

Intergovernmental Finance in Five Emerging Market Economies

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Executive Summary

In this study, the features of fiscal decentralization in five such nations . Brazil, China, Indonesia, Russia, and South Africa . are surveyed, with a view to summarize the essentials of the groups of characteristics that are common to all structures of fiscal federalism. These include assignment of functional responsibilities, fiscal imbalances, intergovernmental transfers to resolve the imbalances, and sub-national borrowing. In addition, these surveys also consider the role of sub-national governments in macroeconomic stabilization in the context of the recent past . during and after the global financial crisis.

Country-wise key findings

Brazil

Brazil shifted from a heavily centralized system under the army rule to a decentralized setup with the enactment of the 1988 Federal constitution. It changed the balance of power within the federal system and also paved the way for a commitment to improve the role of local governments.

Functions generally considered national in character like defence, foreign affairs, international trade and monetary policy are in the central domain. Functions with limited benefit areas like city roads, water supply and sewerage, basic health and education, street lighting, and basic social assistance have been allocated to local governments. Law and order, health, and social assistance are functions that are performed jointly by all levels of governments. Taxes such as import tax, export tax, personal and corporate income tax, tax on industrial product, tax on financial transactions, and rural property tax are assigned to the federal government. Taxes assigned to sub-national governments are VAT, tax on inheritances and gifts, motor vehicle tax, and real estate property and transfer tax. In Brazil, the ownership of natural resources lies with the Federal government. Royalties and excises are shared between the federal and sub-national governments. The three sources of revenue from the oil and natural gas sector . royalties, special participations and compensation for oil exploitation activities . are governed by laws framed at the national level. The rules for sharing revenues from other natural resources as specified by the law depend on the type of resource concerned. The sharing of

revenues from natural resources overall is fairly generous to the sub-national governments, but in general distributed by origin

There are various institutional arrangements designed in Brazil to resolve intergovernmental disputes. On tax related issues, the National Council of Fiscal Policy has the legal prerogative to harmonize it. There are state secretaries forums as well as national councils that bring together the three levels of governments to harmonize service provision and other issues. Lastly, federative entities can always refer particular issues to the Supreme Court if they feel that the federative clause of the Constitution was breached.

Since the adoption of 1988 Federal constitution, more revenue sources are assigned to the subnational governments. As a result the level of vertical imbalance has reduced. However, unlike vertical imbalance, horizontal imbalances are highly significant in Brazil, with no provision for fraternal (from one sub-national unit to another) transfers. Therefore, the federal government has to take the responsibility for equalization through a transfer system. Intergovernmental transfers include three types of transfers: (a) mandatory unconditional transfers, (b) mandatory conditional transfers, and (c) discretionary federal grants. First two transfers account for the bulk of the intergovernmental transfers, whereas discretionary grants share is very small. However, the mandatory transfers are based on tax sharing, which makes the system pro-cyclical; also, the *inter se* distribution is not particularly equalizing.

Brazil today has excellent human development indicators (HDI) across the country. Delivering public services and goods through conditional cash transfers (CCT) scheme is argued to be one for the major reasons for the improved HDI. Both federal and sub-national governments use CCT mechanism to deliver public services, but with substantial reduction in poverty in the last decade, the relevance of these programmes are dwindling and they have also started suffering from substantive leakage.

Sub-national debt in Brazil experienced prolonged crises during the 1980s and 1990s. Partly as a result, at present the sub-national borrowing in Brazil is subject to restrictions imposed by fiscal responsibility law, the senate resolutions, and resolution from the National Monetary Council. These initiatives have successfully monitored the sub-national debt situation and have helped in preventing debt crisis reoccurring at the provincial level. In the last two decades, different administrations in Brazil have maintained and built on a macroeconomic framework of inflation targeting, a flexible exchange rate and rules-based fiscal management. It paved the

way for a gradual stabilization of government indebtedness, which facilitated a countercyclical response to the slowdown in activity brought about by the global crisis of 2008. 09. However, the longer-term impact of the crisis is proving to be more difficult to tackle.

China

The 1994 reform in China, which created a framework of fiscal relations between the central and local governments, is considered the most intensive and far reaching institutional restructuring for intergovernmental fiscal relations since 1949.

The exclusive central responsibilities include national defence, foreign affairs, geological prospecting expenses, and public debt. The exclusive sub-national responsibilities are urban maintenance and construction, environmental protection, water supply, and community services. All other government spending is shared by the centre and sub-national governments. Sub-national governments at each level are responsible for delivering public services, including education, health care, social welfare, public safety, and other local and urban services; government administration; and local economic development. There is substantial jurisdictional overlap and ambiguity in assignment of responsibilities.

The tax-sharing reform of 1994 explicitly defined taxes as (a) central taxes, (b) shared taxes and (c) local taxes. Those taxes which can be used in the pursuit of national objectives are assigned as central taxes, such as tariffs, excise taxes on tobacco, alcohol, petroleum products, cars and jewellery (known collectively as the consumption tax), taxes on foreign trade etc.; taxes that can be interpreted as more relevant to economic development are assigned as shared taxes and includes taxes like VAT, business tax, stamp tax on sales of securities, personal income tax, and company income tax. Taxes more suitable for collection and administration by the local governments, such as urban maintenance and development tax, taxes on use of arable land and urban land use are assigned as local taxes. Under the new mineral resource regulations, the local governments were allowed to auction the development rights of mineral resources to both public and the private sector, including multinational companies. Local governments were also permitted to explore and develop mineral resources. Under the new regulations, state enterprises still enjoyed preferential treatment in developing large mineral reserves. Resource producing companies pay various taxes, fees, duties and surcharges to the government, and they are shared by the central and relevant local governments at

different ratios. The intergovernmental conflicts in China are essentially sorted out through a process of bargaining and use of political clout.

The assignment of revenues and expenditure responsibilities in the latest phase across different levels of government in China has resulted in a situation where for the sub-national governments expenditures far exceed their revenues. Therefore, the subnational governments receive a substantial amount as transfers from the central government. The system of intergovernmental transfers consisted of four kinds of central-local grants: (i) fixed subsidies (subsidies were given to provinces for which the base year expenditures were larger than base year revenues); (ii) special purpose grants (initially given for disaster relief, poverty reduction, and other specific purposes, but were later expanded to cover a whole range of programmes); (iii) annual account closing transfers (acted as an adjustment to net revenues and expenditures, taking into account transfers between central and local governments and were determined at the end of each fiscal year) and (iv) capital grants (conditional grants disbursed by central government mainly for local capital construction and other investment activities). Even so, the shortage of resources at the local level, partly caused by unfunded expenditure mandates from other levels of government, has made local governments obtain funds through various irregular means (extra-budgetary funds), which have accumulated to very large amounts and threaten their financial stability.

Local governments in China are in principle subject to strict borrowing constraints. Under China's 1994 budget law, sub-national governments are not allowed to borrow from either domestic or international sources unless otherwise permitted by the law. The continuing imbalance between resources and expenditure responsibilities at county and township levels, particularly in poor jurisdictions, has negatively affected the quality of services provided. In the wake of global financial crisis China introduced a massive stimulus programme in the fourth quarter of 2008 and implemented through 2009 and 2010. The fiscal stimulus programme, decided by the central government, was largely implemented by local governments with only partial funding from the centre, which has further strained their finances.

Indonesia

The idea of decentralization in Indonesia gained momentum in the late nineties, and sub-national tiers of government started playing a significant role

in public supply of several services after the 'big bang' decentralization in 2001.

As the process of decentralization in Indonesia is a work-in-progress, the institutional arrangements are yet to settle down. Assignment of functional responsibilities is one of the weakest areas in the Indonesian decentralization programme. Formally, the central government has exclusive functional responsibility of items such as foreign policy, defence, internal security, monetary policy and macroeconomic matters, and the sub-national governments have social services, roads, water supply, farming and forestry. However, there is no clarity on the items that constitute concurrent list in Indonesia. Therefore, there is a substantial amount of *de facto* overlapping functional domain with respect to all levels of government as the central government tends to have control over most of the functional responsibilities through a centralized administrative structure. All intergovernmental disputes are resolved through exercise of central authority, with little recourse to the judicial system. Revenue collection process is highly centralized in Indonesia. The local governments are not allowed to change tax bases or rates at their own discretion. All such changes have to be approved by the centre. All broad-based taxes (personal and corporate income tax, VAT, customs) are with the centre, and taxes like motor vehicle tax, water tax, cigarette tax, and entertainment tax are assigned to the sub-national governments. The centre also gets majority of the revenues collected from natural resource extraction.

As the centre's share in total revenue is more than 90 percent, the sub-national governments receive a substantial amount as the central transfers. The horizontal imbalance is also quite high in Indonesia. The significant inter-jurisdictional inequalities actually provide an added reason for the vertical imbalance. Transfers include (a) tax sharing, (b) general purpose grants (include basic allocation and fiscal gap transfers), (c) specific purpose matching grants, and (d) other (discretionary) grants. The formula-based grants have a number of flaws in the design, but together with the other grants, are believed to provide more than adequate funds for the local governments.

Although given the difficulties in reaching public services in a country like Indonesia with numerous islands -- some of them quite far-flung -- the supply of public services has over the years been reasonable, decentralization *per se* does not seem to have improved public service delivery at the sub-national level. This cannot be ascribed to unavailability of resources; possibly capacity constraints and corruption could explain this phenomenon. The use of CCTs also does not seem to have made much difference.

Sub-national borrowing is severely restricted in Indonesia with the central government wielding complete control on such borrowings through pre-approval requirements. The participation of the sub-national governments in macro stabilization policy has been minimal, and the last episode of recession in the economy was almost entirely handled by the central government through tax cuts and additional expenditures.

Russia

In 1991, the Soviet Union collapsed and the modern Russian federation emerged. The economic system shifted from a command and control based one to a market-oriented one. The major commitment to adopt a federal governance structure in Russia came with the adoption of the Constitution in 1993.

Budget code of Russia, adopted in 1998, and which came into force in 2000, deals with assigning functional responsibilities and revenue sources to different levels of governments. As per the budget code, the federal government has exclusive responsibility to spend on national defence, tax collection, space exploration, federal courts, financial support to regional governments, and official statistics; and the regional governments on mass media, public transport, fire protection, housing, and providing financial aid to local governments. The expenditure responsibilities of items such as education, health, road construction, police services, environment, and welfare compensation are allocated to all levels of governments. Though there are formal institutional arrangements to resolve intergovernmental conflicts, they are designed in such a way that it has helped the federal government to dominate the regional governments and dictate its terms.

On the revenue side, the central government not only constrains sub-national governments' revenue options, but also decides their tax bases. The federal

government also has the discretion to unilaterally levy or cancel regional or local taxes, change tax rates, and grant tax breaks. Among the major taxes, the federal government retains 100 percent revenues collected from VAT, whereas it shares revenues collected from corporate profit tax, personal income tax, and excise duties with the sub-national governments. Asset-based taxes such as property tax, vehicle tax, and land tax are assigned to the sub-national governments. The federal government retains 100 percent revenue from gas extraction and 95 percent from oil extraction. Different regions of Russia also possess rich reserves of iron ore, manganese, chromium, nickel, platinum, titanium, copper, tin, lead, tungsten, diamonds, phosphates, and gold. Revenues earned from these resources are shared between the federal and the regional governments in the ratio of 40:60. Revenue collected from common minerals such as sand, gravel, and clay etc. is retained entirely by the regional governments.

The Russian Federation suffers from severe horizontal fiscal imbalance as the demographic structure, resource endowment, industrial location, weather, geographic location and conditions, and level of socioeconomic development varies enormously across the regions. To address such disparities, in recent years the Russian Federation has moved towards fiscal recentralization. This has increased vertical imbalance and the sub-national governments have become overly dependent on federal transfers.

All federal transfers can be divided into four broad categories: (a) general grants (include equalization grants and gap-filling subsidies), (b) earmarked transfers for co-financing regional programs, (c) earmarked transfers for execution of federal mandates, and (d) other transfers (largely ad hoc subsidies). As sub-national governments in Russia do not have much fiscal autonomy, they play a limited role in providing public goods and services. There is no evidence of using CCT mechanism in Russia. The Budget Code has imposed restrictions on the deficit and debt limits at the sub-national level. As a result, the share of sub-national governments in total debt is very small. Though the Russian economy felt the impact of global financial crisis, the centralized governance structure did not allow the impact to affect the sub-national governments very much.

South Africa

The Constitution of South African created a platform for further deliberations and negotiations on the various unresolved and contested issues in 1993. The end result of such negotiation was the adoption of the Final Constitution Act 108 of 1996.

The assignment of functions to all three spheres of government in South Africa has been provided in the Constitution. The national government looks after the criminal justice system (which includes police, justice, and prisons), defence, external affairs, higher education and such other functions that have nationwide coverage. It also provides social services such as school education, health, welfare and housing concurrently with the provincial governments. Local governments have the responsibility of providing electricity, water, housing for the poor, sanitation, municipal administration, city streets, streetlights, and garbage collection. All broad-based taxes such as income and corporate taxes, VAT, excises, fuel levy and customs are assigned to the national government. Provinces can levy minor levies such as gambling taxes, motor car license fees, and user fees on hospital services. As South Africa has substantial deposits of gold, platinum, diamonds, coal, manganese, iron ore, chromium, uranium and several other minerals as well as petroleum, revenue from royalties is also substantial. In line with the centralization of all major revenue sources, royalties are collected by the central government only, and there is no explicit sharing of revenue from royalties with sub-national governments. The South African Constitution provides for a constitutionally entrenched distribution of powers and responsibilities between the national and provincial governments, and appoints the Constitutional Court to enforce the arrangements.

Given the centralization of all major taxes at the central level and the delegation of responsibility for implementing most of the expenditure obligations to the sub-national level, the degree of vertical imbalance has been quite substantial. Horizontal imbalances at the provincial level are present, but probably to a smaller degree compared to developing economies in general. Therefore, it would be safe to venture a view that the vertical imbalances provide a much stronger rationale for intergovernmental transfers as compared to the horizontal imbalances in the South African context. With little fiscal autonomy at sub-national level, the South African fiscal system enables fiscal equality, harmony and efficiency at sub-national level through the transfer system. The allocations from the divisible pool to sub-national governments is done in terms of providing equitable shares and conditional grants as determined by the cabinet based on recommendations of the Financial and Fiscal Commission (FFC). The conditional grants are provided to the sub-national governments for identified and prioritized national schemes.

Provinces are not allowed to borrow except for the running of overdrafts on their current accounts that are held at various commercial banks. The provinces borrow only for bridging purposes mainly in the form of overdrafts. This has limited the scope

of borrowing for the sub-national governments. Inadequate resources and capacity constraints at the sub-national level, particularly in the case of local governments in delivering public goods and services has resulted qualitatively poor outcomes. This has tended to contribute to serious public unrest. The impact of global financial crisis was strongly felt by all levels of government in South Africa, but given the centralized fiscal arrangements, it was the national government that took upon itself the responsibility of responding to it. The immediate impact of the crisis was managed successfully without any major adverse impact on the sub-national governments, but it has further contributed to centralization, and the sustained recession is expected to create difficulties in the near future. The local governments are responding with PPP and other innovative business models to discharge their responsibilities along with an increased demand for raising debt at their level, but the failures of the local governments on the public services front is straining the credibility of the entire system for the citizens, particularly the poor.

Lessons

- The structure of the decentralized systems in the countries covered clearly indicates a substantial reliance on the third tier of local governments, with or without their own compulsions. The lack of adequate recognition of the role of the local governments stands in contrast.
- The assignment of expenditure responsibilities is fairly similar across the countries and is not too different from that in India. The assignment of revenue sources appears to be more centralized in all the countries covered except Brazil, relying on sharing of centrally collected revenues. This is a model that may have some advantages in the particular country contexts, but is not something that can be recommended for India.
- The cases of Indonesia and South Africa point to the fact that building up local government capacity is an important requirement; while it is necessary to augment their role in economic development, and provide them the necessary resources, the beneficial outcomes expected from such decentralization are unlikely to materialize without simultaneous capacity building for the purpose.
- The *de facto* centralization through controlling the purse strings despite formal decentralization on the expenditure side warns against centralization of revenues, if sub-national autonomy is valued.
- The Brazilian system of transfers is not ideal by any means, but it has an element that illustrates a viable option for India. The Brazilian system of collecting shared taxes into a fund and distributing the fund among sub-national governments as per shares determined, shows that there is the option of unifying various kinds of general purpose transfers in India under a single fund. This would have the advantage of a sharper focus on the objective . e.g., equalization.

- The reviews also point to the dangers inherent in over-reliance on shared revenues because of their pro-cyclical nature; the obvious lesson is to have a judicious combination of shared revenues, which have the advantage of transparency and predictability with grants that can be adjusted as per prevailing situation.
- Most of the countries reviewed (not Brazil) have tried to adopt a system of formula-based transfers that is determined by estimated normative need for resources, keeping both revenue and expenditure side in mind. Barring the Ninth Finance Commission, explicit, full-blown normative estimation of resource requirements has not been favored in India for intergovernmental transfers. Perhaps it is time we shed the inhibitions against such a method and ventured to adopt it, even if imperfectly.
- The case of China illustrates the danger of unfunded mandates and, in general, overburdening sub-national governments without adequate funding. While there has been nothing like the kind of extra-budgetary funds of China in India, examples from the 1980s and 1990s do show cases of borrowed resource mobilization by states in India that bypassed institutional checks. It is always better to treat the disease rather than the symptom, and hence the stability and balance of the sub-national finances should probably be the first priority.
- The increasing demands for relaxation of fiscal rules in some of the countries reviewed indicates a growing conflict between developmental aspirations and need for fiscal prudence. This is a pertinent issue in India too, and perhaps needs thought about modifying fiscal rules to accommodate both objectives. Also, the fact that none of these countries have fiscal rules applicable specifically to the national government (except some rules regarding expenditure pattern in some cases), this review fails to provide any guidance on how to apply fiscal rules in a more balanced way across different levels of government.
- The example of Indonesia shows that while CCTs were successful in Brazil in achieving their objectives, there are certain prerequisites (mainly adequate supply in terms of quantity and quality) of public services concerned that need to be attended to before we try to persuade the poor to utilize them. As in Indonesia, in the present state of supply of public services in India (particularly primary health) throw some doubts on the usefulness of CCT.

