://dx.doi.org/10.1787/25cf7545-en. [2]

OECD/UCLG (2019), *2019 Report World Observatory of Subnational Government Finance and Investment - Country profiles*, OECD Publishing, Paris, https://www.oecd.org/cfe/regional-policy/Observatory-on-Subnational-Government-Finance-and-Investment.htm. [1]

Rodríguez-Pose, A. and M. Di Cataldo (2014), "Quality of government and innovative performance in the regions of Europe", *Journal of Economic Geography*, Vol. 15/4, pp. 673-706. [26]

Smoke, P. (2019), "Fiscal decentralisation and inclusive growth: The role of institutional context in selected Asian economies", in *Fiscal Decentralisation and Inclusive Growth in Asia*, OECD Publishing, Paris, https://dx.doi.org/10.1787/67eca5ea-en. [10]

Ter-Minassian, T. (forthcoming), "Challenges of Subnational Capacity Development", OECD. [18]

Tselios, V. et al. (2012), "Income inequality, decentralisation, and regional development in Western Europe", *Environment and Planning A*, http://dx.doi.org/10.1068/a44334. [31]

UNDP (2019), *Human Development Index*, http://hdr.undp.org/en/content/human-development-index-hdi. [22]

United Nations (2019), *Average annual population change (%) 2030-2035*, https://population.un.org/wpp/. [5]

United Nations (2019), *World Population Prospects 2019 Database*, https://population.un.org/wpp/Download/Standard/Population/. [15]

United Nations (2018), *World Urbanization Prospects: The 2018 Revision*, https://population.un.org/wup/Publications/Files/WUP2018-Report.pdf. [14]

Weingast, B. (2014), "Second Generation Fiscal Federalism: Political Aspects of Decentralization and Economic Development", *World Development*, http://dx.doi.org/10.1016/j.worlddev.2013.01.003. [33]

Wingender, P. (2018), *Intergovernmental Fiscal Reform in China*, IMF Working Paper, https://www.imf.org/~/media/Files/Publications/WP/2018/wp1888.ashx. [32]

World Bank (2020), *Macro Poverty Outlook for East Asia and the Pacific: Data Dashboard*, https://www.worldbank.org/en/publication/macro-poverty-outlook/mpo_eap#sec4 (accessed on 9 November 2020). [7]

World Observatory on Subnational Government Finance and Investment (2019), *Country profiles*, http://www.sng-wofi.org/country-profiles/. [16]

Notes

1. In the World Observatory, data on demographic and economic indicators are available for all 122 countries.
2. The World Bank East Asia and Pacific region encompasses 37 countries and territories: https://data.worldbank.org/country/Z4
3. 12 countries are covered in the Emerging Asia region as defined by the OECD: the members of the Association of Southeast Asian Nations (ASEAN) member countries: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Viet Nam; in addition to China and India.
4. Indonesia experienced a severe centralisation trend between 1950 (14.0) and 1979 (5.9) when it reached its lowest RAI score. The RAI score remained constant until 1998 and the fall of the President Suharto.
5. Data here are sourced from the 2019 update of the country profiles and the database of the World Observatory on Subnational Government Finance and Investment. The year of reference of the territorial organisation data are 2017/18 but can vary country by country according to data availability. There is data for all 122 countries of the database at www.sng-wofi.org. More information can also be found at https://stats.oecd.org/viewhtml.aspx?datasetcode=SNGF_WO.
6. Australia, India, Japan, Korea, Malaysia, Nepal, New Zealand, Sri Lanka and Thailand.
7. Bangladesh, Cambodia, China, Indonesia, Mongolia, Philippines and Viet Nam.
8. The averages are non-weighted. For the share of subnational spending as a percentage of GDP and as a percentage of public spending, no data are available for Bangladesh and Nepal.
9. The year of reference of fiscal indicators is 2016 but can vary country by country according to data availability.
10. The sample is reduced to 14 since no data on fiscal indicators are available for Bangladesh or Nepal.
11. Here, the coefficient of determination (R2) determines to which extent the information embodied in the level of GDP per capita explains the level of subnational expenditure. In simple linear regression, the coefficient of determination is the square of the Pearson-correlation coefficient.
12. To provide a consistent analysis, only the countries present in the World Observatory are considered to draw figures from the World Governance Indicators' database, which covers 214 countries and territories.

Chapter 5. Fiscal transfers in Asia: Pitfalls and opportunities for achieving the Sustainable Development Goals

by Roger Shotton and Uyanga Gankhuyag

To achieve the Sustainable Development Goals (SDGs), increased and better quality public spending is needed, among other things. Responsibility for a significant share of this spending has been mandated to subnational governments across Asia, which are primarily dependent on fiscal transfers to fulfil these mandates. Not only do fiscal transfers provide the necessary resources for this spending, but how they are allocated can be critical in two crucial ways, for better or for worse. First, allocations shape geographic equity in spending across the national territory and hence progress toward SDG 10 (Reduce inequality within and among countries). Second, transfers often also have unintended incentives that can undermine the local budget priority-making processes needed to steer spending to SDG priorities. There is also an increasing body of experience in explicitly attaching positive incentives to transfers, which hold promise for promoting better local service delivery performance and accountability, and hence for attaining the SDGs.

This chapter is based on a wider review of the same issues prepared by the authors for the United Nations Development Programme (UNDP), available at www.undp.org/content/undp/en/home/librarypage/poverty-reduction/fiscal-transfer-in-asia.html.

Introduction

To achieve the Sustainable Development Goals (SDGs), increased and better quality public spending is needed, as indicated in Figure 5.1.

Figure 5.1. Selected SDGs and examples of public spending needed

Selected SDGs	Examples of local public expenditure needed
SDG 2:Zero Hunger	Social protection and employment programmes for the vulnerable Rural access roads, markets and storage Crop and livestock protection Irrigation and drainage infrastructure Agricultural research and extension
SDG 3:Good Health and Well Being	Preventive health services Primary and referral health facilities Health personnel Medicines and medical supplies
SDG 4: Quality Education	Teachers School buildings and facilities School supplies School meals Scholarships
SDG 6:Clean Water and Sanitation	Public and community drinking water supply systems Latrines Solid waste disposal Sewerage systems
SDG 11: Sustainable Cities and Communities	Public transport systems Water supply systems Solid waste disposal Sewerage systems Sanitation facilities Electrical energy power and transmission Public lighting Public parks and recreation facilities
SDG 13: Climate Action	Transport, water supply, drainage, flood protection and other public infrastructure adapted to local climate-change stress Public investments in livelihood opportunities less vulnerable to climate- change risks
SDG 15: Life on Land	Conservation of fragile ecosystems Natural resource management Watershed protection Mitigation of negative impacts of economic activity

Source: United Nations (n.d.[1]), *Sustainable Development Goals*, https://sustainabledevelopment.un.org/sdgs.

Much of this public expenditure is mandated to subnational governments (SNGs) in Asia. For example, *Gram Panchayats* and *Union Parishads*, the lowest SNG tiers in India and Bangladesh respectively, are usually responsible for: building and maintaining village roads and bridges; water supplies; irrigation; early education; primary education and primary health facilities; as well as for managing various social welfare programmes. Vietnamese *communes*, Indonesian *kapubatens* and Mongolian *soums* all have similar responsibilities. The range of SDG-critical public expenditures then widens much further when the spending responsibilities of higher-tier districts, provinces or regional SNGs in these countries are also factored in (OECD and UCLG, 2016[2]).

Achieving the SDGs requires more and better public spending on their mandates by these SNGs. No matter how well prepared the sustainable development policies and plans are, there can be little progress unless these policies and plans are operationalised into locally appropriate budget-spending priorities. These budgets need to be executed efficiently, to reflect the right balance between investment and operational spending, to ensure sustainability of benefits. Finally, overall, budget resources must be allocated and spent effectively, efficiently, equitably and accountably.

Fiscal transfers to SNGs[1] are the major source of financing for SDG-related expenditures for most SNGs worldwide, and certainly in Asia. They matter for achieving the SDGs in several ways. First, and most obviously, the volume of resources transferred will determine the levels of local spending on sustainable development priorities. Second, the manner of their allocation across SNGs will also affect territorial equity in spending and hence may promote – or undermine – progress on SDG 10 (Reduce inequality within and among countries). Third, and less obviously, fiscal transfers often also carry various unintended

consequences that can shape local budget processes and priority-making decisions, and so directly affect the level and quality of local spending on SDG priorities.

Fiscal transfers can also be expressly designed to carry positive incentives to promote better local performance. To this end, there are now a number of initiatives in Asia that offer important lessons.

Objectives and types of fiscal transfers in Asia

The rationale and objectives of transfers

With the exception of large, wealthy metropolitan areas, the levels of revenues mobilised by subnational governments around the world are almost always well below the levels of spending mandated (UCLG, 2010[3]); this is particularly true of rural SNGs in Asia. This asymmetry arises from the fact that the major national revenue sources are managed more efficiently and equitably under central control, added to which there is often central resistance to decentralise even those revenues that might be better placed under local control. The relative importance of subnational spending in total government expenditure in Asia varies greatly – from a mere 4% of government expenditure in Cambodia to 85% in the People's Republic of China (hereafter "China") (OECD and UCLG, 2016[2]).[2]

Overall, in Asia, as seen globally, wealthier countries tend to display greater degrees of decentralisation of spending responsibilities. But this rough correlation is of course qualified by structural and political country contexts – the subnational share in overall government spending also reflects the history, size and configuration of subnational administrations, as well as the strength of the national political and policy drives to assign spending responsibilities and resources to the subnational level. Thus Viet Nam displays a relatively high degree of decentralisation of both expenditures and revenues (55% and 33% respectively), reflecting the historical importance of provincial administration and local party structures. Thailand, on the other hand, which is notably wealthier, remains relatively centralised (with only 17% of decentralised expenditures and 8% of decentralised revenues), reflecting the historical dominance of the central bureaucratic and military establishment, as well as the reluctance to empower subnational governments.

However, in all cases, there is a "fiscal gap" at the subnational level, which governments seek to fill through intergovernmental fiscal transfers. While the primary objective of fiscal transfers is to address these SNG fiscal gaps and supplement local spending capacities, there are also sometimes other policy objectives. One such common objective is to use transfers to equalise spending capacities "horizontally" across SNGs, recognising that "fiscal gaps" may vary considerably across the national territory.

Other transfers may have different objectives: to encourage SNG spending in specific sectors deemed of national priority; to address the costs of social, economic or environmental externalities faced by SNGs, or the costs of "spillovers" across jurisdictions; to address what may be a region-specific spending urgency or to implement a specific national government programme. Transfers may also be established for political reasons – e.g. to recognise local political demands to share in the benefits of natural resource extraction activities, perhaps to discourage tendencies toward secession; or to give parliamentary representatives a spending fund for their constituencies.

Fiscal transfers in Asia

Fiscal transfers are established in different ways to meet these various objectives. There are many typologies of transfers (Boadway and Shah, 2001[4]), but for the purposes of this chapter, the following main types of fiscal transfer are:

- **Grants**. These may be of two types: unconditional grants (UCGs) allowing for wide discretionary use by SNGs, or conditional grants, whose use is restricted to a particular type of expenditure (which may be defined by sector, by expenditure classification, by type of beneficiary, by geographical area, etc.). Very often, UCG transfers are also intended to perform an equalising role across SNGs.
    - One variant to be noted here is the "gap-filling" grant transfer, common in (former) socialist countries. This is a transfer to SNGs whose use has been largely pre-determined in the budgeting process, by virtue of the nesting of subnational budgets into the state budget (Ebel, Wallich and Bird, 1995[5]; Martinez-Vazquez and Boex, 1999[6]; Bahl, 2000[7]; Dabla-Norris and Wade, 2006[8]).[3]
- **Revenue-sharing** (RS) **arrangements**. Where specific revenues are shared "downward"[4] from central government to the SNG areas *where the revenues derive from*, on a percentage basis. These transfers are usually open for discretionary use, though in some cases their use is restricted. RS arrangements are very often related to natural resource extraction activities – e.g. oil and gas, mining, logging, hydropower, etc. (Bauer et al., 2016[9]).

Patterns and trends

There is considerable variation in both the magnitudes and combinations of these sorts of fiscal transfer arrangements across Asia.

Overall, fiscal transfers to SNGs in South Asia are dominated by various grant mechanisms (although Indian states and Pakistani provinces also receive revenue-sharing transfers from the federal government). Socialist/transition countries in South East and East Asia, such as China, Viet Nam, Lao People's Democratic Republic (hereafter "Lao PDR") and Mongolia, have historically featured complex revenue-sharing arrangements between levels, which in many cases are now being reformed into a combination of conditional grants, "gap-filling" grants and "downward" RS transfers. Indonesia has instituted a significant natural resource-related revenue-sharing mechanism alongside a mixture of unconditional grants and conditional grants as part of its "big bang" decentralisation reforms initiated 20 years ago. Thailand maintains sets of UCG and conditional transfers as well as RS based on commercial, business and other taxes and fees.

Not surprisingly, in federal states such as India and Pakistan, there is considerable variation in the transfer patterns within different states and provinces. However, even some unitary states such as China (Wong, 2007[10]; Man and Hong, 2011[11]; Wang and Herd, 2013[12]) and Viet Nam (World Bank, 2015[13]) also allow a substantial degree of autonomy to provinces in establishing sub-provincial transfer arrangements through their state budget laws.

Over time, in some countries such as India, Nepal or Viet Nam, fiscal transfer systems became more complicated, with a proliferation of different sectoral or programme conditional grant transfers, each with their own allocation criteria and procedures, reducing – in some cases for better, but often for worse – the degree of local discretion in spending, and complicating local planning, financial management and reporting. In India, however,

this trend is now being reversed, with a shift towards discretionary UCGs, to promote local discretion and leverage the benefits of decentralised decision making (Government of India, 2015[14]).[5]

A number of countries have moved away from *ad hoc* transfer arrangements to allocations towards more stable, transparent and predictable rules-based arrangements for the financing of both the allocable pools and for the allocation of transfers to individual subnational governments. For example, in the Philippines, the Local Government Code (1991) specified a 40% share of national revenues going to the Internal Revenue Allotment (IRA) to be allocated to subnational governments (Government of the Philippines, 1991[15]). Since 1994, China has been implementing major reforms to its complex, vertically negotiated sharing arrangements, placing transfers to provinces within a more stable and transparent rules-based framework, although these reforms are still ongoing (Wong, 2000[16]; Wang and Herd, 2013[12]; Man and Hong, 2011[11]). In Indonesia, the Law on Fiscal Decentralization of 1999 dictates a specified share of the national budget be allocated to the Balancing Fund transfers to SNGs (ADB Institute, 2016[17]). More recently, in Cambodia the national pools for the two main UCG instruments, the District/Municipal Fund and the Commune/Sangkat Fund, are now linked to specific percentages of national government revenues; and since 2015, in Myanmar, the main UCG grant pool for transfers to states and regions is linked to gross domestic product (GDP) growth and allocations now made by formula rather than by the previous "gap-filling" arrangements (Shotton, Yee and Oo, 2017[18]).

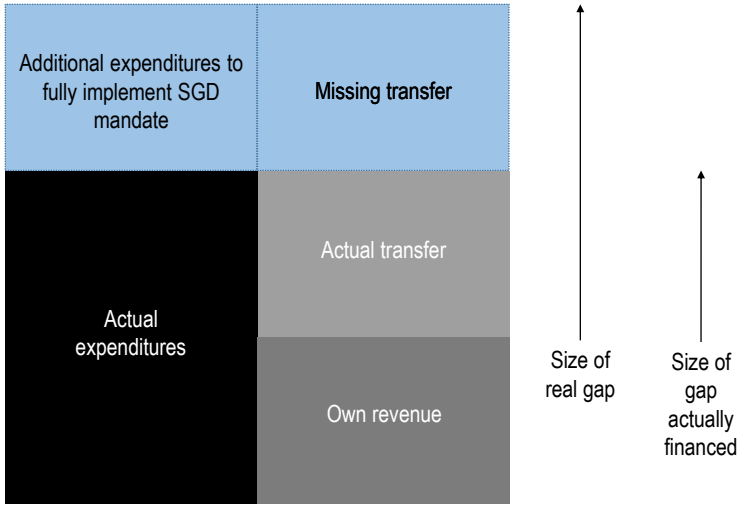
Challenges

Despite the reforms being made, transfer mechanisms across Asia are typically beset by a number of problems (Smoke and Kim, 2003[19]; White and Smoke, 2005[20]; Martinez-Vazquez, 2011[21]):

1. **Inadequacy**. Most fundamentally, the volume of resources budgeted for subnational government transfer pools are generally inadequate. Given the critical nature of most of the devolved services at risk of underfunding, this will be a serious constraint on achieving local SDGs. To some extent, this inadequacy of central budgetary allocations for fiscal transfers is simply a reflection of the overall budgetary constraints faced by most Asian countries. But it is also the result of two other factors. First, there is typically weak advocacy for SNG budget interests – as compared to that for central sector ministries and national programmes – in the national budget allocation process. Second, there is a general lack of information on the volume of resources SNGs require to properly fulfil their service delivery expenditure mandates, due simply to lack of basic "groundwork" research on service standards and delivery costs. In other words, the size of the real fiscal gap is often an unknown quantity (Figure 5.2).
2. **Unreliability**. Moreover, even the budgeted levels of transfers are sometimes not fully released to SNGs. This may be for several reasons: the actual central revenues allocated to the national pool are less than those estimated in the original central government budget – which itself may be due to an unforeseen economic downturn or to bad revenue forecasting; national budget priorities change in the course of the year (this is more of a problem where the arrangements for financing the national transfer pool have not been specified in law); or the central government is unable to approve the release of all the budgeted transfers within the fiscal year, due to SNG capacity, reporting delays or related treasury blockages.

3. **Lack of clarity and co-ordination**. Transfer mechanisms are sometimes instituted without clarity as to their policy objectives – e.g. this is frequently the case with revenue-sharing arrangements, as discussed below. Even where there may be clarity within central government, very often there is inadequate guidance to SNGs as to the spending scope, rules and procedures for spending resources transferred. There is also a tendency for transfers to proliferate in response to particular political or bureaucratic interests or their passing priorities but without overall co-ordination of their policy aims or monitoring of the total resource flow implications.

Figure 5.2. The real funding gap



Source: Authors' illustration.

More generally, transfers often unintentionally create geographic disparities in public spending and may also transmit perverse incentives for local performance. The next sections look at these issues in more detail.

The equity effects of transfers in Asia

Achieving SDG 10 to reduce inequalities and achieve the goal of "leaving no one behind" means that public spending should be geographically equitable.

Overall, geographic spending patterns across the national territory reflect the sum of both spending from subnational government budgets on their devolved mandates as well as of deconcentrated spending by ministries and other central agencies from the central government budget.[6] This chapter focuses on spending for those mandates devolved to SNGs, which are financed by own revenues and transfers, rather than on deconcentrated spending.[7]

SNG own-source revenues usually provide only modest budget resources in aggregate. Nevertheless, these may still cause substantial horizontal inequities between SNGs, given the inevitable variations in revenue bases between regions and more and less urbanised areas.

Fiscal transfers constitute the bulk of resources for most SNGs and their allocation has a direct impact on the equity of public resources and spending across SNG localities.

As noted earlier, in some countries, there is a proliferation of transfer flows. The equity of geographic distribution of these resources is the outcome of two factors: allocation arrangements and the size of the national pools for each of the various transfers.

Revenue-sharing fiscal transfers do not aim to promote horizontal equity. Instead, they aim to promote other objectives – simply supplementing SNG spending overall, addressing socio-economic externalities, or satisfying local political claims on resources being taxed. These transfers are therefore almost certain to result in inequities across SNGs, given the usually very uneven geographic distribution of the revenue bases concerned, such as income, profits and sales tax revenues, and natural resource-related revenues in particular. Revenue sharing will, therefore, very likely further compound the disparities that already arise from own-revenue assignments.

It is the role of unconditional grant transfer instruments to play the equalising role to address horizontal disparities between SNGs. UCGs are usually allocated to SNGs by a formula that aims to capture broad, proxy measures of relative spending need and fiscal capacity (Martinez-Vazquez and Boex, 2006[22]). There are two sides to relative need. On the one hand, SNGs will have different expenditure needs due to different population sizes, levels of development and poverty incidence, physical conditions of the area, and differing service unit delivery costs arising from differing population densities or degrees of remoteness.[8] On the other hand, SNGs will have different levels of own-source revenues and shared revenues due to differing levels of economic development, urbanisation, size and the composition of tax bases.

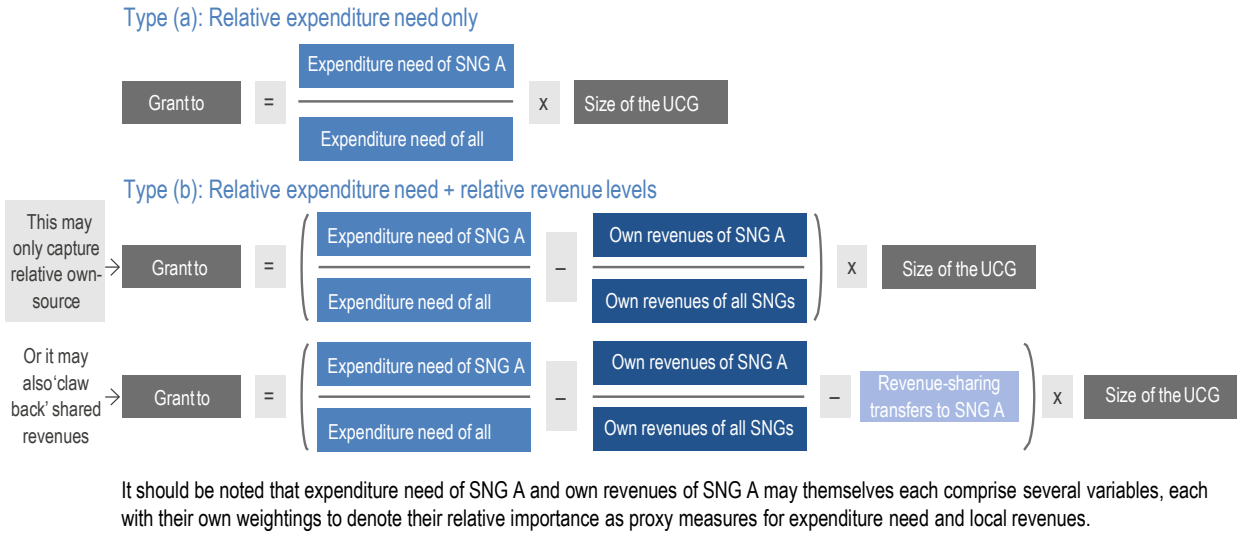
Ideally, fiscal transfer systems are established to take all of these factors into account and ensure "equalisation" of need and fiscal capacity, but all too often, they fail to do so in practice, for various reasons.

Allocation of equalising grant transfers

A frequent source of inequity in transfer systems lies in the allocation criteria for grant transfers – and particularly those unconditional grant transfers that are intended to play a fiscal equalising role. Different problems may arise:

1. **Inadequate scope of the allocation formula**. Generally speaking, three types of "equalising formula" exist based on the ranges of factors taken into account (see Figure 5.3). In many cases, the allocation formula only considers relative expenditure needs; it does not consider the relative revenue generation capacities of SNGs [the Type (a) formula]. Even when own revenues are taken into account, the revenue-sharing transfers to SNGs may not be [the top formula of Type (b) that only takes into account SNGs' own revenues].

Figure 5.3. Fiscal equalising formulae: Varying scopes



Source: UNDP (2019[23]).

2. **Problems in the design and management of the allocation formula**. There are a number of common errors in the design of allocation formulae for equalising UCGs:
   - assigning a weighting that is too low relative to the population sizes of SNGs, and so undervaluing the prime determinant of relative spending needs
   - using the absolute poverty index or similar index values, or other per capita values, without normalising these values by SNGs' relative population sizes[9]
   - using variables that may to some extent duplicate each other (e.g. SNG land area and SNG distance from the capital, as proxies for costs of infrastructure and service delivery) and thereby overweighting the importance of those "need" factors relative to others, particularly population size
   - when inserting a "fixed element" in the formula to ensure there is a floor guaranteed to all SNGs, setting it at too high a level, thus limiting variance in total allocations.[10]

   The upshot of such flaws is the introduction of a bias against more populated SNGs. There may well be reasons why less populous SNGs need relatively higher per capita allocations (if this correlates with remoteness, or lower population density, which in turn may increase relative spending need), but this should be addressed by using explicit criteria to capture such factors, and not by accident.

3. **Inappropriate management of the formula**. At a more practical level, formulae can be mismanaged or even wilfully manipulated by officials. Thus, for example, in Myanmar the allocation formula has only been applied to increments to the annual transfer pool – the aim being not to overly disturb historic relative allocations to states and regions. In Bangladesh, the results from the earlier formula used by the Planning Commission to make allocations to *Union Parishads* were found to have been substantially manipulated by local members of parliament in some areas.[11]

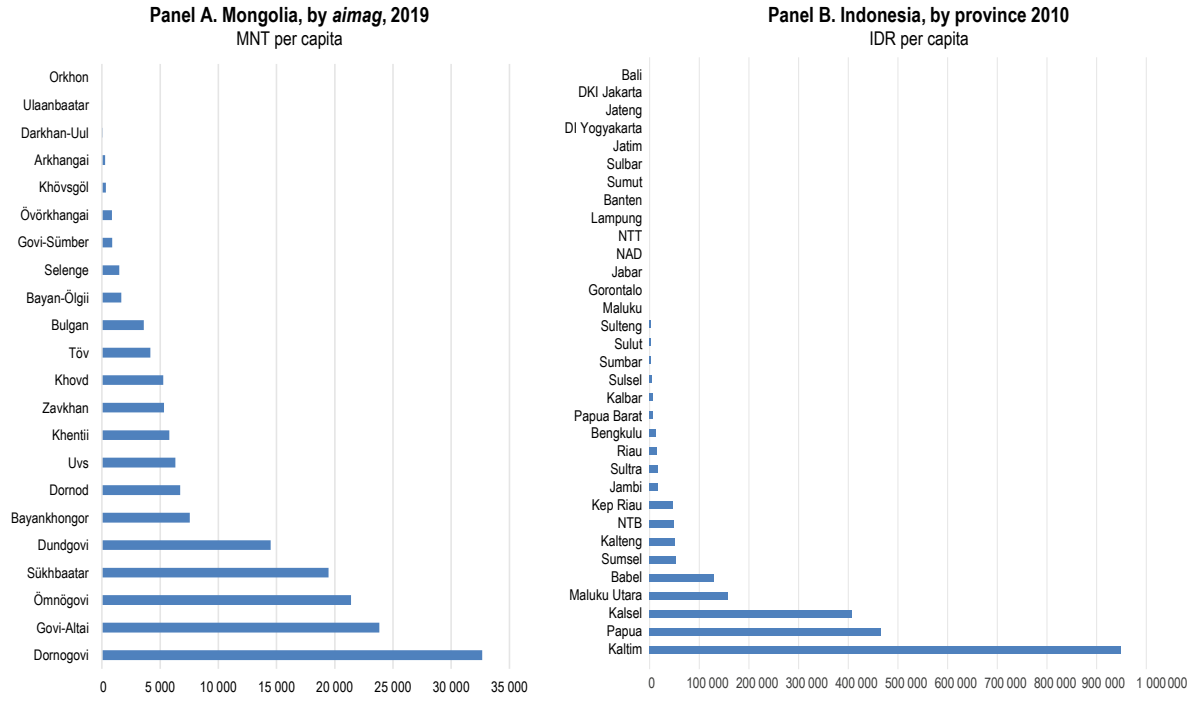
4. **A special case: "Gap-filling" transfers**. In a number of countries, in particular transition countries, the predominant fiscal transfer mechanism is through the "gap-filling" transfers previously mentioned. This form of transfer carries several perverse incentives, which will be examined further below. The focus on bilateral negotiations by a ministry of finance with individual SNGs that characterises this sort of mechanism also makes it very hard for central government to balance resource allocations across all SNGs in an equitable manner. To illustrate the outcomes of these processes: in 2017, in Mongolia, the ratios between the highest and lowest *aimag* per capita deficit grant allocations were 6:1 overall, but 14:1 for health and education transfers combined. In 2019, in Lao PDR, the range between the highest and the lowest levels of total provincial transfers per capita was 11:1.