Chapter I: Introduction

The merits of decentralization as a better structure for governance compared to a centralized system were rediscovered in several countries across the world during the last two decades, irrespective of whether they were federations in the political sense or not. Several of these systems do exhibit some characteristics of a federal structure, particularly with respect to decentralized decision making and autonomy in their allotted domains. In this study, the features of fiscal decentralization in five such nations . Brazil, China, Indonesia, Russia, and South Africa . are surveyed, with a view to summarize the essentials of the groups of characteristics that are common to all structures of fiscal federalism. These include assignment of functional responsibilities, fiscal imbalances, intergovernmental transfers to resolve the imbalances, and sub-national borrowing. In addition, these surveys also consider the role of sub-national governments in macroeconomic stabilization in the context of the recent past . during and after the global financial crisis. Institutional features are alluded to where relevant, although in deconcentrating systems like China and Indonesia, durable institutions have not had time to develop, nor are they particularly relevant in a situation where the centre is dominant. Assignment of revenues from natural resources are discussed in relatively more detail than other revenue sources, mainly because of its role in creating tensions between tiers of government in some countries as also between sub-national units, sometimes with tragic consequences (as in Nigeria).

Even before allocation of functions and powers are considered, sometimes it is instructive to understand the way decentralization/federalism comes about. The motives often embedded in history usually play a large role in determining the way the structure is formed and evolves subsequently. All the nations covered in this study have actually changed their governmental structure with some deliberation within the last three decades to implement decentralization, primarily to allow at least limited political expression or ~~voice~~to the preferences of ordinary citizens and to benefit from the perceived advantages of fiscal decentralization. Brazil, from all accounts, is different from the other four in that sub-national economic-political power centres have existed there for a long time, and though it has fluctuated between democracy and dictatorship in the past, these regional power centres have nearly always succeeded in holding on to their base, occasionally able to negotiate some degree of decentralization that explicitly acknowledges their position.

In some cases, the relative importance of different tiers of sub-national government and even their number has been determined by political as well as economic considerations (as has been highlighted in the case of Indonesia and South Africa). Generally speaking, our coverage takes the sub-national tiers and their structure as given, and considers only the issues relevant for *fiscal* decentralization. In what follows, it will be seen that unlike in the case of an established federation, in four of the five nations covered (barring China), it is not the state/province level government at which decentralization is primarily aimed. The local governments are the focus of decentralization. Whatever be the reason for this, such a structure inevitably leads to a situation where even after decentralization, the central government retains control of many important functions. The reason is that for several functions, the benefit area and the jurisdiction of the local governments simply would not match, resulting in too much of spillover benefits/costs that can lead to provision of public services that is not optimal, and also inefficient. Such a situation provides sufficient cause for the central government to maintain control through its supervisory and coordinating role.

Assignments best indicate the importance of a particular level of government in a multi-tier structure. Further, theoretical considerations for allocation of functional responsibilities are different from those relating to assignment of revenue powers; typically, the latter side ends up as more centralized than the former. However, this feature may reflect deliberate policy as well, particularly in those nations where an essentially unitary system is evolving into a decentralized system, for whatever reason. A possible reason is that while expenditure decentralization is thought to be administratively and politically expedient, the centre is able to retain control over the sub-national units by controlling the purse strings. This particular feature gets accentuated in systems that focus on local governments. Because the local governments are not administratively suited to manage any taxes other than those on immobile bases or benefit taxes against some local public goods, and some non-tax revenue sources, the vertical imbalance tends to be larger.

This is so for horizontal imbalances too in large nations¹ (four of the five nations covered can probably be called large; South Africa is the only one which is relatively small) simply because of the large numbers and variety, and the usual way

¹ In any case, all the countries covered have substantial regional inequalities, as indicated by the population weighted coefficient of variation (WCV) relating to per capita regional domestic product. The estimated values are . Brazil: 0.48, China: 0.51, Indonesia: 0.89, Russia: 0.37 and South Africa: 0.41. These values are as estimated by Lessman (2011). For India, the estimated WCV is 0.42.

of correcting for these . intergovernmental transfers . becomes much more important in the context of financing functional responsibilities at the sub-national level. The control of the purse strings by the centre allows qualitative centralization, even on the expenditure side, to be stronger than what would be indicated by the formal assignment of responsibilities, because it can dictate priorities and budgetary allocations by using conditional transfers as a part of the overall scheme of transfers. These *a priori* considerations are clearly relevant factors in all the five countries covered.

Sub-national borrowing can be a source of funds for discharging assigned functional responsibilities, particularly larger capital expenditure requirements for developmental purposes as also consequent upon rapid urbanization, at the local level. Also, subnational borrowing finances infrastructure more equitably across multigenerational users of infrastructure services because the debt service can match the economic life of the assets that the debt is financing+(Canuto and Liu, 2013). However, it can have macroeconomic implications and can also lead to moral hazard type of problems. As such, the extent to which the sub-national governments can utilize this financing mechanism, and the actual process of doing so, has substantive implications for macroeconomic stability as also sub-national autonomy in delivering even the assigned services and efficiency of the system.

The elements of federalism common between these countries and India gives rise to the possibility of India learning some lessons from an examination of their fiscal decentralization . both positive (better practices) and negative (practices to be avoided). To this end, we try to provide an assessment of the prevalent systems in these countries where warranted. It should be added here that the country reviews are completely based on available literature in English language without the benefit of any first-hand information on decentralization in these countries. The limitations of such reviews hardly need elaboration.

As an aid to broad comparability, the next five chapters, each covering a country, follow a roughly similar format. The seventh and final chapter provides a summary, and concluding observations.

Chapter II: Fiscal Federalism in Brazil: A Review

A. Introduction

As per the Brazilian federal Constitution (Art. 1 of the 1988 Federal Constitution), the Brazilian Federation is the "indissoluble union" of two levels of distinct political entities: the States and the Federal District (state and municipality rolled into one), and the Municipalities (*municípios*). It is a federation composed of 26 States, one Federal District and 5,570 Municipalities.² States have autonomous administrations, collect their own taxes and receive a share of taxes collected by the Union government. Municipalities, like the states, have autonomous administrations, collect their own taxes and receive a share of taxes collected by the Federal and state governments.³ The Brazilian Constitution treats the municipalities as parts of the Federation and not simply dependent subdivisions of the states.⁴ However, the states have independent Courts of Law for common justice, but municipalities do not have any separate Court of Law.

Despite being portrayed as one of the most promising emerging economies with vast natural resources and a dynamic industrial sector, Brazil faces significant social, economic and fiscal disparities among regions, which poses a complex challenge for its economic and social development. In this light, this chapter attempts to review the fiscal structure of various levels of government in Brazil along with the issues faced by them.

² The number of municipalities had increased considerably over time, reaching its apex in 1996, when the Constitution was amended calling for a complementary law to set the rules for the creation of municipalities. This law has not been approved until now, which in practice has put an end to the intense creation of municipalities seen after the 1988 Constitution. Ter-Minassian (1997) points out that the increase in the number of municipalities has been quite divorced from economic and financial viability considerations. A major incentive for such an increase was precisely of a financial nature, namely the revenue-sharing mechanisms currently in place.

³ The allocation of wide-ranging powers to the municipalities is said to be an outcome of lobbying at the time of drafting the new Constitution (Souza, 1997). 54 percent of the constitutional drafters had been previously a mayor, a local councillor, a governor or a state deputy; their close ties with local and state constituencies helped in assigning significant financial powers to the local bodies.

⁴ Thus the current Brazilian Federation is a three-tiered federation in which the municipalities are not creations of the state but are a part of the federation. The 1988 Constitution incorporated municipalities as a part of the federation together with the states, reflecting a tradition of municipal autonomy and little state control in municipal matters.

B. Federal structure in Brazil – an overview

Brazil, the fifth largest country in the world by geographical area, is a highly decentralized country with a long and complex federalist history (Rodden, 2005). The early Brazilian federalist model was adopted during what is known as 'The Old Republic' which lasted from 1889 to 1930. The 1891 Federal Constitution (modelled upon that of the United States) created an uncoordinated federation with few constitutional and practical links among the different levels of government (Souza, 2002). The earlier adoption of federalism was as a reaction against the Empire's authoritarian, heavily centralized rule in a country of distinct regions with different traditions. The federation did not result from a historical evolutionary process. The virtually powerless former provinces were simply converted into quasi-sovereign states, first by military fiat and later by the 1891 Constitution. As a result, even after the enactment of the 1891 Constitution, fiscal and economic resources were concentrated only in a handful of sub-national governments.

Between 1930 and 1987, the nation saw various changes in administration led by the military coups and shifted towards a centralized system. After more than 20 years under the aegis of the military regime, democracy was restored in Brazil and a new Constitution was passed in the year 1988. The nation shifted from a heavily centralized system under the army rule to a decentralized setup with an enactment of the 1988 Federal constitution. It changed the balance of power within the federal system and also paved the way for a commitment to improve the role of local governments. Although Brazil is under the aegis of the 1988 Constitution, several constitutional amendments have been passed to make important changes to it, particularly in the late 1990s. As regards the local governments, constitutional amendments mainly concern the imposition of limits on local governments' freedom to spend their resources, as a requirement of the federal policy of fiscal control, and the earmarking of specific resources to be spent on social services.

It is interesting to note that in Brazil, the adoption of fiscal policies does not require changes in the Constitution. This is because the federation has been designed to allow adjustments to new agendas without the formal approval of sub-national institutions. Furthermore, the functioning of institutions and decisions regarding public policies affecting the states depend more on the federal Constitution and policies rather than of the states. In practice, the states' role in the federation has been constrained by several factors, including new fiscal policies. Addressing the lack of investment capacity and the relative loss of revenue experienced by the

states depends more on what is agreed at the national level rather than at the level of the states.

Thus, Brazil has adopted symmetrical federalism in a socio-economically asymmetrical federation. Constitutionally, each constituent unit at the same tier has the same powers. The states have their own Constitutions promulgated in 1989. The preparation of these Constitutions followed the same rules applied to the federal Constitution, as did the rules for their approval and further amendments. Although states' Constitutions are not limited by federal constraints except that they should not have anything contrary to the federal Constitution, most of them simply replicate federal mandates. States' Constitutions are, therefore, modelled on the federal Constitution.

The governance of Brazil takes place in a framework of a federal presidential representative democratic republic; the President is both head of state and head of government. As mentioned earlier in this draft, the political and administrative organization of Brazil comprises the federal government, the states, the federal district and the municipalities. The federal government exercises control over the central government and is divided into three independent branches: executive, legislative and judicial. Executive power is exercised by the President, advised by a cabinet. Legislative power is vested upon the National Congress, a two-chamber legislature comprising the Federal Senate and the Chamber of Deputies. Judicial power is exercised by the judiciary, consisting of the Supreme Federal Court, the Superior Court of Justice and other Superior Courts, the National Justice Council and the Regional Federal Courts.

In states, the executive power is exercised by a governor elected to a four-year term. The executive role is vested in the Governador (Governor) and his appointed *Secretários* (Secretaries); the legislative role is held by the *Assembléia Legislativa* (Legislative Assembly); and the judiciary role, by the *Tribunal de Justiça* (Justice Tribunal). The Governors and the members of the assemblies are elected, but the members of the judiciary are appointed by the Governor from a list provided by the current members of the State Law Court, a collegium of only judges (these are chosen by merit in a selection system open to anyone with a Law degree). The name chosen by the Governor must be approved by the Assembly before inauguration. States hold elections every four years and exercise a considerable amount of power.

The 1988 constitution allows states to keep their own taxes, and mandates regular allocation of a share of the taxes collected locally by the federal government.

Municipalities are governed by an elected *prefeito* (Mayor) and a unicameral *Câmara de Vereadores* (Councillors' Chamber). In municipalities with more than 200,000 voters, the Mayor must be elected by more than 50 percent of the valid vote. The municipality (*município*) is a territory comprising one urban area, the *sede* (seat) from which it takes the name, and several other minor urban or rural areas, the *distritos* (districts). The seat of a municipality must be the most populous urban area within it; when another urban area grows enough to compete with the original seat, it usually splits to form a new municipality. A municipality is relatively autonomous: it enacts its own constitution which is called organic law (*Lei Orgânica*), and it is allowed to collect taxes and fees, to maintain a municipal police force (albeit with very restricted powers), to pass laws on any matter that do not contradict either the state or the national constitutions, and to create symbols for itself (like a flag, an anthem and a coat-of-arms). However, not all municipalities exercise all of this autonomy. For instance, only a few municipalities keep local police forces; some of them do not collect some taxes (to attract investors or residents) and many of them do not have a flag (although they are all required to have a coat-of-arms).

The Federal District is an anomalous unit of the federation, as it is not organized in the same manner as a municipality, does not possess the same autonomy as a state (though usually ranked among them), and is closely related to the central power. It is considered a single and indivisible entity, constituted by the seat, Brasília and some satellite cities. Brasília and satellite cities are governed by Regional Administrators individually and as a whole are governed by the Governor of the Federal District.

The latest Brazilian parliamentary election was held on October 3, 2010, as part of the country's general election. On that date, 54 of the 81 seats in the Federal Senate and all 513 seats in the Chamber of Deputies were up for election. According to the Constitution, each state is represented by three Senators elected by a majority of the votes. They are directly elected to an eight-year term, and there is no limit on the number of terms a Senator may serve. Alternating, one third and then two thirds of the seats are up for election every four years. The Federal Deputies represent the people of their state, elected by a system of proportional representation for a four-year term, and there is no limit on the number of terms a Deputy may serve. Brazil

has a multi-party political system with no independents allowed; coalitions are often important and officially recognised. Voters have the choice of voting for a party/coalition or an individual candidate while casting their vote.

C. Assignment of responsibilities and revenue sources

In contrast to the traditional 'layer cake' model of dual federalism (with clear division of competence between the central and local governments), Brazil adopts a complex 'marble cake' federalism model (see Shah, 1994). It has the 'marble cake' model with overlapping and shared responsibilities among various levels of the governments, and all are treated as equal partners in the federation. Although some functions are exclusively assigned by the 1988 Constitution, the 'marble cake' model is evidenced by the absence of a clear division of responsibilities across three levels of the governments for several functional areas, for example, health care, social security, education, agriculture, sanitation, housing, public transport, natural resource management, law enforcement and environmental protection (de Mello, 1999).

The federal government holds the largest number of and also the most important exclusive powers. Although residual powers rest with the states, the high level of detail in the Constitution leaves little room for the states to make use of their residual powers. Concurrent powers are listed in the Constitution, covering a wide range of issues, but gaps remain between what the articles in the constitution say and how it is put into practice.

Although the states enjoy relatively less constitutional power, they do levy and determine the rates of the most lucrative tax in absolute terms, the ICMS (*Imposto sobre Circulação de Mercadorias e Serviços*) . a tax on Circulation of Goods and Services . a type of Value-Added Tax (VAT) which, unlike in many federations, is under the states' jurisdiction.

1. Assignment of expenditure responsibilities

Formally, the Brazilian Constitution follows the principle of subsidiarity in allocating functional responsibilities. Functions with limited benefit areas (basic services of local nature) like city roads, water supply and sewerage, basic health and education, street lighting, and basic social assistance have been allocated to local governments. Local governments, however, depend heavily on the federal government for financial and technical help. On the other hand, functions generally considered national in character like defence, foreign affairs, international trade and

monetary policy are in the central domain. There are several areas where legislative powers are located at a level different from the actual provider level (Table 2.1).

Table 2.1: Legislative Responsibility and Actual Provision of Services in Brazil

Service Area	Legislative Responsibility	Actual Provider
Defence	Federal	Federal
Law and Order	Federal/State	Federal/State
Basic Education	Federal/State	State/Local
Higher Education	Federal/State	Federal/State
Health	Federal/State/Local	State/Local
Social Assistance	Federal/State/Local	Federal/Local
Water and Sewerage	Local	State/Local
Police	State	State
Environmental Protection	Federal	Federal/State
Street Cleaning and Lighting	Local	Local
Public Transportation	Local	Local
Urban Infrastructure	Local	Local
Waste Management	Local	Local
Fire Protection	State	State

Source: Rezende (2007), updated.

There are several areas where responsibilities are divided between two or even all three levels of government. For example, while law and order is primarily the responsibility of the state level, certain aspects like organized crime, drug trafficking, smuggling of arms and ammunition, and money laundering are in the federal jurisdiction. In the area of health, all three levels of government share the responsibilities. With a system of functional assignment of this nature, it is inevitable that there would be some amount of overlapping jurisdiction, and occasional frictions. The absence of a clear definition of the functions to be performed by each order of government is a major source of continuing conflicts (Rezende, 2007). In terms of actual expenditure share, the federal government spends 55-60 percent of the aggregate public expenditure, the states account for roughly half of that, and the rest is spent by the local bodies. Oddly enough, ignoring the exclusive domain of the federal government, its largest share among different functional areas characterized by overlapping jurisdictions is in the broad area of social services, mainly because of its predominant share in old age assistance and conditional cash transfers, which account for the largest part of expenditures on social services.

2. Allocation of revenue sources

Brazil has an aggregate revenue structure that has evolved over time in a particular way. The current tax system essentially originated in the 1960s, but was highly decentralized. The military governments centralized the system, which was

reversed in the 1988 Constitution. But it also installed a distinct set of compulsory levies . the so-called social contributions . [that] was assigned to the federal government to finance pensions and free access to healthcare and social services for every Brazilian citizen regardless of previous contribution to the social security system+(Rezende, 2007). This created a sort of dual fiscal regime, and ended up substantially centralizing revenues because of rising social and special contributions (Table 2.2).