The dominance of revenue-sharing transfers

As already noted, in many countries, multiple fiscal transfer instruments are established, often with different rationales and often by different parts of central government. Policy co-ordination is, therefore, difficult – even securing budget data and monitoring the overall resource flow patterns can often prove challenging.

For example, several countries have established revenue-sharing arrangements, particularly to share license, tax or royalty revenues deriving from natural resource extraction. Since these natural resources are distributed unevenly, this inevitably results in considerable geographic disparities in SNG revenues. Figure 5.4, for example, illustrates the variance in per capita mining-related revenues in Mongolia for 2019 (Panel A) and Indonesia for 2010 (Panel B). In Mongolia, at the extremes, Dornogovi aimag receives USD 13 per capita, while Orkhon receives nothing; earlier 2016 budget data indicate that the range in per capita revenues shared with the *soums*, the lowest SNG level, is much greater, at nearly 2000 : 1. In Indonesia, the Kaltim province received USD 65 per capita, and Papua and Kalsel around USD 30 per capita, while 17 provinces received virtually nothing.

Figure 5.4. Shared mining-related revenues



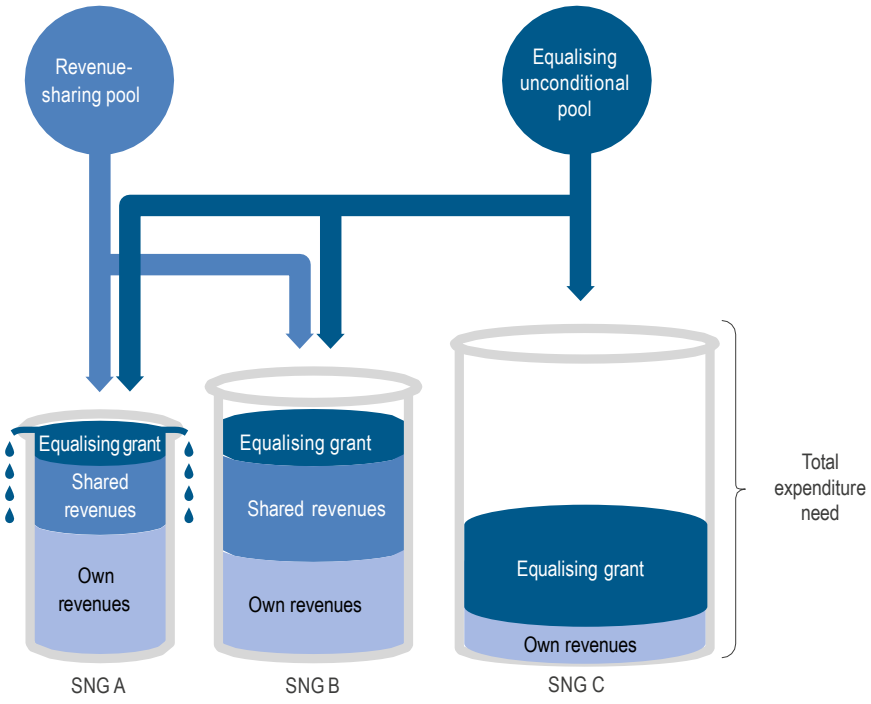
Source: The data for Mongolia are from the authors' analysis of 2019 budget data from the Mongolian Ministry of Finance; the data for Indonesia are from Agustina et al. (2012[24]), "Political Economy of Natural Resource Revenue Sharing in Indonesia", *Asia Research Centre Working Paper* 55, ARC, London, http://eprints.lse.ac.uk/57962/.

Whether such wide disparities are justified depends partly on the policy objectives of these transfers. However, while policy reference is often made to such transfers being aimed at compensating for social and environmental externalities faced by the provinces due to extraction activities, there is little clarity about the types or levels of spending expected by SNGs to address these.[12] In reality, in both countries, it is likely that the prime aim of these transfers is political – to satisfy demands of local communities and leaders who feel excluded from the benefits arising from these extractive activities.[13]

Whatever the policy rationale for sharing revenues, equity concerns dictate that there must be limits to the disparities in per capita funding that result from revenue sharing. The challenge presented by the volume of such RS transfers is that it then proves very hard to compensate disparities, through allocation of other transfers intended to equalise – even with allowing SNGs in natural resource extraction areas some higher level of per capita revenues to address special spending needs. There are two main reasons for this difficulty:

- In many cases, as noted, the equalising transfer allocation formula is not designed to take into account different levels of shared revenues received by SNGs, but – at best – only own-revenue capacities.
- However, even if these were taken into account, very often, equalising transfer resources may be merely inadequate to offset the disparities caused by revenue-sharing transfers (Figure 5.5).

Figure 5.5. The equalising challenge



Source: UNDP (2019[23]).

As a result, in both Indonesia and Mongolia, the net result of all transfers combined still displays a substantial degree of inequity across subnational governments. To illustrate, Table 5.1 shows the data relating to per capita *aimag* transfers in Mongolia. Despite the moderating effect of the General Local Development Fund (GLDF) (the "equalising transfer"), which significantly reduces disparities generated by shared revenues, the net result is still a substantial 12:1 range from highest to lowest per capita value. If these are viewed at the lowest SNG level – the *soum* – the total transfer disparity is much greater.

Table 5.1. Mongolia: *Aimag* shared revenue and GLDF transfers, 2016

MNT per capita

	Shared mining revenues per capita	General Local Development Fund per capita (equalising transfer)	Total transfers per capita
Median allocation	18 150	44 803	62 663
Minimum allocation	392	24 241	29 633
Maximum allocation	289 049	142 474	351 172
Max:Min ratio	737:1	6:1	12:1

Source: Authors' analysis of data from the Mongolian Ministry of Finance.

Aggregate transfer allocation patterns display similar disparities in Indonesia, with the equalising unconditional grant transfer – the DAU (*Dana Alokasi Umum*) – merely being too small to offset the large disparities noted above.

Sector conditional grants

Equity issues can also arise with the allocation of sector-specific or other earmarked conditional grants. In some countries, these grants are allocated by criteria related to the size of the existing infrastructure stock in the sector – e.g. in Viet Nam, health sector conditional grants are allocated to provinces based on several factors, including the number of hospital beds, introducing a bias in favour of better-endowed areas. Similarly, where conditional grants are allocated based on performance in the achievement of service delivery outcomes, this can also generate inequity in funding. For example, in India over the 13th Central Finance Commission period (2010-15), health transfers were linked to local infant mortality rate (IMR) outcome improvements. This led to massive disparities in funding (some states receiving INR 200 per capita, others less than INR 1) because there was not adequate recognition of the very different degree to which improvements in IMRs could be made in states at different points on the IMR spectrum – and so states starting at better IMR levels, which were relatively harder to improve, were penalised (Centre for Global Development, 2015[25]).

Ensuring geographic equity: Some lessons

Several conclusions emerge concerning the equity outcomes of fiscal transfer systems. First, the lack of clear policy objectives of some transfers can make it hard to assess the overall equity of outcomes. Second, there is often little or no comprehensive oversight of the equity consequences of the entire set of all fiscal transfer flows combined. Third, "equalisation" grants are often inadequately resourced to compensate for other disparities, and/or they are inappropriately allocated.

Co-ordination and monitoring

These equity problems are very often hidden, simply because of the lack of readily available, comprehensive data on the whole set of centre-local fiscal transfers. It is important to establish a comprehensive mechanism to consolidate data on, and monitor, the various fiscal transfer flows that may be managed by different central government departments and agencies that do not necessarily co-ordinate with each other, particularly in countries without a national local government ministry or finance commission with a mandate to ensure such monitoring. A comprehensive mechanism to monitor different transfer streams – unconditional grants (usually intended to equalise), conditional grants, and revenue-sharing transfers (not intended to equalise), and own-revenues of SNGs – would allow for the monitoring of the combined equity effects of subnational public financing arrangements, and hence the implications for achieving SDG 10.

The reform challenge: Winners versus losers

Even where such equity problems are identified, however, it can be hard to undertake reforms. In any reform to the fiscal transfer system toward greater equity, some SNGs will benefit, but others will lose from a change to the status quo. This will be a greater or lesser problem depending on the political power of subnational government leaders.[14]

In principle, the simplest way to address this is for the central government to increase the total volume of national transfer pools to a level where no SNGs will lose in absolute terms with a change in allocation criteria (the "hold harmless" approach). This was the case in Nepal, where a move from equal allocations to formula-based village grants meant that the less-populated villages would lose out. This problem was avoided by a massive increase in the national village grant pool. But not many countries have the resources or the political

drive for devolution to make the large budgetary increases to the national grant pools needed for such reforms.

Elsewhere, the problem has been addressed by phasing in changes over time, to allow SNGs the time to adjust to the increases or decreases in annual budget resources brought by such reforms. This has been considered to ease proposed transfer changes in Indonesia where reforms to bring in greater horizontal equity have been stalled for many years.

The unintended incentive effects of transfers

There is a longstanding concern in public finance and public choice literature that fiscal transfers may weaken accountability mechanisms for local spending and/or discourage local revenue-raising effort (Pöschl and Weingast, 2013[26]). However, the evidence for these effects is somewhat mixed. With regard to the impact on local fiscal effort, there is indeed contrary evidence that unconditional grant transfers may actually encourage local revenue effort (Brun and El Khdari, 2016[27]; Lewis and Smoke, 2017[28]; Troland, 2014[29]).[15]

Less frequently discussed are the incentive effects that transfers may exert on the local budgeting process and determination of spending priorities. As already underlined, sustainable development policies and plans to achieve SDGs have minimal traction at the local level unless these priorities are reflected in local budgets and spending. It is the quality of the capital and recurrent budgeting procedures, and the explicit or default priority-setting arrangements within them, which determine the quality of the expenditure priorities that are chosen, and which in turn determines the quality of the public services delivered. Fiscal transfers may shape these budget processes – for better, but often for worse – in several ways.

Conditionalities of use: Discretionary or earmarked

This is the major policy feature of any transfer instrument: whether the transfer allows subnational governments wide discretion, as is the case with most revenue-sharing transfers and unconditional grants, or whether it may only be spent on centrally determined priority areas of expenditure, as with conditional grants. The rationale for such conditionality lies in the view that SNGs may otherwise be inclined to underspend on the areas in question. Where transfers are earmarked, there is, therefore, an overwhelming incentive[16] for SNGs to spend those funds in the designated manner, or else face sanctions for failure to comply.

It is not easy to make general *a priori* judgements about the merits of imposing conditions or allowing discretion; the right balance will be very context-specific. On the one hand, if transfer-use conditions reflect a central expenditure blueprint which does not recognise variations in a local context or which precludes desirable local flexibility, then this may undermine the achievement of the SDGs. On the other hand, if, without such restrictions, SNGs are tempted to undervalue certain national priorities, or undermine service standards, then earmarking is positive.

Excessive conditionalities

While some conditionality will be necessary for some types of transfers, a transfer system dominated by conditional grants may have two undesirable effects for the sustainable development agenda.

- **Rigidities in budget options**. First, the local sustainable development agenda requires substantial flexibility of spending between and within sectors, to allow tailoring of overall policies and plans to specific local contexts. An excessive degree of earmarking in the overall transfer system can limit – or even prevent altogether – the sort of discretionary choices that UCGs are able to make, and the budgetary flexibility they enjoy.

  An extreme case of this rigidity is seen in the problems faced by SNGs in India until the 14th Central Finance Commission (CFC) reforms (see Table 5.2). This illustrates how Indian SNGs (even in states with the most advanced devolution policies) have been faced with transfer flows dominated by an array of highly conditional or tied grants.

Table 5.2. The dominance of conditional transfers in India, 2014/15

Transfers per capita in INR

State and Panchayati Raj Institutions (PRI) level	UCG "untied funds"	CG "tied funds"
Kerala		
Gram Panchayat	257	970
Block Panchayat	0	379
District Panchayat	0	28
Karnataka		
Gram Panchayat	97	488
Block Panchayat	68	3 311
District Panchayat	34	2 249

Source: Government of India and Tata Institute (2015[30]).

The benefits of decentralisation are built on better local knowledge about local needs and realities, and the ability to adapt spending priorities accordingly. Rigidity in fund use through excessive earmarking will undermine the flexibility, and hence the effectiveness and efficiency of local spending. One example of this is seen in countries such as Bhutan, Lao PDR and Viet Nam where public investments must be consistent with those outlined in the five-year plan, perhaps prepared several years previously – precluding local ability to respond to unforeseen emergencies or opportunities that arise in the short term. Another example is seen in Indonesia, in the DAK (*Dana Alokasi Khusus*) grants. These are earmarked for investment spending, especially for capital budget expenditures. There is some evidence that SNGs are encouraged to invest in new facilities, even where rehabilitation of existing facilities is needed more and represents a more efficient use of funds, simply because the latter may not always qualify as "capital" expenditure (Lewis, 2013[31]; Lewis and Smoke, 2017[28]). Similarly, in Mongolia, the emphasis that Local Development Fund grants be used only for capital budget expenditure has encouraged subnational governments to make infrastructure investments they cannot then sustain in the long run since they are not able to make the corresponding recurrent budgetary allocations for the operation and maintenance of existing facilities.

- **Too many local planning procedures**. A plethora of earmarked conditional grants encourages, or even obliges, SNGs and communities to engage in separate planning exercises for each of the funds, through various sector-specific community group and committee arrangements. This undermines the overall integrity of SNG

planning and budgeting, and thus the general effectiveness and efficiency of spending; it may also lead to "participation fatigue".

This is a problem that was long faced by SNGs in India, which have often had to organise parallel community-planning arrangements for the large number of centrally sponsored conditional grants in sectors such as water and sanitation, education and health (Government of India and Tata Institute, 2015[30]).

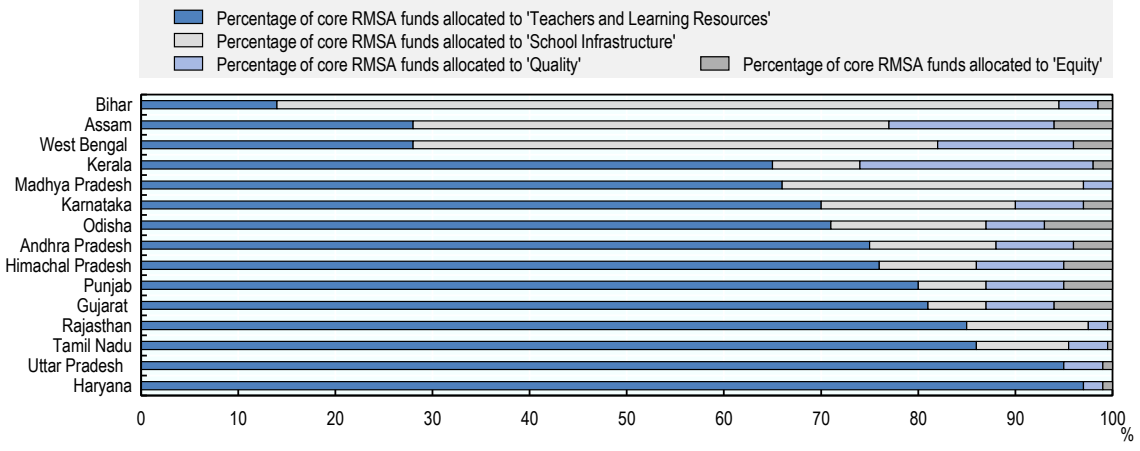
Excessive discretion

Conversely, excessive discretion can also be problematic. Subnational governments may face local pressures to make budget priorities that do not always fully match local developmental needs, or bow to pressures to spend more than optimally on local staff and administration, particularly where local planning and budgeting capacities and accountability mechanisms are weak.

For this reason, limitations are frequently placed on the use of unconditional grants (as in Cambodia, Mongolia and Kerala state in India) to ensure that a minimum part will be spent on development rather than administration. By contrast, in Indonesia, where there has been no such limitation on the use of DAU grants, there is some evidence of excessive spending on administration (Lewis and Smoke, 2017[28]).

Similarly, where there is no clear earmarking by expenditure component for conditional grant transfers for key sectors such as education and health, there can be a risk of excessive variance in spending patterns, which may undermine national service quality standards if there is insufficient guidance to SNGs. The Indian experience following the recent relaxation of grant conditionalities is instructive. The extreme interstate variance in component expenditure for secondary education conditional grants seen in Figure 5.6 raises questions, although this variance can perhaps partly be justified by different state contexts.

Figure 5.6. India: Differing spending patterns in the use of secondary education grants 2017/18



Note: RMSA – Rashtriya Madhyamik Shiksha Abhiyan scheme for secondary education.
Source: Accountability Initiative and Centre for Policy Research (2018[32]).

Determination of the national allocable pool

Here the key issue lies in how the national pool for each transfer instrument is determined each year in the national budget process. Where the national pool is determined on an *ad hoc* basis, then the size of the pool may vary considerably year by year. In consequence, allocations from the pool to individual subnational governments will also vary and will be hard to predict. Insofar as such transfers are a major revenue source for SNGs, this will make the annual budgeting exercise very difficult and may undermine efforts to make any serious budget priorities. Furthermore, it will also make medium-term planning very hard for SNGs and undermine efforts for more strategic multi-year spending plans at the subnational level.

This volatility will be greater still where the national pool is determined as a percentage of only one or two revenue streams, rather than from the entire national revenue base, which is inherently more stable. The volatility of the total allocable pool is particularly large if they are tied to revenues from economic activities subject to world market fluctuations, such as the mining of minerals, oil and gas. Where this annual volatility is extreme, the incentive effects can be especially undesirable. In "boom" years, high revenues can encourage wasteful showcase spending simply to use the funds; while in "bust" years, the SNGs may have to renege on commitments and cut back on essential services. All of this undermines efficiency and effectiveness. In Mongolia in boom years, the *aimags* and *soums* have undertaken generous social spending, but then in later bust years, this spending had to be drastically cut back, causing serious social problems (Bauer et al., 2016[9]).

Timing of transfer allocation announcements and "gap-filling" transfers

Although rather neglected in the literature, at what exact point in their budget cycle SNGs are informed of the amount of the fiscal transfer they will receive in the upcoming fiscal year matters a great deal. Where SNGs are not informed until after they have finalised their budget and determined their budget priorities, this can lead to serious problems affecting the local budget prioritisation process.

Lack of advance notice of transfers undermines SNG incentives to review spending options seriously, from what is usually a long list of budget proposals coming from different sources, and to determine the optimal, affordable priorities in light of the total known budget resource ceiling. Therefore, when the centrally approved transfer is finally announced, SNGs have to scramble then to select the spending priorities that are affordable, with little time for proper review, consultation and comparative assessment of different spending options. This is an especially serious problem in countries operating "gap-filling" transfer arrangements, and where SNG budgets are "nested" within the overall state budget (see Box 5.1).

Box 5.1. "Gap-filling" transfers and wish-list budgeting

In Lao PDR, provinces submit current budget proposals by sector to central line ministries and the Ministry of Finance some seven months before the start of the new budget year. Since there are no advance budget ceilings given to the provinces, these proposals are usually much more than can eventually be funded; and budget proposals are also not prioritised (they are essentially wish-lists) – indeed there is little incentive to do so. The Ministry of Finance cuts back these proposals, based on its own budget norms and so as to fit the chart of account envelopes it can allocate, and the overall state budget proposal to the National Assembly. It is at the start of the budget year that provinces are then informed of their various approved sector budgets – at which point province sector departments have to reconvene to hurriedly consult with districts and service personnel to determine their spending plans within the approved envelopes by account category. By the admission of all concerned, this is an inefficient and challenging process that does not encourage spending based on real needs and priorities.

Similarly, in Mongolia,[17] lower-level SNGs (*soums*) also have only one to two weeks between being informed of the upcoming unconditional (Local Development Fund, LDF) grant size, and having to finalise their own budget. In both cases, this means that the task of appraising and prioritising some dozens of affordable budget priorities from hundreds or even thousands that have been proposed has to be done in an impossibly short space of time. This restricts the technical analysis and the consultation needed for budget prioritisation. As a result, there is every reason to believe that the budget priorities selected do not reflect those which are most efficient nor most effective in attaining the SDGs.

There is a further undesirable knock-on incentive effect in such countries. Where SNGs are not informed of the budget ceiling in advance, it is impossible for SNG authorities, in turn, to transmit budget ceilings either to SNG departments or to authorities at lower levels. This means that in the annual bottom-up planning and budgeting process, an excessively large volume of proposals is generated because originating departments or lower levels of administrations have no incentive[18] to screen and eliminate options from the long lists, and to identify priority proposals before they are submitted to SNG authorities. In consequence, SNG authorities receive an overwhelmingly long, unfiltered set of proposals that have to be appraised and prioritised to determine what to include or exclude from the budget, making it an even harder exercise given the concise time allotted.

In the specific case of countries where gap-filling transfers dominate the transfer arrangements, SNGs have clear incentive to generate inflated sets of expenditure proposals with little real prioritisation, and underestimated revenue projections, in order to present the greatest deficit possible and thereby game the system to attract a greater transfer.

The disbursement process for transfers

The arrangements for actual release of funds down to SNGs and the associated treasury and reporting requirements for SNGs to access these funds can have consequences for actual spending priorities.

In some cases, the fund flow route is so slow that SNGs only receive transfer funds very late in the fiscal year. Two examples from India illustrate the issue. An extreme case is the Backwards Region Grant Fund, from which grants were reported as sometimes arriving right at the end of the fiscal year or even well into the following fiscal year (i.e. one to two years late) (World Bank, Sida and Government of India, 2010[33]). Less extreme, but still serious, are delays registered in the allocation of health and education conditional grants through the treasury system. Reports on education conditional grants[19] suggest that only some 50% of grants arrived in the first six months of the fiscal year and that up to 10% had not even arrived by the end of the year (Accountability Initiative and Centre for Policy Research, 2018[32]);

In such cases, when funds finally arrive in the SNG account, local officials will be tempted to reorder the original budget priorities so that funds can hurriedly be spent in time – resulting in suboptimal expenditures. Generally speaking, where subnational governments have little faith that such funds will arrive on time, the incentive to make a serious effort to plan and budget in the first place, and prepare considered implementation and procurement plans, is greatly diminished.

In countries that operate single treasury systems,[20] two sorts of problems may arise: first, transferred funds can be stuck in local treasury offices, where problems in payment order documentation provided by SNGs may hold up their release. These delays are reported as common in Cambodia where commune and district officials must travel to the (often distant) Provincial Treasury Office in the hope of finding an official present that day to approve the release of funds. This not only wastes time, delaying budget execution but also encourages rent-seeking by the officials involved.

That aside, where central guidance is unclear as to what legitimate SNG expenditure responsibilities are, local treasury officials may be reluctant to approve even legitimate spending requests. Again, in Cambodia spending on construction from the unconditional grant transfer (Commune/Sangkat Fund) is well understood as legitimate by treasury officials, while recurrent spending on special services from this transfer is reportedly often questioned and approval denied, despite such spending on services being encouraged by the central government. These known treasury problems may perhaps be one of the factors underlying a widespread concern that Commune budgets are overly biased toward spending on construction works.

Retention and carry-over provisions

The reason why central governments often do not allow carry-over of unspent funds is to pressure SNGs into efficient execution of national budgetary resources. SNGs are often faced with serious budget execution constraints, however, through no fault of their own. This is particularly the case for the capital budget in rural, more remote SNGs where:

- the funds regularly arrive late in the fiscal year, as illustrated above, leaving little time to spend before year-end
- there are seasonal weather constraints, such as the long, intense monsoon season in Myanmar, and the long hard winter in Mongolia, which allow only a few months each year to undertake investment activities, especially in rural areas
- there are problems and inevitable delays in securing supplies, contractors and technical support to implement development activities.

Unable to carry over unspent funds, SNGs may be encouraged to select the sort of spending priorities for inclusion in the budget that minimises the risk of underspending by year-end: investments in more accessible urban areas, rather than more inaccessible rural areas; a few, more manageable, large investments rather than many, smaller, dispersed investments; investments in facilities for which standard design blueprints are available rather than those which require site-specific design work. The resultant investment pattern may thus not always match local needs and sustainable development agenda priorities.

Similarly, especially where no carry-over is allowed and when funds only arrive late in the fiscal year, SNGs may be compelled to make rushed spending decisions to use the money in time, but may not always reflect the original budget priorities. That aside, there may also be little incentive for efficient spending if any savings are not retained by subnational governments but returned to the central government.

However, in allowing carry-over of unspent funds, caution is also required to avoid misuse. For example, provinces in Lao PDR are allowed to carry over unspent funds into the next year, but can then spend them in a manner that does not allow any real oversight, and which may all too easily undermine the effectiveness and transparency of spending.

Avoiding perverse incentives: Some conclusions

Some of the pitfalls noted above stem from problems in the design of particular transfer instruments, but others derive from more systemic problems in the underlying national public financial management (PFM) arrangements.

Predictability of transfers

It seems clear that any move towards a "rules-based" determination of national transfer pools, linked to specified shares of total national revenues, is positive in ensuring year-to-year predictability of SNG allocations and hence encouraging more realistic annual budgeting and priority setting. The stability and predictability are greater if these arrangements are formally embedded in law. Such rules, of course, are not always popular since they undercut the discretion of national policy makers. Such commitments also require central government confidence in its medium-term fiscal projections, based on the adoption of a reliable medium-term fiscal framework.

If stability and predictability of fiscal transfers is a preferred objective, it is also best to avoid creating oversized revenue sharing or other transfer mechanisms linked to a few individual revenues, which are inherently more variable from year-to-year than overall government revenues – particularly when these revenues are linked to potentially volatile natural resource commodities markets. Indeed the unpredictability at SNG level is further amplified through the allocation of such transfers on the derivation-sharing principle since the difference between estimated and actual revenues and the year-to-year variations in revenues derived from single SNG jurisdictions will likely be much greater than aggregate national variations.

Balancing conditionalities

There are, of course, always important reasons for some spending conditionalities in the transfer system. Indeed, where central governments are moving to devolve additional spending responsibilities to SNGs, it may often be prudent to do so initially through conditional transfers to help allay the understandable concerns of sector ministries. However, where possible, more – rather than less – local discretion is preferable, to ensure

that the advantages of decentralising SDG-related mandates to SNGs are not undermined by overly "straitjacketing" local budget priority setting. Where it is necessary to introduce spending conditions, these should be kept as few and as simple as possible, with practical guidance to SNGs on the "eligible menus". There should be a strategy to gradually relax these over time, as both SNG capacities and central monitoring capacities are expanded (Spahn, 2012[34]).

Recognising subnational governments' own budget cycle imperatives

As far as possible, transfers should be designed and managed such that SNGs are given notice of their (likely) transfer amounts sufficiently in advance before SNGs finalise their own budget proposals. This advance "hard budget constraint" will allow subnational governments to review and appraise spending options and determine priorities in the knowledge of their total revenue ceiling, and thereby prepare a comprehensive spending plan based on that ceiling before they finalise their budget proposals. Lack of such advance notice of the forthcoming transfer amount is an incentive for wish-list budgeting without any priority-setting – always the easiest default approach, since selecting some proposals as priorities also means rejecting others, and alienating the local stakeholders concerned. Further, without some budget certainty, it is also much harder to engage stakeholders or communities in discussions around priorities year after year. There is also evidence to suggest that advance knowledge of resources to be transferred is an encouragement to local efforts to mobilise other sources of financing, notably from local revenue collection.

Leveraging incentive effects to promote better local performance

Overview of performance-based transfer mechanisms

While there may often be perverse incentives embedded within transfers, fiscal transfers can also be expressly designed to transmit positive incentives to promote better SNG performance. Historically, the focus of such attempts has been to encourage local revenue-raising efforts. However, recent years have seen the emergence of performance-based grants (PBGs) with a deliberate focus on improved local governance and public financial management performance, many of which were initially piloted through donor-supported programmes in Asia and Africa.[21] These PBGs are usually linked to existing grants (unconditional grants or conditional grants) and carry explicit incentives to encourage better subnational government performance in service delivery and governance. Early lessons show that they offer promising avenues to encourage better quality spending and service delivery for the local sustainable development agenda, with some cautions and caveats.

The key characteristics of PBGs are that they are given as a reward "top up" existing grant transfers based on the results of annual performance assessments of SNG performance. The assessment scores are then used to reward or sanction SNGs (by transferring more or less to them) depending on their performance.

Broadly, PBGs can be categorised into multi-sectoral PBGs and sectoral/thematic PBGs:

1. **Multi-sectoral PBGs**. These are PBGs linked to multi-sectoral UCGs. Here the performance criteria are generally "process" indicators related to governance, planning, budgeting, public financial management and transparency (Steffensen, 2010[35]).[22] The common features of this mechanism as implemented in several countries in Asia and Africa are detailed in Box 5.2.

2. **Sector-specific PBGs**. These are PBGs linked to sectoral or thematic conditional grants. Here it is more feasible to link performance criteria to higher-order service delivery "output" indicators, although "process" indicators are also used. To illustrate:
    - Health sector PBGs have been introduced and implemented in a number of countries, such as Argentina, Brazil, India, Pakistan, Tanzania and Uganda (Musgrove, 2011[36]; UNICEF, 2013[37]; Fritsche, Soeters and Meessen, 2014[38]; Forgia and Baeza, 2015[39]). Funds are transferred to subnational governments and then further to health service units, based on measures of both general process performance and of health service outputs delivered.[23]
    - Ecological Fiscal Transfers have been implemented in Brazil, France and Portugal to reward subnational government performance in environmental protection, with performance measured against the size and quality of conservation measures by subnational governments (Cassola, 2010[40]; Borie et al., 2014[41]; Droste et al., 2017[42]; Loft, Gebara and Wong, 2016[43])

Box 5.2. Performance-based multi-sectoral unconditional grants: Common features

Conditions of access

Performance-based grants (or some part of the PBG pool) are allocated only to SNGs that have shown satisfactory compliance with a set of minimum conditions (MCs). These MCs are intended to measure the capacity of SNGs to perform their functions and minimise fiduciary risk. They are usually binary yes/no criteria related to quality of management, such as basic planning, budgeting, procurement, audit and reporting procedures, asset management, human resource management, disclosure and transparency to the public. SNGs with satisfactory compliance with MCs become eligible to receive the PBG, which provides the incentive for better performance in the areas concerned.

Calibration of reward

Usually, PBGs represent a top-up grant (usually 20–25% of the unconditional grants) in addition to the UCGs. Some PBGs also include an additional incentive, whereby the size of the PBG to eligible SNGs may be calibrated (adjusted) up or down depending on the quality of performance measured against the MCs. In this case, at least some of the MCs are not binary but are scored on a relative scale. This is intended as an added incentive.

PBG use and discretion

Generally, PBGs may be used for the same expenditures allowed for the UCGs that they are topping up – though in some cases, they are limited only to development investments.

Annual performance assessment

A key feature of a PBG mechanism lies in the annual performance assessment (APA): an annual process whereby independent evaluators usually visit each SNG to verify performance against the specified criteria. The APA is undertaken sometime before the start of the fiscal year in which the PBGs are to be allocated. In some countries, SNGs are also encouraged to undertake a prior self-assessment as part of this process. The APA process is usually undertaken on behalf of the Ministry of Finance, the Ministry of Local

Government or the Finance Commission, which must validate the results before approval of PBG allocations.

Publicity

Another key feature is that the results of the APA and the PBG allocations are made public. Otherwise, the incentive effects will be greatly reduced if people are not aware of the consequences of SNG performance and are not able to bring pressure to bear for improvement.

Link to capacity development targeting

In most countries, the APA results are also used to help target remedial capacity development to bring all SNGs up to standard. Indeed, the prospect of access to PBGs provides an incentive for SNGs to make full use of capacity development support.

Performance against process rather than outcomes

Lastly, common to multi-sectoral or broad-based PBG systems is the focus on the assessment of SNG performance in managing procedures (such as planning, budgeting and procurement) or in delivering basic procedural outputs (such as plans, budgets and other reports), as proxy measures for the quality of public financial management and service delivery. The reason for the focus on processes is that there are significant methodological problems in assessing and fairly comparing SNGs against higher-order results related to the quality and quantity of service delivery.

Scope for wider adoption of performance-based transfers: Some conclusions

The impact of performance-based grant transfers

The impact of some sector-specific performance-based grants such as the health grants under Plan Nacer in Argentina has been well documented (World Bank, 2015[44]).

However, for multi-sectoral PBG mechanisms linked to unconditional grants, the evidence mainly relates to general trend improvements in the annual performance scores of subnational governments over the years. This performance is generally related to the degree of "process compliance" around planning and PFM processes and governance arrangements, and itself is not evidence of the improved quality of public spending or service delivery outputs and outcomes. There is, of course, a reasonable presumption that greater compliance will lead to these higher-order results, but hard evidence so far is scarce. This appears to be an area in which in-depth research and case studies would be useful.

Selecting appropriate performance indicators

While it is tempting to try to link performance to service output or even outcome performance, this is very challenging and often not feasible. For multi-sectoral PBGs linked to UCGs, this would involve comparing often very different service delivery mixes across SNGs (such variations being indeed a key rationale for decentralised decision making).

For some sectoral PBGs, notably in the health sector, using "output" or "outcome" indicators of performance is possible, but requires much preliminary groundwork and can still be challenging. Measuring the quantity and quality of service outputs requires a much greater, more costly and time-consuming fieldwork effort – while comparing outcomes

across SNGs faces the challenge that the starting point for such outcomes will vary considerably across SNGs. PBGs linked to output or outcome performance, therefore also require a considerable baseline study effort to calibrate rewards accordingly. All that aside, many other extraneous factors come into play, outside the control of SNGs, such that the results may be more easily contested and seen as less legitimate than measures based solely on compliance.

However, even for "process" compliance, the essentials need to be in place. Laws and regulations against which "process" performance is assessed should be appropriate, clear and consistent, and subnational governments should be able to comply with these processes on their own initiative, independent of human or other resources outside SNG control – such as those provided by central governments or donors. Preliminary work needs to be done to determine reasonable standards and assess capacities.

Indicators to measure performance should be relevant, objective, verifiable, and few in number. They should also be based on reasonable rather than "ideal" standards and relate to relatively recent subnational government activities (in the past two years).

Calibrating the rewards

The relative size of the "top-up" performance-based grant reward is important in transmitting incentives. It is doubtful that those (mainly urban) SNGs that have substantial own-source revenues, and for which fiscal transfers account only for a small part of overall revenues, will be encouraged to improve performance with a PBG mechanism. For other SNGs, if the amount of the PBGs is too small, it will not provide an incentive to improve performance (the usual rule of thumb is to calibrate PBGs to about 15-20% of the "parent" unconditional grant or conditional grant fiscal transfer). Similarly, if too many or too few SNGs are rewarded with PBGs, then the PBGs will also lose the ability to incentivise governments (here, the rule of thumb is to reward about 30-70% of SNGs). Lastly, the formula for PBG allocation should be simple so that subnational governments can see the link between performance and reward.[24]

Managing performance assessments

Given what is at stake in terms of resources gained or denied, performance assessments should be seen as objective and impartial by SNGs. There is, therefore, a strong argument for these to be undertaken independently. Most of the PBG mechanisms outlined above, supported by donors, out-source the assessments to private contractors or research agencies that send teams into the field, process the results and report to the Ministry of Finance. Out-sourcing provides independence and also allows the necessary personnel to be fielded to visit large numbers of SNGs in the relatively short time window required by the budget calendar imperatives, which would not be possible for a central government ministry.

However, these outsourcing arrangements are not without problems. Procurement and management of the contractors throughout the process itself take effort, as does the quality controls over the results of the different teams fielded. Keeping to the timeline to ensure that results are forthcoming in time to meet Ministry of Finance deadlines for budget submission for the following year is also often difficult. These all prove to be real challenges to sustaining performance-based grants, even in the presence of donor technical support; they are thus even more worrisome at the point they need to be fully taken over by the government.

Sustainability

The challenges outlined above around management of assessment processes constitute a problem for the long-term sustainability of PBG mechanisms. These challenges stem both from the technical management of the assessment process but also from the cost, if this cost is borne by the government. In principle, of course, these costs are perhaps far less than the benefits of the PBG mechanism in terms of improved PFM and service delivery and so should be justifiable. However, to date, there is little hard evidence, of the sort that might convince cost-conscious ministries of finance, to support this contention.

One avenue to ensure the long-term sustainability of such assessments could be through the broadening of the scope of the external audits of subnational governments. However, in many countries in Asia, there is as yet no effective external audit of SNGs. More generally, the full costs of implementing performance-based grant mechanisms, including assessment and monitoring costs, should be acknowledged and factored in, along with the fiscal resources needed for the actual PBG transfers.

All that said, there may be an argument that such performance-based mechanisms may have value as part of a temporary strategy to strengthen SNG performance, and are not needed for perpetuity once SNG performance has reached generally acceptable levels. At that point, any shortfalls in performance may be addressed through either *ad hoc* remedial support or legal sanctions.

Transparency and political buy-in

Ultimately, the aim of these PBG mechanisms is to create incentives for SNG personnel to perform better. It is therefore essential that information about performance criteria and results be made public, for transparency reasons, to dispel suspicions of favouritism or influence in allocation of the PBGs, and also so that pressure can be put on poorly performing subnational governments by local citizens. Central governments have so far proven reluctant, however, to publish such information on the results, for fear of provoking controversy.

Finally, these mechanisms require that politicians and central government policy makers back up the results and be willing to resist the inevitable pressures from SNGs that failed to secure PBGs, or that feel that the results were unfair.

References

Accountability Initiative and Centre for Policy Research (2018), "Rashtriya Madhyamik Shiksha Abhiyan (RMSA), Government of India 2017-18", *Budget Briefs*, Vol. 10/2. [32]

ADB Institute (2016), *Government Decentralization Program in Indonesia*, https://www.adb.org/publications/government-decentralization-program-indonesia. [17]

Agustina, C. et al. (2012), *Political Economy of Natural Resource Revenue Sharing in Indonesia*, ARC, London, http://eprints.lse.ac.uk/57962/. [24]

Bahl, R. (2000), *Intergovernmental Transfers in Developing and Transition Countries: Principles and Practice*, World Bank, Washington, DC. [7]

Bauer, A. et al. (2016), *Natural Resource Revenue Sharing*, NRGI and UNDP, https://www.undp.org/content/undp/en/home/librarypage/poverty-reduction/nrgi-undp-natural-resource-revenue-sharing.html. [9]

Boadway, R. and A. Shah (2001), *Intergovernmental Fiscal Transfers, Principles and Practice*, World Bank, Washington, DC. [4]

Borie, M. et al. (2014), "Exploring the Contribution of Fiscal Transfers to Protected Area Policy", *Ecology and Society*, Vol. 19/1, http://dx.doi.org/dx.doi.org/10.5751/ES-05716-190109. [41]

Brun, J. and M. El Khdari (2016), "The Incentive Effects of Conditional and Unconditional Transfers on Local Own Revenue Generation: Empirical Evidence from Moroccan Municipalities", *Études et Documents* 6, http://publi.cerdi.org/ed/2016/2016.06.pdf. [27]

Cassola, R. (2010), *TEEB Case: Financing Conservation Through Ecological Fiscal Transfers in Brazil*, http://TEEBweb.org. [40]

Centre for Global Development (2015), *Power to the States Making Fiscal Transfers Work for Better Health*, https://www.cgdev.org/publication/power-states-making-fiscal-transfers-work-better-health. [25]

Dabla-Norris, E. and P. Wade (2006), "The Challenge of Fiscal Decentralization in Transition Countries", *Comparative Economic Studies*, Vol. 48/1995, pp. 100–131. [8]

Droste, N. et al. (2017), "Ecological Fiscal Transfers in Brazil – incentivizing or compensating conservation?", *Environmental Policy and Governance*, Vol. 27/4. [42]

Ebel, R., C. Wallich and R. Bird (1995), *Decentralisation of the Socialist State: From Command to Market*, World Bank, Washington, DC. [5]

Forgia, J. and C. Baeza (2015), *Performance-Based Intergovernmental Transfers: Brazil's Family Health Program*. [39]

Fritsche, G., R. Soeters and B. Meessen (2014), *Performance-Based Financing Toolkit*, World Bank, Washington, DC. [38]

Government of India (2015), *Report of the Fourteenth Finance Commission*, https://www.indiabudget.gov.in/budget2015-2016/survey.asp. [14]

Government of India and Tata Institute (2015), *Devolution Report 2015-16*, https://www.panchayat.gov.in/documents/20126/0/devolution2015-16.pdf. [30]

Government of the Philippines (1991), *The Local Government Code of the Philippines*, http://www.dilg.gov.ph/PDF_File/reports_resources/dilg-reports-resources-2016120_5e0bb28e41.pdf. [15]

Lewis, B. (2013), "Local Government Capital Spending in Indonesia: Impact of Intergovernmental Fiscal Transfers", *Public Budgeting and Finance*, Vol. 33/1, pp. 76–94. [31]

Lewis, B. and P. Smoke (2017), "Intergovernmental Fiscal Transfers and Local Incentives and Responses: The Case of Indonesia", *Fiscal Studies*, Vol. 38/1, pp. 111–39. [28]

Loft, L., M. Gebara and G. Wong (2016), *The Experience of Ecological Fiscal Transfers: Lessons for REDD+ Benefit Sharing*, http://www.cifor.org/library/6168/the-experience-of-ecological-fiscal-transfers-lessons-for-redd-benefit-sharing/. [43]

Man, J. and Y. Hong (2011), *China's Local Public Finance in Transition*, Lincoln Institute of Land Policy. [11]

Martinez-Vazquez, J. (2011), *Fiscal Decentralization in Asia: Challenges and Opportunities*, Asian Development Bank, Manila. [21]

Martinez-Vazquez, J. and J. Boex (2006), *The Design of Equalization Grants: Theory and Applications*, World Bank and Georgia State University. [22]

Martinez-Vazquez, J. and J. Boex (1999), "Fiscal Decentralization in the Russian Federation during the Transition", *International Studies Program Working Paper*, 99–3 Georgia State University. [6]

Musgrove, P. (2011), *Financial and Other Rewards for Good Performance or Results : A Guided Tour of Concepts and Terms and a Short Glossary*, World Bank, Washington, DC, http://www.rbfhealth.org/sites/rbf/files/documents/Rewards for Good Performance or Results - Short Glossary.pdf. [36]

OECD and UCLG (2016), *Subnational Governments Around the World: Structure and Finance*, OECD Publishing, Paris and United Cities and Local Governments, Barcelona, https://www.uclg.org/sites/default/files/global_observatory_on_local_finance_0.pdf. [2]

Pöschl, C. and B. Weingast (2013), *The Fiscal Interest Approach: The Design of Tax and Transfer Systems*, https://www.stanford.edu/group/mcnollgast/cgi-bin/wordpress/wp-content/uploads/2013/11/Weingast-Poschl-BRW-CP-BRW-15-Nov.print_.pdf. [26]

Shotton, R., Z. Yee and K. Oo (2017), *State/Region Financing, Planning & Budgeting in Myanmar*, Asia Foundation, https://asiafoundation.org/publication/state-region-financing-planning-budgeting-myanmar/. [18]

Smoke, P. and Y. Kim (2003), *Transfers in Asia: Current Practice and Challenges for the Future*, http://hdl.handle.net/11540/263. [19]

Spahn, P. (2012), *Conditioning Intergovernmental Transfers and Modes of Interagency Cooperation for Greater Effectiveness of Multilevel Government in OECD Countries*, https://www.oecd.org/cfe/regional-policy/Conditioning-Intergovernmental-Transfers-paper.pdf. [34]

Steffensen, J. (2010), *Performance-Based Grant Systems: Concept and International Experience*, UNCDF. [35]

Troland, E. (2014), "Can Fiscal Transfers Increase Local Revenue Collection? Evidence From The Philippines", https://pdfs.semanticscholar.org/7aab/f946088afeff374633417672e282d9cbdd5b.pdf. [29]

UCLG (2010), *Financing Local Government: The Challenges of the 21st Century. Second Global Report on Decentralization and Local Governance*, United Cities and Local Governments, Barcelona. [3]

UNDP (2019), *Fiscal Transfers in Asia: Challenges and opportunities for financing sustainable development at the local level*, United Nations Development Program, Bangkok, https://www.undp.org/content/undp/en/home/librarypage/poverty-reduction/fiscal-transfer-in-asia.html. [23]

UNICEF (2013), "Performance-Based Equitable Resource Allocation Model: The Punjab Experience", *Maternal, Newborn and Child Health Working Paper*, UNICEF, http://www.unicef.org/health/files/Punjab_Model_FINAL.pdf. [37]

United Nations (n.d.), *Sustainable Development Goals*, https://sustainabledevelopment.un.org/sdgs (accessed on 11 February 2020). [1]

Wang, X. and R. Herd (2013), "The System of Revenue Sharing and Fiscal Transfers in China", *OECD Economics Department Working Papers*, No. 1030, OECD Publishing, Paris, https://dx.doi.org/10.1787/5k4bwnwtmx0r-en. [12]

White, R. and P. Smoke (eds.) (2005), *East Asia Decentralizes: Making Local Government Work*, World Bank, Washington, DC. [20]

Wong, C. (2007), "Budget Reform in China", *OECD Journal on Budgeting*, Vol. 7/1, https://dx.doi.org/10.1787/budget-v7-art2-en. [10]

Wong, C. (2000), "Central-local relations revisited the 1994 tax-sharing reform and public expenditure management in China", *China Perspectives*, pp. 52-63. [16]

World Bank (2015), *Argentina : Can Performance Payments Improve Newborn Health*, World Bank, Washington, DC. [44]

World Bank (2015), *Making the Whole Greater Than The Sum Of The Parts: A Review Od Fiscal Decentralization in Vietnam*, World Bank, Washington, DC. [13]

World Bank, Sida and Government of India (2010), *First Independent Review of the Backward Regions Grant Fund - BRGF*, World Bank, New Delhi. [33]

Notes

1. Fiscal transfers are made by central governments to legally constituted subnational governments to whom responsibilities are devolved or delegated. Fiscal transfers are different from the flows of resources from central government ministries to deconcentrated local branches of these ministries, though fiscal transfers usually coexist with deconcentrated flows. This chapter focuses on fiscal transfers; however, some of its recommendations are also relevant for deconcentrated flows of finance to subnational administrations.

2. See also country subnational finance profiles at www.oecd.org/regional/regional-policy/sngs-around-the-world.htm.

3. In countries that have had a history of socialist economic management (e.g. China, Viet Nam, Lao PDR, Mongolia, and, until recently, Myanmar), significant similarities can be seen in the intergovernmental fiscal arrangements they have inherited. SNGs are frequently classified according to whether they are "deficit" or "surplus" SNGs. "Deficit SNGs" are those where the sum of own-source revenues and transfers is not enough to cover their expenditures, while in "surplus SNGs", they are usually sufficient. "Gap filling" or "deficit" grant transfers are then provided on some negotiated basis to partly fill the gap, through bilateral reviews and negotiations with the Ministry of Finance. SNG recipients of such transfers are then subject to tighter controls and enjoy less discretion than surplus SNGs. There is ample documentation that this mechanism is replete with many negative incentives that undermine local budget priority setting, is very inequitable, and promotes non-transparent patronage relationships between different levels of government. It is also common that the budgets of each level are nested, in *matryoshka* fashion – which leads to the need for a much more lengthy and iterative budget preparation process for subnational governments, and may also introduce greater uncertainty into their subnational revenue estimates for expected fiscal transfers, with the attendant negative incentives.

4. Although it is conventional to consider revenue sharing as a form of fiscal transfer from central to subnational governments, in a number of socialist/transition countries in Asia (e.g. China, Viet Nam, Lao PDR, Mongolia) there has been a tradition whereby revenues are shared "upwards" by subnational governments – sometimes through a complex array of sharing agreements varying between SNGs.

5. Following the recommendations of the 14th Indian Central Finance Commission. These recommendations were for a five-year period from FY 2015/16 to FY 2020/21. At the same time, the states' share in national revenues was increased from 32% to 42%.

6. There are also often other centre-to-local resource flows such as donor and non-governmental organisation (NGO) project spending and constituency grants, but these are generally much smaller in volume.

7. In principle, assuming devolved spending mandates are clearly distinguished from central spending mandates; then the geographic patterns in deconcentrated spending should not affect the equity implications arising from devolved spending patterns.

8. For example, in mountain areas of Nepal the cost of cement and other construction materials is two to three times higher than in Kathmandu or the Terai area in neighbouring India.

9. This failure to normalise index variables is surprisingly common, and has been seen in the past in both Mongolia and Nepal (where corrections were subsequently made), and presently in Myanmar.

10. There appears to be a widespread tendency for central government officials to aim for similar-sized grant allocations to SNGs – regardless of size or need – perhaps on the grounds that this seems fairer or is more defensible than allocations that vary greatly in size, regardless of the per capita rationale for such variations. For example, in the past, both village and district grants in Nepal were of equal size. When an allocation formula was first introduced for district grants, the "fixed element" was expressly set at such a high level that the variance of total district allocations still remained quite limited.

11. This occasional manipulation emerged from a case study of *Union Parishad* grant allocations within selected *Upazilas* commissioned by the United Nations Capital Development Fund in 2002.

12. Discussions with local authorities in Mongolia in receipt of shared revenues suggests that they are used simply for general investment expenditures, not to address problems arising from mining; the expectation is that such mitigation measures are the responsibility of central government.

13. The issues around natural resource revenue sharing are discussed in detail in Bauer et al. (2016[9]).

14. This is one reason why it has proved impossible so far to reform fiscal transfers in Indonesia. Allegedly, one reason why reform of own-revenue powers and revenue-sharing arrangements in the Lao PDR was so difficult is that provincial governors sit on the Party Central Committee and are immensely powerful. There are probably similar structural-political reasons why such reforms were also so hard in other one-party countries like China and Viet Nam.

15. For example, in Morocco, a 10% increase in UCGs was shown to be associated with a 6.9% increase in SNG own-revenue collection; in the Philippines, a 10% increase in IRA grants with a 3.4-3.9% increase in local fiscal effort; and in Indonesia, a 10% in DAU grants was associated with a 1.2% increase in SNG revenues.

16. The strength of the incentive to spend accordingly will be dependent on the perceived likelihood that the central government will indeed monitor use of the transfers, and exert sanctions in case of non-compliance. In this regard, there is considerable variation between countries in the degree of supervisory control and sanction.

17. In general, the budget timetables in socialist/transition countries where SNG budgets are approved inside national budgets, they all appear to provide little time for SNG authorities to carry out key steps in the process.

18. In Myanmar, township administrations (which receive no advance budget ceiling information) typically submit around five to ten times the number of capital investment proposals than are later approved for funding. It must be understood that there is always an in-built reluctance by communities, local authorities or sector departments to make priorities, unless they are compelled to do so. Making priorities means favouring some proposals but also discarding other proposals; this can be very difficult both technically and politically, particularly where consensual norms prevail.

19. These are conditional grants provided under the national flagship "Education for All" programme Sarva Shiksha Abhiyan (SSA).

20. These are systems operated under the central ministry of finance, and where SNG authorities must request payments to be made to vendors from their subaccount at the local treasury office. Such systems are quite common in South East Asia. They stand in contrast to systems whereby SNGs manage their own bank accounts, which is more common in South Asia.

21. These programmes were supported variously by the United Nations Capital Development Fund and the World Bank.

22. Such multi-sectoral PBG initiatives have been introduced in several Asian countries: Bangladesh, Bhutan, India, Mongolia and Nepal. Indeed, the 14th Central Finance Commission in India has recommended the national rollout of a PBG mechanism, whereby 10% of UCGs in rural areas and 20% in urban areas will be allocated on a performance basis, informed by earlier experiences in West Bengal and Kerala.

23. "Outcome" measures were used in India for health transfers but were found to be inequitable, and so changed to "output" performance measures.

24. The methodology for determining the size of the PBGs to be received by SNGs in some donor-supported programmes is extremely complex – to the point that the link between performance and reward is probably obscured to all but the programme staff who make the computations.

Chapter 6. Natural resource taxation and revenue sharing in Asia

by Andrew Bauer and Uyanga Gankhuyag

More than 30 countries have put in place natural resource revenue-sharing systems – systems that allocate revenues from natural resources to subnational governments separately from other fiscal revenues. The main aim of such systems is to enable natural resource-producing regions of a country to benefit more from natural resource extraction in these regions and mitigate conflicts between national and subnational governments. Natural resource revenue-sharing systems can be derivation-based, in which case revenues are allocated predominantly by origin, or indicator-based, in which revenues are allocated typically by the equalisation principle. Derivation-based systems aim to compensate producing regions for the costs of resource extraction more directly, but they also bring significant equity challenges, volatility and public financial management challenges at the subnational level. They also may encourage accelerated resource exploitation. In contrast, indicator-based systems aim for greater equalisation but may suffer from excessive complexity. They are largely used to counterbalance the downsides of derivation-based systems and may not be politically acceptable to resource-producing regions. To work smoothly and enhance trust between national and subnational authorities, natural resource revenue-sharing systems need to be overseen by an adequate governance mechanism and be transparent. If well designed and implemented, resource revenue sharing can help drive economic transition and poverty reduction in resource-rich regions.