Table 2.2: Composition of Aggregate Revenue by Level of Government in Brazil (in 2013)

	Federal Level	State Level	Municipal Level
Own revenue	67.8%	26.0%	6.2%
After Federal Sharing	57.4%	31.4%	11.3%
After Federal and State Sharing	57.4%	24.3%	18.4%

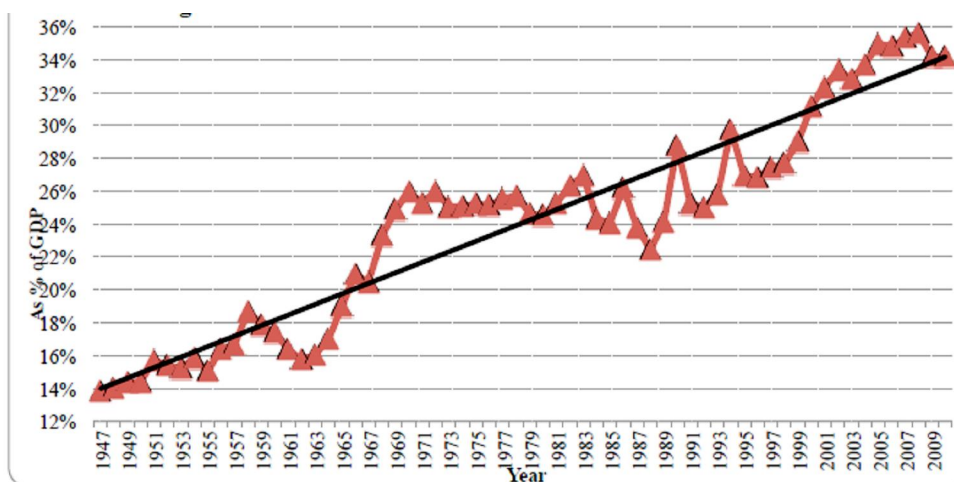
Source: Brazilian Tax Agency

As mentioned earlier, Brazil is a Federal Republic, and each of the 26 states and the Federal District has their own legislation. This gives rise to 27 regulations on indirect state taxes, implying varying application, administration and compliance rules in each state that gives rise to some amount of disharmony.

The 1988 federal Constitution adopts a rigid and detailed revenue assignment system, with a few innovations. It has a comprehensive and a complex revenue system, with multiple levies on consumption, capital, income, property, commodities and services. All levels of the government have significant revenue raising powers as the Constitution grants revenue raising authority to all the three levels of government. Some of the revenue sources are exclusive to one level, others are collected by the federal government and shared with states and municipalities, and still others are collected by the states and shared with their municipalities. The rate and rules of certain taxes, including state and local, are broadly determined by federal legislation. For example, the rate of municipal taxation of services must be set within the upper and lower bounds set by federal legislation. According to Bird (2010), the pattern of broad and multi-layered tax assignment is consistent with the fact that Brazilian sub-national governments enjoy significant political power and decision-making autonomy. In accordance with Article 20(1) of the Federal Constitution, non-tax revenues (royalties and financial compensation for the use of natural resources like mining) are also assigned to constituent units.

The overall tax ratio, a simple ratio of the total revenue collected to the Gross Domestic Product (GDP) in the same period, for Brazil is plotted in Figure 2.1 below. It shows the historical evolution of the tax ratio for the period since World War II (from 1947). The ten year period between the early 1960s and 1970 is when the Brazilian tax burden accelerated most. Throughout the 1970s, the tax burden remained more or less constant, with a few fluctuations. At the beginning of the 1980s, coinciding with the global and national economic crisis ("the Lost Decade"), the tax burden became more volatile, but maintained its upward trend. In the 1990s, especially after the implementation of the Real Plan (1994) along with the end of hyperinflation and the return of macroeconomic stability, the tax burden began to resemble the 1960s performance, when growth was steady year after year. In 1999, the last year of the decade, the tax burden approached the milestone of 30 percent of GDP. This trend has continued to a lesser extent in the following years, reaching a peak of 35.6 percent of GDP in 2008. In 2012, the ratio stood at 35.85 percent.

Figure 2.1: The Gross Overall Tax burden in Brazil (1947-2010)



Source: Afonso *et al* (2013)

An interesting comparison of the two phases of highest tax burden growth in Brazil (1960s and 1990s) can be seen in Afonso *et al* (2013): "... in the past, tax revenue was highly elastic compared to gross domestic product, i.e., taxation increased when the economy grew, especially when expansion rates were higher. At the turn of the century, the tax burden continued to grow as the economy slowed, and even had low growth rates compared to the post-war period".

The first aspect of the national tax burden that attracts attention is its concentration in just a few sources of revenue. The category Merchandises,

Services and Goods which represents almost all the Brazilian indirect taxes, accounts for 45 percent of all taxation. This means that approximately 15.38 percent of the national GDP is collected by means of indirect taxes alone. The origin of almost 90 percent of the Brazilian tax burden can be seen in two other tax bases after Merchandises, Services and Goods. While taxation on Salaries contributes a little more than 1/4 of the total tax burden (8.87 percent of GDP), tax on Income and Capital Gains accounts for 18.6 percent of the total collected, or 6.37 percent of GDP. The relatively heavy reliance on indirect taxes in Brazil, not a feature of advanced tax systems even after a recent increase in their share (and rates) in the relevant nations, is sometimes seen as possibly regressive.

Another way to look at the tax burden is to group taxes by sphere of government i.e. how much each federal level of government levies in taxes, before constitutional transfers (See table 2.3 below).

	Tax Revenues (R\$ Billions)	% of Total Revenues	% GDP	R\$ per capita
Overall	1288.98	100	34.19	7022.32
Federal Government	869.41	67.45	23.06	4736.50
States	341.64	26.50	9.06	1861.23
Municipalities	77.93	6.05	2.07	424.58

Source: Afonso *et al.* (2013)

From this table, we see that despite the decentralization of revenue and of the power to tax promoted by the 1988 Constitution, tax collection in Brazil remains highly concentrated in the Central Government. In 2010 this government tier levied more than 67 percent of the tax revenue, leaving for the sub-national (state and municipal) governments less than 33 percent of the total. States, even with the country's most important tax - Tax on the Circulation of Goods and the Provision of Communication and Transportation Services (*Imposto sobre Circulação de Mercadorias e Prestação de Serviços de Comunicação e de Transporte*, or ICMS) - collected much less than the Federal Government: just over 9 percent of GDP. Municipalities had even lower revenues, representing 2.07 percent of GDP. However, the weak fiscal decentralization seen in respect to own revenues is partially reversed when the revenues available to each sphere of government is analyzed. That is, after the constitutional transfers between the Union and sub-national governments, one can see somewhat higher resource availability for the state and especially municipal governments, although even after devolution of tax revenues, the central share

remains at a level higher than half of the total tax collections. It should also be noted that the aggregate tax ratio in Brazil is lower than only some of the North European countries, and significantly higher than in all of its neighbours and other countries with similar levels of socio-economic development. This has often led to assertions about too high a level of taxation in Brazil.

2.1. Tax assignment

Ability-to-pay taxes are unrelated to any specific public service delivery and are meant for financing general government activities. These taxes are singularly assigned to the federal government, states, the federal district, and to municipalities. As per (Art. 153 of) the federal constitution, the seven such assigned taxes to the federal government are:

- Import tax (II);
- Export tax (IE);
- Personal and Corporate Income tax (IRPJ and IRPF);
- Tax on industrial product (IPI);
- Tax on financial transactions (IOF);
- Rural property tax (ITR);
- Tax on Large Fortunes.⁵

Moreover, Art. 154 assigns to federal government a residual power to create new ability-to-pay taxes.

For the state level, the Constitution assigns three such taxes (Art. 155 of the federal Constitution):

- Tax on inheritances and gifts (ITCMD)
- Tax on circulation of goods and rendering of communication and interstate transportation services (ICMS)
- Tax on motor vehicle ownerships (IPVA).

For municipalities and the federal district the assigned taxes are (Art. 156):

- Tax on the provision of services (ISS)
- Tax on real estate property (IPTU)
- Tax on real estate transfers (ITBI).

The Federal District is entitled to collect both state and municipal taxes.

It may be noted that almost the entire tax revenue from merchandises, services and goods is under the authority of the central government and the states. With only a 6 percent share of taxes levied on this tax base (through the ISS),

⁵ This last mentioned tax is not levied despite a constitutional provision for the same for want of complementary legislation, which was never passed.

municipalities collected R\$37.6 billion (1 percent of GDP) in 2010. In that year, states collected the most, 48 percent of the total or R\$275.9 billion (7.32 percent of GDP). Of state taxes collected from this tax base, 96 percent is through the ICMS. And finally, the central government collected R\$266.3 billion (7.06 percent of GDP), which represented 46 percent of the total taxes levied on merchandises, services and goods.

2.2. User fees

User fees are the charges connected to specific government actions directed towards the taxpayer and are based on benefit principle. Each level of government is entitled to levy user fees tied to its own expenditure responsibilities [Art. 145 (II)]. Most commonly enacted user fees in Brazil are: Sewer fees, tolls, electricity fees, and water supply fees. However, these types of revenue sources play only a minor role in financing the expenditure needs of various levels of government.

2.3. Public improvement contribution

It is a kind of special assessment or betterment tax [Art 145(II)] and is assigned to all levels of the governments. These taxes are levied on the basis of the benefits derived by the real estate owners from certain public works projects. It is seldom charged by constituent units in Brazil.

2.4. Social Contributions

An interesting feature of the Brazilian tax system is the varied array of social contributions, which are intended to finance social services including social security expenditures. It is mostly collected by the federal government with some provisions for the states and the municipalities (collected from their own employees to finance their respective pension systems). The federal government is empowered by the 1988 Constitution to enact social contributions on:

1. Gross receipts
2. Import of goods and services
3. Net profit.

It represents the most important revenue source of the federal government. In 2009, various forms of the social contributions accounted for a combined share of 44.23 percent of the aggregate national revenues (it was around 10 percent in 1988) and 63.33 percent of the federal revenues. Brazil has observed a sharp rise in the share of social contributions since inception of the 1988 federal Constitution in contrast to the decline of shared ability-to-pay taxes. This is often attributed to the federal government's attempt to tap new sources of non-shared revenue.

2.5. Compulsory loans

Compulsory loans can be enacted to finance urgent and relevant federal public investments or extraordinary expenses incurred due to external wars or public calamity and are fully refundable to taxpayers. It is assigned to central government and can only be put into force by complementary laws. It has not yet been enacted after the 1988 Constitution, although it was used before that.

2.6. Special contributions

Special Contributions are tied to specific government activity that they are created to fund; these are non-shared high revenue yielding taxes. It encompasses the following:

1. Market intervention contribution
2. Contribution on economic (labour unions etc) and professional categories (lawyers, physicians, etc). These are sometimes off-budget.

2.7. Sub-national consumption taxes

The consumption taxes comprise of several levies, uncoordinated among the various levels of the governments and most remarkably none of the consumption taxes is creditable against the others.

Brazil has been one of the pioneers in value added taxation (VAT). It adopted a fully developed VAT to replace a state-based cascading tax on consumption (ICM) in mid 1960s and its features were upheld in its replacement in 1989 by the current ICMS, which remains the highest yielding non-social security tax in Brazil. As an additional caveat ICMS bears the distinctive attributes of a hybrid origin/destination VAT.

Each of the 26 states and the Federal District set their own indirect tax rates, although the rate on interstate trade is set by the Federal Senate. Some examples of the ICMS standard rate are as follows:

- São Paulo, Paraná e Minas Gerais: 18%
- Rio de Janeiro: 19%
- Remaining States: 17%
- Rates of IPI range from 0 to 330%, and average around 15%.
- ISS standard rate ranges from 2% to 5%.

The Brazilian tax system is complex and has some unique features. The overall tax burden stands out for two broad reasons: its size (no other emerging economy collects as much, with levels surpassing even the average of advanced

economies) and, its quality (often being criticised for being unfair, anticompetitive, costly, and complex, among other distortions). As a Federation both in law and fact, the most salient features of the Brazilian system are reinforced and concentrated by the intense decentralization. Brazil is the only country reviewed here that has allocated a broad-based tax like VAT to sub-national governments. It is levied with so much enthusiasm by the intermediate government sphere that it has provoked one of the best known fiscal wars in specialized international literature on taxation.

Competition arises across levels of government when they co-occupy a tax base, which creates vertical externalities in tax setting and among same level jurisdictions, typically to attract cross-border shoppers, investment, and wealthy residents (de Mello, 2008). Because in Brazil the states do not have the autonomy to tax factor incomes as in some other large federations such as the United States and Canada, they have used the VAT extensively as an industrial policy instrument, granting tax exemptions and holidays to attract economic activity, particularly investment. This type of competition among states has predictably distorted economic decisions like choice of location of business activity.⁶

3. Government Revenues from Natural Resource Exploitation

Brazil is rich with various renewable and non-renewable natural resources. Its natural resource stock includes extremely rich mineral reserves that are only partly exploited, such as iron ore, tin, copper, pyrochlore, and bauxite. There are also significant amounts of granite, manganese, asbestos, gold, gemstones, quartz, tantalum, and kaolin. Most industrial minerals are concentrated in Minas Gerais and Pará, including iron ore, bauxite, and gold. Mato Grosso and Amapá have most of the known manganese ore deposits. The vast majority of kaolin is found in the Amazon basin. Low-quality coal reserves are located in Rio Grande do Sul and Santa Catarina. Brazil also has deposits of several other metallic and non-metallic minerals, some of which substantially contribute to its exports. It has huge offshore reserves of petroleum and natural gas, notably in the Southeast.

In 2007, Brazilian geologists made the biggest oil find in the Americas in three decades. Buried more than five miles below sea-level, the discovery was estimated to raise the country's crude reserves by 62 percent. The find of this huge reserve led to the prospect of it becoming a major energy power, and prompted then-President Luiz Inacio Lula da Silva to declare amid a rush of patriotism that "God is Brazilian."

⁶ See Jiménez (2010) for an overview of ICMS . the state-level VAT . taxation and a discussion of the channels for predatory tax competition among the states.

This area has been named Pre-Salt, considering its location about 7 Km below the sea bed, under a series of layers of rock and salt.

As happens around the world, a salient characteristic of non-renewable resources production in Brazil is its geographic concentration. Oil and mineral resources are very frequently discovered and exploited in sparsely populated areas, creating potentially large horizontal imbalances, if rents were assigned exclusively or even preponderantly to sub-national governments. Obviously, major imbalances across sub-national jurisdictions stimulate political pressures and provide theoretical grounds for national equalization of these resources. At the same time, sparsely populated regions typically exercise very small voice in national politics. This increases their perceived risks of having to bear the costs of exploitation without reaping the benefits, if entitlements to national resources revenue are transferred to the national government. In Brazil, the ownership of natural resources lies with the Federal government. Royalties and excises are shared between the federal and the producing and bordering states and municipalities. Direct taxes and a very tiny share of royalties are shared between the federal and all states and municipalities. The equalization of natural resource revenues in Brazil remains a matter of ongoing public debate.

The revenue from natural resource exploitation in Brazil can be classified as partially restitutive, non-matching, conditional mandatory transfers. Initially, in 1953 (Law No. 20,004), the tax collected was intended exclusively for the state from whose land the resource was extracted; in addition, it was mandatory for the state to distribute 20 percent to its municipalities. Starting in 1969, when offshore oil exploitation began, tax on these exploitations were collected exclusively by the Federal Government. These rules applied until 1985 (Law No. 7453), when revenues from offshore exploitation were shared: 20 percent to the Federal Government, 60 percent to states and municipalities facing the wells, and 20 percent to all other sub-national governments. These rates were changed to 20 percent, 70 percent and 10 percent respectively, in Law No. 7990 of 1989, and have remained the same since then for the basic rate (5 percent) on land-based oil wells. There is an additional rate now (5 percent) the allocation of which is different and more complex. Special participations (collected from higher-volume, high-profit wells), governed by Law No. 9478/97, are distributed as follows: 50 percent to the Federal Government, 40 percent to states and 10 percent to municipalities (Afonso *et al*, 2013). Details of the current sharing scheme are provided in Table 2.4.

Table 2.4: Distribution of Revenue from Oil and Natural Gas

(Percentages of Total)

Level of Government	Basic Rate (5%)		Additional Rate (5%)		Special Participation
	Land	Sea	Land	Sea	
Federal	–	20 (Navy)	25 (Ministry of Science and Tech.)	40 (15 -Navy, 25 -Ministry of Science & Tech)	50
States (Total)	70	32	52.5	24	40
Producing	70		52.5		40
Facing Oil Wells		30		22.5	
All States (Special Fund)#		2		1.5	
Municipalities (Total)	30	48	22.5	36	10
Producing	20		15		10
Facing Oil Wells		30		22.5	
Producing Zone (PZ)					
PZ Neighbourhood					
Hosting Loading/Unloading	10		7.5		
Affected by Loading/Unloading		10		7.5	
All Municipalities (Special Fund)*		8		6	
Grand Total	100	100	100	100	100

FPE criteria * FPM criteria

Source: Collated from various sources

Table 2.5: Criteria for Distributing Financial Compensation Related to the Production of Electric Power, Royalties from the Itaipu Plant and Exploitation of Mineral Resources

Federal Entity Category	Water resources	Itaipu Royalties	Mineral Resources
States directly affected	40.00%	38.25%	23.00%
Municipalities directly affected	40.00%	38.25%	65.00%
States affected by upstream reservoirs	-	6.75%	-
Municipalities affected by upstream reservoirs	-	6.75%	-
Federal Government	20.00%	10.00%	12.00%
Total share of states and municipalities	80.00%	90.00%	88.00%
Total share of Municipalities	40.00%	45.00%	65.00%

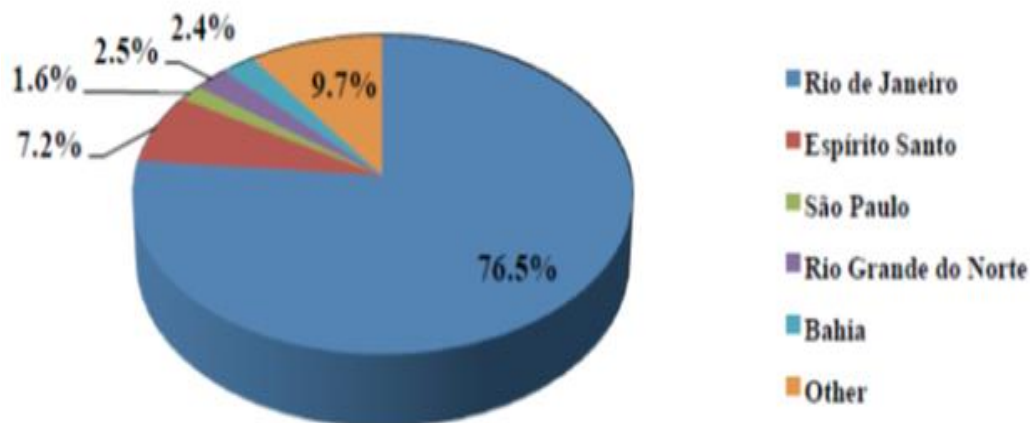
Source: Collected from various sources

The three sources of revenue from the oil and natural gas sector . royalties, special participations and compensation for oil exploitation activities . are governed by laws framed at the national level. The rules for sharing revenues from other natural resources as specified by the law depend on the type of resource concerned. The sharing schemes are presented in Table 2.5. It can be seen that the bulk of revenues from natural resources are transferred to sub-national entities, with the municipalities and states directly affected by the extraction activities getting a larger share than others.