Introduction

In nearly every country, subnational governments receive public funds through a combination of direct tax collection and transfers from the national government. In most, non-renewable natural resource revenues are apportioned no differently than all other revenues. However, in more than 30 countries – most of them resource-rich – distribution of non-renewable natural resource revenues is governed by a set of rules that are distinct from those governing distribution of general revenues. Many of these systems were introduced or reformed during the 2000s "commodities super-cycle" – the sustained period of high prices of minerals and hydrocarbons – resulting in resource-rich countries seeing increases in their fiscal revenues from these resources. In most cases, the revenues in question are generated from the extraction of non-renewable resources such as minerals, oil and gas, but there are cases of countries where revenues generated by renewable resources, such as hydropower, forestry and fisheries, are apportioned through a separate system too.

In several countries, some revenues from the oil, gas and mineral sectors are collected by the national government and transferred back to their area of origin or adjacent areas. Angola, Bolivia, Brazil, Canada (some regions), Chad, People's Republic of China (hereafter "China"), Colombia, Democratic Republic of the Congo (hereafter "Congo"), Ecuador, Ethiopia, Ghana, Guatemala, Guinea, India, Indonesia, Iraq, Kyrgyzstan, Madagascar, Malaysia, Mexico, Mongolia, Nepal, Niger, Nigeria, Papua New Guinea, Peru, the Philippines, South Sudan, Uganda, the United States (some regions) and Venezuela each have enacted a "derivation-based" intergovernmental transfer system for all or part of their mineral, oil or gas revenues.

Some resource-rich subnational governments are extremely dependent on these transfers. In Nigeria and Peru, for instance, more than 80% of the budgets of some subnational governments depend on resource revenue transfers from the central government.

A few countries also transfer some of their natural resource revenues to subnational governments using an "indicator-based" formula. In these countries, the national government distributes natural resource revenues to subnational authorities based on a set of objective indicators – such as population, revenue generation, poverty level or geographic characteristics (e.g. remoteness) – irrespective of where the natural resources are extracted. Ecuador, Mongolia, Mexico and Uganda are examples of countries that use indicator-based resource revenue-sharing formulas.

In another set of countries – including Argentina, Australia, Canada, China, India, the United Arab Emirates and the United States – subnational governments collect substantial revenues directly from oil, gas or mining companies. Direct tax collection can constitute a significant proportion of local budgets. For example, from 2012 to 2014, more than 25% of all fiscal revenues collected in Alberta, Canada came from direct petroleum taxation. In the United States, severance taxes from the oil sector in 2014 constituted 72% of total fiscal revenues in Alaska, 54% in North Dakota, and 39% in Wyoming.

Governments establish resource revenue-sharing arrangements to address several, sometimes competing objectives. These are different from the objectives that can justify more general subnational tax assignments or general intergovernmental transfer programmes covering all fiscal revenues, such as improving public service delivery at the local level, fiscal risk sharing, or the equalisation of opportunities across the country.

Communities in the vicinity of mining, oil and gas projects or other large-scale natural resource developments often bear the most significant environmental and social impacts of

resource exploitation, but sometimes benefit less than other regions. For example, extractive industries may attract migrants to the region, causing added congestion in public utilities (e.g. clogging transportation networks such as roads and railroads or putting a strain on water delivery systems). The presence of oil or mining companies in a region may also raise housing rents and costs of everyday non-tradeable services such as taxis and restaurants. Local governments can use resource revenue sharing as compensation or to fund efforts to mitigate the social and environmental losses associated with extraction, not just at the production site but also across all affected areas. Ecuador, for instance, levies USD 1 per barrel of oil produced in the Amazon region, the implicit assumption being that associated environmental damage is directly linked to the number of barrels that a company produces (Viale and Cruzado, 2012[1]).

In the most pressing cases, natural resource revenue-sharing arrangements may be introduced to mitigate or prevent violent conflict. The perception that revenues are not being distributed fairly can be a source of conflict and instability, especially in societies divided along ethnic, religious or other fault lines. Establishment of natural resource-sharing arrangements can signal the recognition of claims to a specific territory or a share of subsoil assets. Resource revenue sharing can also help build peace by encouraging dialogue between national authorities and local leaders, and generating a "peace dividend" for local populations (Bailey et al., 2015[2]). Thus, national governments will sometimes transfer a share of resource revenues to local governments in resource-rich regions to preserve or create harmony between the central government and the regions, as has been the case in Indonesia, southern Iraq, Nigeria and Papua New Guinea. In Indonesia, special resource revenue-sharing agreements with the regions of Aceh and West Papua helped end years of violent conflict. In Nigeria, the 1999 Constitution establishing a revenue-sharing system, followed by a 2002 court case reinforcing entitlements of oil-producing states, has contributed to greater peace and security in the Niger Delta. That said, resource revenue sharing does not always prevent conflict and may exacerbate it. Poorly designed revenue-sharing systems can incentivise groups to seize control of extractive sites to access a higher share of revenues. These revenues can then be used to finance violent actions.

Resource revenue-sharing systems have also helped to increase prosperity in resource-rich regions and address conflicts. For example, in Canada, an oil revenue-sharing accord of the federal government with Newfoundland province contributed in large part to the restoration of the economic prosperity of the province in the mid-2000s, following years of recession due to the collapse of fisheries.

Resource revenue sharing ought not to be confused with the issue of resource ownership (Haysom and Kane, 2009[3]). Ownership of natural resources *per se* does not necessarily translate to better prosperity for communities and regions with natural resources unless it is backed by arrangements on management and control of resources and associated revenue sharing. Shifting the discussion from ownership of natural resources to natural resource benefit sharing can help address the sticking points of disagreement between national and subnational leadership on who benefits from natural resources. Natural resource revenue sharing is one way of sharing benefits from natural resources.

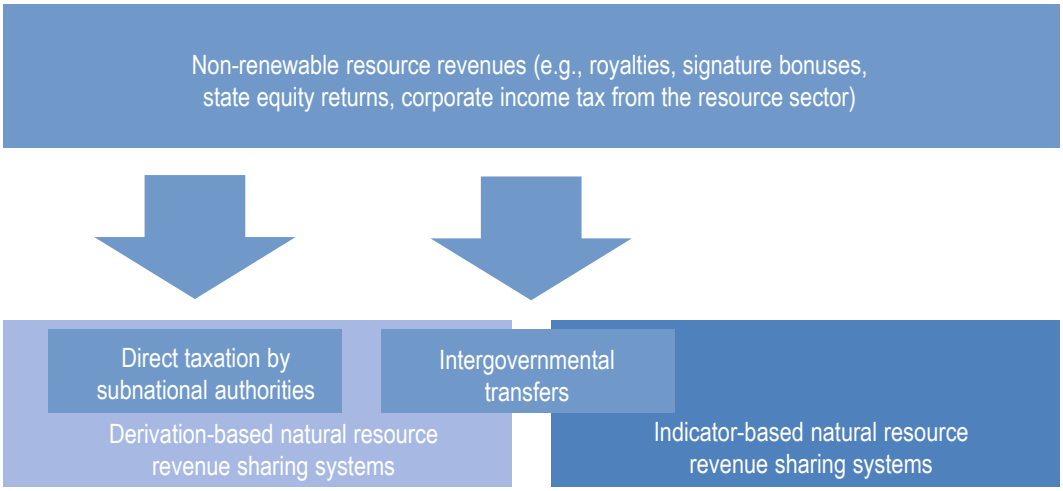
This chapter summarises a study carried out by the Natural Resource Governance Institute (NRGI) and the United Nations Development Programme (UNDP) that reviewed countries' experiences in natural resource revenue sharing, with some updates. It emphasises examples from Asia-Pacific but also includes salient examples from other regions. The chapter is organised as follows: the next section provides key definitions, distinguishing natural resource revenue-sharing systems from other related concepts; the

third section discusses details about the design of natural resource revenue-sharing systems; the penultimate section reviews challenges with natural resource revenue-sharing systems and ways of addressing them; and the final section presents concluding remarks.

Natural resource revenue-sharing systems: Definitions and distinctions

A natural resource revenue-sharing system is a system whereby fiscal revenues from natural resources are allocated to subnational governments – differently and separately from fiscal revenues generated from other sources. Natural resource revenue-sharing systems can be classified based on: 1) the principles used to distribute resource revenues to subnational governments; and 2) the methods of sharing. Generally speaking, two principles of distributing resource revenues to subnational governments can be distinguished: distribution by derivation (by origin) and distribution by other principles (based on indicators) - the latter called "the indicator-based principle". In derivation-based principle, a portion of natural resource revenues collected, extracted in a given region, is returned to that region. In the indicator-based principle of distribution, objective indicators are used to determine allocations, such as population, levels of education or revenue-generating capacity by region (see Figure 6.1).

Figure 6.1. Types of natural resource revenue-sharing systems



Source: Authors' illustration based on NRGI-UNDP (2016[4]).

Derivation-based systems are more directly related to some of the justifications for natural resource revenue sharing - they are used to compensate producing regions for the costs of extraction and depletion of a finite asset. However, derivation-based systems also bring significant public financial management challenges at the subnational level. For instance, they can generate fiscal volatility that subnational governments are often ill-equipped to manage. They can also exacerbate local Dutch disease effects and can encourage further conflict. For example, between 2005 and 2008, the increase in global mineral prices and the consequent increase in fiscal transfers to mining regions incentivised local leaders in Peru to instigate violent protests in order to extract additional transfers from the central government and gain jurisdiction over mine sites (Arellano-Yanguas, 2010[5]).

In terms of methods, the natural resource revenues may be shared by tax assignments to subnational governments, or by fiscal transfers from central to subnational governments. By definition, the tax assignment method allocates natural resource revenues based on the derivation principle, since the subnational government of the natural resource-producing

and taxing province gets to keep all or some of these revenues, while non-producing subnational governments do not get any share. This type of natural resource revenue sharing is prevalent in countries such as Argentina, Canada, India, the United Arab Emirates and the United States. Often subnational governments collect a large share of resource revenues directly in federal states, but there are exceptions. For example, Brazil, Malaysia, Mexico, Nigeria and the Russian Federation are federal states, yet almost all resource revenues are collected by their respective national governments. China is a unitary state, yet the provinces collect a large proportion of the royalties.

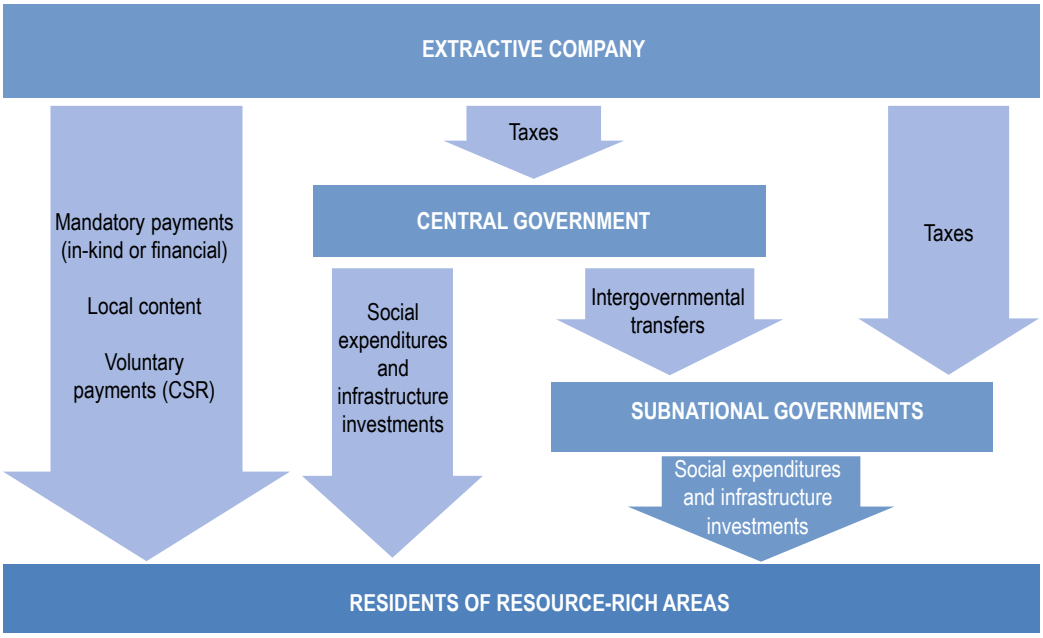
The fiscal transfers method can be designed so that it allocates natural resource revenues either on a derivation basis or an indicator basis. The derivation-based allocation comprises the majority of countries with natural resource revenue-sharing systems. In the Asia-Pacific region, this includes China, Indonesia, Kyrgyzstan, Papua New Guinea and the Philippines.[1] In addition, India, Malaysia and Mongolia have a derivation-based fiscal transfer system for at least a portion of their natural resource revenues.

Indicator-based systems can use, for instance, subnational indicators of population, poverty levels, and geographical characteristics such as remoteness, and generally seek to meet the fiscal needs of provinces lagging behind. They treat natural resource-producing and non-producing provinces in the same way. Fewer countries use such indicator-based systems for natural resource revenue sharing; Ecuador, Mongolia, Mexico and Uganda are among them. Indicator-based systems have several advantages. They can be more effective at addressing poverty and horizontal inequality by targeting less developed and more affected regions. They do not exhibit the same volatility, and "shock-concentrating" effects of derivation-based systems and public financial management challenges are less pronounced.

A key issue with indicator-based systems is that the objective of such a system is usually to equalise, but so is the objective of general equalisation or other types of inter-governmental transfers. The primary economic justification for separating non-renewable resource revenues, and then distributing them based on a special indicator-based formula is to counterbalance the downsides of a derivation-based system. For instance, in Canada, provinces collect royalties and provincial corporate income taxes, while the federal government collects national corporate income taxes. As a result, fiscal revenues per capita are disproportionately large in oil-rich provinces such as Alberta and Saskatchewan. Canada's provincial equalisation formula helps to rectify this by calculating the revenue-generating capacity of each province on a per capita basis and allocating equalisation payments to provinces with a below-average capacity to generate own revenues. All provincial corporate income taxes from extractive industries and 50% of royalties are included in this formula. Through this formula, Canada has reduced inequalities in the fiscal capacities of provinces while allowing resource-rich regions to retain most of their resource revenues.

Natural resource revenue sharing as part of the intra-governmental system, which is discussed in this chapter, should be distinguished from revenue sharing between companies and governments, which would be referred to as tax and royalty collection, and benefit sharing. Benefit sharing expresses the overall idea of the extractive industry sharing its benefits with the host country's residents. Benefits can be shared through different mechanisms – either through the payment of taxes that can then trickle down to host communities through the government, or through voluntary financial contributions, or development-oriented projects directly benefitting host communities (Wall and Pelon, 2011[6]) (see Figure 6.2).

Figure 6.2. Revenue sharing versus benefit sharing



Source: Authors' illustration based on NRGI-UNDP (2016[4]).

Natural resource revenue-sharing systems

This section reviews the key characteristics of natural resource revenue-sharing systems:

- Which revenues are shared?
- Between whom and how much is shared?
- How are natural revenue-sharing systems established?

Which revenues are shared?

Countries can share all or some streams of revenues generated from natural resources.

Revenues collected only from – and specific to – natural resource companies include royalties, signature bonuses and fees for permits for natural resource exploitation. Royalties are rents paid to the owner of natural resources – usually the government – in exchange for the right to exploit the resource. In many countries, royalties, along with corporate income taxes, constitute the largest portion of revenues from the extractive industries. Royalties may be assessed on the volume of mineral or hydrocarbon production (unit-based) or the value (*ad valorem*), and less commonly, they can be imposed in fixed amounts. Royalties can also be set on a sliding scale – set at a variable rate depending on the market price of the resource, as in China with Special Petroleum Proceeds, a royalty-like instrument levied with rates varying depending on the international price of crude oil. Signature bonuses are one-time payments made to host governments upon signing a contract for exploitation of natural resources. License fees for utilisation of natural resources are also specific to natural resources. Royalties and license fees are usually imposed not only for actual extraction but also for exploration. Production entitlements are also collected from governments from the oil and gas sector – in-kind payments instead of taxes or rents. Some countries also have

introduced mandatory contributions from mining, oil and gas companies towards local development, education or other purposes. Kyrgyzstan has a 2% levy on mining companies' revenues, called "payment for development and maintenance of local infrastructure".

Revenues collected from all companies irrespective of their business sector include corporate income taxes, withholding taxes, customs duties, value-added taxes (VAT), property taxes, land taxes, natural resource utilisation fees, pollution taxes, and other fees and fines. In addition, the government can also receive dividends from government equity held in natural resource companies.

Countries' experiences show that it is more common to include royalties and property taxes in natural resource revenue-sharing schemes, which reflect the relative ease with which these taxes and payments are assessed. Less commonly included are corporate income taxes, goods and services taxes or dividends from government equity. In the same country, the revenue-sharing arrangement can differ between mining on the one hand, and oil and gas on the other.

For example, Papua New Guinea shares only royalties from oil and gas. Indonesia has a different arrangement for mining versus oil and gas. Whereas for mining, only mineral royalties are included in the resource revenue-sharing arrangement, for oil and gas, all streams of revenues are included. In China, only a few revenue streams are included, of which the most important is the Mineral Resources Compensation, a royalty imposed on mining (excluding coal). This fee is shared 50-50 between the central government and the producing provinces.

Several issues matter in deciding to include certain revenue streams in the natural resource revenue-sharing scheme. First, the decision on which revenue streams to include has implications on the magnitude, the volatility and timing of revenues received. Royalties, corporate income taxes, and goods and services taxes are usually much larger than property taxes or license fees.[2] In terms of timing, whereas some revenues such as license fees or property taxes do not vary significantly depending on the volume of the resource exploited, royalties are dependent on the volume. But royalties are still more predictable compared to corporate income taxes. In addition, different revenues flow to the government at different times in the life cycle of a mine or oil and gas field. Thus, signature bonuses are collected upfront, royalties are usually collected as soon as production begins, while corporate income taxes peak several years into production, after costs have been recovered. Dividends may not be collected until much later. In general, less volatile and more predictable revenue streams should be included in natural resource revenue-sharing schemes.

Second, some revenue streams are easier to calculate, to attribute and to collect. Taxes – or revenue streams – that are easier to administer tend to be assigned or transferred to subnational governments, because their administrative capacity tends to be less than that of national governments. Land and property taxes are relatively simple to calculate. Royalties are more complicated but are still manageable for subnational governments with a reasonable level of capacity. To calculate royalties, one needs information on production volume, quality (grade) and market prices. Royalties can also be more easily attributed to specific mines or oil and gas fields in given territories.

In contrast, corporate income taxes are more complicated. They require more information – not just revenues of the company, but also its costs. They may also include tax credits and tax deductions and may be subject to "creative accounting" to avoid taxes. Corporate

income taxes are also more difficult to attribute. This is because some companies may operate in different parts of the country, whereas their corporate income tax accounting does not apportion common costs to their operations in different locations. Many companies are headquartered in capital cities and thus, most of the revenues may be attributed according to their headquarters, rather than field operations – where the actual natural resource exploitation happens. Subnational governments should have access to sufficient information and adequate administrative and analytical capacity before they are assigned such complex taxes. For this reason, corporate income tax administration generally rests with the national government, whereas property and land taxes are more likely assigned to subnational governments. With royalties, the practice varies: in some countries, they are assigned to the national government and in others, to subnational governments. Table 6.1 shows the assignment of these three types of revenues – between national and subnational governments in selected countries in Asia-Pacific.

Offshore resources are usually under the jurisdiction of national governments. Arguably, exploitation of offshore resources has a less direct, visible impact on adjacent communities, although it can disrupt fisheries or cause oil spills. Offshore resources are also more difficult for armed groups to occupy, and thereby less likely to become the target of demands for local leaders for a share of the revenues. As a result, offshore resource revenues are often not included in resource revenue-sharing schemes. Nevertheless, there are countries – Australia, Brazil, Canada, Italy, Malaysia and the United States – where adjacent subnational governments receive a share from offshore resource exploitation (Brosio, 2006[7]).

With regard to revenues from common minerals such as construction materials (e.g. sand, gravel), many countries assign revenues from them to subnational governments, as magnitude of these revenues is smaller, they are less prone to volatility and, geographically, they are more evenly distributed.

Finally, most natural resource revenue-sharing systems that have been introduced in recent decades include revenue streams from non-renewable mineral and hydrocarbon resources, given that these resources generate substantial amounts of revenues. There are cases, however, when revenues from renewable resources are also covered in the revenue-sharing scheme. In the Philippines, in addition to mining, revenues from fishery and forestry are also included in the "National Wealth", 40% of which is shared with subnational governments. In Norway, local governments received a share of revenues from hydropower produced in their territories.

With whom and how much is shared?

Vertical distribution describes the allocation of revenues between different levels of government. For simplicity, there is the allocation between the national government on the one hand, and all levels of subnational governments on the other. Vertical distribution can range from highly centralised, with minimal natural resource revenues shared with subnational governments, to highly decentralised, with most resource revenues collected by subnational governments. The degree of vertical distribution is determined by underlying fiscal arrangements between levels of government – tax assignments to subnational governments provided in law or transfers from national to subnational governments.

In highly centralised systems, natural resource revenue sharing also tends to be centralised. For example, in Afghanistan and Myanmar, most resource revenues are collected by the central government, while subnational governments collect only minor land taxes and fees.

Table 6.1. Mineral and petroleum tax collection by level of government, selected countries in Asia-Pacific

	Government system	Source of revenues	Level of government	Corporate income taxes	Royalties	Property/land taxes
China	Unitary	Mining	National	●		
			Subnational		●	●
		Petroleum	National	●	●	
			Subnational		●	●
India	Federal	Mining	National	●		
			Subnational		●	●
		Petroleum	National	●	●[1]	
			Subnational		●	●
Indonesia	Regionalised unitary	Mining	National	●	●	●
			Subnational			●
		Petroleum	National	●	●	●[2]
			Subnational			
Kazakhstan	Unitary	Mining, petroleum	National	●	●	
			Subnational			●
Kyrgyzstan	Unitary	Mining	National	●	●	
			Subnational		●[3]	●
		Petroleum	National	●	●	
			Subnational			●
Malaysia	Federal	Mining	National	●	●	
			Subnational		●	●
		Petroleum	National	●	●	●
			Subnational		●	
Mongolia	Unitary	Mining	National	●	●	
			Subnational			●
		Petroleum	National	●	●	
			Subnational		●	●
Myanmar	Unitary	Mining	National	●	●	●
			Subnational			●
		Petroleum	National	●	●	
			Subnational			●
Philippines	Regionalised unitary	Mining	National	●	●	
			Subnational	●	●[4]	●
		Petroleum	National	●		
			Subnational			

Notes:
1. Only offshore.
2. Though legally it is under national jurisdiction, subnational governments sometimes collect land taxes.
3. Local governments at the *aiyl aimak* level collect "payments for development and maintenance of local infrastructure", which are royalty-like payments.
4. Royalties are only assessed and collected by indigenous groups and some local government units.
Source: Authors' compilation.

In other countries, most natural resource revenues are still collected by national governments, but they transfer significant shares of these revenues to subnational governments. For instance, in Indonesia, 80% of mineral royalties, 30% of revenues from gas and 15% of revenues from oil is allocated to subnational governments of producing provinces. In the Philippines, 40% of "national wealth" – revenues from mining, forestry and fisheries – is allocated to producing provinces, municipalities and *barangays*.

The vertical distribution of natural resource revenues also depends on the size of the province or district, and the administrative capacity of subnational governments. For instance, a third-tier subnational government in Indonesia (*Bojonegoro* regency) governs a population of 1 million people, whereas a typical third-tier subnational government in Mongolia (*soum* government) oversees a population of 3 000; so their administrative capacities would differ correspondingly. The distribution of natural resource revenues in relation to administrative capacities is further discussed below.

Horizontal distribution describes the allocation of revenues to subnational governments at the same level of government. In several cases, of the subnational portion of the natural resource revenues, fixed shares are allocated to resource-producing provinces (2nd tier of government), but also to districts (3rd tier) within the producing provinces. Among these, the examples of Indonesia and the Philippines are useful. For instance, in Indonesia, the share of oil, gas and mineral revenues going to subnational governments is further split between producing provinces, as well as producing and non-producing districts within these provinces. In contrast, in the Philippines, the share of mineral revenues is split between producing provinces, producing districts (municipalities), and further to producing *barangays* (the 4th tier of government). In other words, while in Indonesia, non-producing districts within producing provinces receive a share of natural resource revenues, in the Philippines, they do not. Instead, the remaining share goes further to the smaller administrative unit from where the resource is produced. Table 6.2 provides examples of vertical and horizontal resource revenue distribution in selected countries.

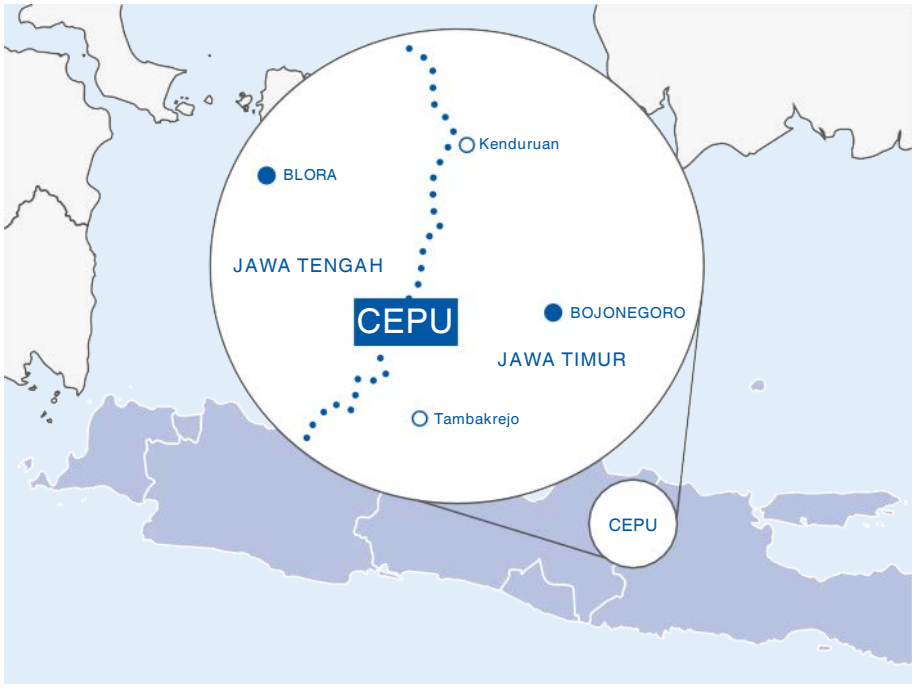
Table 6.2. *De jure* derivation-based inter-governmental transfer formulas in selected countries

	Resource	Revenue stream	Central government	Producing regional / provincial / state governments		Municipal / district governments		Private (e.g. landowners; traditional institutions)
				Producing	Non-producing	Producing	Non-producing	
Brazil	On-shore oil	Royalties	15%	20%	25%	10%	30%	-
	On-shore oil	Special participation (some fields)	42%	34%	9.5%	5%	9.5%	-
DRC	Minerals	Royalties	60%	25%	-	15%	-	-
Ghana	Minerals	Royalties	91%	-	-	4.95%	-	4.05%
Indonesia	Oil	All	84.5%	3.1%	-	6.2%	6.2%	-
	Gas	All	69.5%	6.1%	-	12.2%	12.2%	-
	Minerals	Royalties	20%	16%	-	32%	32%	-
Philippines	Minerals	All	60%	8%	-	18% municipality 14% *barangay*	-	-
Uganda	Petroleum	Royalties	93%	-	-	6%	-	1%

Note: Some listed countries also have other types of inter-governmental transfer systems in addition to the derivation-based inter-governmental transfer system.
Source: National legislation or mining codes; Agustina et al. (2012[8]), "Political economy of natural resource revenue sharing in Indonesia", *Asia Research Centre Working Paper* 55, ARC, London; Morgandi (2008[9]), "Extractive Industries Revenues Distribution at the Sub-National Level," Revenue Watch Institute; Viale (2015[10]), *Distribución de la renta de las industrias extractivas a los gobiernos subnacionales en América Latina: Análisis comparative y de tendencias*, INTE-PUCO, Lima.