Until the mid-1990s, tax revenues from oil and natural gas exploitation were small. However, an institutional change in 1998 was crucial to the change in revenue collected from this activity. Through Administrative Acts No. 155 and 206 of 1998 and 2000, respectively, the Brazilian Oil, Natural Gas and Biofuel Agency (ANP) established criteria for setting the price of oil produced locally for the purpose of calculating royalties. This change, combined with increased Brazilian oil production and an increase in the rate of royalty to 10 percent, resulted in a large revenue increase.

Governments in the state of Rio de Janeiro receive more than three-quarters of revenues distributed to states and municipalities (Figure 2.2), since most of the current production in Brazil occurs in the Campos Basin, which borders the state. With the discovery at the end of 2007 of pre-salt oil deposits, a large reservoir of oil and gas deep under water extending from the state of Espírito Santo to the state of Santa Catarina, there are great prospects for growth in oil exploration revenues. A source of revenues that has thus become more considerably larger is now attracting more than ever attention from states not benefiting from the distribution of oil revenues. This led, at the beginning of 2010, to what became known as the *Absten* Amendment which proposed a reformulation of the criteria for distributing royalties and special participations from oil exploitation.

Figure 2.2: Distribution of Royalties and Special Participations from Oil among States and Municipalities, by Federative Unit - 2010



Source: Afonso *et al* (2013).

The idea of the proposed amendment was to distribute revenues to all states and municipalities, regardless of their geographical location, adopting the criteria used for the FPE and the FPM, based on the argument that oil is a national asset, rather than belonging to just a few regional governments. Since then, the debate over the sharing of oil resources has been a topic much in vogue in the media and Brazilian political debates. In fact, it created a real war for resources between two government blocks: on the one hand, state and municipal governments with no relation to oil production defending the sharing of resources among all the regional governments; and on the other hand, the state and municipal governments of regions directly involved in oil production (or operations related to this activity) that defend the present system of distributing most of the resources to them.

The concentration of resources in a few regions is the biggest point of conflict. Just a few municipalities receive a large amount of resources to the detriment of others. Even within the State of Rio de Janeiro there is great inequality in the distribution of resources. Municipalities such as Campos do Goytacaz, Macaé, Rio das Ostras, and Quissamã benefit greatly, to the extent that some of them are among the cities with the highest per capita revenue in Brazil (Afonso *et al*, 2013).

There are other aspects, which are somewhat unrelated to theory and technical aspects, but which deserve to be addressed simultaneously because of the specific characteristics of the legislations concerned and the underlying philosophy of Brazilian fiscal federalism. The first is the levying of ICMS on the production and sale of fuel. The 1988 Constitution provides the general rules for mixed levying (origin/destination) of ICMS in interstate trade. It states that in the case of fuel, the tax should be levied exclusively by the destination state. This small difference causes states producing/selling oil and its derivatives, such as Rio de Janeiro, to lose a considerable portion of ICMS revenues. That is, the royalties could also be used as compensation for producer states' historical losses· even though, according to the Rio de Janeiro State Secretary of Finance, the ICMS losses are greater than the royalties received (Afonso *et al*, 2013). One way or another, the competition for funds continues among various levels of the government. The controversy attached to the distribution of revenue from oil and natural gas is not unique to Brazil; similar controversies continue to rage in other oil-producing federations . for example, in Canada and Nigeria. In the latter nation, a bitter civil war has already been fought over this issue, and millions of lives lost.

D. Co-ordination and Conflict Resolution

The case of distribution of royalties from petroleum and gas provides one of the best examples of federative conflicts and illustrates the problems arising from no formal mechanism for setting such disputes and co-ordinate federative issues in Brazil. In this particular instance, it is up to the central government to find a solution to this conflict of interests, but there are several instances of informal mechanisms that work to grease the federative wheel. On tax issues, there is the National Council of Fiscal Policy (*Conselho Nacional de Política Fazendária* . CONFAZ) that includes Secretaries of Finance and has legal prerogative to harmonize the ICMS, another major area of federative conflict. The Federal Senate also has legal authority over federative tax issues. Also, for some specific areas such as health and education, there are state secretaries forums as well as national councils that bring together the three levels of governments to harmonize service provision and other issues. Lastly, federative entities can always refer particular issues to the Supreme Court if they feel that the federative clause of the Constitution was breached. For example, it has already ruled the fixed shares of individual states in FPE as unconstitutional in February 2010, and called for a new system by end-June 2013. This is discussed in greater detail in a subsequent section of this chapter.

The cases of distribution of revenues from natural resources, harmonization and reform of ICMS, and the reform of distribution of FPE funds constitute three major reform areas generating considerable amount of controversy in recent times in Brazil. To these three must be added a fourth, the issue of controls on sub-national borrowing, which is discussed in more detail in a subsequent section. Suffice it to state here that while the sub-national entities are chafing at the reins, the issue of macroeconomic stability is seen to be closely connected to this issue, and hence the wisdom of a more relaxed system is being viewed with suspicion by many.

E. Imbalances in the Brazilian Federation

1. Vertical Imbalance

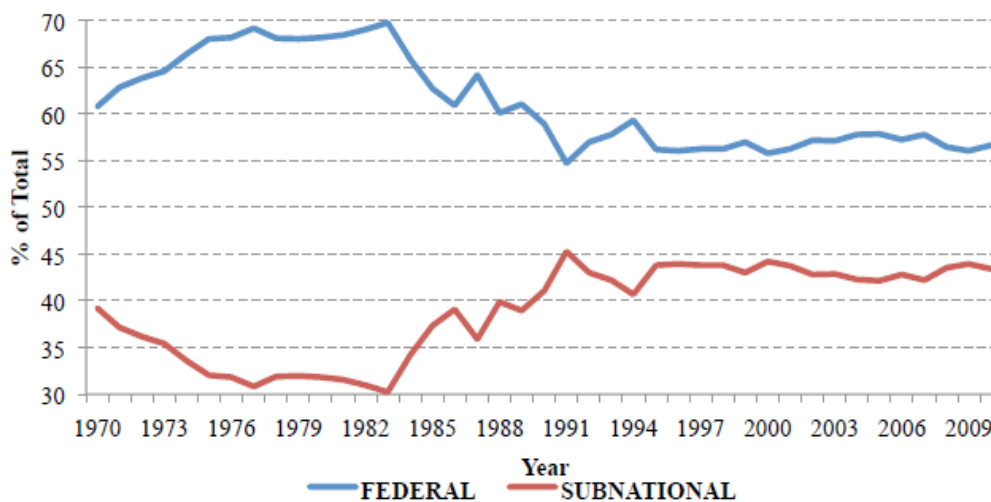
Vertical imbalance refers to the imbalance in available own revenue sources and expenditure responsibilities as per formal assignment of revenues and functional responsibilities with reference to different tiers of government. Conceptually this relates to the *revenue potential* and *expenditure needs*; but both these concepts being normative and therefore somewhat subjective, a proxy for vertical imbalance often used to determine its extent empirically is the comparison of *de facto* shares of different levels of government in revenue collections and in expenditures.

Table 2.6: Vertical Imbalances in Brazil - Shares in Revenue and Expenditure (2009)

Level of Government	Share in National Revenue Collection (%)	Share in National Expenditure (%)
Federal	67.7	49.5
Sub-national	32.3	50.5
State	26.2	30.2
Local	6.1	20.3
All Levels	100.0	100.0

Table 2.6 outlines the *de facto* vertical imbalance in the Brazilian federation before transfers. It can be seen that while the federal government has a surplus, the sub-national governments, particularly the local level governments have a substantial fiscal imbalance. This imbalance is sought to be corrected in the Constitution through the elaborate system of revenue sharing. We have noted above the pattern of assignment of revenue sources and collections; the sums received by each sphere of government through both direct collection and intergovernmental transfers are termed as the available revenue. These are represented in Figure 2.3 for a forty-year period to depict the long term trend.

Figure 2.3: Available Revenues by Levels of Government in Brazil



From the figure we note that an important transition clearly took place in the 1980s. The process started in 1983-1984, when the Federal Government's share of available revenue fell from almost 70 percent of the total to 66 percent. From then on, states and municipalities obtained increasingly more resources, peaking in 1991 when they received just over 45 percent of revenues after transfers. The institutional changes promoted since the early 1980s were responsible for this change. From

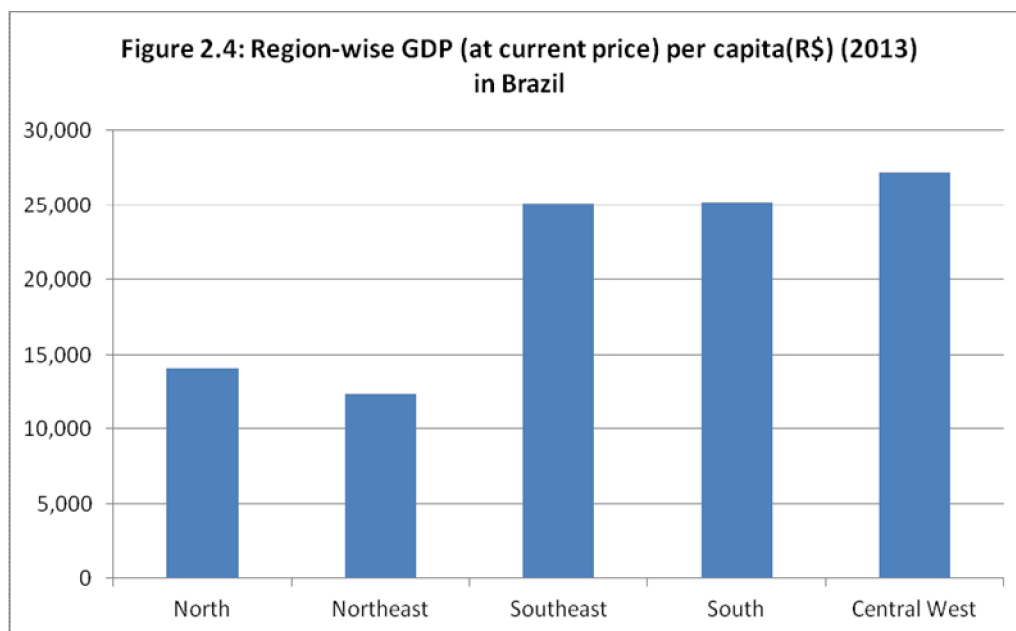
1991 to 1994, the decentralization process reversed slightly, but the process of macroeconomic consolidation since 1995 returned the shares to levels similar to that of 1991; except for small variations in specific years, they have remained stable. In 2010, the sub-national governments' share was approximately 43 percent of the total. In general, "contrary to what is usually defended as 'common sense,' the process of fiscal decentralization preceded stabilization and began during an extremely adverse macroeconomic context of hyperinflation, low growth rates, heightened tensions and increased social demands. But the fact is that today we have a highly decentralized system, in which sub-national units enjoy considerable autonomy, while the country's agenda is committed to the maintenance and guarantee of stability" (Afonso *et al*, 2013).

One of the guiding principles of the 1988 Brazilian Constitution was decentralization. In several policy areas, the state and local governments were given more responsibilities, such as primary and secondary education, public safety and urban planning. To ensure these tasks were properly carried out, fiscal decentralization or fiscal federalism was a fundamental mechanism. Empowered to legislate on taxation and constantly receiving funds from the central government, the states and municipalities have been given more autonomy to manage their resources and budgets than previously. The assignment of revenues and expenditure responsibilities outlined above indicate a substantial amount of vertical imbalance, particularly at the local government level. It can be seen that the extent of overall vertical imbalance is not larger mainly because there is only a small amount of vertical imbalance at the state level. However, the vertical imbalance at the local level is significant, necessitating corrective financial flows from other levels of government.

2. Horizontal imbalance

Unlike vertical imbalance, horizontal imbalances are highly significant in Brazil, and with no provision for fraternal (from one sub-national unit to another) transfers, the federal government has to take the responsibility for equalization, which could possibly account for a large part of the vertical imbalance. First, going by the broad regions, the regional inequalities are easy to deduce from Figure 2.4. The range of per capita income is indicated by the fact that the lowest (in the northeast region) is about a third of the highest (in southeast region). The relatively less developed status of the North and the Northeast regions are fairly obvious with the per capita income below the average. This is confirmed by one of the standard human development indicators . infant mortality rate (Table 2.7). It has come down across all the regions of Brazil over time, with a reasonably low rate of 34.08 for the

country in 2000. But the rate in the Northeast region can be seen to be almost double the national average, with the North also having a rate higher than the average and lower than only the Northeast.

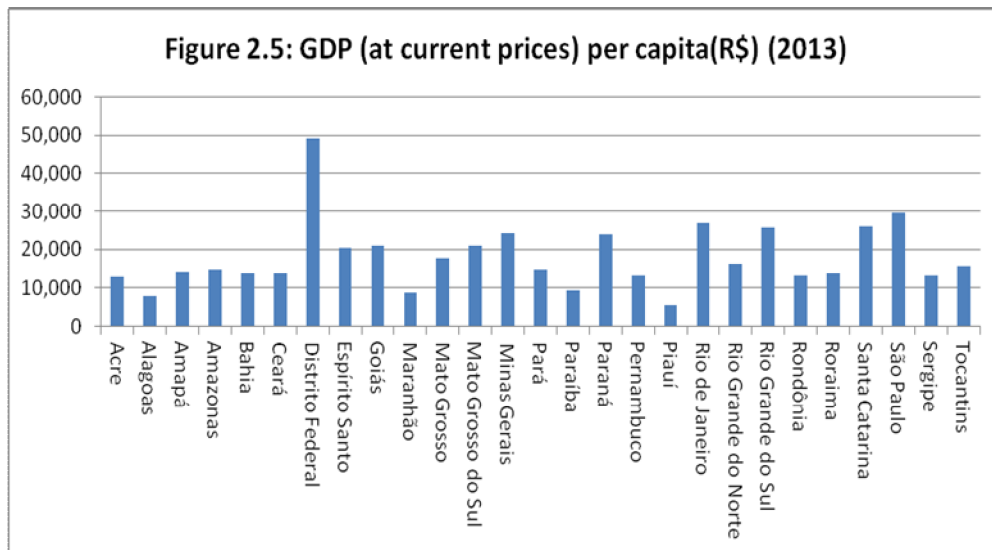


**Table 2.7: Infant Mortality Rates by Regions of Brazil
(per 1,000 live births)**

Regions	1970	1980	1991	2000	2010
North	180.07	135.12	48.93	41.14	21.38
Northeast	111.71	71.01	74.35	64.25	23.39
Southeast	97.34	61.08	34.42	27.46	12.80
South	80.95	51.69	28.93	23.59	9.96
Central West	92.22	59.59	38.6	31.00	16.70
Brazil	123.55	85.3	49.45	34.08	16.85

Source: Fundação IBGE, Census of Population.

Figure 2.5 breaks down the regional imbalance to the state level. It confirms the regional inequalities emphatically, because all the states in the less developed regions of north and northeast region without exception exhibit per capita incomes well below the national average. In fact, the majority of states are below the national average, the average being somewhat inflated by the figure for the federal district, clearly an outlier. As it is, only 8 states have per capita GDP equal to or above the national figure. But the low values of per capita income of the states of the north and northeast region are unmistakable.



Source: http://en.wikipedia.org/wiki/States_of_Brazil

F. Intergovernmental transfers

As in most federal systems, the central government bears the major burden of intergovernmental transfers, but the states in Brazil are also net transferors. States, which collected 9 percent of GDP in 2010, retained 8.6 percent of GDP after transfers. This means that, in net terms (received less transferred), this government tier transferred 0.5 percent of GDP, making it a net transferor. The municipalities, in contrast, are the only tier of government that receives more funds than they transfer, the net receipts being 4.2 percent of GDP. About 67 percent of revenues available to municipalities are received from the Federal and the state governments. The transfer of funds between government levels varies, and flows through several channels for different purposes. The major sources, in terms of volume of funds, are the ICMS, the Municipal Revenue Sharing Fund and the State Revenue Sharing Fund (see table 2.8).

Intergovernmental transfers finance the bulk of local government spending as a whole in Brazil. These are broadly structured as revenue sharing mechanisms, largely unconditional but also conditional for a small part. The complex system of intergovernmental transfers, accounting for 7.0 percent of GDP in 2010, consists of federal to state (2.3 percent of GDP), federal to municipal (2.6 percent) and state to municipal (2.1 percent) transfers, financed by well-defined revenue-sharing mechanisms depicted in Table 2.8.

Table 2.8 : Available Revenue by Level of Government - 2010				
	Total (R\$ Billion)	% of GDP	% of Total	R\$ per capita
Available Revenue - all levels of Government - 2010	1288.98	34.19	100	6940.7
Federal government	729.81	19.36	56.62	3929.77
States	323.36	8.58	25.09	1741.18
Municipalities	235.81	6.25	18.29	1269.75
Constitutional Transfers				
Federal government to states	73.78	1.96	5.72	397.26
FPE	39.02	1.04	3.03	210.13
FPEX	2.95	0.08	0.23	15.88
IOF Gold	0	0	0	0.01
ICMS Insurance	1.17	0.03	0.09	6.32
FUNDEB	11.28	0.3	0.87	60.73
Education Contribution	7.37	0.2	0.57	39.66
FEX	1.46	0.04	0.11	7.88
CIDE	1.34	0.04	0.1	7.21
Financial Aid to States	0.8	0.02	0.06	4.31
Royalties and Participations	8.38	0.22	0.65	45.15
Federal Government to Municipalities	65.82	1.75	5.11	354.42
FPM	43.07	1.14	3.34	231.91
ITR	0.36	0.01	0.03	1.95
IOF Gold	0	0	0	0.02
ICMS Insurance	0.39	0.01	0.03	2.08
FUNDEB	15.26	0.4	1.18	82.17
FEX	0.49	0.01	0.04	2.63
CIDE	0.44	0.01	0.03	2.36
Financial Aid to Municipalities	0.52	0.01	0.04	2.78
Royalties and Participations	5.3	0.14	0.41	28.53
States to Municipalities	92.05	2.44	7.14	495.68
ICMS	51.92	1.38	4.03	279.55
IPVA	10.64	0.28	0.83	57.29
FPEX	0.74	0.02	0.06	3.97
FUNDEB	28.76	0.76	2.23	154.87

Source: Afonso *et al* (2013)

Table 2.9 provides a summary of the revenue sharing arrangements. Mandatory unconditional transfers account for the bulk of the intergovernmental transfers (5.1 percent of GDP), followed by mandatory conditional transfers (1.7 percent). Both types of transfers are based on revenue sharing; as a result, they move in tandem with revenue collections and are hence pro-cyclical. Discretionary

federal grants, which could potentially play a countercyclical stabilizing role, are only 0.2 percent of GDP, around 3 percent of all intergovernmental transfers.

Table 2.9: Composition of Revenue Sharing Arrangements, 2011

Tax/ Type of Sharing	Percentage of GDP	Percentage of Total
Federal to States	1.7	28.4
FPE	1.2	19.4
Transfers for Education	0.3	5.9
Compensatory Sharing	0.1	2.0
Other	0.1	1.1
Federal to Municipalities	1.8	30.5
FPM	1.3	21.4
Transfers for Education	0.5	8.4
Other	0.0	0.7
States to Municipalities	2.5	41.1
ICMS	1.4	23.1
Vehicle Tax (IPVA)	0.3	4.6
Transfers for Education	0.8	13.0
Other	0.0	0.4
Total	6.0	100.0

Source: Ter-Minassian (2012)

The mechanisms of transfer from the Union to the states and local governments can be divided into three types: constitutional transfers, legal transfers and voluntary transfers. The main constitutional transfers are through the State Participation Fund (FPE) and the Municipalities Participation Fund (FPM). The legal transfers are regulated by specific laws like the automatic transfers to education and transfers to the health care system. The voluntary transfers usually relate to specific capital expenditure projects proposed by states and municipalities and submitted to federal institutions for approval on a case by case basis.

The FPE is distributed according to fixed coefficients for each state conforming to the following rule: 85 percent of the resources go to the states of the North, Northeast and Central West and 15 percent are transferred to the states of the South and Southeast. The regional distribution is: 25.37 percent to the North Region; 52.46 percent to the Northeast; 7.17 percent to the Central West; 6.52 percent to the South and 8.48 percent to the Southeast. This is a non-matching, unconditional transfer scheme and is expected to be the main instrument of equalization. But that objective may not be fully achieved at present, as can be surmised from Table 2.10 that shows some of the middle income states to be benefiting the most from this programme. One of the major problems with the fixed shares still being applied is

that they are not as equalizing as before, mainly because of ignoring the varied development experience of Brazilian states (and regions) over the last two decades, making the system out-of-date.

Table 2.10: Distribution of FPE Transfers vis-à-vis that of Per Capita Income in 2009

(R\$)		
State	GDP per capita	FPE transfers per capita
Piauí	5961	494
Maranhão	6161	408
Alagoas	6623	474
Paraíba	7506	457
Ceara	7668	313
Para	7809	300
Rio Grande do Norte	8753	479
Pernambuco	8892	286
Bahia	9326	233
Sergipe	9633	741
Acre	10477	1790
Tocantins	11072	1205
Amapá	11569	1973
Roraima	13008	2133
Rondônia	13217	671
Minas Gerais	14290	81
Amazonas	14360	297
Goíás	14387	175
Mato Grosso do Sul	15170	203
Paraná	17756	98
Mato Grosso	18742	277
Espírito Santo	19185	157
Rio Grande do Sul	19773	78
Santa Catarina	21076	76
Rio de Janeiro	22396	35
São Paulo	26385	9
Distrito Federal	51142	99

Source: Ter-Minassian (2012)

Note: States are arranged in order of GDP per capita.

The state shares are determined in the constitution and have remained unchanged since 1989. These shares were meant to be temporary, to be replaced by a new law to be enacted in 1992. The new law was never brought to vote in the Congress and the fixed shares continue by default. The current FPE sharing criteria were ruled unconstitutional by the Supreme Court (*Supremo Tribunal Federal*) on February 24, 2010 based on the view that they do not meet the constitutional principle of promoting social and economic balance between the states and therefore compromised the federative pact. New rules were then asked to be put in place by

end-June of 2013. This has not happened yet; instead, it is slated to continue till 2015.

From 2016, the total FPE transfers are to be based on the amount for the previous year adjusted for inflation and 75 percent of GDP growth; the distribution among states will be based on population and household income per capita. If the total amount of the FPE envelope is higher than the sum of the adjusted FPE values, then the surplus would be distributed in direct proportion to the share of population of each state and in inverse proportion to their per capita household income. The population shares have a lower bound of 1.2 percent and an upper bound of 7 percent, benefiting the least populated states such as *Roraima*, which is the least populated state with 0.24 percent of the national population. A provision to limit the effects of tax breaks given by the federal government on FPE was included, but was vetoed by the President. The veto was then maintained by Congress. It is easy to see that even the new scheme will be only equalizing in a limited sense, because the lone determinant of per capita income is too simplistic and ignores both revenue advantages like those from natural resources and cost disabilities.

The FPM is distributed according to the population of the municipality and the inverse of average income of the municipality. There is also some differentiation between the state capitals and other municipalities (hinterland). Of the total resources, 10.0 percent are distributed to the state capitals; 86.4 percent for the rest of municipalities and 3.6 percent to municipalities (excluding the capitals) with population above 142,633 inhabitants. This is the second largest transfer programme, largely unconditional. The FPM makes payments to a municipal government exclusively on the basis of its population size (actually, the share depends on the population size category it would fall in, out of 18 predefined categories) with a condition that municipalities must spend 25 percent of the transfers on education (Art. 212). However, this constraint is usually considered non-binding.

Given that size of the population is not necessarily indicative of the status of development of a city, the distribution criteria for the FPM put at a disadvantage the relatively populous and frequently poor satellite cities (*ciudades dormitorio*s) surrounding large municipalities and capital cities, thereby reducing their capacity to provide essential public goods and services to the population. In contrast, the criteria benefit disproportionately small municipalities that grow around large industrial establishments, and that already benefit substantially from own revenues and devolution-based state transfers+ (Ter-Minassian, 2012).

The largest component of intergovernmental transfers in Brazil in terms of the amount involved, sharing of the ICMS is predominantly based on origin and thus non-equalizing. 75 percent is distributed on the origin basis (value added in various municipalities), and 25 percent according to criteria determined by each state, of which there exists a large variety with substantially different objectives.

Natural resources with major revenue potential are constitutionally owned by the federal government, but the revenues are shareable with states and local governments. These revenues are derived predominantly from the oil and natural gas sector. Different sharing schemes are specified for different types of petroleum revenue, but broadly speaking, the largest weight is that of origin. As such, the transfers under this component are very lopsided, with five states accounting for 97 percent of the transfers, and Rio de Janeiro alone accounting for around 85 percent.

There are several other unconditional sharing mechanisms in place for various other taxes . federal tax on rural properties shared with local bodies, federal tax on gold purchases shared with states and municipalities, and state level vehicle tax shared with local governments . but the amounts involved are relatively small. However, the multiplicity of transfer channels and the variety of criteria adopted makes it difficult to assess the overall impact of the transfer system in terms of the major objectives that one may think of.

There are three major categories of specific purpose transfers. The first relates to education, and the transfers are organized through a fund (*Fundo de Manutenção e Desenvolvimento da Educação Básica*, or FUNDEB). This is constituted with 20 percent of state and municipal revenues, supplemented by at least 10 percent of the federal revenues earmarked for education. The distribution is on the basis of indicators relating to basic education.

The specific-purpose transfers in the area of health are less organized, with a number of transfers involved each with its own distribution criteria . some of these mandatory and others discretionary. These transfers are mostly from the federal government to sub-national governments and together amount to more than a third of the total public expenditure on health.

The third category relates to the federal levy on import and sale of fuel (CIDE). 29 percent of the collection is transferred to the states, each of which passes on 25 percent to the local governments. The purposes for which these transfers can be utilized include financing ethanol subsidies, environment-related projects to counter degradations relating to oil and gas exploration, and investment in transport infrastructure including roads. This category is now defunct since CIDE was zero-rated from 2012.

To compensate states for zero-rating industrial exports under ICMS, the federal government shares 10 percent of IPI (federal selective VAT) on the basis of share of exports originating in different states. Another compensatory transfer relates to the so-called Kandir Law, which zero rated exports of primary and intermediate products. Under this scheme, compensatory transfers are composed of two components, one that is set in law and has fixed coefficients for the states and the other which is negotiated yearly. This transfer has been kept stable in nominal terms in the recent years.

On the whole, the Brazilian transfer system has the advantages of being broadly equalizing to some extent, generally formula-based and therefore non-negotiable and predictable, as also large enough to make a difference. On the negative side, the system is probably unnecessarily complex with no uniformity or clarity of objectives, cyclically volatile being almost entirely based on tax sharing, and with no consistent pattern of equalization.

G. Delivery of Public Services and Conditional Cash Transfer (CCT) Scheme in Brazil

Brazil today has excellent human development indicators across the country: there is no state with less than 90 percent literacy and life expectancy below 70 years. The public services for education, health, and water supply are considered to be characterized by wide coverage and of reasonable quality. Transportation and communication services . public and private put together . are also better than adequate. There are, of course, pockets of poor public services in large cities (primarily in slum areas at the outskirts) and outlying areas with very low population density, as also with respect to a few specific public services like sewerage and housing, but overall, the Brazilian citizen has witnessed considerable improvement in supply of basic amenities and services in the last two decades. The population under poverty has also considerably decreased in recent years (World Bank reports 9

percent poor in 2012 as compared to 16 percent in 2007) despite the global financial crisis, although the distribution of income and wealth is heavily skewed. An important reason for the reduction in poverty has been the emphasis on adequate public supply of social services as a strategy for achieving sustainable exit of families from poverty. In this endeavour, the tendency of some of the poor to use public services less than others was noticed, despite the availability in terms of access. Investigations into the causes and a search for remedies led to the gradual introduction of now well-known schemes of conditional cash transfers (CCT).

The idea for CCTs in Brazil emerged out of two strands of debate: first, the inclusion of social assistance as a basic right for the needy (among many other social rights) in the 1988 Constitution and then in the 1990s with various legislative actions to formalize social assistance and minimum income schemes and second, the realization that poverty reduction strategy needed to go beyond the symptoms (low current incomes) and address the underlying structural sources of poverty. The basic premise for the initial linking school attendance to cash assistance was based on demand-side constraints: even if schools are available, poor children cannot always attend due to direct and indirect (opportunity) costs. Cash assistance was seen as an incentive to help counter these demand-side constraints and promote school attendance.

The story of CCT in Brazil started when the first two CCTs were launched in two Brazilian municipalities (representing two different political parties) during the same week in January 1995. These programmes became a model that multiplied in many municipalities and states in Brazil. By 2001 over one hundred municipalities and many states were operating local CCT programmes in Brazil, covering around 200,000 families. All of these programmes had three key features in common: (a) they were targeted to the poor through some sort of means testing (income ceilings); (b) they paid cash to the families (usually the women); and (c) they required some sort of counterpart responsibilities+ (*contrapartidas*) on behalf of the beneficiaries. These conditionalities usually involved: (a) enrolment requirements for school aged children; and (b) minimum daily school attendance requirements (80-90%), monitored by attendance records presented by the parents or in the schools themselves. In fact, the emphasis of the municipal programmes was primarily on their role as education instruments . and with the income transfers serving as incentives to promote educational goals. Some of the early sub-national CCTs also included additional conditions, such as prohibiting beneficiary children from working, child

participation in extra-curricular activities, adult participation in community meetings or seminars and/or literacy programmes, and so forth. Most programmes also included minimum residency requirements (five years) in the municipality or state, out of fear that the lack of a national programme would attract poor migrants to their jurisdictions.

Following on the successful experiences with municipal cash transfer programmes, the federal government started providing co-financing to municipal CCTs. In 1998, the federal government thus launched the Programme for a Guaranteed Minimum Income (PGRM). It provided transfers to municipalities who were implementing CCTs but lacked sufficient resources to sustain such programmes. The PGRM was not a conditional cash transfer programme in and of itself, but rather a mechanism for providing financial support to municipalities to enable them to implement such programmes. As such, it was integral in promoting and sustaining local level CCT initiatives, and also acted as a gateway for future conditional cash transfer programmes.

In 2001, the federal government introduced the Federal Bolsa Escola (BE) Programme as a replacement to the PGRM. The Federal Bolsa Escola programme was modelled after the municipal programmes and managed by the Ministry of Education. Under the BE programme, poor families received cash assistance per month per child up to a maximum of three children, conditional upon a minimum school attendance of 85%. The four central objectives of Bolsa Escola (BE) were to (a) increase educational attainment and thus attempt to reduce poverty in the long run; (b) reduce short-term poverty by providing an income transfer to poor families; (c) reduce child labor; and (d) act as a potential safety net. Bolsa Escola targeted families with children in the age range from 6 to 15 years, and with per capita monthly incomes no greater than R\$90 (US\$43).

The federal government also launched in 2001 the Bolsa Alimentação (health and nutrition grants, BA) programme, which sought to reduce nutritional deficiencies and infant mortality among the poorest households in Brazil. The BA programme also confined itself to poor families and paid the determined benefits per child up to a maximum of three children, targeting pregnant and lactating women and young children. Programme conditionalities consisted of complying with a minimum schedule of pre-natal and post-natal care visits, monitoring the growth of children, and keeping their vaccinations up to date, as well as participation in nutritional

education seminars. Eligibility for BA expired when children completed 7 years of age. They then became eligible for the BE programme as they entered the school system.

On October 20, 2003, the Bolsa Família Programme (BFP) was launched as a merger of the pre-reform cash transfers. The objectives of these reforms included: (a) consolidating and rationalizing federal conditional cash transfer programmes; (b) promoting efficiency in the use of public resources (administrative costs were indeed reduced as a result of this merger, as discussed below); (c) improving the system for identifying the target population; (d) leveraging synergies from jointly promoting education and health incentives; (e) strengthening monitoring and evaluation; and (f) leveraging opportunities to systematize complementarities in the social safety net between federal and sub-national programmes (promoting vertical integration).

Targeting for the BFP is done through a combination of methods: geographic and household assessment based on per capita incomes. Geographic targeting is applied at two levels, federal and municipal. Family eligibility is determined centrally (by MDS) based on household registry data collected locally and transmitted into a central database known as the *Cadastro Único*. Brazil has not yet adopted an official poverty line, so the income ceilings for eligibility are set to mimic the most generous of those of the pre-reform programmes with the principle of ensuring that families did not lose from the reforms. The BFP abandoned the previous practice, however, of indexing these thresholds to the minimum wage (e.g., at $\frac{1}{2}$ or $\frac{1}{4}$ of the minimum wage). Eligibility thresholds are revised occasionally, in order to account for increases in the cost of Living. In the end, the programme designers opted for a pragmatic set of benefits that (a) was simple to administer; (b) favoured the extreme poor; (c) favoured families with children . but with limits to avoid promoting fertility; and (d) prevented eligible beneficiaries of the pre-reform programmes from losing from the reforms. This latter consideration was viewed as politically important in light of the BFP's birth as a reform programme.

The BFP provides two types of benefits: basic and variable, according to family composition and income. The BFP provides a base benefit to all families in extreme poverty; regardless of their demographic composition (moderately poor families do not receive this base benefit). Both extreme poor and moderately poor families receive a variable benefit set according to the number of children in the family (capped at three for variable benefits purposes) and whether the mother is pregnant or breast-feeding. The transfers are conditional on all age-relevant family

members complying with key human development conditionalities. This represents an important policy shift in which the assistance unit for the BFP is the family, not just a sub-set of individuals as was the case under the pre-reform programmes.

An important feature of the Bolsa Família Programme is its implementation in a highly decentralized context. While the BFP is managed by the Ministry of Social Development (MDS), numerous other agencies, both centralized and decentralized, are involved in various aspects of programme implementation. A brief summary of the main institutions involved and their responsibilities is as follows:

- **The Ministry of Social Development (MDS)** is the programme's policy and supervision agency. Within MDS, several secretariats are involved in the BFP:
 - The Bolsa Família Secretariat (*Secretaria Nacional de Renda de Cidadania*, SENARC) oversees the overall programme and its registry (*Cadastro Único*), and is responsible for beneficiary selection, payments authorization, administering consequences for noncompliance with conditionalities, monitoring of the programme, and training municipal managers.
 - The Secretariat for Information Management and Evaluation (*Secretaria da Avaliação e Gestão da Informação*, SAGI) is responsible for commissioning longer-term impact and implementation evaluations (qualitative and quantitative);
 - The National Secretariat for Social Assistance (*Secretaria Nacional de Assistência Social*, SNAS), which is responsible for overseeing the federal government's social assistance programmes for specific vulnerable groups (such as the LOAS/BPC+cash transfer programme for the elderly and disabled, the PETI programme for child labourers, various programmes for youths, social worker services for families at risk, etc.);
 - National Secretariat for Food Security (*Secretaria Nacional de Segurança Alimentar e Nutricional*, SESAN), which oversees a number of other complementary programmes focused on hunger and food security (under the Fome Zero umbrella).
 - Finally, SENARC interacts with the Secretariat for Institutional Articulation and Partnerships (*Secretaria de Articulação Institucional e Parcerias*, SAIP), which handles inter-government and inter-ministry partnerships and outreach with civil society relating to activities for generation of labour and incomes.

- **Municipalities** carry out many aspects of programme implementation. They are responsible for maintaining a local coordinator for the programme (local programme point-of-contact), registering potential beneficiaries in the Cadastro Único, monitoring fulfilment of health and education conditions and consolidating associated information, prioritizing BFP beneficiaries for other complementary services, and establishing social control councils (SCCs).
- The **Caixa Econômica Federal** has been contracted as the programme's operating agent. The Caixa consolidates and manages the national registry database for social programmes, assigns registered individuals the unique Social Identification Number (NIS), and makes payments directly, crediting beneficiaries' electronic benefit cards (EBCs) on a monthly basis through its extensive banking network .
- The **Ministries of Health and Education** are responsible for establishing technical and operational guidelines regarding school attendance (Ministry of Education, MEC) and health conditionalities (Ministry of Health, MS). They are also responsible for promoting the training of state and municipal managers in monitoring human capital conditionalities. Finally, they are responsible for consolidating conditionality compliance information and reporting this information to MDS.
- **State governments** provide technical support and training to municipalities (particularly for smaller municipalities). They also provide basic and complementary services, along with the municipalities. Finally, states are responsible for providing identification documentation for all families in the Cadastro Único registered in their jurisdiction. Three controls agencies . the General Controllers Office (CGU), the Federal Audits Court (TCU), and the Office of the Public Prosecutor (MP) . are responsible for formal oversight and controls of the BFP.