One issue with horizontal distribution is that the area of impact of resource extraction often does not overlap with the administrative division in the country. In other words, such allocation based on administrative boundaries may result in a situation where areas – and people living in these areas – in the impact zone of extractive activities may be left out of fiscal revenue allocation, while areas not impacted may benefit from it. For example, in Indonesia, *Blora* and *Bojonegoro* regencies (districts) sit above the *Cepu* block, one of Indonesia's most lucrative oil fields. But because *Blora* is in the Central Java province, while *Bojonegoro* is in the East Java province (the latter is the home of most oil wells), *Blora* receives significantly fewer resource transfers (see Figure 6.3).

Figure 6.3. *Blora* and *Bojonegoro*, Indonesia



Source: NRGI-UNDP (2016[4]).

While laws setting natural resource revenue-sharing schemes stipulate allocation to "producing", "non-producing" and "adjacent" regions, these terms are often not clearly defined. For example, laws often do not specify whether "producing" means where the resource is located or where the production facilities are located. In cases of oil and gas, the field may lie beneath several districts, but oil wells may be located in one of them. Similarly, in underground mining, the deposits may span the territories of several districts, but the mine mouth can be located in one district. Alternatively, a mine can be located in one district, but mine facilities and waste storage can be located in the adjacent one. In Kyrgyzstan, for example, 20% of a 2% extra non-tax payment by mining companies (royalty on mining) is allocated to "producing" villages. There are already cases of conflict between villages where a mine crosses village boundaries. One option is to specify how revenues would be split between subnational jurisdictions in such special cases. In the Philippines, this was made clear by specifying that in such cases, revenues will be split between jurisdictions where natural resources cross jurisdictional boundaries, using population size (weighted at 70%) and land area (weighted at 30%). The term "producing"

can be defined as the volume or value of production, and this can mean different outcomes for subnational jurisdictions.

The area of impact of resource extraction may also extend beyond resource-producing areas. The impact zone can include areas stretching hundreds of kilometres, such as downstream rivers impacted by extraction, or along the transportation routes of minerals. Brazil and Colombia addressed this issue by allocating royalties from oil and gas not only to producing municipalities but also to municipalities through which oil and gas are transported (Brosio and Jimenez, 2012[11]).

Moreover, natural resource allocations to subnational governments are usually oblivious of changes in population in the provinces or districts driven by mining or oil and gas extraction projects – so-called boomtowns. Such population changes can be sudden and substantial, with subnational governments struggling to meet the public service needs of the enlarged populations. For example, during the mining boom in the 2000s, the population of Zaamar soum in Tuv aimag, Mongolia, quadrupled from 5 000 to 20 000 people, putting increased demand on the local government to provide health and education services. In Lao People's Democratic Republic, commissioning of a large mine in Sepon, Savannakhet province in 2005 led to in-migration to the area and additional demand for public services, in response to which the government relocated 200 public servants to the area to help deal with the demand (ICMM, 2011[12]).

In some cases, governments use asymmetric arrangements with resource-rich provinces, whereby a larger share of natural resource revenues is allocated to resource-rich provinces with special status. For example, in China, the Tibet Autonomous Region and the Inner Mongolia Autonomous Region receive 60% of the Compensation Fee levied on mineral resource extraction activities, whereas other provinces receive 50%. In Indonesia, the Aceh province also has an asymmetric arrangement, ending 30 years of conflict: a peace agreement (Memorandum of Understanding) signed in 2005 stipulated, among other things, that the Aceh province is to receive 70% of revenues from oil and gas for 8 years, and 50% thereafter – compared with 15% of oil revenues and 30% gas revenues received by other provinces (UNEP and UNDPA, 2015[13]; Keating and Brown, 2015[14]).

Countries with revenue allocation by indicator-based inter-governmental transfers use indicators measuring the population, poverty rate, or the economic activity of provinces (e.g. regional gross output), or allocate revenues expressly to provinces lagging in terms of development. For example, the formula for petroleum revenue allocation in Mexico includes population, revenue generation, as well as a third variable, which benefits states with low populations and high revenue generation (Castanada and Pardinas, 2012[15]; Courchene and Diaz-Cayeros, 2004[16]). In Bolivia, 1% of the value of gross sales of petroleum is allocated to Beni and Pando, the two poorest municipalities at the time the resource revenue-sharing system was established.

In mixed systems, a part of natural resource revenues is allocated based on derivation, while another part is allocated based on indicators. For example, in Uganda, 6% of petroleum royalties are allocated to local governments "located within the petroleum exploration and production areas". Of this amount, 50% is allocated based on the level of production or size of the area affected, and the other 50% is allocated based on "population size, geographic area and terrain" (Government of Uganda, 2015[17]). Likewise, Mongolia has a system which aggregates 10% of VAT, local budget surpluses, 30% of petroleum royalties, 5% of mining royalties, 30% of royalties from large (strategic mines) and 50% of mineral exploration license fees (Shotton, 2017[18]; Government of Mongolia, 2011[19]). Of these,

the first three sources of funding are allocated on an indicator basis, and the last three are allocated by origin.

Especially with indicator-based systems (or the indicator-based part of a mixed system), the allocation formulas can get unnecessarily complicated. To avoid this, indicators to be used for allocation should be kept to a minimum; they should be easily measurable and regularly updated. Importantly, indicators and formulas should be understandable to subnational governments and local stakeholders, which is part of the transparency of the system.

In some countries with natural resource revenue-sharing systems, there are "clawback" provisions built into the general inter-governmental transfer systems, cancelling out or moderating the effect of a derivation-based system. These "clawbacks" result in less general transfer allocations to subnational governments that receive more allocations through natural resource revenue-sharing schemes. In Canada, the Northwest Territories retain a share of mineral, oil, gas and water-related revenues, of which 25% is passed on to aboriginal governments in these territories. However, in the allocation of general unconditional grant per the Territorial Financing Formula from the federal government to Northwest Territories, for each dollar raised by the province in taxes, approximately 70 cents is deducted. Thus, much of the resource revenues raised in taxes by the territory is clawed back (Bauer, 2014[20]). Natural resource revenue-sharing systems – and the receipts by subnational governments – should be analysed not only separately, but also along with all other flows of revenues – including own revenues and general transfers. In general, rather than having a derivation-based natural resource revenue-sharing system together with clawback arrangements that effectively negate this system, it is more straightforward not to have a natural resource revenue-sharing system in the first place.

Formulas for allocation of natural resource revenues ought to derive from the objectives of the natural resource revenue-sharing system. Often, these objectives are implied; but it is worth it to make them explicit. For example, if the objective is to compensate the regions for the loss of livelihoods and environmental damage of resource-exploitation activities, then affected areas should be defined and indicators can be used, such as the volume or value of mineral production; area of land under mining contracts; length of mineral transportation routes, etc. If the objective is to improve development in poor regions that are resource-rich, indicators such as population size, poverty rate, remoteness and access social services can be used.

The legal basis for resource revenue sharing

Systems for natural resource revenue sharing are usually established in legislation, including the formulas for allocation. In rare cases, natural resource revenue-sharing systems are referenced in constitutions (Brazil, Canada, Iraq, Nigeria, South Sudan).

At the other extreme, there are also ad hoc resource revenue-sharing systems. Kazakhstan allocates disproportionately large per capita transfers to the oil-rich and conflict-affected regions Atyrau and Mangistau, as part of annual allocations. This fiscal arrangement started from a political agreement that set a precedent for such transfers to these regions, but it is not specified in the law.

Formula-based allocations result in more stable and predictable financing flows, are more conducive to good subnational budget planning, and are thus clearly superior to ad hoc allocations. However, the implementation of the rule can be weak, and lack of information on fiscal transfer can prevent verification, and thus a formula-based system may not work

in practice. Alternatively, the laws (and the formulas) can be changed so often as to render the system essentially ad hoc. This is the case in Mongolia, where the (General) Local Development Fund, which represents a mixed system, has been amended at least three times since its introduction in 2013 (Shotton, 2017[18]).

In summary, there are many considerations for deciding on the allocation of natural resource revenues. Once such systems are in place, they are difficult to change. Provisions for revisiting resource revenue-sharing systems once every few years can be embedded in laws. In addition, any changes to resource revenue-sharing systems should be analysed and considered carefully. For this purpose, simulation models should be used to assess implications of changes in revenue allocation formulas on provinces and districts, which can help to take actions to minimise the transition impact on "losing" subnational governments.

Revenues from natural resources can change substantially over time. Therefore, their magnitude – both nationally and at the subnational level – should be considered not only at a point in time when the system is designed but also into the future. The models above can be used to apply different scenarios of revenue levels under different allocation formulas.

Addressing challenges with resource revenue-sharing systems

This section discusses challenges with resource revenue-sharing systems, specifying whether they are relevant to one or the other type of system. It also discusses ways to address these challenges.

Inequality. Natural resource revenue-sharing systems can aggravate regional inequalities when they are derivation-based.[3] If resource-producing regions are relatively wealthy to start with, and a derivation-based system is applied, these regions will receive disproportionately larger revenues. In Brazil, for example, the state of Rio de Janeiro is the third wealthiest state by gross domestic product (GDP) per capita and is one of Brazil's largest offshore oil producers. It disproportionately benefits from the revenue-sharing regime. Until 2013, producing states in Brazil were allocated 52.5% of royalties and 40% of "special participation" earnings; since the 2013 reforms, these shares were reduced to 20% and 34%, respectively (Viale, 2015[10]).

Incentives for resource exploitation. Resource revenue-sharing systems by derivation may encourage accelerated resource exploitation. This is particularly the case if the resource-hosting provinces and districts are poor and natural resource revenues account for a significant share in subnational revenues.

Volatility. Since the underlying revenues are volatile, derivation-based resource revenue-sharing systems are pro-cyclical, exacerbating the natural resource boom-bust cycles. The resulting volatility incentivises over-spending on wasteful projects or increasing government wages unsustainably during boom times while resulting in painful public spending cuts or ratcheting debt in bust times. In Brazil, large oil royalty windfalls to municipalities were associated with increases in spending on government housing and urban infrastructure projects, all the while the efficiency of public service provision deteriorated, resulting in a decrease in access to piped water, connections to sewage networks and garbage collection (Ardanaz, 2014[21]). Whereas at the national level, the shocks can be absorbed and their effects smoothed out, at the subnational level, there is less possibility to do so.

There are several ways to reduce the volatility of revenues at the subnational level. One option is to assign or transfer to subnational governments those streams of revenues that are more stable, with the caveat that the magnitude of more stable streams of revenues tends to be smaller. Alternatively, an indicator-based formula can be used instead of a derivation-based formula. However, both these options may not be politically acceptable to resource-rich regions.

The second option is to enable subnational governments to save resource windfalls in stabilisation funds, to use when resource revenues decline and replenish when they increase. Such a mechanism can smooth spending, protecting it from the volatility on the revenue side [see NRGI, (n.d.[22])]. There are a few cases of subnational jurisdictions establishing such funds. Among the more established funds are Abu Dhabi (United Arab Emirates), Alabama (United States), Wyoming (United States), Alberta (Canada) and Quebec (Canada) (Bauer, 2014[23]). The problem with such funds is that they are prone to patronage and corruption; subnational governments may lack the capacity to manage such funds and, apart from a few exceptions, the magnitude of funds may be too small to justify setting up of a stand-alone fund. The pooling of funds from several resource-rich regions in a country could justify establishing a fund where each jurisdiction's resource revenues are too small to warrant one.

Another way to help stabilise the inflow of revenues is to enable subnational governments to borrow when revenues decline and pay back when revenues increase. Although this option avoids revenue management challenges with stabilisation funds, it has problems with debt management and over-borrowing. There have been many cases of debt crises of subnational governments due to such attempts to manage subnational-level volatility. In some cases, governments have bailed out the subnational governments – such as Chile, Colombia, Indonesia, Mexico and Russia. In other cases, they were allowed to default on their debts, such as in Bolivia, Nigeria and Peru (Liu and Waibel, 2008[24]).

Another solution involves national governments stepping in to smooth revenue volatility. For example, resource revenue allocation can be determined based on a moving average of resource revenues over several years, rather than a single year, or allocated based on non-production-based indicators.

Public financial management problems. The very nature of a derivation-based mechanism may undermine a fundamental principle of sound financial management, the "finance follows function" rule since derivation-based fiscal transfers are neither linked to subnational needs for financing nor the expenditure responsibilities of subnational governments (Boadway and Shah, 2007[25]; Martinez-Vazquez, 2015[26]). During booms, local governments end up receiving revenues that exceed their absorptive capacity or needs, so these revenues are likely to be wasted on high-visibility vanity projects or expenditures that can be increased quickly, such as government salaries, without improvements in service delivery. Again, while all systems of natural resource revenue-sharing systems may be affected by such public financial management challenges, in derivation-based systems, these challenges are more pronounced since derivation-based systems do not distribute revenue based on subnational government needs.

Measures can be taken to improve subnational financial management of resource revenues. Some countries put conditions on the spending of resource revenues, or earmark them for certain uses, primarily for spending on human or physical capital investments. For example, in Indonesia, 0.5% of revenues must be spent on education by provinces and regencies, while in Kyrgyzstan, Regional Development Fund allocations financed by royalty-like payments from mining companies, are required to be spent on small-scale infrastructure

and economic development. In Ecuador, severance tax payments must be spent on environmental restoration, among others (Viale and Cruzado, 2012[1]). Although such conditions and earmarks can protect spending on underfunded expenditure items, they can undermine budgetary autonomy and flexibility without necessarily improving service delivery. More fundamentally, earmarking does not guarantee that more money is available for an expenditure item due to the fungibility of money. Subnational governments can add resource revenues to a budget line and subtract revenues from other sources, leading to a net impact of zero.

Governments also establish special-purpose funds that are intended to benefit resource-rich provinces and districts, such as Nigeria's Niger Delta Development Commission or Kyrgyzstan's Regional Development Funds. These funds may be set up simply as separate accounts of the general budget, or as entirely separate institutions. An example of the former is the General Local Development Fund in Mongolia, which is managed by the Ministry of Finance and administered by it together with local authorities. An example of the latter is Nigeria's Niger Delta Development Commission, a federal commission controlled primarily by representatives of oil-producing states, along with the federal government and some companies, that receives 15% of inter-governmental transfers due to states and 3% of oil companies' annual budget, and is supposed to spend funds on economic development in the Niger Delta. Whether national or subnational authorities should manage a fund is context-specific.

Complexity. The problem of complexity is more common to indicator-based resource revenue-sharing systems. Indicator-based allocation requires the collection of data to track indicators at the subnational level. These data requirements can become extensive. At one time, the Canadian allocation formula contained 37 indicators. Currently, the indicator-based part of Mongolia's resource revenue allocation scheme includes 3 stand-alone indicators and another composite indicator (Local Development Index), which in turn consisted of 65 indicators (Volooj et al., 2016[27]). However, an indicator-based system does not need to be so complex. At the other end of the spectrum, South Africa's indicator-based resource revenue-sharing scheme uses only one indicator – regional GDP as a proxy for fiscal capacity (Shah, 2007[28]). Having fewer indicators not only saves time and resources when collecting data, but it also helps make the system better, e.g. less prone to data manipulation and errors, less likely to include several highly correlated indicators, and more transparent.

Transparency challenges. To enforce revenue-sharing systems and benefit from them, it is essential that the necessary information is available and that the systems are transparent. Transparency – at the subnational level, with information in disaggregated form – is necessary to align the expectations of local communities with the magnitude of revenues received at the local level and to hold subnational governments accountable. If a resource revenue-sharing system is not transparent, it will not be effective in improving trust and addressing disagreements between subnational and national governments. Subnational governments in several countries, including the Democratic Republic of the Congo (DRC) and the Philippines, have questioned whether they are receiving what they are entitled to due to lack of transparency around payments from extractive companies to the national government.

In addition to past flows of revenues, subnational governments should also be informed of prospective flows of revenues to handle their volatility and manage expenditures better. For this purpose, in addition to the above, they also need project-by-project projections on natural resource projects – sales revenues along with costs, and the applicable fiscal regime.

However, in practice, only about half of the countries reviewed disclose details of natural resource revenues collected or transferred to subnational governments. Natural resource revenue-sharing systems have significant information requirements. Under derivation-based systems, subnational governments need several pieces of information: the applicable resource revenue-sharing system with the formulas for allocation, disaggregated information on fiscal payments from natural resource projects in their locality, by type of revenue streams, information on sales as well as the costs of natural resource projects. Much of this information, for larger mining, oil and gas projects, is available through the Extractive Industries Transparency Initiative (EITI), for countries that are part of this initiative. Under indicator-based systems, in addition to the information above, the basis for making the assessment and the actual calculations to allocate revenues should also be transparent. For example, the Australian Commonwealth Commission makes such detailed information, with a breakdown per region, publicly available (Government of Australia, n.d.[29]).

Depletion. Resource-dependent regions are affected by depletion of their resources, usually to a greater extent, compared with countries as a whole. Moreover, subnational governments may be less informed than national governments about how long their resource revenues are expected to last and may be less prepared to deal with the economic and fiscal consequences of resource depletion. To mitigate this problem, subnational governments should invest their resource revenues during good times into financial, human and physical capital.

Sovereign wealth funds that allow their owners to earn interest or "permanent" income is a form of financial capital. Defined by the International Monetary Fund (IMF) as government-owned entities with a macroeconomic purpose that do not have explicit liabilities and invest at least partly in foreign assets, sovereign wealth funds must be distinguished from extra-budgetary domestic spending accounts, development banks or so-called "strategic investment funds" whose primary purpose is to channel money into domestic assets. While these domestic spending vehicles may have a role to play in driving economic growth, the international experience with these types of funds highlights several challenges. Chief among them is that they are inherently political, as asset managers choose domestic winners and losers when deciding which local assets to invest in. They can also circumvent legislative oversight and government procurement systems (Bauer, 2018[30]).

Although there are a few cases of successful subnational funds such as funds in Abu Dhabi (the United Arab Emirates), Alaska (United States) and Quebec (Canada), many national and subnational funds have also not achieved their objectives. If such funds are created, appropriate deposit, withdrawal and investment rules should be put in place and enforced, their operations should be transparent, and there should be proper oversight (Bauer, 2014[23]).

Resource revenues can also be invested in human and physical capital, to support the diversification of the local economy away from its natural resources. Again, there are not many recent examples of successful diversification of local economies away from mining, oil and gas. The better-known examples are Dubai in the United Arab Emirates and the coal-producing Appalachian region of the United States (Gelb, 2010[31]).

Conclusion

In conclusion, natural resource revenue-sharing systems can enable communities to benefit from resource exploitation in their areas. Regardless of national or subnational legal ownership, natural resource revenue-sharing systems can bring tangible benefits, can act as a response to local claims for a share of subsoil wealth, and can help mitigate conflicts between national governments and subnational authorities. By introducing a natural resource revenue-sharing system based on clear objectives, clear formula, written into law and implemented systematically, debates around benefit sharing can shift from purely political to technical and more productive discussions.

Natural resource revenue-sharing systems are also superior to direct benefit sharing from natural resource companies to individuals and communities, in that they go through public financial management systems and therefore, arguably, are more accountable. This is not the case in all contexts, however – in some countries and communities where there is a lack of trust by subnational leaders towards the national government, or systems for public service delivery are absent, direct company-to-community transfers may be the preferable or the only option. Nevertheless, where possible, natural resource revenue-sharing systems, if designed and implemented well given the local context, can be more inclusive and transparent.

However, there are many challenges concerning the design and administration of natural resource revenue-sharing systems. This chapter reviews some key challenges with these systems and experiences of countries in addressing these challenges.

To work smoothly and to enhance trust between national and subnational authorities, natural resource revenue-sharing systems need to be overseen by an adequate governance mechanism and should be transparent. They must also improve the delivery of services at the subnational level. The exploitation of non-renewable natural resources often represents a one-time chance for regions to transform their economies or escape poverty. If well designed and implemented, resource revenue sharing can help drive such an economic transition and poverty reduction.

References

Agustina, C. et al. (2012), *Political Economy of Natural Resource Revenue Sharing in Indonesia*, ARC, London, http://www.lse.ac.uk/asiaResearchCentre/_files/ARCWP55-AgustinaAhmadNugrohoSiagian.pdf. [8]

Ahmad, E. and G. Brosio (eds.) (2015), *Tax Assignments at the Regional and Local Levels*, Edward Elgar Publishing, Cheltenham. [26]

Ahmed, E. and G. Brosio (eds.) (2006), *The Assignment of Revenue from Natural Resources*, Edward Elgar Publishing, Cheltenham. [7]

Arellano-Yanguas, J. (2010), *Local politics, conflict and development in Peruvian mining regions*, Institute of Development Studies, University of Sussex. [5]

Bailey, R. et al. (2015), *Investing in Stability: Can Extractive-Sector Development Help Build Peace?*. [2]

Bauer, A. (2018), *Funds and Mechanisms for the Management of Oil and Gas Revenues to Support Sustainable Development: Insights from Country Experiences and Lessons for Senegal*, United Nations Environment Programme (UNEP). [30]

Bauer, A. (2014), "All That Glitters is Not Gold: Will Expectations be Dashed in Canada's North?", *Natural Resource Governance Institute* 30 June. [20]

Bauer, A. (ed.) (2014), *Natural Resource Fund Governance: The Essentials*, Natural Resource Governance Institute (NRGI) and Columbia Center on Sustainable Investment (CCSI). [23]

Boadway, R. and A. Shah (eds.) (2007), *A Practitioner's Guide to Intergovernmental Fiscal Transfers*, World Bank, Washington, DC. [28]

Boadway, R. and A. Shah (eds.) (2007), *Intergovernmental Transfers: Principles and Practice*, World Bank, Washington, DC. [25]

Brosio, G. and J. Jimenez (2012), *The Intergovernmental Assignment of Revenue from Natural Resources: A Difficult Balance Between Centripetal and Centrifugal Tendencies*, Edward Elgar Publishing, Northampton, MA. [11]

Castanada, L. and J. Pardinas (2012), "Sub-national Revenue Mobilization in Mexico", *IDB Working Paper Series*, No. 54. [15]

Conger, B. and B. Dahlby (2015), "Policy Forum: Taxation of Machinery and Equipment and Linear Property in Alberta", *Canadian Tax Journal*, Vol. 63/2, pp. 487–499. [32]

Gelb, A. (2010), *Economic Diversification in Resource-Rich Countries*, IMF, Washington, DC. [31]

Government of Australia (n.d.), *Commonwealth Grants Commission*, https://www.cgc.gov.au/ (accessed on 11 November 2019). [29]

Government of Mongolia (2011), *The Law on the Budget, 23 December 2011*. [19]

Government of Uganda (2015), *Public Finance Management Act, 6 March 2015*. [17]

Guigale, M. and S. Webb (eds.) (2004), *Transfers and the Nature of the Mexican Federation*, World Bank, Washington, DC. [16]

Haysom, N. and S. Kane (2009), *Negotiating natural resources for peace: Ownership, control and wealth-sharing*. [3]

ICMM (2011), *Utilizing mining and mineral resources to foster the sustainable development of the Lao PDR*, Lao PDR Ministry of Energy and Mines, National Economic Research Institute and International Council on Mining and Metals. [12]

Keating, M. and O. Brown (2015), *Addressing Natural Resource Conflicts: Working Towards More Effective Resolution of National and Sub-National Resource Disputes*, Chatham House. [14]

Morgandi, M. (2008), *Extractive Industries Revenues Distribution at the Sub-National Level*, Revenue Watch Institute. [9]

NRGI (n.d.), *Natural resource fund web page*, http://www.resourcegovernance.org/nrf (accessed on 11 November 2019). [22]

NRGI-UNDP (2016), *Natural Resource Revenue Sharing*, Natural Resource Governance Institute (NRGI) and United Nations Development Programme (UNDP) policy paper. [4]

Shah, A. (ed.) (2008), *Subnational Borrowing, Insolvency and Regulation*, International Bank for Reconstruction and Development and the World Bank, Washington, DC. [24]

Shotton, R. (2017), *Local Development Fund allocation arrangements: Current issues and options for change*, Sustainable Livelihoods Project-3. [18]

UNEP and UNDPA (2015), *Natural Resources and Conflict: A Guide for Mediation Practitioners*, United Nations Department of Political Affairs and United Nations Environment Programme, New York. [13]

Viale, C. (2015), *Distribución de la renta de las industrias extractivas a los gobiernos subnacionales en América Latina: Análisis comparative y de tendencias*, INTE-PUCO, Lima. [10]

Viale, C. and E. Cruzado (2012), *Distribution of Revenue from the Extractive Industries to Sub-national Governments in Latin America*, Revenue Watch Institute. [1]

Vieyra, J. and M. Masson (eds.) (2014), *Fiscal Windfalls, Transparency, and the Efficiency of Public Good Provision: Evidence from Brazilian Local Government*, Inter-American Development Bank, Washington, DC. [21]

Volooj, S. et al. (2016), *Extractive industries Revenue Management System in Mongolia*, UNDP, Ulaanbaatar. [27]

Wall, E. and R. Pelon (2011), *Sharing Mining Benefits in Developing Countries: The Experience with Foundations, Trusts and Funds*, World Bank, Washington, DC. [6]

Notes

1. This is not an exclusive list.
2. One exception is property taxes on machinery, equipment or pipelines in Canada and the United States, which generate significant tax revenue for municipalities. See Conger and Dahlby (2015[32]).
3. However, if not designed adequately, an indicator-based system can also be inequitable. For example, in Mongolia, the ratio of allocations from the General Local Development Fund, for *aimags* receiving the highest and the lowest per capita allocation was 14.3 to 1, and for *soums* it was even higher (as of 2014, at which time the system was more indicator-based, and had only a minor derivation-based component). See Shotton (2017[18]).

Chapter 7. Municipal finance and property taxation in China

by Zhi Liu, Lincoln Institute of Land Policy and
Peking University – Lincoln Institute Center for Urban Development and Land Policy

For the last two decades, Chinese cities have relied heavily on the revenues from public land leasing to finance urban development. Recently, the People's Republic of China (hereafter "China") amended the Land Administration Law, which allows villages to supply rural land for urban development without going through land expropriation by local governments. This amendment will have a significant impact on the future of municipal finance. In the context of China's inter-governmental fiscal framework, this chapter discusses the current issues facing its municipal finance system, the new issues that would emerge as a result of the amendment and several options to address them.

The author is grateful for the assistance of Vivian Wei Liu, who prepared the data for Figure 7.1 and for helpful comments from Andrew Reschovsky on an earlier version of the chapter.