While most assessments agree that the CCTs have succeeded in meeting their objectives to a significant extent, certain reservations are also being expressed. Steady economic growth has significantly reduced the impact of poverty in Brazil over the last 15 years or so; to that extent, the relevance of CCTs is declining. Coverage has reached around 50 percent of the poor (the targeting conditions may

not actually require any significant further increase), but among the beneficiaries about half are now estimated to be non-poor (Stampini and Tornarolli, 2012). In this light, further expansion of CCTs is not called for, and there is probably a case for gradually tightening and reducing the scope of these expensive programmes with large administrative costs.

H. Sub-national borrowings in Brazil

Sub-national debt in Brazil experienced prolonged crises during the 1980s and 1990s. This period was also characterized by macroeconomic instability, balance of payments crisis and oil shocks in the Brazilian economy. Three rounds of debt restructuring of sub-national governments were carried out by 2000. The first two rounds in 1989 and 1993 were essentially bailout operations from the central government through renegotiations, but were not very successful in restoring sustainability to sub-national debt and present an example of moral hazard.⁷ The failure was mainly because of (a) not refinancing the sub-national debt and (b) the structural origins of the problem . sub-national fiscal imbalances . were not tackled.

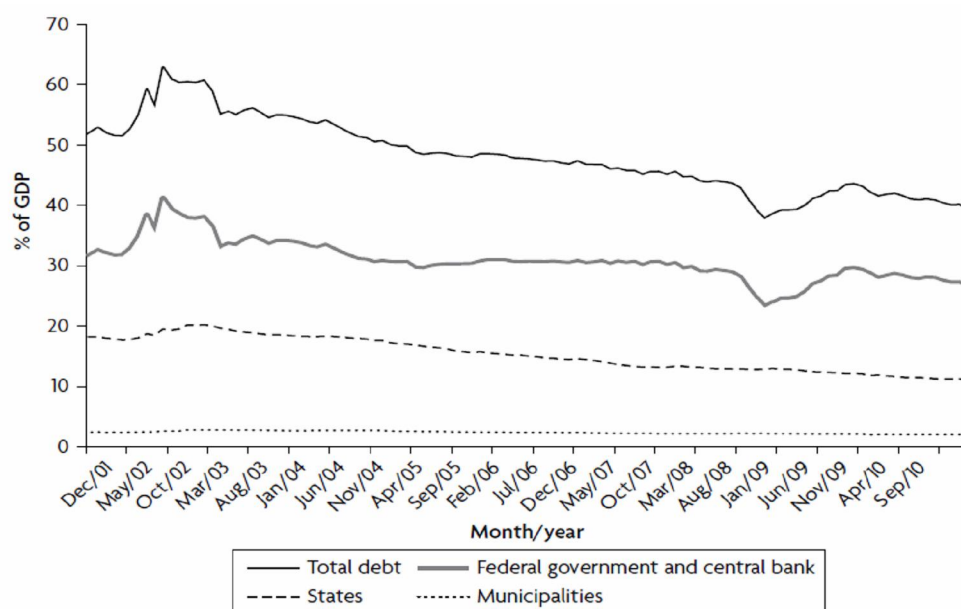
A new framework emerged through the largest renegotiations between 1997 and 1999 that included states' debt. The debt restructuring was conditional upon their compliance with rolling three-year medium-term fiscal reform plans and structural adjustment programme determined in agreement with National Treasury Secretariat (*Secretaria do Tesouro Nacional*, STN). This was important because the federal government was/is the largest lender to the states. Similar renegotiations were concluded with the local bodies in 2001 (see Manoel, Garson and Mora, 2013 for details). The fiscal responsibility legislation was adopted in 2000, which was complemented by two important Senate resolutions in 2001. The period after 2000 also saw significantly improved fiscal positions of sub-national governments.

The terms of renegotiation were not uniform for all states: the rate of interest charged on rescheduled debt were 6, 7.5 or 9 percent plus the general rate of increase in price level depending on the extent of initial debt stock till 2000 amortized, although the maturity period of all rescheduled debt was uniform at 30 years. A subsidy to the extent of the difference between the benchmark interest rate and the actual rate charged to the state government was payable by the federal

⁷ Brazil's experience with sub national borrowing during this decade serves as a cautionary tale of the deep and lasting effects that weak central control, macroeconomic instability, fiscal indiscipline, and insufficient regulation can have on a country's public finances. This story in large part reflects the legacy left by imprudent lending by state banks and failure to subject the states to the discipline of the capital market.

government. State government owned banks were either closed down, or privatized, or recapitalized on a case by case basis. Together, all these changes contributed to a consistent reduction in sub-national indebtedness (Figure 2.6).

Figure 2.6: Public Debt in Brazil, 2001-10



Source: Manoel, Garson, and Mora (2013)

Currently, the framework for sub-national debt consists of three pieces - the Fiscal Responsibility Law 2000,⁸ the Senate's Resolutions of 2001, and a resolution from the National Monetary Council (CMN, *Conselho Monetário Nacional*), which has put a cap on overall lending from the banking sector to public sector institutions.⁹ There is also a ban on further debt renegotiation between levels of government to avoid moral hazard. There was also a ban on further bond issues by sub-national governments till 2020, though federal debt is not constrained at all. This new essentially administrative framework to control sub-national government indebtedness mimics market discipline through a rule-based system, insofar as creditors are well aware that bailout operations are no longer possible, and lending to financially weak governments may lead to losses. The system is characterized by an absence of competitive domestic market for sub-national debt instruments and

⁸ The fiscal responsibility law imposes charges if public sector managers do not meet their requirements. It limits public sector debt and expenditure, including on payroll (60% of current revenues of sub-national and 50% of the national government) and prohibits the bailing out by the federal government of new debts contracted by sub-national governments.

⁹ This has lost its teeth over the years, because the small original list of exceptions has been repeatedly added to.

participation of public banks in credit operations relating to sub-national governments.

Borrowings by sub-national government are now controlled. In order to borrow, federal, state, and local governments have to obtain the approval of their legislature; additionally, to avail of foreign loans, sub-national governments have to (a) submit their request to the federal Ministry of Finance which issues a report sent to the Senate recommending approval or rejection of the request, and (b) obtain Senate approval. The last mentioned is required for federal foreign debt too.

The Fiscal Responsibility Law sets a limit of 200 percent for the states and 120 percent for the municipalities on the debt to net current revenue ratio (current revenue net of certain national government transfers). There is a legal limitation on the amount of new debt flows and a limit of 12 to 15 percent on the debt service to net current revenue ratio. If debt service exceeds the prescribed limit in any year, the excess is capitalized and gets added to the principal under the same terms. A loan request from a state or municipality is subject to scrutiny by the Ministry of Finance, to ensure compliance with the limits and conditions set by the Senate; and domestic banks are free to reject any loan request.

However, a broader planning framework for sub-national borrowing is still lacking in Brazil. A new cycle of sub-national borrowing started in 2008, in line with the renewed emphasis on infrastructure investments as a driver of growth and later as part of the government response to the global crisis. This new cycle was enabled by the post-crisis creation of a new financing line by the National Bank for Social and Economic Development (BNDES) for sub-nationals, increasing sub-national lending by two major public banks, and greater reliance on multilateral sources for infrastructure financing at the state and municipal levels. In 2012, the federal government allowed 21 states to raise an additional debt of R\$58.3 billion (USD29.1 billion), representing roughly 14 percent of total outstanding debt with the federal government. Significant investment needs that exceed the states' financing capacity and are not suitable for or able to attract private investors are expected to drive up sub-national debt in Brazil in the coming years.

Sub-national governments in Brazil do not have earmarked funds dedicated to the repayment of financial debt. They have traditionally relied on loans provided by state-owned institutions, multilaterals, and supranational agents in maturities of over 10 years. However, these traditional creditors are said to be approaching their

lending limits. Sub-national solvency is a matter of concern again as the interest subsidy to the sub-nationals is plummeting because the benchmark rate has been declining over the years, closing the interest rate gap. Further, the debt service cap together with the evolution of macro conditions has led to significant accumulation of unpaid ~~excess~~ debt servicing obligations by major sub-national governments. The accumulation of the ~~excess~~ has put in question the ability of some states - Rio Grande do Sul, Minas Gerais, São Paulo and Alagoas, and the Municipality of São Paulo . to be able to fully repay their debts to the federal government within the agreed timeframe. Both factors have contributed to the ongoing pressure by some sub-nationals to renegotiate the terms of their debt with the federal government.

Despite the many reforms in regulation, the criteria used by the federal government to authorize new debt are not transparent. In order to promote orderly growth of sub-national debt, the internal ratings assigned by the federal government for the purpose of providing guarantees to the debt of sub-national governments, as well as the loan agreements should be widely disseminated in the public domain. Also, the analysis of repayment capacity, multiplier effects in the regional economy, underlying risks, and federal debt limits (none at present) should be considered as part of the process of authorizing new loans. The highly indebted state of Sao Paulo was allowed to increase its debt level by 6.6 percent or R\$11.9 billion. Other states in the Northeast region that obtained permission to raise new debt are highly dependent on federal transfers as a revenue source. Unless these funds are channelled to investment, the new debt could pose a threat to the financial profiles of many states, since they are already relatively highly indebted and have committed a significant proportion of revenues to meet interest payments. However, the need for resources at the sub-national levels to finance public investments, particularly given the narrow fiscal space, cannot be wished away. Thus, for the sub-national governments % challenge ahead is to identify ways of increasing infrastructure investments and finance while maintaining fiscal discipline+(Manoel, Garson, and Mora 2013).

De Mello (2001) argues that fiscal decentralization should not only prevent fiscal disarray at the local level, but should also insulate central government finances from fiscal imbalances at the local government level. His conclusions are that sub-national borrowing costs are greater when local government have a greater reliance on grants and transfers from the central government. Based on this conclusion he makes a series of recommendations.¹⁰

¹⁰ De Mello (2001) recommended policies are:

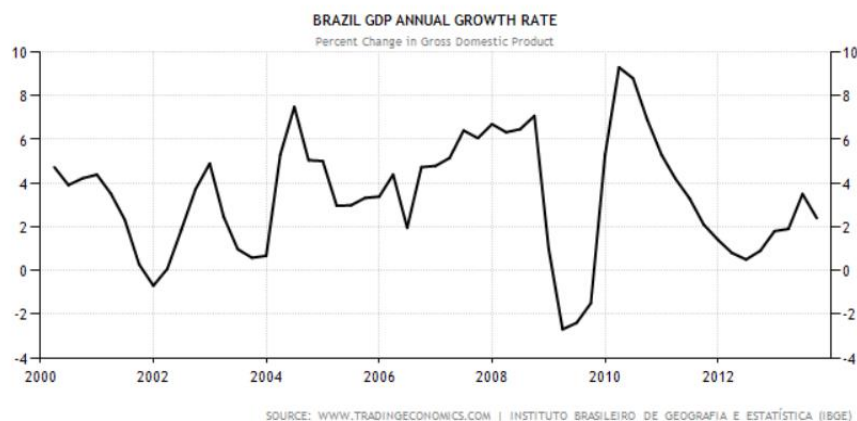
Martell (2008) examined the effectiveness of Brazilian fiscal institutions (constitution, fiscal responsibility law, and borrowing arrangements) in the light of 2001 policy recommendations for strengthening efficiency and fiscal discipline in sub-national borrowing by means of fiscal policies that encourage efficiency, discipline, and controls. The study found that the Brazilian institution arrangements for municipal borrowing achieve some of de Mello's (2001) recommendations, but some practices and values diverge. The values advocated by de Mello are efficiency, discipline, and controls; however, the values promoted by the actual institutions in Brazil are administrative feasibility, equity, fiscal discipline, rule-based control, protection from political intervention, certainty and some constructs of efficiency. Finally, one of the main conclusions is that while the constraints imposed by the fiscal arrangements have been very effective at controlling expenditures, the encouragement of long-term discipline is limited to rule-based, not market-based, control. It is recommended to have a reform in the fiscal law in order to leverage fiscal management to reward successful performance by establishing policies that enable local governments' access to a broader tax base, greater discretion at setting tax rates, and more extensive borrowing options. One may add that competition among sub-national entities in the debt market could also promote the imposition of market discipline on them.

I. Recent global financial crisis and sub-national finances

In the last two decades, different administrations in Brazil have maintained and built on a macroeconomic framework of inflation targeting, a flexible exchange rate and rules-based fiscal management. It paved the way for a gradual stabilisation of government indebtedness, which facilitated a countercyclical response to the slowdown in activity brought about by the global crisis of 2008. 09. Structural reforms during the 1990s, not least to liberalise the country's trade and investment regimes and to make regulations in product markets and network industries more pro-competition, yielded important productivity gains and alleviated several structural impediments to faster growth. These factors helped considerably to mitigate the fallout of the global financial crisis in the real sectors of Brazil and kept it on its feet.

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- Spending and revenues should be aligned at the local level;
 - Local government fiscal management should be encouraged through the use of stringent constraints on local government indebtedness via fiscal institutions and markets; and
 - The form of decentralized arrangements should be carefully designed (for example, revenue sharing arrangement should encourage local revenue mobilization, institutional arrangements should foster fiscal discipline, and earmarked transfers should be avoided).

Figure 2.7



As the US financial crisis broke in 2008, it did not immediately have any major impact on the Brazilian economy, largely because its exposure to the toxic financial instruments was negligible. Also, the relatively low dependence on foreign trade as such, and on exports to industrialized countries, made for only a minor fall in demand for its exports. The larger share of primary goods in its exports, the demand for which was relatively stable and prices rising, also made the contagion effect less severe. But after a few months, the liquidity problem of most financial institutions of industrialized countries impacted their investment in Brazil negatively, and they withdrew as much liquidity as they could, including repatriation of profits and suspension of investment plans. This did cause a fall in available credit and the growth rate of the Brazilian economy in 2009 until the government countered it with fiscal measures, and the economy bounced back (Figure 2.7). But a milder form of the negative impact lingers on to date; this has had some fiscal implications.

The federal government responded to the crisis by tax cuts and new concessions for investment, keeping its expenditures intact. In fact, although public expenditures have grown in Brazil during and after the 1990s, they have been financed by rising taxes, in spite of an already high tax-GDP ratio. Different distributive and social protection programmes have been introduced since the early 1990s. At the federal level, spending on payroll has been on the rise following several years of stability, and pension outlays already account for about 12 percent of GDP (including both social assistance and insurance programmes benefiting private- and public-sector workers). These expenditure commitments, together with sizeable primary budget surpluses needed to service a large public debt, have been financed through successive revenue hikes in a fiscal landscape with a fairly

burdensome and complex tax system. Some researchers believe that greater effort is therefore needed to break this vicious spend-and-tax circle (de Mello, 2007), which may be difficult to sustain over the longer term without further prejudice to the economy's growth potential.

During and after the crisis, despite the tax cuts and concessions, the tax-GDP ratio did not really fall, but did stagnate unlike in the earlier years when it was steadily growing. The same happened at the sub-national level too, but their revenues did suffer some setback, because the stagnant tax collections at the federal level meant less than expected transfers to states and municipalities. The main problem at the sub-national level was that expenditure commitments were made on the assumption of higher levels of expected revenues that did not materialize, but they could not back out from the expenditure commitments, particularly when business sentiment was already shaky. The resultant budgetary resource imbalance . considerably more pronounced in states and municipalities that depended heavily on transfers . was managed through some relaxation on the control over their borrowing, as mentioned in the previous section. Even this was predicated upon only a short period of resource crunch, but the problem has turned out to be of a longer duration than anticipated, causing some disquiet and apprehensions now. On the positive side, federal countercyclical policies benefited the sub-national governments, along with the reduction in rate of inflation and the nominal interest rate, limiting the burden of additional borrowing. Also, the resilience of domestic consumption demand has been a distinct advantage in weathering the global crisis.

The fiscal expansion at the national level was partly counteracted by fiscal contraction by subnational governments in 2009. The fiscal deficit of the central government expanded 3 percentage points of GDP, reflecting both the operation of automatic stabilizers and discretionary stimulus measures, including temporary tax reductions and spending increases. However, in 2009 the fiscal deficit of subnational governments (states and municipalities combined) contracted 1.3 percentage points of GDP, turning into a small surplus. This was partly helped by some extraordinary transfers to municipalities from the federal government. The net effect was a fiscal expansion of 1.7 percentage points. In subsequent years, however, the sub-national deficits have been creeping up because of greater borrowings.

To sum up, the federal three-tier presidential system of government in Brazil is backed up by a bicameral legislature and a multi-party-party democracy. All three levels of government are given substantive functional responsibilities by the

Constitution and these assignments broadly correspond to other similar federations. The revenue powers are also fairly decentralized with the most productive indirect tax . ICMS, which is the main component of the VAT system . collected at the state level and shared with local bodies. Further, there is liberal sharing of other sources of revenue collected at the centre, including those from natural resources. However, there is some centralizing tendency discernible in recent years with the federal government introducing non-shareable instruments of revenue collection at its own level (social contributions).

Even so, there is a significant amount of vertical imbalance particularly at the local level, partly attributable to significant horizontal imbalances necessitating equalizing transfers from the federal level to the other two and from the state level to local. The transfer system is heavily dependent on the shared revenues, making the system rather pro-cyclical and hence somewhat unsuitable for recessionary periods. The equalizing potential of the system is also suspect because of (a) origin based sharing of revenue from natural resources, (b) failure to consider both expenditure and revenue sides while determining intergovernmental transfers, and (c) weak equalization potential of the formula-based transfers. Even the change in the system that is on the cards is unlikely to correct this.