Introduction

Over the last few decades, the People's Republic of China (hereafter "China") has experienced unprecedented, rapid urbanisation. Taking advantage of the Land Administration Law that gave the state monopoly power to convert rural land for urban use, the municipal governments around the country have relied heavily on the revenues from public land leasing to finance urban development. This land-based finance instrument has helped China develop and modernise cities in a short period of time, but it is also running out of steam due to the scarcity of land and to the recent Amendment of the Land Administration Law that permits villages to supply rural land for urban development without going through land expropriation by local governments.

Today, 60% of China's population lives in urban areas, and rapid urbanisation is expected to continue. The central government has also called for a transition from a development phase that emphasised gross domestic product (GDP) to a new phase of high-quality development. Municipal governments will be at the forefront to provide high-quality public services to meet the increasingly diversified needs of the majority of Chinese citizens who live in cities. Sound and sustainable municipal finance will be important for the future of urbanisation.

This chapter first describes how the current municipal finance system functions within China's inter-governmental fiscal framework. In particular, the chapter highlights the uniqueness of China's governance structure, its national fiscal system, the role of public land leasing in financing rapid urbanisation and the challenges of municipal finance that have resulted from the decline of land revenues and will be further impacted by the amendment. In this context, the chapter highlights the potential applications and hurdles of various municipal finance instruments, including property taxation, land value capture, public-private partnerships, and the municipal bond market, which could prove essential elements of the future municipal finance system in China. This chapter will mainly focus on the revenues of municipal governments. Expenditure assignments are also important but are beyond the scope of this chapter.

China's inter-governmental fiscal framework

Levels of government

China's administration system includes five levels of government, namely central, provincial, prefecture, district/county, and village/township. Broadly, the term "local government" (*di fang zheng fu*) refers to any level of government under the central level. However, the central-local relationship in the central government documents often refers specifically to the relationship between the central and provincial-level governments, not the sub-provincial governments.[1]

Any government body at each level, except the level of village/township, is a fiscal unit with specified revenue and expenditure assignments, as well as its own budget. The village/township governments have their own budgets, but all their revenues are transferred from higher-level governments. All governments at each level are all-purpose governments. They are responsible not only for public services but also for economic development and social affairs within their administrative areas.

There are no special-purpose governments, such as school districts, that provide a single or specialised public service to an administrative area. Nor are there governmental bodies that involve two or more administrative areas, such as metropolitan service districts in the

United States. If a metropolitan area or a megacity region grows across the boundaries of two or more administrative areas (say, prefecture-level municipalities), the management and co-ordination of cross-jurisdiction matters will be taken up by the higher-level government (such as the provincial government).

Government revenues and the general tax burden

China is a unitary state. In terms of budget management, government revenues are allocated among four separate budgets: general public budgetary revenues (comprising tax revenues and non-tax revenues), revenues from various government-managed funds (such as land concession revenues, railway construction funds, local education surcharge, etc.), operating revenues from state-owned enterprises, and revenues from social insurance funds. Table 7.1 shows the four sources of government revenues in 2018. It is worth noting that tax revenues account for only half of total government revenues, and the rest is from other sources of government revenues.

Table 7.1. Government revenues in China, 2018

CNY trillions

			Central	Local	National	
					Amount	% of total
(1)	General public budgetary revenues		8.54	9.80	18.34	57.5%
	Of which	Tax revenues	8.04	7.60	15.64	49.0%
		Non-tax revenues	0.50	2.20	2.70	8.5%
(2)	Revenues from various government-managed funds		0.40	7.14	7.54	23.6%
	Of which	Land concession revenues	0.004	6.29	6.29	19.7%
(3)	Operating revenues from state-owned capitals		0.13	0.16	0.29	1.0%
(4)	Revenues from mandatory social insurance funds		0.03	5.72	5.75	18.0%
Total			9.10	22.82	31.92	100.0%

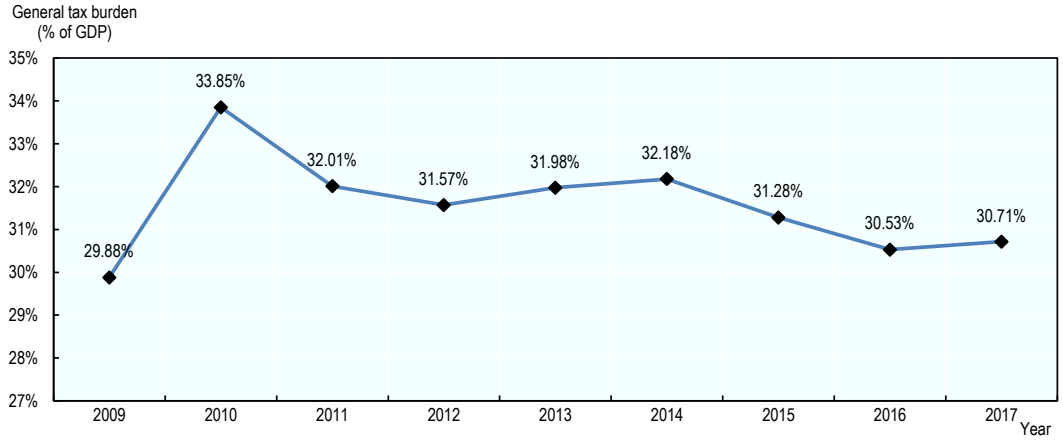
Source: Ministry of Finance (2018[1]), "National Government Final Account", http://yss.mof.gov.cn/2018czjs/.

The OECD classifies taxes by the base of the tax, including income and profits, compulsory social security contributions paid to the general government (which are treated as taxes), payroll and workforce, property, goods and services, and other. Using this tax revenue classification, the OECD calculates the tax-to-GDP ratio for its member countries (OECD, 2018[2]). The average tax-to-GDP ratio for all OECD countries in 2017 was 34.2%, with the highest at 46% (Denmark and France) and the lowest at 16% (Mexico).

The total amount of government revenue in China shown in Table 7.1 is not readily comparable to the OECD tax revenue statistics. The government revenues from government-managed funds in China include, among other things, the gross revenues from public land leasing (i.e. land concession revenues), from which the expenditures for land acquisition and resettlement should be excluded in order to make the land concession revenues comparable with the OECD tax definition. The Peking University-Lincoln Institute Center for Urban Development and Land Policy (PLC) devised a method to calculate the share of "net" government revenues over GDP that is comparable to the OECD tax-to-GDP ratio.[2] This ratio is referred to as the "general tax burden" (*guang yi hong guan shui fu*).

Figure 7.1 shows the changes in the general tax burden from 2009 to 2017. Since the tax system reform in 1994 that introduced the tax-sharing system, China has made significant efforts to increase the share of government revenues over GDP. The general tax burden peaked in 2010, reaching 33.85% of GDP. Then it declined in 2011 and 2012, increased slightly again in 2013 and 2014 before falling to a level of slightly above 30%. The declines in recent years are the result of government-enacted tax cuts.

Figure 7.1. General tax burden in China, 2009-17



Source: Calculated based on published government finance statistics, available from: www.stats.gov.cn/english/.

China's general tax burden is at the lower range of the tax-to-GDP ratio for OECD countries. However, the general tax burden in China should not be considered as low, given the fact that China is still an upper-middle-income country.

The tax-sharing system

The current system of taxation in China, which was adopted in 1994, is known as a tax-sharing system. There are three categories of taxes: central, local, and shared. Central taxes are collected and fully retained by the central government. Local taxes are collected and fully retained by local governments.[3] Shared taxes are collected by the central government and shared in a pre-determined proportion with the local (provincial) government where the shared tax revenues are generated. The most important feature of this system is that the central government determines the types and rates of all taxes. Practically speaking, local governments have little independent taxing power, or tax autonomy, except for setting the tax rates for several small local taxes within a range determined by the central government. Table 7.2 lists the taxes under the three categories. Table 7.3 shows the tax revenues by selected years between 1995 and 2018. It is worth noting that the share of local tax revenues has been consistently less than 50% of the total tax revenues.

Table 7.2. Taxes by category under the tax-sharing system in China

	Central	Local	Shared
Turnover taxes	Excise tax (assigned to local in 2019)	Business tax (all converted to value-added tax in 2018)	Value-added tax (50:50)
Income taxes			Corporate income tax (60:40) Individual income tax (60:40)
Resource taxes		Resource tax Urban and township land use tax	
Specific purpose taxes	Vehicle purchase tax	Urban maintenance and construction tax Arable land occupancy tax Fixed asset investment orientation regulation tax Land appreciation tax	
Property taxes		Real estate tax Inheritance tax (not yet levied)	
Behaviour taxes		Vehicle and vessel tax Stamp tax Deed tax Vessel tonnage tax	
Customs duty	Customs duty		

Source: Ministry of Finance of the People's Republic of China: http://szs.mof.gov.cn/shuizhijianjie/index.htm.

Table 7.3. Tax revenues in China by year, 1995-2018

	National GDP (CNY billions)	Total tax revenues (CNY billions)	Tax revenues as % of GDP	Central tax revenues (CNY billions)	Local tax revenues (CNY billions)	Local share of national tax revenues
1995	6 079	597	9.8%	312	286	47.8% (1)
2000	9 922	1 258	12.8%	657	601	47.8% (1)
2005	18 494	2 878	16.7%	1 605	1 273	44.2%
2010	40 151	7 321	19.3%	4 051	3 270	44.7%
2015	68 905	12 492	18.1%	6 226	6 266	49.8%
2016	74 359	13 036	17.5%	6 567	6 469	49.6%
2017	82 712	14 437	17.5%	7 570	6 867	47.6%
2018	90 031	15 640	17.4%	8 045	7 596	48.6%

Note: 1. The percentage is taken from the published share of local budgetary revenues over total budgetary revenues. It is used by the author to estimate the central tax revenues and local tax revenues in 1995 and 2000.
Source: National Bureau of Statistics of China (2019[3]), www.stats.gov.cn/english/.

In contrast, general public budgetary expenditures are highly decentralised. Since the establishment of the tax-sharing system in 1994, the share of general public budgetary expenditures by the local governments has increased steadily from 70% in 1995 to about 85% over the past eight years. In 2018, the total amount of general public budgetary expenditures was CNY 22.09 trillion, of which local governments spent CNY 18.82 trillion or 85.2%, while the central government spent CNY 3.27 trillion (or 14.8%), and transferred CNY 6.97 trillion to the provincial governments.

The central-to-provincial transfer system is highly complex, and it closes the gap between the relatively centralised revenues and the highly decentralised public expenditures. There are two types of central-to-provincial transfers: general-purpose transfers and earmarked transfers. In 2018, the general-purpose transfers accounted for 62.8% of the total transfers, while the earmarked transfers accounted for 38.2%. The purpose of the transfers is to equalise the basic public services across China, but the amount to each targeted province is not formula-based; it is more the result of central government discretion and negotiation with each provincial government.

The inter-governmental fiscal framework at the subnational level

Compared to the central-provincial fiscal framework, the inter-governmental fiscal framework at the subnational level is much more complex. As mentioned above, there are four levels of subnational governments (province, prefecture, county, and village/township). Significant variations exist among the provinces in terms of population, incomes, economic structure, level of urbanisation, as well as fiscal capacity. There are several tax-sharing arrangements between the provincial and prefecture levels. Most provinces adopt a fixed share for the type of local taxes with large and stable revenues between the provincial and prefecture governments, and assign the revenues of the small local taxes to the prefecture governments. Some provincial governments also take all tax revenues generated from the pivotal industries with provincial significance. In a few provinces (Zhejiang, Fujian, and Jiangsu), a quota is set for the total tax revenues generated from each of the prefectures; the quota amount is retained by the prefecture, and the excess amount above the quota is shared with the provincial government at an agreed proportion (Zhong, 2017[4]).

The expenditure assignments are essentially similar among the provincial, prefecture and county governments. This pattern is often criticised as “one size fits all” that ignores the comparative advantages of different levels of government in carrying out a certain expenditure responsibility. Because of that, there is a long recognised tendency that the higher-level government often presses the lower-level government to carry out the mandates that the former is not able to fully fund and implement. As a result, the latter, which has less financial resources and implementation capacity, has to carry a heavier burden of expenditure responsibilities.

This pattern of behaviour is made possible partly by the highly centralised political system. The top leader of a local government (i.e. the party secretary) is directly appointed by the higher-level party committee. For example, the central party committee appoints the provincial party secretary, the provincial party committee appoints the prefecture party secretary, and so on. This centralised political system is designed to ensure that the central policy and directives are implemented by the lower-level governments. To some extent, it is compatible with the tax-sharing system in which the central government maintains almost all taxing powers, and the local governments are given little taxing power.

There are also inter-governmental transfers between the provincial and prefecture-level governments. But this is perhaps the least known area of local public finance in China. There are essentially no centrally collected and published data on local government transfers. These data are available from provincial finance departments in some provinces. It is highly unlikely that the provincial-prefecture transfers are formula-based.

Land-based finance for urban development

Definition of municipalities

China's urbanisation has been rapid since 1978, the year when the economic reform started. Between 1978 and 2018, the total population grew from 963 million to 1.4 billion, and the share of the urban population grew from 18% to 60%. Today, over 831 million of China's citizens live in cities. The number is expected to reach over 1.13 billion (or 75% of the total population) by 2050. The physical expansion and development of cities have been visibly dramatic over the last two decades. Most cities, large and small, have expanded in population and land area by several times. A number of large cities, megacities and urban regions (or cluster cities) have emerged, and serve as the major centres of the nation's economic activities. The development of three top urban regions (or city clusters), namely the Beijing-Tianjin-Hebei Region, the Yangtze River Delta Region centred on Shanghai and Hangzhou, and the Greater Bay Area of Guangdong-Hong Kong-Macau, is expected to drive China's economy for the next few decades.

Administratively, a municipality (*shi*) in China is not exactly a city. It is an administrative area comprising both urban and rural areas. There is no government created specifically for an urbanised area. Usually, a municipality contains a central city built-up area and the surrounding rural districts or rural counties. A large municipality may contain several urban districts, one or two county-level cities, and several rural counties. This spatial arrangement allows sufficient geographical space for the municipalities to expand their urbanised areas. It also complicates municipal financial management, however. A prefecture-level municipality has two levels of fiscal arrangements: the prefecture-level government itself and the county-level governments, each having its own revenue and expenditure assignments. In a few provinces, the provincial governments establish the direct fiscal relationship with the rural county governments within a prefecture, leaving the prefecture-level government to manage its own finance over the central city areas.

Currently, China has 661 municipalities, with varying administrative ranks. Four municipalities are at the rank of provincial level; they are Beijing, Shanghai, Tianjin and Chongqing, also known as the centrally administered municipalities (*zhi xia shi*). There are 283 municipalities at the prefecture level (*di ji shi*) and 374 at the county level (*xian ji shi*). In addition, there are 1 636 county towns (*xian cheng*) that serve as the administrative seat of a county, and about 20 000 administratively designated townships (*jian zhi zhen*), mostly market towns serving the rural areas. Some of the county towns and townships are large, with populations over 100 000.

Local taxes on real estate properties

In the local tax system, there are five taxes that are related to real estate properties: urban and township land use tax, arable land occupancy tax, land appreciation tax, real estate tax, and deed tax. As the statistics in Table 7.4 show, in recent years the total revenues from these five taxes account for about 22-24% of the local tax revenues and about 2% of the national GDP. As discussed below, these five property-based taxes do not include a tax on the ownership of private residential properties (also known as property tax).

Table 7.4. Revenues from five taxes on real estate properties in China, 2013-18

CNY billions

	2013	2014	2015	2016	2017	2018
Urban and township land use tax	158.2	185.2	205.1	225.6	236.1	238.8
Farmland occupancy tax	171.8	199.3	214.2	202.9	165.2	131.9
Land appreciation tax	329.3	391.5	383.2	421.2	491.1	564.1
Real estate tax	182.8	205.9	209.7	222.1	260.4	288.9
Deed tax	384.4	400.1	389.9	430.0	491.0	573.0
Total of five taxes	1 225.6	1 381.9	1 402.1	1 501.8	1 643.8	1 796.7
As % of local tax revenues	22.7%	23.4%	23.9%	23.2%	23.4%	23.7%
As % of GDP	2.1%	2.1%	2.0%	2.0%	2.1%	2.0%

Source: National Bureau of Statistics of China (2019[3]), www.stats.gov.cn/english/.

The urban and township land use tax is imposed annually on urban land in use. An organisation or individual using land in cities, county towns, administrative towns, and industrial and mining districts must pay the urban land use tax. The annual tax rates on each square metre of land used are: 1) CNY 1.5-30 in big cities (with populations over 1 million); 2) CNY 1.2-24 in medium-sized cities (with populations between 0.5-1 million); 3) CNY 0.9-18 in small cities (with population under 0.5 million); and 4) CNY 0.6-12 in county towns, administrative towns, and industrial and mining districts.

The farmland occupancy tax is a one-time tax imposed on entities and individuals who use arable land to build houses or for other non-agricultural construction purposes, based on the occupied area of farmland. Differentiated tax rates are adopted for different locations. Differentiated tax rates are adopted for different localities (mainly at the county level), ranging from 5 yuan per square meter to 50 yuan per square meter. Higher tax rates are adopted in localities with smaller area of farmland per capita.

The land appreciation tax is a one-time tax levied on the incremental value received by the entities and individuals who transfer the right to use state-owned land, above-ground structures and their attached facilities and attain income from such transfer. There are four levels of progressive rates (30%, 40%, 50%, and 60%).

According to the tax code, the real estate tax is imposed annually on owners of houses within cities, county towns, administrative towns, and industrial and mining districts. The real estate tax for self-occupied houses is calculated at a tax rate of 1.2% on 70-90% of the original value of the property. The real estate tax for rented houses is calculated based on rental income, and the applicable tax rate is 12%. Rental of personally owned residential houses is taxed at 4% of rental income; rental of residential houses by enterprises and public institutions, social groups and other entities is taxed at a preferential rate of 4%. So far, this tax is only implemented on houses for commercial use, not on private residential houses.

The deed tax is a one-time tax imposed on the transferee (entities and individuals) of land and houses within China for the market price for the transferred right to use the land or the right of ownership of the house, or the price margin resulting from the exchange of land use rights and house ownership. The tax rates are 3-5% of the purchase price of the house. The purchase of a housing unit under 90 square metres by individuals or households, for whom this is the only housing unit, is taxed at a preferential rate of 1%. The purchase of a housing unit over 90 square metres by a household, which is the only housing unit of the household, is taxed at half of the applicable tax rate.

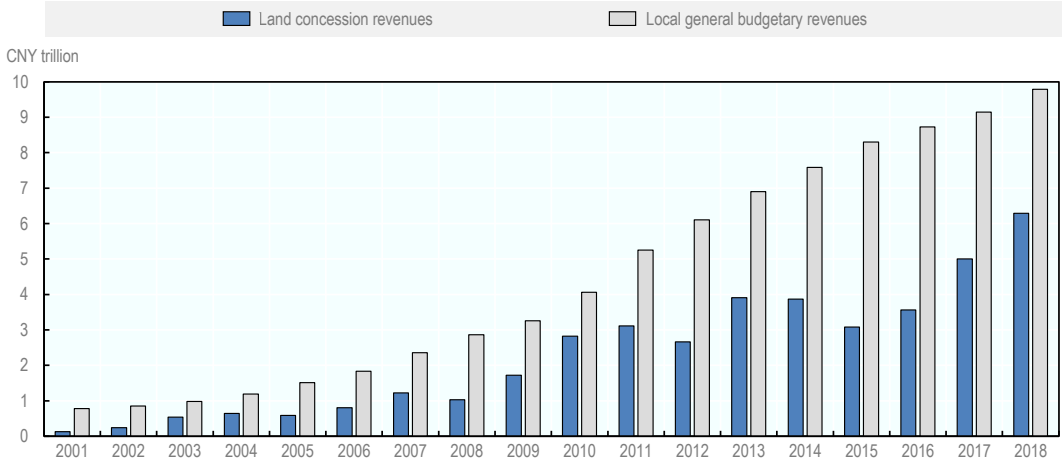
As part of the new round of the tax system reform, the government plans to implement a property tax (i.e. a tax on the ownership of private residential properties), and a national property tax law is being drafted. This has been a major topic of public debate. If the property tax is introduced, there will be a need to restructure the five taxes related to land and housing properties. This topic is discussed later in this chapter.

Land concession revenues

As discussed earlier, land concession revenues constitute a significant source of government revenues. To a great extent, the rapid urban development over the last two decades was attributable to the ability of the municipal governments to mobilise financial resources. The performance of municipal finance was shaped by the tax-sharing system and the legal framework for land management that gave the local governments monopoly power to provide land for urban development. According to the Constitution, urban land is owned by the state, and rural land by the village collectives. The Land Administration Law (before the recent amendment) gave the state the power to control and regulate land use, and monopoly power to convert rural land into urban land through land expropriation. The law also allowed the state to sell the urban land use rights, through market competition, to real estate developers for commercial and residential development. Therefore, to supply land for urban expansion, a municipal government would acquire land from rural areas, service the land with basic infrastructure, and sell the land use rights to real estate developers, often through a bidding process for commercial and residential development. According to government regulation, the compensation to the villages and villagers for rural land taken was set at the agricultural production value (or the value of land in its original use). As rapid urbanisation created significant demand for urban commercial and residential development, real estate developers bid very high prices for the land use rights, often significantly above the total costs of land acquisition, resettlement and basic infrastructure. Under these circumstances, the municipal government would profit handsomely from such a public land leasing operation. The profits would then be used to invest in the urban infrastructure needed to support urban development.

The land concession revenues, which accounted for nearly 20% of the total government revenues and 70-80% of total revenues from government-managed funds, are kept almost 100% as local government revenues, which are then used mainly for capital expenditures.. Figure 7.2 shows the size of the land concession revenues as compared to the size of local general budgetary revenues. In most years since 2001, the land concession revenues were at least as high as 30% of the local general budgetary revenues; in some years, the ratio reached over 60%.

Figure 7.2. Local general budgetary revenues and land concession revenues in China, 2001-18



Source: China Statistical Yearbooks, various years (National Bureau of Statistics of China, 2019[3]).

However, a significant amount of the land concession revenues is spent on land acquisition and resettlement related to the public land leasing operations. In fact, the share of land acquisition and resettlement costs over total land concession revenues has steadily increased from about 45% in 2009 to 60% in 2015 (Liu and Xiong, 2018[5]). The share stood at 70% in 2017.

Municipal borrowing through local government finance vehicles

Land is also used as collateral for the municipal government to borrow from commercial banks, and loans are often backed by future land concession revenues. For years until its amendment in 2014, the Budget Law did not allow local governments to borrow directly from commercial banks or raise funds directly from capital markets. Facing the constraint, municipal governments created municipal government-owned local government finance vehicles (LGFV) – also known as urban development investment corporations – to borrow, often using land as collateral.

The borrowing through LGFV has caused a major local government debt problem. A 2013 State Audit Report revealed a total of CNY 17 trillion in outstanding local debt, an amount equivalent to 28.6% of the national GDP in 2013. Over the last few years, efforts were made to reduce the share of outstanding local debt over the national GDP. The central government imposed a debt ceiling on local government borrowing and pledged that there would be no bailouts. Moreover, the central government permitted a small number of local governments to issue bonds in order to ease their repayment pressures. These measures appear to have been successful in getting local debt under control. The State Audit Office reported that the local government outstanding debt stood at CNY 15 trillion or 20.2% of the national GDP by the end of 2016, and the Ministry of Finance reported that the amount was CNY 18.4 trillion or 20.4% of the national GDP at the end of 2018.

Emerging challenges in municipal finance

The key question

Over the last few years, a few economic and policy changes have occurred that will have a lasting impact on municipal finance. First, China's economy has entered a new growth stage known as the "New Normal" since 2014. National GDP growth no longer registers a rate close to the 10% per year as before. Instead, the rate has dropped to under 7% a year. Demand for land slows accordingly for most cities except the most economically viable cities at the top of the urban hierarchy, such as Beijing, Shanghai, Guangzhou, Shenzhen, and Hangzhou. With a weakened land market, many municipal governments are seriously concerned about the sustainability of land-based finance in the near future. On the other hand, the compensation for rural land taking has also risen in recent years as farmers continue to press for higher compensation. This narrows the net revenues from land concessions.

Very recently, in August 2019, the National People's Congress passed an amendment to the Land Administration Law. The amendment essentially removes the monopoly power of the state to covert rural land for urban development; instead, village collectives are permitted to lease their rural land for urban development as long as new land use conforms with spatial planning. When the amendment takes effect in January 2020, it is expected that the municipal governments will lose much of the land concession revenues. One piece of good news is that the central government recently decided to assign the excise tax revenues (CNY 1.1 trillion in 2018) to the local governments. Nevertheless, municipal governments face a significant challenge: What alternative, stable source of municipal revenues for urban development will there be? To answer this question, the current round of fiscal policy reform set to greatly affect municipal finance provides context.

The new round of fiscal policy reform: Balancing indirect and direct taxes

The current round of fiscal policy reform started after the Third Plenary Session of the 18th National Congress of the Communist Party of China, which was held in November 2013. The principal objective of the reform is to optimise the tax structure while maintaining the level of overall tax burden on the economy. It is also considered a key measure under the government's "supply-side" reform initiative that aims to cut the high tax and non-tax burdens on the real economy. It requires an increase in direct tax revenues and a reduction in indirect tax revenues.

China's taxation system is characterised by the dominance of indirect taxes. By definition, an indirect tax is a tax that is paid to the government by a firm or entity in the supply chain but is passed on to the consumers as part of the price of a good or service. A direct tax is a tax paid directly by a person or a firm. In China's taxation system, direct taxes include corporate income tax, individual income tax, vehicle purchase tax, vessel tax, deed tax, and real estate tax. Calculated from the tax revenue data published by the Ministry of Finance, direct tax revenues accounted for 40% of total tax revenues in 2018. In comparison, direct tax revenues usually account for over 50% of total tax revenues in OECD countries.

As there is still no property tax on the ownership of private residential properties, the share of tax revenues from individuals (instead of firms) is small in China. As the data in Table 7.5 show, individual income tax revenues accounted for 8.9% of total tax revenues (not including social security contributions) in 2018. In comparison, on average, 33.1% of total tax revenues (excluding social security contributions) came from individual taxpayers in OECD countries in 2016.[4]

Table 7.5. Individual tax revenues in China, 2013-18

CNY billions

	2013	2014	2015	2016	2017	2018
Individual income tax revenues	653	738	862	1 009	1 197	1 387
Total tax revenues	11 053	11 918	12 492	13 036	14 437	15 640
% of total	5.9%	6.2%	6.9%	7.7%	8.3%	8.9%

Source: National Bureau of Statistics of China (2019[3]), www.stats.gov.cn/english/.

The dominance of indirect taxes in the tax-sharing system is partly a legacy of the planned economy where the government collected "profits" from state-owned enterprises as the main source of fiscal revenues. When the tax-sharing system was established in 1994, China was still a low-income country. The system only taxed the personal incomes of foreigners and Chinese individuals with very high incomes, and excluded the majority of the people as a source for taxation. In 2011, the central government raised the threshold of individual income tax from CNY 2 000 per month to CNY 3 500 per month. The decision was highly popular, but it substantially limited the number of individual income taxpayers to less than 50 million people, or less than 4% of the total population. In 2018, the central government further raised the threshold to CNY 5 000 per month. Under the taxation system dominated by indirect taxes, most Chinese citizens are not used to paying direct taxes. This explains a strong social tendency to resist the introduction of broadly based direct taxes, such as property tax on the ownership of private residential properties.