The sub-national governments in Brazil have performed reasonably well in terms of discharging their constitutional obligations of providing designated public services. The federal system in Brazil is vibrant enough to throw up specific innovations that eventually got implemented at the national level (the conditional cash transfer scheme, which is assessed to have contributed to the reduction in poverty and improvements in utilization of basic services although its relevance may be reduced now). But it also engenders conflicts of interest and controversies from time to time and there are several institutions to deal with these issues in a consultative manner; the final recourse, of course, is to the judicial system. At the present juncture, there are a few issues relating to federalism that are being debated nationwide . one of these relates to the strict control of sub-national borrowing under the fiscal rules, and the demand for their relaxation. A history of poor sub-national fiscal management and unsustainable borrowing in the past is now pitted against increasing resource requirements at the sub-national level not matched by their own revenues and intergovernmental transfers. This is because the recent global financial crisis has left a long-term recessionary impact on Brazil (as on several other economies) although its short-term fiscal impact on sub-national governments was mild and successfully countered at that time by federal compensatory fiscal policies.

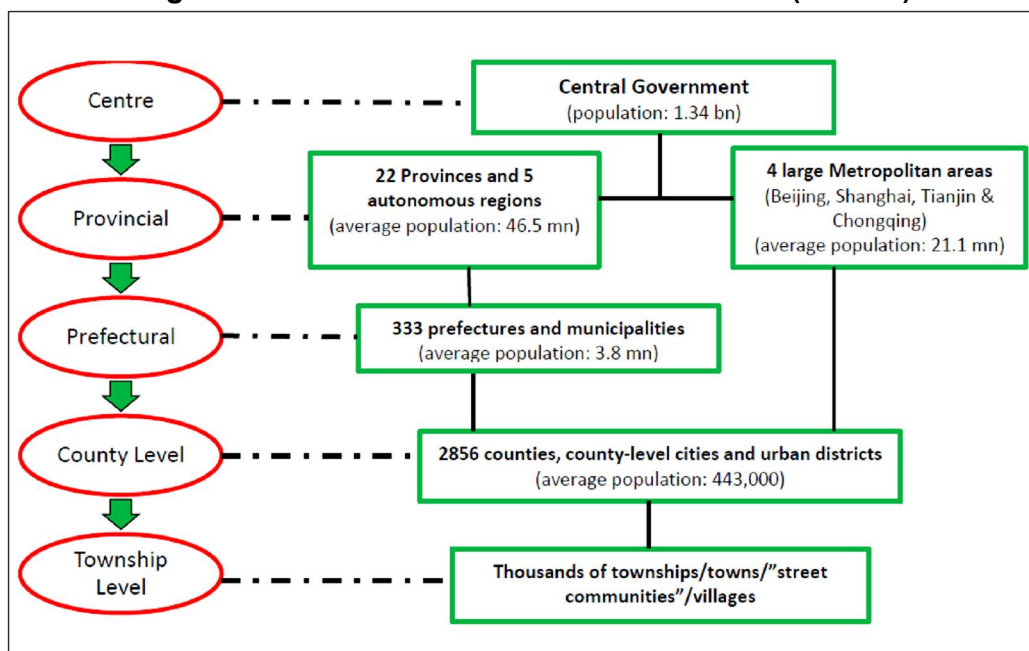
Chapter III: Intergovernmental Finances in China

A. Introduction

Restructuring of intergovernmental fiscal relations has been an important issue in most of the developing and transitional economies in recent decades. The focus is on decentralization and its effect on the quality of governance. China's transition from a centrally planned economy to a free market economy and its simultaneous transition from a closed economy to an open economy shaped the reform of its intergovernmental fiscal relations. China entered its reform and opening up stage in the late 1970s. Since then its intergovernmental relations have experienced fundamental changes.

China is a large country making a transition from Soviet type planning to market-based development. Although China remains a unitary political system, the current structure of governance bears prominent features of fiscal decentralization. Sub-national governments in China are organized into a five-level hierarchical structure comprising of central government, provincial level government, prefectures and municipalities, county and township comprising of thousands of villages and towns (see Figure 3.1). Each level of government reports to the next higher level.

Figure 3.1: Structure of Government in China (in 2010)



Source: Shen et al. (2012) and Wong (2013)

In a comparative perspective, China is much more decentralized than most developing and transition countries, especially on the spending side. Although sub-national governments do not have powers to determine tax bases and rates, they have considerable manoeuvrability in regard to spending decisions. In 2009, more than 80 percent of the public expenditure was incurred at the sub-national levels, in contrast to the average 19.6 percent in developing countries and 22.3 percent in transition economies.¹¹

Intergovernmental fiscal relations in China have evolved over the years. How a country's institutions develop depends critically upon where they start. To understand either the present or the future of China's fiscal system, one must first understand where it came from. In other words in order to understand the challenges facing the intergovernmental fiscal system in China today it is essential to look into the history and process of fiscal decentralization in the country. To do so, we divide the system of intergovernmental transfers into three broad periods namely,

- (i) 1949 to 1978, the pre-reform period.
- (ii) 1979 to 1993, the period of ad-hoc decentralization, and
- (iii) 1994 to the present, the tax sharing reform period.

Between 1949 and 1978 the fiscal regime was highly centralized. Planning, finance and administration were all centralized. In fact it was a system in which all decisions about what the people needed were decided from the top i.e., by the central government. Revenue and expenditure plans were made by the central government. Under such a system called *tong shou* (unified revenue collection and budget appropriation), local governments were de facto implementers of central plans, with no independent budgets and little discretionary fiscal power. The revenues were collected by the local governments and accrued to the centre. The consolidated budget system prohibited discretionary spending power for local governments.

The tax system during this period was crude. There were no personal or corporate income taxes. Profit remittances from the state-owned enterprises (SOEs) were the main source of revenues accounting for about 60 percent of the revenues while the share of tax revenues was around 30-40 percent. Relatively industrialized

¹¹ The expenditure figures for developing countries and transition economies are for the year 2005.

provinces contributed most of the fiscal revenues of the Centre. The tax administration was simple since there were relatively few taxpayers, and those few were mainly SOEs and tax collection was delegated to the local governments.

Expenditures of local governments were determined by the central government. The central government set spending priorities, approved local budgets according to local spending needs, and determined civil service salary scales, pension and unemployment benefits, educational and health care standards, etc. In the absence of independent budgets, sub-national governments lacked discretionary spending power. Sub-national governments were budgetary units identical to SOEs. They were merely agents of the central government.

The central government was responsible for national defence, economic development (capital spending, R&D, universities and research institutes), industrial policy, and administration of national institutions while the sub-national governments were required to deliver day-to-day public administration and social services such as primary and secondary education, public safety, health care, social security, housing, and other local/urban services. The gap between locally collected revenues and permitted local expenditures was filled by the transfers from the central government. The system was such that local incomes in excess of permitted local expenditures were transferred to the central government; in case of a shortfall, the gap between expenditures and income would be automatically covered by the central government. In other words the revenue sharing system was highly redistributive,¹² extending the communist ideology of contributing according to ability and taking according to need to the sub-national governments.

The pre-reform fiscal system was simple and effective, but it was completely lacking in fiscal incentives for the local governments. Such a correspondence between the fiscal system and SOEs deprived both incentives and accountability to the local governments seeking local economic growth. This resulted in slow economic growth during this period.

From 1979 onwards as China moved from a centralized economy towards a market economy. The mechanisms of the planned economy including monopoly state ownership of industry, administrative prices, and central economic planning

¹² For example, industrialized provinces like Shanghai were contributing 80-90 percent of their collected revenues to the central government, while a relatively poor province like Guizhou financed nearly two-thirds of its expenditures from central subsidies (Wong, 2000).

were dismantled. With growing competition from the non-state sector and rising wages and resource prices, the profits of the SOEs, which were the foundation of the pre-reform fiscal system, dwindled and the prevailing fiscal system in the country quickly broke down. The fiscal reforms in this period were aimed at promoting local economic development through increasing the responsibilities of local governments and also increasing their autonomy in carrying out fiscal functions, and at the same time also ensuring an adequate degree of fiscal control for the central government. In a real sense, the change represented a break from the past, and elements of proper decentralization were introduced into the system in this period. However, the dominance of the centre in making policies remained significant, and the role of the public enterprises was not completely eliminated, although substantially diminished and qualitatively changed. This study focuses on the intergovernmental fiscal relations in the post 1994 period; we try to bring out the flow and logic of the changes that have brought the country to the extant system by linking it with the previous one prevailing during the period 1979 to 1993 where such a link between the two periods is discernible.

The 1994 tax reform introduced a major overhaul of the tax and transfer system and tax administration in China. The over-arching objective of the reform was to strengthen macroeconomic performance, achieve regional equalization and efficient public goods provision. Specifically, the reform measures attempted to (a) arrest the fiscal decline and raise the two ratios (the ratio of total government revenue to GDP, and ratio of central government's revenue to total revenue), (b) simplify the tax system and eliminate distortions, (c) modify revenue assignments to different levels of government, and (d) shift from ad hoc and negotiated transfers to transparent and rule-based revenue assignments and sharing. In order to achieve these goals, the government introduced various reform measures. Some of the important measures introduced were:

- (i) reforms in the tax system including the introduction of production-based VAT;
- (ii) reassignment of taxes between central and local governments to have separate central fixed incomes, local fixed incomes, and shared revenue from VAT;
- (iii) establishment of separate tax administration to collect central and shared taxes;
and
- (iv) establishment of general purpose equalization transfers.

The 1994 reform, which created a framework of fiscal relations between the central and local governments, is considered the most intensive and far reaching

institutional restructuring for intergovernmental fiscal relations since 1949. The reform was essentially an attempt to deal with basic revenue problems by curbing the fiscal decline and providing sufficient resources, especially to the central government; simplifying the tax structure by reducing tax types and rates; and unifying the tax burden on taxpayers. It also put central-local revenue-sharing on a more transparent, objective basis by replacing negotiated contracts with a rule-based system of tax assignment.

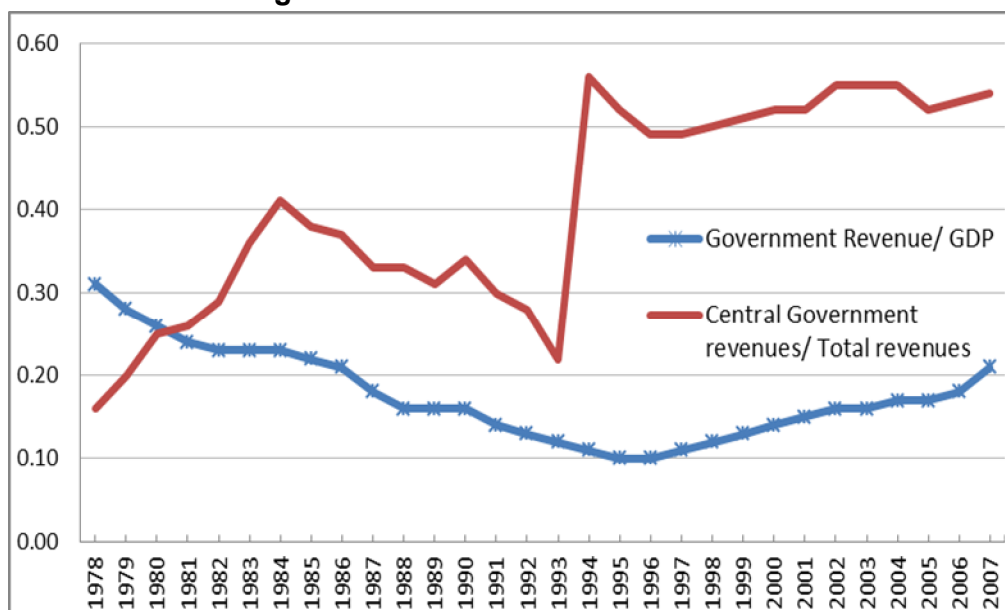
The centrepiece of the reform was the introduction of the tax assignment system, which specifies the way revenues are to be shared between the central and provincial level governments. The reforms greatly simplified the tax structure. A Value Added Tax (VAT) on goods replaced scores of cascading indirect taxes. Income tax thresholds were lowered, causing a much larger proportion of employees to pay income tax. Corporate income tax was unified to include all domestic enterprises, and the top rate was reduced from 55 percent to 33 percent. Excise taxes on tobacco, liquor, and other luxury items were introduced and the system of profit and tax contracts which existed in the previous period, under which SOEs negotiated annual transfers to the government budget, was largely eliminated.

In addition to changes in the division of revenue sources, a major effort was made by the central government to establish its own revenue-collection bodies which in effect centralized the revenue system for the first time since the initiation of economic reforms in 1978. During 1994 and 1995, National Tax Services (NTS) were established in all the provinces to collect central fixed revenues and shared revenues.

The 1994 reforms ended the reliance of central government on local remittances to finance its outlays. The ratio of the central government's revenue to the total revenue which had been declining since 1983 increased sharply from 22 percent in 1993 to about 56 percent in 1994. Although the ratio came down slightly after 1994, the average was above 50 percent and in 2007 it was around 54 percent (Figure 3.2). Establishment of National Tax Services resulted in tighter control over general tax collection and local tax exemption policies. The interference of local authorities in tax administration and collection of central and shared revenues was considerably restrained. The 1994 reform abolished all tax reductions and exemptions that the provincial governments had granted for turnover tax in the past. Any new tax exemption by the provincial governments had to be now approved by the centre and reported in a separate schedule of tax return. Owing to the unified

taxation system in which local governments were forbidden to introduce tax reductions or exemptions without central approval, the fall in the ratio of revenue to GDP was halted in 1996, after a 17-year decline. The total government revenues as a percentage of GDP increased from 12 percent in 1993 to about 21 percent in 2007 (Figure 3.2).

Figure 3.2: The Two Ratios 1978-2007



Source: Based on data from Jing and Liu (2009)

B. Revenue Assignment

The basic feature of the reforms during the period of ad hoc decentralization was that the central and the provincial governments, on a one-to-one basis, negotiated and signed revenue sharing fiscal contracts, under a principle that provinces should be responsible for balancing their budgets. Such negotiation and establishment of fiscal contracts would extend until the grassroots level governments were reached. In 1980, the highly centralized system was changed into a revenue-sharing system in which the central and provincial governments each began to ~~eat~~ ^{eat} in separate kitchens. Three different revenue-sharing systems were introduced. These were the Contract Responsibility System (CRS) in 1980, Modified CRS in 1985 and Fiscal Contracting System (FCS) in 1988. Under the new revenue sharing system, central-provincial revenue sharing rules were established by the central government; provincial-prefectural relations were governed by the province; and this principle extended further down to prefectural-county relations.

The reforms in this period reclassified the revenues sources into: (a) central-fixed revenues (i.e., those revenues and taxes which accrued to the centre), (b) local-

fixed revenues (those which accrued to the localities), and (c) shared revenues (those which were shared between the centre and localities according to some agreed rules). The bases and rates of all taxes, whether shared or fixed, were determined by the central government. Enterprises were supposed to pay taxes to the level of government to which they were subordinate. Almost all the revenues, except a few minor central fixed revenues were collected by local finance bureaus.

Under the CRS, about 80 percent of the shared revenues were remitted to the central government and 20 percent were retained by the local governments. Although the contract responsibility system encouraged some provinces to collect revenues, the uniform sharing formula resulted in undesirable surpluses in wealthy provinces and deficit in poorer provinces. The Modified CRS was mainly a response to the newly established income tax for the enterprises. Due to the rise of the non-state sector since the late 1970s, the profits of SOEs declined and profit remittances increasingly conflicted with the operation of the market. The reforms in 1983 and 1984 replaced profit remittances from SOEs with income tax. The 1985 reforms stipulated that the income taxes of the central SOEs belonged to the fixed central revenues while those of local SOEs became part of fixed local revenues. While the division of revenues began to be dependent on tax categories, the revenue sharing structure of 1980 reforms that offered central government a lump sum remittance subject to an annual growth rate was retained.

In 1985, the State Council (the highest executive body, headed by the Premier) redesigned the revenue-sharing arrangements by varying the shares of the concerned governments based on localities' budget balances in previous years. The financially weak provinces were allowed to retain larger shares of revenues, but the wealthier regions, like Shanghai, Beijing, Tianjin, Liaoning, Jiangsu, and Zhejiang, were required to remit more revenues to the centre. As a result, revenues from these regions grew more slowly than the national average, since the high level of remittances adversely affected the incentives for larger revenues in these regions. To mitigate this effect the State Council in 1988 adopted a new revenue sharing system called the FCS under which each level of government contracted with its subordinate level to meet certain revenue and expenditure targets. Six different types of central-provincial revenue-sharing methods were adopted and applied to different provinces. The FCS increased the revenues shares retained by the sub-national government, especially of those local level governments that were the major contributors to the

central revenues. The contracts were not strictly followed and were revised repeatedly for some regions.¹³

Taxation power in China now very much resides in the centre. The two major means of controlling tax revenues are determining the tax rate and defining the tax base. There is almost complete centralization of both these dimensions in China. Local governments have no discretionary power to raise taxation, though they can lower taxation by granting tax holidays for new investors. The central government sets the legislation governing taxation and the rate of each tax. The central government assigns various portions of taxes directly to local governments. The precise share varies from tax to tax. Sub-national governments have the latitude in determining the rates of some minor taxes, but even for these they are only allowed to set tax rates within a limited range.

The tax-sharing reform of 1994 explicitly defined taxes as (a) central taxes, (b) shared taxes and (c) local taxes. Those taxes which can be used in the pursuit of national objectives are assigned as central taxes, such as tariffs, excise taxes on tobacco, alcohol, petroleum products, cars and jewellery (known collectively as the consumption tax), taxes on foreign trade etc; taxes that can be interpreted as more relevant to economic development are assigned as shared taxes and includes taxes like VAT, business tax, stamp tax on sales of securities, personal income tax, and company income tax. Taxes more suitable for collection and administration by the local governments, such as urban maintenance and development tax, taxes on use of arable land and urban land use are assigned as local taxes.