Over the past five years, the reduction of indirect tax revenues has been achieved through the conversion of business tax to value-added tax, both of which are indirect taxes. The reduced amount of indirect tax revenues amounted to about CNY 1 trillion a year (Gao, 2017[6]). This revenue reduction is to be made up of other taxes if the level of public expenditures is maintained. China recently introduced a resource tax and will soon roll out a new environmental tax; both are local taxes. The amount of revenues from these two new taxes will be far from adequate to close the revenue gap, however.[5] On the side of direct taxes, there is no room for higher corporate income tax as the policy is to reduce the tax burden of enterprises. Therefore, the hope for a solution lies with personal income tax and private residential property tax. Otherwise, the government will have to rely on borrowing, which will increase fiscal risks, particularly at the local level, where the burden of local public debt is already heavy.

New sources of municipal revenues and finance

In the context of the new round of fiscal policy reform and the difficulties encountered in the personal income tax reform process, much of the fiscal policy needs to be reformed at the subnational level. The key is to seek more sustainable own sources of municipal finance. The following section will discuss property taxation, land value capture, public-private partnerships and the municipal bond market.

Property taxation on private residential properties

The 19th National Congress of the Communist Party of China, held in October 2017, continues to emphasise fiscal policy reform. Specifically, it continues to call for the deepening of tax system reform, and the improvement of the local tax system. A crucial task is to continue the current round of fiscal policy reform by increasing the share of direct taxes. The focus is on the introduction of a property tax. In 2018, the government revealed

three principles for the rollout of a property tax. First, a property tax law has to be passed by the National People's Congress before the rollout of the property tax. Second, the central government will give full authorisation to local governments for the implementation of the property tax, which implies local flexibility on tax rates and exemptions. Third, the rollout should be taken step by step, implying that the cities that are ready to implement the tax may do so first. Furthermore, the residential property tax will be based on property value assessment, and the other taxes on the construction and transaction of properties will be lowered.

By all indications, the government is determined to move ahead with the rollout of the property tax, even though there is no specific timetable yet for the property tax law to be presented to the National People's Congress for approval. Even if the law is passed by the National People's Congress in the near future, it will still take a few years for many municipalities to establish a working system of residential property assessment and administration. Therefore, it will be years before residential property tax becomes one of the main sources of municipal revenues.

However, the introduction of property tax will be significant in shaping urban governance in the future. Residential property tax is a local tax, introduced on the justification that the revenues would be used by municipal governments to provide local public services, which would constitute a percentage of property value. As such, taxpayers are expected to demand the right to influence and participate in municipal decision making and the monitoring of municipal expenditures. This bottom-up pressure will fundamentally change the management style of municipal leaders, from responding mainly to directives from the higher level, to responding to the needs of urban residents.

The political hurdles for the introduction of a property tax on the ownership of private residential properties are obvious and very strong. Few households who owned one or more housing units will be happy to pay the property tax. The tax would represent a considerable outlay for an average household. Suppose that the annual amount of new property tax revenues from urban areas accounts for 1% of the national GDP of CNY 90 trillion (as of 2018), it would amount to CNY 900 billion in total, or CNY 1 033 per urban resident. Nonetheless, one could question why a property tax was implemented in a large number of countries (including many with lower per capita income than China) for many years, but not in China.

In fact, the central government studied the feasibility of the property tax in the early 2000s. It is a significant missed opportunity, that the property tax was not introduced just a few years after the housing policy reform to transform housing provision from welfare to market in 1998 and right before the start of the housing boom that lasted until 2013. Today, over 90% of urban households own one or more housing units. They form the strongest public resistance to the property tax.

Given the urgency to strengthen the municipal finance system when the traditional land-based finance is losing steam, it would be ideal if the property tax were introduced immediately. A possibility is to adopt a wide tax base and a very low rate to start with. The rate may be determined locally by municipal governments, depending on the income affordability of their urban households. The acceptance of urban households is critical in changing the culture of not paying direct taxes. Introducing the property tax would require tremendous political will and perhaps a bit of luck in terms of timing for the economy. Once a property tax with a low rate is accepted, municipal governments will have the opportunity to gradually raise the property tax rate to the point that balances affordability and revenue needs for public services.

The government should consider allowing time for multiple-home owners to adjust their home investment portfolios before the property tax law comes into effect. Most current urban housing units were built and purchased after the housing reform of 1998. Many households own multiple housing units that they keep vacant. This phenomenon is caused by various distortions, such as lack of household investment alternatives, weak social security coverage, and very low carrying costs in the absence of a property tax. For these households, the property tax burden would be very high if the owners do not sell or rent out the extra or vacant housing units. Considering that they made the purchase of the properties at the time without a property tax, the government should allow them a certain period of time to adjust their housing investment portfolios after the national property tax law is passed by the National People's Congress. A simple way to do so is to make the law effective two to three years after its approval.

As seen above, China has a large number of municipalities, county towns and administrative townships. Most of these municipalities and towns are not ready to implement a residential property tax, due to lack of institutional capacity for property value assessment and property tax administration. However, a number of large municipalities have been making significant efforts to establish a city property database and develop property valuation methodologies. Some are ready to implement the property tax. Therefore, it makes a great deal of sense for the central government to allow the municipalities that are prepared to implement the property tax to go ahead as soon as the national property tax law is effective. At the same time, the central government and provincial governments may consider funding a capacity development programme to assist other municipalities in developing property assessment and administration systems. A financial incentive programme based on the inter-governmental transfer system may be considered by the central government to reward municipalities that make substantive efforts to roll out the property tax.

Land value capture

Internationally, many cities use various area-based land value capture (LVC) instruments to finance urban infrastructure. Notable instruments include betterment contributions, special assessments, exactions, impact fees, land readjustments, rail and property co-development, inclusionary housing, transferable development rights and tax incremental finance (German and Bernstein, 2018[7]).

In a broad sense, the mobilisation of revenues from competitive land concessions by China's municipalities is also an LVC instrument. For most municipalities, this is the only LVC instrument in use. However, a few cities (such as Shenzhen and Nanchang) have started to learn from the Hong Kong experience in using rail and property co-development to finance urban rail investment. Also in Shenzhen, a variant of land readjustment is adopted for the redevelopment of urban villages, in which a portion of the profit from the redevelopment is used to fund neighbourhood public infrastructure (Liu and Zeng, 2019[8]). Moreover, some cities adopt a development-oriented approach to locate the new urban rail lines and stations in the under-developed corridors with an expectation that the land value will rise for capture once the investment is announced and implemented (Yang et al., 2016[9]).

These cases demonstrate the potential for wider applications of LVC in Chinese cities. However, there is no policy and legal framework for local governments to adopt most of the LVC instruments. In the case of rail transit development in the Pearl River Delta Region of Guangdong Province, it was found that the provincial and relevant municipal

governments did not have a ready institutional and policy framework to handle the value capture issues (Li et al., 2013[10]). If China intends to introduce the LVC instruments, a policy and legal framework should be established to enable the local governments to do so.

Public-private partnerships

China started using public-private partnership (PPP) arrangements to finance and deliver infrastructure in the 1990s. The Build-Operate-Transfer (BOT) financing model was extensively used in tolled roads and urban water supply projects. However, PPPs slowed after the central government pumped an economic stimulus package of CNY 4 trillion into the economy in response to the adverse impact of the global financial crisis in 2007-08. A significant portion of the package was spent on infrastructure. PPPs were revitalised in 2014 when the central government decided to tame local government debt by closing the LFVs and opening the front door to PPPs. Then PPP projects emerged rapidly. In just two years, China became the biggest PPP market in the world. By August 2019, the total value of all PPP projects recorded in the national PPP management system amounted to CNY 13.9 trillion and the total value of the PPP projects in the pipeline amounted to CNY 3.4 trillion (China Public Private Partnerships Center, 2019[11]).

PPP financing in China is unique. It emphasises financial co-operation between the government and society, instead of the private sector due to the significant presence of state-owned enterprises. The scope of PPPs extends from economic infrastructure (such as urban rail, water supply, wastewater treatment, etc.) to land development, real estate projects, affordable housing, nursing homes, ecological repair and protection projects, shantytown redevelopment, urban village redevelopment, and urban regeneration. Many PPP projects are a public good in nature and have little capacity to generate a revenue flow from users. Therefore, these projects entail a significant viability gap to be financed by local governments, often with an annuity arrangement funded by government revenues, particularly the expected future land concession revenues.

China does not have a clear regulation on the local fiscal commitments to PPPs, neither for direct liabilities (such as viability gap payments) nor contingent liabilities. Therefore, the fiscal risks to municipal governments with significant fiscal commitments to PPPs are substantial. It is imperative for the central government and provincial governments to strengthen the legal and regulatory framework for the management of fiscal commitments. One measure would be to set a limit on the viability gap finance to not exceed a certain percentage (say 30%) of the total cost of the PPP project.

The municipal bond market

As discussed earlier, commercial bank loans are one major source of finance that municipal governments rely on to finance urban infrastructure projects. Most loans have a term less than eight years, which is often not long enough to match the life of a project. Moreover, these loans often involve land as collateral and are backed mainly by future land concession revenues. As the role of land in municipal finance is expected to decline, it is necessary to develop alternative long-term investment financing instruments. A viable alternative is the municipal bond market. In the United States, the municipal bond market provides a mechanism for more than 50 000 state and local government units to raise funds for public purposes, such as infrastructure, schools and public buildings.

The municipal bond market is potentially viable in China, as urbanisation continues and the market for institutional investors (pension funds, endowments, foundations, and other institutional asset owners) expands. China's local government bond market started just a

few years ago and has grown rapidly, driven mainly by the local debt-swap programme. Outstanding local government bonds reached CNY 14.7 trillion in 2017. However, the local government bond market is still under-developed, and its development is constrained by severe impediments, including low liquidity, weak credit discipline and structural fiscal deficit in local governments (Lam and Wang, 2018[12]). Much needs to be done by both the central and local governments to remove these impediments.

Conclusion

Sound and sustainable municipal finance will be crucial for China's municipal governments to provide quality public services to meet the growing needs of the majority of the Chinese population. However, municipal finance reform faces significant hurdles. China's general tax burden is high, and there is pressure for the government to cut taxes on the supply side (i.e. indirect taxes) in order to help businesses remain competitive. It has proven difficult to maintain the level of general tax burden due to the difficulties in raising revenues from direct taxes.

Municipal governments are losing revenues from public land leasing due to the new amendment to the Land Administration Law. Finding stable own source revenues will be crucial for municipal governments to fund continuing urbanisation. China missed an opportunity to implement a property tax before the housing boom. Today, it is extremely difficult for the house-owning public to accept the tax. If not implemented, the problem of finding a sustainable own source revenue will continue to challenge municipalities. In a broad sense, a property tax is a significant missing piece in China's tax reform strategy that aims to better balance indirect and direct taxes.

Despite the political hurdles, there are ways to make the introduction of a property tax less painful to the public. These include starting with a low rate, allowing time for ownership adjustment, and allowing municipalities to implement the tax as soon as they are ready. Moreover, China could learn a great deal from international experiences in land value capture and the management of fiscal risks associated with PPP projects. Finally, China should make further efforts to remove the impediments that constrain the sound development of the municipal bond market.

References

China Public Private Partnerships Center (2019), *Monthly Report of PPP Projects*, http://www.cpppc.org/ (accessed on August 2019). [11]

Gao, P. (2017), "Taxation Reform under the New Normal of Economic Development", *Economic Herald*, in Chinese. [6]

German, L. and A. Bernstein (2018), *Land Value Capture: Tools to Finance Our Urban Future*, Lincoln Institute of Land Policy, Cambridge, MA. [7]

Gielen, D. and E. van der Krabben (eds.) (2019), *Infrastructure Contributions and Negotiable Developer Obligations in China*, Routledge, London. [8]

Lam, W. and J. Wang (2018), "China's Local Government Bond Market", *IMF Working Paper*, No. WP/18/219, IMF, Washington, DC. [12]

Li, G. et al. (2013), "Value Capture beyond Municipalities: Transit-Oriented Development and Inter-city Passenger Rail Investment in China's Pearl River Delta", *Journal of Transport Geography*, Vol. 33, pp. 268-277. [10]

Liu, S. and X. Xiong (2018), "Dual-track Urbanization under the Dual Land Ownership System", *Academic Journal of Urban Planning*, in Chinese, pp. 31-40. [5]

Ministry of Finance (2018), *National Government Final Account*, http://yss.mof.gov.cn/2018czjs/. [1]

National Bureau of Statistics of China (2019), *National Bureau of Statistics of China*, http://www.stats.gov.cn/english/. [3]

OECD (2018), *Revenue Statistics 2018*, OECD Publishing, Paris, https://dx.doi.org/10.1787/rev_stats-2018-en. [2]

Yang, J. et al. (2016), "Density-Oriented versus Development-Oriented Transit Investment: Decoding Metro Station Location Selection in Shenzhen", *Transport Policy*, Vol. 51, pp. 93-102. [9]

Zhong, X. (2017), *Local Finance*, The Renmin University of China Press, Beijing. [4]

Notes

1. The provincial-level administrations include 23 provinces, five autonomous regions, four centrally administered municipalities (Beijing, Tianjin, Shanghai and Chongqing), and two special administration regions (Hong Kong and Macau, China).
2. In 2013, using officially published statistics, the PLC calculated the Chinese government revenues consistent with the OECD definitions and classifications of government revenues. The method was documented in an unpublished technical report of the PLC. The share of government revenues over GDP was calculated by the PLC for each year from 2009 to 2017 (see Figure 7.1). The 2018 share of government revenues over GDP is not available as the data on the expenses incurred for land acquisition and resettlement in the public land leasing were not available at the time of writing.
3. In 2018, a tax administration reform took place at each level of subnational government. The central government tax bureau merged with the local tax bureaus. This reform merged the collection management of central and local taxes, but did not affect the tax-sharing arrangements.
4. The data were obtained from OECD.Stat on revenue statistics at https://stats.oecd.org/.
5. In 2018, the local revenues from the resource tax amounted to CNY 0.16 trillion or 2.1% of local tax revenues.

Chapter 8. Fiscal federalism in India

by N.K. Singh, Chairman, Fifteenth Finance Commission, India

While fiscal federalism in India has a long history, its practice has grown increasingly opaque over the years. Serious attention is required to improve its principles and practices. The India of today, notably through its governance "matrix", economic development, institution-building and multilateral relations, are vastly different from the India that drafted its constitution in 1950. India is going through a transition in its intergovernmental relations. Boundaries based on linguistic factors and administrative convenience are blurring, given changes brought on by innovation and migration. Socio-economic trends such as technological change, rising mobility and market integration will affect the future of fiscal federalism in India.

Introduction

The term "fiscal federalism" was introduced by the German-born, American economist Richard Musgrave in 1959. Wallace E. Oakes, in 1999, defined it as, "*Fiscal Federalism is concerned with understanding which functions and instruments are best centralised and which are best placed in the sphere of decentralised levels of government. This concept applies to all forms of government: unitary, federal and confederal*" (Oates, 1999[1]).

Thus, constitutional divisions of powers among various orders of government fall into three categories: unitary, federal, and confederal (Table 8.1).

Table 8.1. Unitary, federal and confederal systems of government

Unitary government	Federal government	Confederal system
A unitary country has a single or multi-tiered government in which effective control of all government functions rests with the central government. The city-states of Singapore and Monaco are single-tiered unitary governments. The People's Republic of China, Egypt, France, Indonesia, Italy, Japan, Korea, New Zealand, Norway, the Philippines, Portugal, Sweden, Turkey, and the United Kingdom have multi-tiered governments based on unitary constitutions.	A federal form of government has a multi-layered structure, with all orders of government having some independent as well as shared responsibilities of decision-making. Federalism represents either a "coming together" or a "holding together" of constituent geographic units. "Coming together" has been the guiding framework for mature federations such as the United States, Canada, and, more recently, the European Union. The "holding together" view of federalism, also called "new federalism", represents an attempt to decentralise responsibilities to state-local orders of government to overcome regional and local discontent with central policies. This view is the driving force behind the current interest in principles of federalism in unitary countries and in relatively newer federations such as Brazil and India and emerging federations such as Iraq, Spain and South Africa.	In a confederal system, the general government serves as the agent of the member units, usually without independent taxing and spending powers. The United Nations, the European Union, and the Commonwealth of Independent States (CIS), which now consists of 11 of the former republics of the Union of Soviet Socialist Republics (USSR), approximate the confederal form of government. A confederal system suits communities that are internally homogeneous but, as a group, are completely heterogeneous.

Source: Author's compilation based on Shah (2007[2]), "Introduction: Principles of Fiscal Federalism", in A. Shah and J. Kincaid (eds.), *The Practice of Fiscal Federalism: Comparative Perspectives*, McGill-Queen's University Press.

Fiscal federalism broadly considers the vertical structure of the public sector, fiscal policy institutions and their interdependence.

First, one needs to determine at which level of government to assign different expenditure responsibilities. The conventional starting point is that local governments hold more detailed information on the preferences and local needs of their citizens than any higher level of government and that, and consequently, it is in their interest to provide many of the public goods and services to their citizens. In general, this suggests that the lowest possible level of government should provide public goods and services. This consideration is also implicit in the European Union subsidiarity principle and fiscal decentralisation in most sovereign countries. However, according to the conventional view, policies concerning macroeconomic stabilisation and redistribution should be left primarily for higher levels of government, such as the federal government, since they serve national interests. In addition, policies that induce significant spillover effects to other jurisdictions could justify assigning particular tasks to the central government.

Second, one needs to determine the strategy to finance a given level of public goods and services. The starting point is that the level of government that is responsible for the provision of a particular good or service should also be responsible for its funding and

collecting the necessary revenue. In this case, it is more likely that the provider bears the full costs related to provision and, consequently, moral hazard is limited. As different types of tax instruments have heterogeneous characteristics, for example, due to differences in the mobility of their tax base, instruments should be allocated to the level that is most effective in raising the revenue. Thus, tax instruments should be assigned so that each government can realistically collect sufficient tax revenues. In practice, different levels of government are only rarely self-sufficient in terms of financing their legal responsibilities.

Third, and as a consequence of the previous two points, one needs to determine the appropriate instruments (and their degree) to equalise disparities in fiscal resources and fiscal needs, both over time and across jurisdictions. In most federal systems, there exist both vertical transfers, in which there are transfers from different levels of government to each other, and horizontal transfers, in which there are transfers across the same level of government. The differences between revenues and expenditures are called vertical and horizontal fiscal imbalances, or fiscal gaps. Borrowing and different types of transfers (including tax sharing, conditional and unconditional grants and transfers based on demographic factors) are alternative instruments used to stabilise the imbalances in revenues and government expenditures over time.

Fourth, and to the extent that the vertical design does not impose fiscal discipline to an adequate degree, one needs to adopt strategies to cap excessive spending and borrowing at each level of government. The logic is mainly to avoid fiscal free-riding and moral hazard: given the interconnected area and fiscal framework, governments may implement policies that have negative spillover effects on other jurisdictions and regions. Governments may also aim to benefit from transfers from other regions. In all federal countries, there exist some form of fiscal rules and governance concerning budget deficits and borrowing, but strategies differ.

Finally, it should be noted that in many respects, the allocation of responsibilities and instruments to different levels of governments is never clear-cut; there is always some degree of overlap. For example, many government responsibilities are either shared between the federal and state governments, or their actions are coordinated. In addition, harmonisation in tax bases and national standards imply that fiscal instruments are not always fully adjustable to regional preferences, even if the instruments were solely assigned to their use.

Here, the focus will be to discuss the changing landscape of centre-state relations and the dynamic federal polity, particularly of India. Federalism means different things to different people. Some federal romantics believe that the future of India lies in greater autonomy and power to states and that the evolution of the polity has deprived the subnational governments of making a more meaningful contribution to the development process. This could equally be said about the third tier of government, namely *Panchayat* and Urban Local Bodies (as they are called in India). There are others however, who look at this issue more clinically, broadly examining the architecture of fiscal federalism and its adherence to the original architecture. As Charles Kennedy said, however, "we have to win vocabulary before we succeed in the vision". The same holds true for fiscal federalism.

This chapter is organised as follows: the following section provides some background on the principles of fiscal federalism and the changing dynamism of federalism. This is followed by a description of the evolution of fiscal federalism in India during the pre-independence (pre-1950s) and post-independence periods (post-1950s). The sixth and seventh sections trace the trend of fiscal transfers to subnational governments over time.

The penultimate section discusses emerging challenges in India's fiscal federalism, and the final section offers some concluding remarks.

Broad principles associated with fiscal federalism

Several accepted theories provide a strong rationale for decentralised fiscal constitutions on the grounds of efficiency, accountability, manageability and autonomy. Alternative views and ideas have emerged in the domain of fiscal federalism over time (Table 8.2).

Table 8.2. Broad principles associated with fiscal federalism

Fiscal equivalency	Decentralisation theorem	Principle of subsidiarity
The principle of "fiscal equivalency" requires a separate jurisdiction for each public service. Wallace Oates proposes a related idea, the so-called "correspondence principle". According to this principle, the jurisdiction determining the order of provision of each public good should include the set of individuals that consume it. This generally requires a large number of overlapping jurisdictions.	According to the "decentralisation theorem" advanced by Oates, "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalise the benefits and costs of such provision." Unlike the general prediction, a higher degree of spillovers may reduce the difference in the utility of centralisation and decentralisation.	The "subsidiarity principle" states that functions should be performed at the lowest level of government. The principle, if not explicitly but implicitly, implies hierarchy. The deeper questions that arise are who will decide, and for whom, coupled with which functions will be assigned to which level.

Source: Author's compilation.

The changing dynamism of fiscal federalism

Democracies all over the world have become leadership-oriented; this is more *de jure* than *de facto*. With forms of government headed by presidents, it is self-evident, but this is also the case in democracies where citizens vote for prime ministers.

In federations, central leadership matters greatly. In India, for example, electoral positions are significantly centred on the leadership of political parties. Votes are sought for the prime minister or the chief minister for elections, most recently with strong electoral mandates. Even in many subnational government elections, the prime minister is often seen rallying the ruling party to garner electoral support.

The nature of governance has changed fundamentally in India. For example, it is not possible for any prime minister, while visiting a subnational government, to state that he/she cannot provide support for drinking water, improved power supply or enhanced agriculture just because the subject is not in the purview of the central government, but in the domain of the states. This is not a practical proposition because the Constitution serves the people and states that government must adapt to its citizens' changing expectations.

Reconciling harmonious relationships between subnational and national entities must address the principal challenge of the changing dynamics within the electoral framework itself, and the parliamentary democracy from which multiple mandates are born. Politics have changed the effects and rationality of several primary relationships that were perceived initially in the Constitution and enacted in the early 1950s.

Federalism in India, pre-independence

The federal system is essentially a post-industrial revolution phenomenon. India, as a federal system, is about 70 years old, compared to the federal systems of the United States, Switzerland or Canada, which are more than two centuries old. There is a wide variety of international experiences in fiscal federalism based on: 1) the division of functions among different tiers of government; 2) the design of fiscal transfers; 3) principles of assessment; and 4) institutional arrangements (Ma, 1997[3]). Furthermore, intergovernmental fiscal transfers are either constitutionally or legally mandated.

Many of the features of India's fiscal federalism are intertwined with the history of the East India Company and the British Crown. The East India Company was granted a Charter of Incorporation in the year 1600 by Queen Elizabeth, which gave the company exclusive trading rights with India. The East India Company then set up a number of factories and trading centres in different places in India. Bombay, Madras and Calcutta became the main settlements and were declared as presidencies. Under the Act of 1773, the Calcutta presidency was given full powers over the other two presidencies of Madras and Bombay, which for the first time resembled setting up a government.

Only in the Charter Act of 1833, however, was a central fiscal authority with presidencies as integral constituents actually formed, which vested the financial and legislature powers in India solely in the Governor-General of Bengal, who was designated the Governor-General of India, centralising the entire administration. The current system of the financial year ending on 31 March, along with the principles of the English budget system, was adopted with the Crown taking direct control in 1858. The Union, State and Concurrent Lists in the current Indian Constitution have its genesis in the first budget, which was presented in 1860-61 under the new system.

A system of diarchy, dividing the administrative subjects into two categories of central and provincial was the result of the Montague-Chelmsford reforms enacted in the Government of India Act, 1919. Under the Act, provinces gained power by way of delegation, whereas the central legislative retained the power to legislate on any subject for the entire country. The Act also divided the sources of revenue between the centre and provinces.

The Government of India Act, 1935, established a federal system with provinces and Indian states as two distinct units. Under the act, legislative powers were distributed under three lists: the Federal List, the Provincial List and the Concurrent List. This act made the revenues and finances of the provincial government distinct from those of the federal government. The act also provided for the collection and retention of levies by the federal government and spelt out details for the distribution of financial resources and grants-in-aid to provinces. As per the act, such sums as prescribed by his majesty – in Council – were to be charged on the revenues of the federation. The Government of India Act, 1935 established the basic structure of fiscal federalism in India, one that survives today.

The Constituent Assembly was constituted in 1946, which adopted a unitary form of government. The federal framework evolved, though indigenously, over a period. The final shape of the federal form of government and federal finance was incorporated in the Government of India Act, 1935. The framework also had some features of a parliamentary system. However, the nature of the relationship between the proposed federal government and the provinces of British India relative to that of the princely states was resolved only after independence, but before the Constitution was adopted.

Federalism in India, post-independence

India, at the time of independence, had nine provinces and over 500 princely states. The princely states accounted for 40% of the territory and 30% of the population, and were diverse in size, character, systems and in the nature of their relations with British India. They were integrated with India after independence, and the union of states came into existence on 26 January 1950. The evolution of fiscal federalism in India was heavily based on the Government of India Acts of 1919 and 1935. While the Act of 1919 provided for a separation of revenue heads between the centre and the provinces, the 1935 Act allowed for the sharing of the centre's revenues, and for the provision of grants-in-aid to provinces.

There was no unanimity among the members of the Constituent Assembly with regard to the name of the country. Wherein some members suggested the traditional name (*Bharat*), others advocated for the modern name (India). Hence, the Constituent Assembly adopted a mix of both ("India, that is, Bharat"). Secondly, the country was described as a "union" although its constitution is federal in structure. On 4 November 1948, Dr B. R. Ambedkar, while moving the Draft Constitution in the Constituent Assembly responded to the question as to why India is a "union" and not a "federation of states":

> *"The Drafting Committee wanted to make it clear that though India was to be a federation, the federation was not the result of an agreement by the states to join in a federation and that the federation not being the result of an agreement no state has the right to secede from it. The federation is a union because it is indestructible."*

Political scientist Alfred Stepan, categorised India as a "holding together" as opposed to a "coming together" federation. Unlike the federal form of government in the United States, which is described as an indestructible union composed of indestructible states, India is described as an indestructible union of destructible states. The Indian federation has seen multiple transformations since 1947. This is because Article 3 of the Constitution empowers Parliament to create new states. While such a provision can be seen as giving too much power to the union, it has arguably been central in holding India together since it allows the federation to evolve, respond and change according to subnational aspirations.

Initially, in 1950, the Constitution contained a four-fold classification of the states of the Indian union, into Parts A, B, C, and D. With the States Reorganisation Act (1956), the distinction between Part A and Part B states was done away with, while Part C and Part D states were abolished. Currently, India now has 28 states and 9 union territories.

Broadly speaking, with the evolution of fiscal federalism in India, there has been marked stability in its process and procedures. The annual budgetary processes of both the central and federal governments are independent exercises and must pass through the Parliament or state legislature. The Finance Commission, which was first constituted in 1951, performs the functions broadly enshrined in Article 280 of the Indian Constitution (Box 8.1).

Box 8.1. Article 280 of the Indian Constitution

(1) The President shall, within two years from the commencement of this Constitution and thereafter at the expiration of every fifth year or at such earlier time as the President considers necessary, by order constitute a Finance Commission which shall consist of a Chairman and four other members to be appointed by the President.

(2) It shall be the duty of the Commission to make recommendations to the President as to:

(a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them under this Chapter and the allocation between the States of the respective shares of such proceeds;

(b) the principles which should govern the grants in aid of the revenues of the States out of the Consolidated Fund of India;

(c) any other matter referred to the Commission by the President in the interests of sound finance.

(3) The Commission shall determine their procedure and shall have such powers in the performance of their functions as Parliament may by law confer on them.

For most of the post-independence era, the existence of the Planning Commission injected centralising dependence in more ways than one. The Planning Commission became a parallel institution for the transfer of resources from the Union of States. While the focus of the Finance Commission remained on the revenue account, the Planning Commission was concerned predominantly with the capital account. Successive Finance Commissions commented on this as being inconsistent with the spirit of the Constitution in the devolution of resources. There were other developments, like the 73rd and 74th Amendments of the Constitution in 1992 giving status to *Panchayat Raj* institutions and Urban Local Bodies with specific functions assigned to them under the 11th and 12th schedules.

As coordinating entities between the central and subnational governments, two key institutions have remained: the National Development Council constituted in 1952 to oversee the work of the Planning Commission (to approve their five-year plans and their mid-term appraisals), and the Inter-State Council, set up following a Constitutional Amendment in 1990, based on the recommendations of the Sarkaria Commission Report. Centre-state relations and their dynamics have kept pace with the changing needs of the time. India has changed remarkably in its economic policies and its governance rubric.

The role of the Finance Commission in India's federal architecture

The Finance Commission has an important role to play in India's overall federal architecture. In fact, it may be older than the Constitution of India. Article 280 of the Constitution says the Finance Commission was formed to define the financial relations between the central government of India and the individual state governments.

The Finance Commission broadly assesses the overall gross tax revenues of the union: cesses, surcharges and non-tax revenue are netted out from gross tax revenue to arrive at the net divisible pool (NDP). Following a constitutional amendment in 2000, the divisible pool now consists of all taxes of the union and not merely income tax and excise duty. Thus, in deciding the distribution of the corpus contained in the net divisible pool, the Finance Commission undertakes consultations and visits all subnational governments, and receives their memorandums/submissions as well as those of the union government. Bearing in mind the needs of the central and subnational governments, the Commission then decides on what percentage out of the net divisible pool should be assigned to the subnational governments and thereby, leaves the balance to the central government.

The Fourteenth Finance Commission decided that 42% of NDP should go to the sub-national governments by way of devolution, or net proceeds of taxes, and the balance should go to the central government. In addition, after projecting the likely growth rates of individual subnational governments and their likely buoyancy in appropriate cases, a revenue deficit grant under Article 275 was given. This is in addition to resources being made available to subnational governments from out of the resources of the government for disaster management and state-specific grants. As far as the interstate allocation of resources among the subnational governments is concerned, the Finance Commission decides on the parameters and then assigns weights to them. Over time, the parameters have remained constant, namely population, income distance, geographic area and fiscal compliance. The weightages to be assigned to these individual factors have also been circumscribed by past legacy, but each Finance Commission has faced its unique challenges.

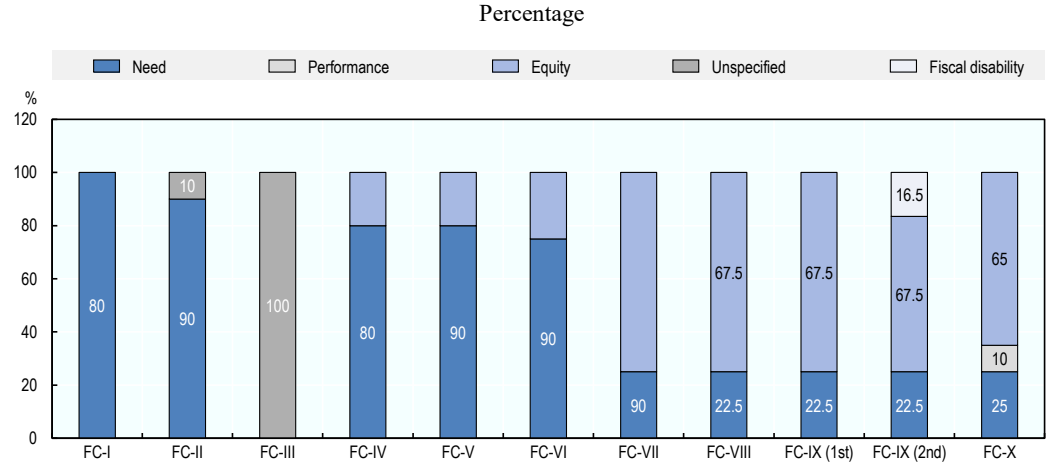
Trends in fiscal transfers to the states over the years

At the core of fiscal federalism in India lie fiscal transfers from the central government to subnational governments. Transfers are predominantly based on the recommendations of the Finance Commission and consist of tax devolution and grants. With the initiation of planned economic development and the centre's interventions in a number of subjects in the State List in the form of centrally sponsored schemes (CSS), a significant number of transfers are taking place outside the recommendations of the Finance Commission. Therefore, to gain a comprehensive view of central transfers, it is necessary to analyse the aggregate transfers, i.e. those recommended by the Financial Commission and those made outside of it. The study of these shows that vertical as well as horizontal balances recommended by the Finance Commission can be counterbalanced to some extent by the Union through the levy of cesses and surcharges, and through non-Commission transfers.

One noteworthy development due to the acceptance of the recommendation of the Fourteenth Finance Commission is the decline in discretionary transfers since 2015-16 from the centre. With the removal of the distinction between plan and non-plan, the predominant share of the Finance Commission transfers in total transfers is likely to continue, if the centre does not use its fiscal headroom to introduce more schemes funded by the centre.

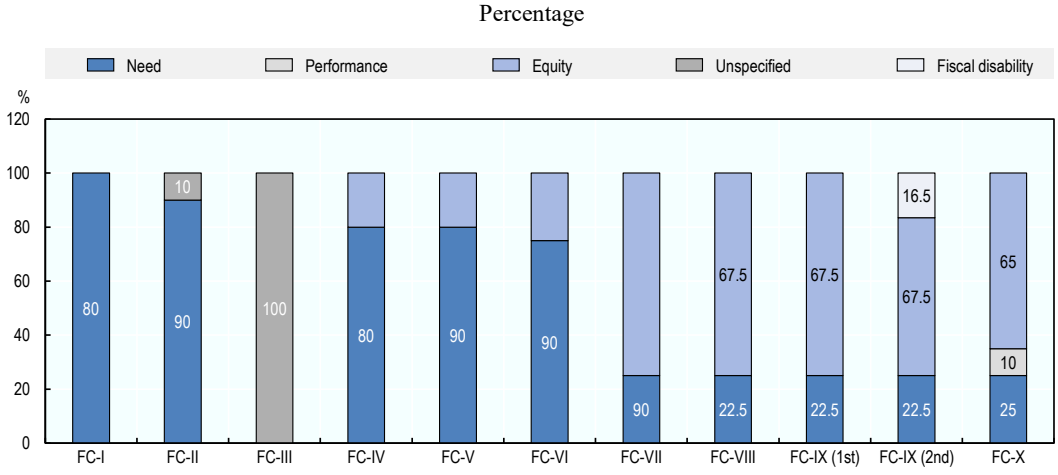
Different Finance Commissions have used various combinations of parameters of need, performance, equity and fiscal disability in determining *inter se* shares of the subnational governments, as evidenced in the broad criterion for devolution of taxes by previous Finances Commissions set out in Figure 8.1, Figure 8.2 and Figure 8.3.

Figure 8.1. Criteria for the distribution of income tax proceeds to states, First to Tenth Finance Commissions



Source: Author's calculations.

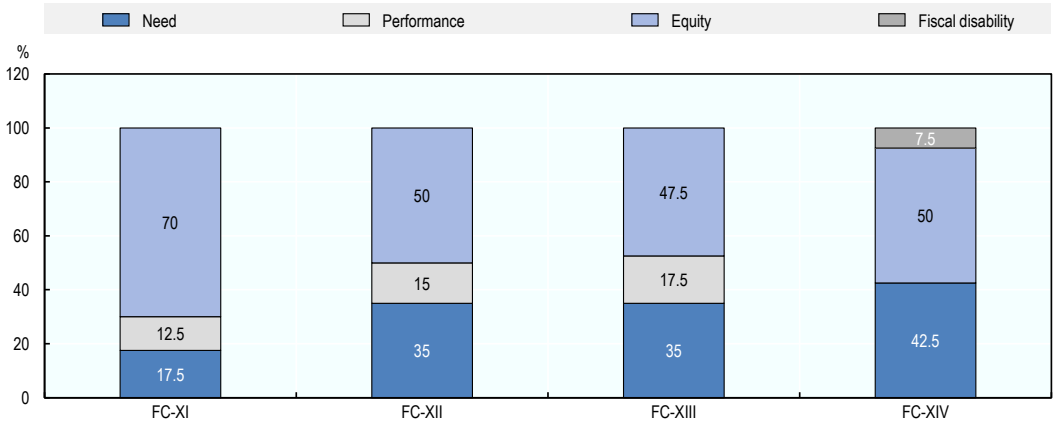
Figure 8.2. Criteria for the distribution of union excise duties, First to Tenth Finance Commissions



Note: The FC-III considered that while population should be the main factor, other factors, such as relative financial weakness of the states and disparities in the level of development should be taken into account; however, the exact method followed in arriving at the *inter se* allocation was not specified.
Source: Author's calculations.

Figure 8.3. Criteria for the distribution of states' share in all central taxes, Eleventh to Fourteenth Finance Commissions

Percentage



Source: Fifteenth Finance Commission and author's calculations.

An examination of the weights assigned to each one of the above criteria reveals that over the years, there has been a shift from needs-based parameters to criteria representing equity and efficiency.

The success of a federal system lies in its proportional revenue-raising capacity with responsibility at different levels of the government. In India, however, vertical imbalances exist historically, with the centre mobilising higher taxes and subnational governments invested with greater responsibilities. Rebalancing mechanisms can take the form of transfers to subnational governments from the centre, comprising: 1) tax devolution (at present, 42% of the divisible pool, as recommended by FC-XIV); 2) grants recommended by the Finance Commission; and 3) grants and loans from the centre to subnational governments outside the recommendations of the Finance Commission in the form of support to centrally-sponsored schemes.

Emerging challenges in India's fiscal federalism

There are a number of challenges facing India's fiscal federalism. First, the Seventh Schedule of the Indian Constitution broadly demarcates the functions of governance into three lists. This schedule distributes the legislative and financial powers between the union and the states. List I pertains to subjects of the centre. List II pertains to subjects that belong to the subnational governments. List III is a category called the Concurrent List, which belongs to both the central and subnational governments, and in the event of conflicting legislation, the law passed by the centre prevails.

Over time, the Concurrent List has sought to occupy increasing space, transgressing its earmarked borders and intervening in the subjects of subnational governments. This has taken the form of a formal act through, for example, constitutional amendments like the 42nd Amendment of the Constitution (1975), which shifted the subjects of forest and education from the State List to the Concurrent List.

There have been other ways in which the original demarcation has been altered. Take, for instance, the issue of entitlement-driven legislations. Some time ago, India entered an era of entitlement-based stand-alone legislation. The classic examples are the Mahatma Gandhi

National Rural Employment Guarantee Act of 2005, the Right of Children to Free and Compulsory Education Act of 2009 and the National Food Security Act of 2013. This was the area where fiscal authorities should have intervened, as employment, education and food were originally intended to be the domain of subnational governments.

Second, there is the issue of the incongruence of Article 282 of the Constitution with the letter and spirit of the Seventh Schedule. Article 282 of the Constitution states that *"The Union or a State may make any grants for any public purpose, notwithstanding that the purpose is not one with respect to which Parliament or the Legislature of the State, as the case may be, may make laws."*

Originally, in the Indian Constitution, it was not expected to be an overarching provision, but an extraordinary provision that was to be used very sparingly. Shri K. Santhanam, Chairman of the Second Finance Commission on Article 282, said:

> *"This was not intended to be one of the major provisions for making readjustments between the Union and the States - if that was the idea, then there was no purpose in evolving such a complicated set of relations of shares, assignments and grants. There is no purpose in having two Articles enabling the Centre to assist the States- one through the Finance Commission and the other by more executive discretion. In the latter case, even parliamentary legislation is not needed. Of course, it will have to be included in the Budget. But, beyond being an item in the Budget, no further sanction need to be taken. Therefore, in my view, this Article was a residuary a reserve Article to enable the Union to deal with unforeseen contingencies. That was how this Article was used both by the British Government and, after transfer of power, before the first year of the First Five Year Plan. Under this Article, only some grow-more-food grants and some rehabilitation grants were given."*

N. A. Palkhivala, a Constitutional expert, stated in his opinion given to Ninth Finance Commission, "Art. 282 is not intended to enable the Union to make such grants as fall properly under Art. 275. Art. 282 embodies merely a residuary power which enables the Union or a State to make any grant for any purpose, irrespective of the question whether the purpose is one over which the grantor has legislative power."

The legitimacy of all centrally sponsored schemes, most of which are in the domain of the states, emanates from the use or misuse through recourse to Article 282. Indeed, the *raison d'etre* of the Planning Commission in many ways emanated from excessive use of Article 282 in the plethora, if not the jungle, of what has come to be known as the centrally sponsored schemes. Here again, notwithstanding the successive attempts to rationalise these schemes, the last being under the Committee headed by the former Chief Minister of Madhya Pradesh, Shivraj Singh Chauhan, their numbers and diversity remained very robust. Based on an exercise by the Fifteenth Finance Commission, there are approximately 211 schemes/sub-schemes under the umbrella of 29 core schemes. Many of these exist masked under the so-called umbrella schemes. What is even more staggering is that the total outlay of the central government on these centrally sponsored schemes is approximately INR 3.32 trillion in 2019-20. Considering that the states often protest that these schemes are ill-designed, not suited to their specific needs and entail significant financial outlays by them, no state has decided to abandon them. Far from centrally sponsored schemes seeing the end, some large schemes in the shape of Ayushman Bharat and Swachh Bharat are expanding their scope and dimensions.

Table 8.3. Views of earlier commissions and committees on centre-state relations in India

First Administrative Reforms Commission (1966)	• Role of the union government in areas that are covered by the State List of subjects in the Constitution should be largely that of a "pioneer, guide, disseminator of information, overall planning and evaluator". • It felt that, except in the most essential areas and that for a limited duration, the union government should not take upon itself the functions and responsibilities that are legitimately in the states' domain.
Rajamannar Committee (1969)	• The union government should not take any decision without consulting the Inter-State Council when such decision can affect the interests of one or more states. • Every bill that affects the interests of the states should be first referred to the Inter-State Council before it is introduced in Parliament. • Article 356 should be used only in rare cases of a complete breakdown of law and order in a state. • Residuary power of taxation should be vested with states.
Sarkaria Commission – Committee on Centre-State Relations (1988)	• Recommended that the number of centrally-sponsored schemes should be kept to the minimum and that state governments should be involved in determining the contents and coverage of such schemes to cater to local variations. • Set up a permanent interstate council called the "Inter-Governmental Council" under Article 263 of the Constitution. • Fresh constitution of Zonal Councils to promote the spirit of federalism. • Corporation tax should be included in a sharable pool. • Centre should consult the states before making a law on the Concurrent List.
Punchhi Commission - Commission on Centre-State Relations, headed by Justice M.M. Punchhi (2010)	• The number of centrally sponsored schemes should be restricted to flagship programmes of national and regional importance. Accordingly, the Commission recommended reduction in the number of these schemes and their funding in a phased manner, as well as flexibility in the guidelines governing their implementation to suit state-specific situations. • It also recommended a comprehensive review of all transfers to the states, particularly through centrally-sponsored schemes, with a view to minimising the component of discretionary transfers. • There should be a consultation process between the union and states via the Interstate Council for legislation on concurrent subjects. • The National Integration Council (NIC) should be provided "teeth" so that it can take some actions in the event of communal violence. However, it rejected constitutional status for NIC.
Report of the Sub-Group of Chief Ministers on Rationalisation of Centrally Sponsored Schemes, under the Convenorship of Shri Shivraj Singh Chauhan (2015)	• The Sub-Group recommended that the existing centrally sponsored schemes should be restructured and their number reduced to a maximum of 30 schemes. All these schemes would be "umbrella schemes", with every scheme having a large number of components with a uniform funding pattern. As far as possible, except for a few core components, the decision to implement components within a scheme should be left to the state government, thereby allowing states maximum choice among components. If there are multiple schemes in a sector, the approach should be to consolidate all such schemes into a single "umbrella scheme".

Source: Author's compilation.

Another challenge is that of fiscal incongruity. One of the terms of reference made to the Fifteenth Finance Commission is to review the current level of debt of the union and the states and recommend a fiscal consolidation roadmap for sound fiscal management. As per the amended Fiscal Responsibility and Budget Management (FRBM) Act, the central government shall take appropriate steps to ensure that:

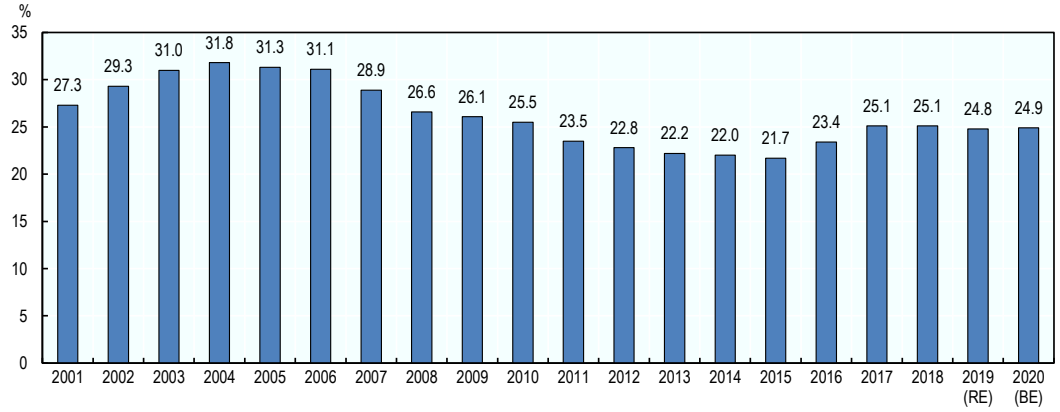
1. The general government debt does not exceed 60%.
2. The central government debt does not exceed 40% of gross domestic product (GDP) by the end of fiscal year 2024/25.
3. According to the central government budget (Statement of Fiscal Policy as required under FRBM Act 2003, July 2019), the central government debt is estimated at 48.4% of GDP for 2018/19 RE. It is expected that central government liabilities will come down to 48% of GDP in 2019/20 BE.

4. The outstanding liabilities of the state governments stands at 25.1% of gross state domestic product (GSDP) in 2017, with a range of 42.8% in the subnational government of Punjab and 17% in the subnational government of Chhattisgarh (Reserve Bank of India, 2019[4]).

The combined outstanding liabilities of states and union territories have been on the rise since 2014 (Figure 8.4). This is mainly due to central policies concerning the Ujwal DISCOM Assurance Yojana (UDAY) and the Farm Loan Waiver.

Figure 8.4. Total outstanding liabilities of states and union territories in India, 2001-20

As a percentage of GSDP (as of end March 2020)

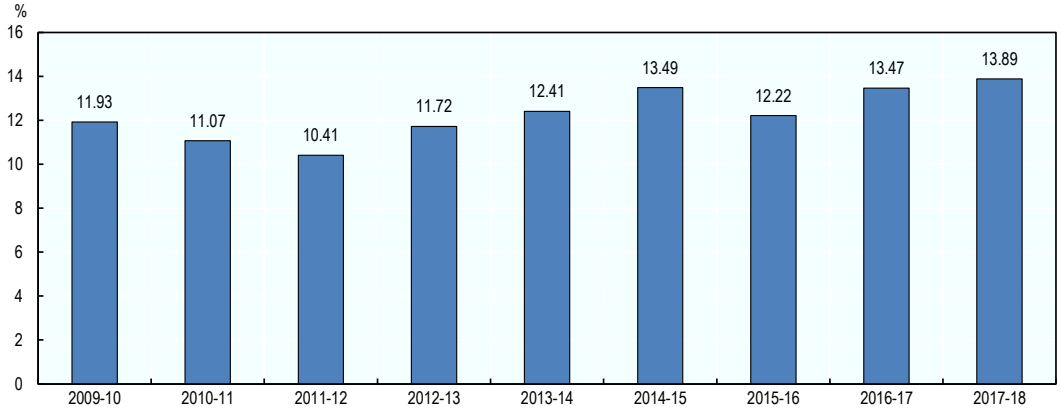


Source: Reserve Bank of India (2019[4]), *State Finances: A Study of Budgets of 2019-20*, Reserve Bank of India, Mumbai.

Another emerging challenge is that cesses and surcharges are becoming a disproportionate proportion of the overall divisible revenue, with non-tax revenues being kept outside the divisible pool (Figure 8.5). These are worrisome issues, and there should be some mechanism to ensure that the basic spirit of the devolution process should not be undercut by clever financial engineering or by the manipulation of methods that makes them technical and legally tenable, but perhaps not morally so.

Figure 8.5. Cesses and surcharges in India, 2009-18

As a percentage of gross tax revenue



Note: The figures for 2017-18 also includes GST compensation cess.
Source: Fifteenth Finance Commission and author's calculations.

Finally, there is the issue of the goods and services tax (GST), which was rolled out across the country on 1 July 2017. The GST subsumes the majority of the indirect taxes – excise, services tax, sales tax, octroi (entry tax) – to create "One Nation, One Market". To sort out issues pertaining to the implementation of the GST, the GST Council was formed as a constitutional body involving the centre and the states under Article 279 A(1). Since the Council decides the central goods and services tax (CGST) and state goods and services tax (SGST) rates, it ensures that the states are significant partners even on issues such as macroeconomic engagement, and in deciding tax rates. However, on the flip side, states have lost the autonomy to decide the tax rates of subjects that fall within the State List. Previously, state governments used to fix tax rates by taking into account their spending requirements, revenue base, etc. The inability of states to fix tax rates to match their development requirements implies greater dependence on the centre for funds.

Conclusion

Indian polity has evolved beyond recognition. When the Constitution of India was drawn up, the interdependence among states, fostered by technology and migration had not gathered pace. The autonomy of states in a pre-globalised era is vastly different from that found in an era where both migration and technology erode the boundaries of states unperceptively. Not undermining the importance of global value chains (GVCs), the time has come to develop and foster the Indian value chain. Products, processes and services commenced in one state could involve several states before it reaches the final consumer.

National priorities and notable policy initiatives like Swachh Bharat, the New Education Policy, Ayushman Bharat and Swachh Jal through Jal Jeevan Mission constitute an integral part of the changing dynamics and nature of responsibilities between the centre and the states. The issues of National Priority transcend boundaries as they are designed to address the basic tenets of growth multipliers, benefitting every segment of society and addressing welfare tenets on health, housing and employment as core national priorities.

Figure 8.6. Challenges facing the development of fiscal federalism in India



Source: Author's illustration.

There are several points of action to be considered. For example, it is important to take another look at the Seventh Schedule – the allocation of centre-state responsibilities – in today's contemporary context. Unless the contours of the schedule are redrawn, some of the incongruities between the contours of the Schedule and Article 282 of the Constitution and the stand-alone legislation of the subjects will remain cluttered and opaque.

A far more credible policy for the rationalisation of centrally sponsored schemes and central outlays is also needed. Several committees have attempted to do so in the past, but the outcome has been elusive. This is even more relevant since the role of the National Institution for Transforming India (NITI Aayog), which is primarily a think tank institution and not a financial body, remains somewhat unclear in the financial sphere. There is no central entity with an overview of the centrally-sponsored schemes and how many and in what form many of these could be amalgamated with central sector outlays.

Further, with the abolition of the Planning Commission, many economists and policy makers have argued that there exists an institutional vacuum. While the National Development Council (NDC) is performing an important function, states have pleaded for a credible institution to act as a link for policy dialogue with the centre of government, as in many countries around the world. In Australia, for example, states came together in 2005 to set up the Council for the Australian Federation to jointly represent their interests in Canberra. India has an institutional entity – the Inter-State Council – how to rejuvenate and rekindle it deserves serious consideration.

Another area of incongruity is the fiscal story. As mentioned above, one of the terms of reference made to the Fifteenth Finance Commission is to review the current level of debt of the union and the states and to recommend a fiscal consolidation roadmap for sound fiscal management. Reforms in public finance management (PFM) systems are a continuous process. Previous Finance Commissions have made recommendations on various aspects of the PFM systems of both the union and states, focusing on budgetary and accounting processes, financial reporting, etc.

It is important now to rethink the design and structure of a genuine fiscal partnership, which should not merely be a race to garner more resources, but a creative attempt to move towards a vibrant Indian value chain that can catapult India's growth rate closer to the quest for double-digit growth. Times of economic slowdown must be viewed anecdotally as they are transient in nature and cannot impair India's vision, both with regard to its potential and its historical compulsions. It is necessary to recast the ideology in a more contemporary context; only then will the practice become more transparent, and India will benefit from congruence between its precepts and practice.

References

Ma, J. (1997), "Intergovernmental Fiscal Transfers in Nine Countries: Lessons for Developing Countries", *World Bank, Policy Research Working Papers* 1822, http://dx.doi.org/10.1596/1813-9450-1822. [3]

Oates, W. (1999), "An essay on fiscal federalism", *Journal of Economic Literature*, Vol. 37/3, pp. 1120–1149. [1]

Reserve Bank of India (2019), *State Finances: A Study of Budgets of 2019-20*, Reserve Bank of India, Mumbai. [4]

Shah, A. and J. Kincaid (eds.) (2007), *Introduction: Principles of Fiscal Federalism*, McGill-Queen's University Press. [2]

OECD Fiscal Federalism Studies

Local Public Finance and Capacity Building in Asia

ISSUES AND CHALLENGES

Subnational governments' capacity to effectively fund and deliver public services are crucial for the realisation of the benefits of decentralisation. However, subnational capacities often suffer from significant weaknesses, ranging from inadequate assignments of own-revenues, through to flaws in tax administration, the design of intergovernmental transfers, spending assignments and various aspects of public financial management. The volume discusses how better diagnostics and more strategic reforms can contribute to easing the resource constraints on subnational governments, as well as creating appropriate incentives for these governments to improve performance. The volume includes studies of the enabling conditions for subnational capacity-building in Asia, as well as focused studies of China and India's fiscal relations challenges.

PRINT ISBN 978-92-64-61206-8
PDF ISBN 978-92-64-94300-1