Table 3.1 summarizes the tax assignment system. There is a well-defined formula for allocating different taxes, which has been slightly changed three times since 1994. It has not been altered since 2003, when the central share in income taxes was raised from 50 to 60 percent, the share of stamp duty on financial

¹³ The sharing arrangements are all executive decisions by the State Council. These decisions acquire the status of legally binding nature only when the apex legislative body, the National People's Congress (NPC), approves a proposal containing such decisions put up to it. In China, all fiscal matters are not necessarily put up to the NPC to obtain legal status. The unique combination of a *de facto* single political party, a State Council expectedly dominated by leaders of the party, and a legislature (or the Standing Committee of the legislature that represents it for most part of the year) dominated by Members of the same party has not been enough to prevent differences of opinion among the legislature and the other two organs. Some of the legislations proposed by the State Council have actually been blocked by the NPC (e.g., on gasoline tax). As such, the State Council does not put up anything for legislative approval if it can do without it.

transactions rose from 50 to 97 percent, and the business tax on the financial industry was assigned to the central government.

Table 3.1: Tax Assignment between Central and Local Governments (2011)

	Central	Provincial
	<i>Stipulated share (%)</i>	
Central taxes		
Consumption tax	100	0
Tariffs	100	0
Intl trade-related consumption tax and VAT	100	0
Refunds of VAT and consumption tax on	100	0
Vehicle purchase tax	100	0
Cargo tax	100	0
Shared taxes		
VAT	75	25
Corporate income tax	60	40
Personal income tax	60	40
Stamp tax on securities	97	3
Sub-National taxes		
Business tax	1	99
Resource tax	0	100
Urban maintenance and development tax	0	100
House property tax	0	100
Real estate tax	0	100
Urban land use tax	0	100
Land appreciation tax	0	100
Tax on vehicles and boat operation	0	100
Tax on the use of arable land	0	100
Tobacco tax	0	100
Tax on deeds	0	100

Source: Wang, X. and R. Herd (2013)

Table 3.2 shows tax revenues of both central and local governments in 2011. From the table we see that the central government is relatively more dependent upon shared taxes which accounted for about 66.5 percent of its tax revenues in 2011. The important shared taxes for the central government are VAT (37.6 percent), corporate income tax (20.6 percent) and personal income tax (7.5 percent). The other important Central taxes are consumption tax and international trade related consumption tax and VAT. For the sub-national governments the most important source of tax revenues is local taxes which accounted for about 63 percent of their revenues in 2011. The share of shared taxes was 37 percent. The largest tax assigned to

provincial governments is that on services, known as the business tax.¹⁴ Its share in total tax revenues of the local governments was 32.8 percent. The other important local taxes are the tax on deed (6.7 percent), urban maintenance and development tax (6.3 percent) and urban land use tax (5 percent). Among the shared taxes, the important ones are VAT (14.6 percent), corporate Income Tax (16.4 percent) and personal income tax (5.9 percent).

Table 3.2: Central and Local Revenues (2011)

	Central	Provincia 	Total	Central	Provincia 	Total
	<i>CNY billion</i>			<i>Receipts as % of</i>		
Central taxes	1593	0	1593	32.8	0.0	17.8
Consumption tax	694	0	694	14.3	0.0	7.7
Tariffs	256	0	256	5.3	0.0	2.9
Intl trade-related consumption tax & VAT	1356	0	1356	27.9	0.0	15.1
Refunds of VAT and consumption tax	-920	0	-920	-18.9	0.0	-10.3
Vehicle purchase tax	204	0	204	4.2	0.0	2.3
Cargo tax	3	0	3	0.1	0.0	0.0
Shared taxes	3236	1517	4753	66.5	36.9	53.0
VAT	1828	599	2427	37.6	14.6	27.0
Corporate income tax	1002	675	1677	20.6	16.4	18.7
Personal income tax	363	242	605	7.5	5.9	6.7
Stamp tax on securities	43	1	44	0.9	0.0	0.5
Sub-National taxes	34	2594	2628	0.7	63.1	29.3
Business tax	17	1350	1367	0.4	32.8	15.2
Resource tax	0	60	60	0.0	1.5	0.7
Urban maintenance & development tax	17	261	278	0.3	6.3	3.1
House property tax	0	110	110	0.0	2.7	1.2
Real estate tax	0	122	122	0.0	3.0	1.4
Urban land use tax	0	206	206	0.0	5.0	2.3
Land appreciation tax	0	30	30	0.0	0.7	0.3
Tax on vehicles & boat operation	0	108	108	0.0	2.6	1.2
Tax on the use of arable land	0	60	60	0.0	1.5	0.7
Tobacco tax	0	9	9	0.0	0.2	0.1
Tax on deeds	0	277	277	0.0	6.7	3.1
All Taxes	4863	4111	8974	100.0	100.0	100.0

Source: Wang, X. and R. Herd (2013)

¹⁴ Existence of business tax is an anomaly as all goods-specific (and hence cascading) taxes were abolished in 1994 and replaced by VAT on goods. The government is committed to merging the business tax with VAT. The first pilot was undertaken in Shanghai in 2011 and was widened in September 2012 to Beijing, Tianjin, Shenzhen and Xiamen, as well as the provinces of Guangdong, Jiangsu, Zhejiang, Anhui, Fujian and Hubei (Brys et al., 2013). In 2013, the business tax will be replaced by VAT in the following economic zones: Bohai, Yangtze River Delta and Yangtze River, Pearl River Delta and the Straits economic zones (Wang, X. and R. Herd, 2013).

The present tax-assignment arrangement has two outstanding features. First, the central government gets control over major profitable taxes, collecting about 75.3 percent of VAT, 59.7 percent of corporate income tax and 60 percent of personal income tax. In 2011, tax revenues of the central government from shared taxes accounted for about 68 percent of the total government revenues (both central and sub-national) from shared taxes. Second, sub-national governments are highly dependent on local taxes which accounted for about 63.1 percent of their total tax revenues in 2011. In addition to the tax revenue estimated in Table 3.2, local governments also collect a considerable amount from various non-budgetary revenues (i.e., extra-budgetary and off-budgetary revenues). Unlike the tax revenues which are shared between the central and local governments, non-budgetary funds are almost exclusively levied by the local authorities based on ad hoc standards.

Each level of sub-national government shares its tax revenues with the lower levels of government. The provinces use various mechanisms for sharing their tax revenues with governments below them like (i) the sharing of specific taxes; (ii) the assignment of specific taxes; (iii) the sharing of the increase in the yield from a base year; and (iv) assignment of an amount that depends on a predetermined growth rate. On average, the largest share of all local taxes is taken by the prefectural governments as can be seen from table 3.3. This is true of all individual local taxes except the property and resource taxes, which mainly accrue to the county and township governments. There are considerable differences both across and within provinces in the distribution of taxes to lower-level authorities.

Table 3.3: Distribution of Tax Sources by level of Sub-national Government (2009)

	Provincial	Prefecture	County	Township	All Sub-national Governments		
	(% of total tax revenue)				(% of GDP)	CNY Billion	
VAT	19.6	32.0	31.9	16.6	100.0	1.3	457
Business tax	29.2	30.5	29.1	11.3	100.0	2.6	885
Urban maintenance and development tax	6.4	44.5	36.1	13.0	100.0	0.4	142
Corporate income tax	37.8	31.1	23.0	8.1	100.0	1.2	392
Personal income tax	34.6	31.2	25.1	9.0	100.0	0.5	158
Property tax	8.0	37.9	39.7	14.5	100.0	0.1	34
Resource tax	19.4	16.7	37.0	26.9	100.0	1.4	481
Other	6.3	32.2	40.7	20.7	100.0	0.1	49
All taxes	23.3	32.9	31.1	12.7	100.0	7.6	2597

Source: Wang, X. and R. Herd (2013)

In addition to tax revenues, sub-national governments have non-tax revenue from fees, levies, penalties and the profit from the sale of land-use rights. Sub-national governments also have significant income from the ownership of state-owned enterprises, in contrast to the central government. The total amount of non-tax income (excluding asset sales) amounts to nearly 30 percent of their total revenue as can be seen from table 3.4. Earlier, fees were major part of non-tax revenue. They were administered through off-budget funds mainly to fund education and transport. Since 2012, all fees have been administered through the budget but reliance on fees remains. Indeed, these fees are one of the three elements of local governments' fiscal autonomy. The other two are income from land sales that accrues to extra-budgetary funds and the financing of infrastructure through infrastructure development companies.

Table 3.4: Taxes and other sources of revenue by levels of government (2009)

	Central	All Sub-National	Provincial	Prefecture	County	Township
<i>(Percent of GDP)</i>						
1. Taxes	9.8	7.6	1.8	2.5	2.4	1.0
2. Non tax revenue	1.6	4.4	1.5	1.4	1.4	0.2
Fees and penalties	0.2	2.2	0.8	0.7	0.6	0.1
Asset income	0.0	0.6	0.1	0.2	0.3	0.0
Other	1.4	1.7	0.7	0.5	0.4	0.1
3. Land sales (net)	0.0	2.1	0.1	1.1	0.9	0.0
4. Non tax plus land sales (net) [2+3]	1.6	6.5	1.7	2.5	2.2	0.2
5. Total revenue [1+4]	11.4	14.2	3.4	5.0	4.6	1.2

Source: Wang, X. and R. Herd (2013)

Sub-national governments also raise significant revenues from the sale of land-use rights for periods ranging between 30 to 70 years. These stem from the government's ownership of all urban land and its monopoly of the right to transform land from agricultural to construction use. In 2009, the gross revenues from the sale of land-use rights amounted to about 4.2 percent of GDP, and were over 7 percent in 2010 and 2011, and in 2012 it was around 5 percent of GDP. However, not all of the land sale revenues represent profit for the government, as compensation needs to be paid. In addition, the land is sold fully serviced. The cost of installing the road, water, drainage, electricity and telecom networks has to be deducted from the gross sales revenue. In 2009, these two cost elements absorbed half of gross sales revenue. The net revenue from land sales is concentrated mainly at the level of county and prefecture governments.

C. Assignment of natural resources and revenue therefrom

China is endowed with abundance of mineral resources.¹⁵ According to the Constitution of China, all natural resources beneath the ground belong to the state. Article 3 of the Mineral Resource Law of People's Republic of China, 1986 states: *All mineral resources shall be owned by the state. The state ownership of the mineral resources, either near the earth's surface or underground, shall not be changed with the ownership of the land or the right to the use of the land which the mineral resources are attached to. The State Council shall exercise the ownership of the mineral resources on behalf of the state. The department in charge of geology and mineral resources under the State Council is authorized by the State Council to exercise a centralized management over the allocation of the mineral resources throughout the country.*

Prior to the adoption of the Mineral Resource Law i.e., in the decades between the establishment of the People's Republic of China in 1949 and the enactment of the Law, all the revenues from natural resources belonged either to the government or state-owned enterprises. The SOEs did not provide any compensation to local people for mining natural resources because both the enterprises and resources were owned by the state. The state sector enjoyed exclusive property rights on mining. Following the market reforms since the 1970s, the demand for natural resources went up dramatically. The monopoly mining rights granted to SOEs inhibited the development of this sector and it became imperative to reform the property rights arrangement. The objective of such reforms was to allow more private and foreign investment and increase the supply of natural resources.

Although the Mineral Resource Law was passed in 1986, it was not put into full practice until 1994 when the Implementation Regulations on the Mineral Resource Law were introduced. Overall, from 1949 to 1994, SOEs were the dominant players in the mining sector. Under the new regulations, the local governments were allowed to auction the development rights of mineral resources to the private sector, including multinational companies. Local governments were also permitted to explore and develop mineral resources. However, under the new regulations, SOEs still enjoyed preferential treatment in developing large mineral reserves. Collective enterprises and private investors were also allowed to explore

¹⁵ Out of 171 discovered minerals, China has proven reserves of 158. It is a major producer of coal, crude oil, natural gas, and uranium. It is also one of the major producers of both metallic and non-metallic minerals.

and develop small-scale reserves left over by the state sector. The Ministry of Land and Natural Resources grants permits for the exploration and mining of large-scale reserves, while the provincial and county-level governments are responsible for issuing permits for medium and small-scale reserves falling within their jurisdictions.

Resource producing companies pay various taxes, fees, duties and surcharges to the Government. Taxes levied on mineral production include the corporate income tax (25 percent of taxable income), a value added tax (17 percent of sales value), and a resource tax (5-10 percent of sales revenue since 2011). Since 2006, oil companies selling crude oil have also been subject to a windfall tax or a special petroleum profit tax (in the range of 0-14 percent of the production volume when the crude oil price exceeds 55 dollars per barrel). All firms extracting mineral resources in China are also subject to pay mineral resources compensation fees to the government since 1994 (1 percent of sales revenue). Transfers of resource development rights are subject to a business tax (5 percent of transferred license value). Resource producing companies additionally pay duties and surcharges such as a customs duty, city construction and maintenance taxes [5 percent (towns) - 7 percent (city districts) of VAT, business tax, and consumption tax], national education surcharges (3 percent of VAT, business tax, and consumption tax), local education surcharges (2 percent of VAT, business tax, and consumption tax), etc.

According to the tax sharing system, taxes on resource production are divided between the Central and Local governments. Corporate income tax is shared by the central and relevant local governments at a ratio of 60:40.¹⁶ Corporate income tax revenue from natural gas production is exclusively assigned to the central government. VAT is shared by the central and the relevant sub-national governments at a ratio of 75:25. The resource tax from inland resource production is assigned exclusively to the local governments. In 2010, the Chinese government changed the collection base for the resource tax from production volume to selling value, which resulted in an increase in local governments' budgetary revenue from the resource tax. Finally, a mineral resources compensation fee is evenly split between the central and the local governments. Table 3.5 summarizes the tax items to which natural resource producing companies are subjected, and the tax revenue sharing ratios between central and local governments.

¹⁶ The provincial, prefectural, and county governments split local tax revenues according to negotiated rates. On average, prefectural governments take the largest share of total local taxes.

Table 3.5: Tax on Resource Production (2012)

Tax Items	Tax Rate and Basis	Sharing Ratio (Central : Local)
Enterprise income tax	25% of taxable income	60:40 (100:0 for natural gas)
Value added tax	17% of sales value	75:25
Resource tax	5-10% of sales value	0:100
Special petroleum profit tax (windfall tax)	0-14% (est.) of output when crude oil price > US\$55/barrel	
Mineral resources compensation fees	1% (est.) of sales revenue	50:50
Business tax	5% of transferred (license) value	0:100
City construction and maintenance tax	5-7% of VAT, business tax & consumption tax	0:100
National education surcharges	3% of VAT, business tax & consumption tax	100: 0
Local education surcharges	2% of VAT, business tax & consumption tax	0:100

Source: Reproduced from Hong (2013)

Table 3.6 illustrates the proportions of tax revenue that the central and local governments obtain from resource production. It is estimated that when a company produces and sells 100 dollars' worth of mineral resources, the central government collects 20-23 dollars, while the local governments claim 14-22 dollars.¹⁷ Although the central government collects more from resource production, it is clear that local authorities also receive a substantial amount of tax revenue from resource production.

Table 3.6: Tax Breakup between the Central and Local Governments (2012)

Total corporate revenue from resource sales					
Spl. Petro profit tax	Value added tax	Resource tax	Corp. tax	Other	Corporate's net income & expenses
0-14% (est.)	17%	5-10%	10-15% (est.)	3%	41-65%
	13% central		6-9% central	1% central	⇒ 20-23% central in total
	4% local	5-10% local	3-6% local	2% local	⇒ 14-22% local in total

Source: Reproduced from Hong (2013)

D. Expenditure Assignment

Since the 1980s, the central government stopped stipulating individual items of expenditure in the provincial budgets but it continued to formulate guidelines indicating the acceptable level of expenditure for each province. The allowed expenditure of each province was formulated on the basis of a base figure+i.e., the

¹⁷ This estimation excludes the petroleum special profit tax applied to oil when the monthly average price exceeds 55 dollars per barrel.

expenditure of the province in a certain base year, adjusted by factors such as changes in policy priority (e.g., State Council's approval of a new development zone may increase this region's expenditure allowance) and inflation (e.g., inflation increases the price of wages and other procurement), price reform (e.g., certain price reforms require provinces to spend more on subsidizing food and housing), etc. The provinces were required to make their expenditure plans consistent with central government guidelines, but could augment its expenditure if more resources were available to the province. On individual items of local government expenditure, the centre had a set of detailed regulations restricting government employees' wages and the items that government agencies can purchase.

Central government's expenditure responsibilities included capital construction, technical upgrading of centrally owned enterprises and outlay on their new product development; national defence; foreign aid and external relations; agriculture, forestry and water conservation at the central level; industrial, transportation and commercial operations; education, culture, health and social services; outlay on centrally imposed price subsidies; geological surveys; and the financing of public debt. The Local government's expenditure responsibilities included basic construction, technical improvement of locally owned enterprises and their new product development; rural production assistance and agricultural development and water conservation at the local level; urban maintenance and construction; education, health, culture and social services; social welfare and pensions; administrative expenditure; and a range of price subsidies. There was considerable overlap between central and local governments' actual expenditure responsibilities.

The 1994 reform did not alter the assignments of responsibility prevailing in China before the reforms. The exclusive central responsibilities include national defence, foreign affairs, geological prospecting expenses, and public debt. The exclusive sub-national responsibilities are urban maintenance and construction, environmental protection, water supply, and community services. All other government spending is shared by the centre and sub-national governments. Sub-national governments at each level are responsible for delivering public services, including education, health care, social welfare, public safety, and other local and urban services; government administration; and local economic development.

In the absence of any specific central government guidelines, the actual division of expenditure responsibilities among sub-provincial governments is left to

the discretion of each level of government. The higher-level government has discretion to determine the expenditure assignment of the level immediately below it. In other words, provinces determine the assignments to cities/prefectures, prefectures determine the assignments to counties, and the latter in turn determines the revenues and expenditures of the townships. Table 3.7 shows the in-principle assignment of responsibilities prevailing in China.

Table 3.7: Central and Local Expenditure Responsibilities

	Central	Provincial	Prefecture	County	Township
National Defence	*				
Foreign Affairs	*				
Geological Prospecting Expenses	*				
Public Debt	*				
Education	*	*	*	*	*
Health Care	*	*	*	*	*
Social Welfare	*	*	*	*	*
Agriculture	*	*	*	*	*
Government Administration	*	*	*	*	*
Capital Construction	*	*	*	*	*
Research & Development	*	*	*	*	*
Culture Development	*	*	*	*	*
Policy Subsidies	*	*	*	*	*
Armed Police Troops	*	*	*	*	*
Urban Maintenance & Construction		*	*	*	*
Environmental Protection		*	*	*	*
Water Supply			*	*	*
Community Services				*	*

Source: Shen (2008)

The Constitution sets out the extent of the autonomy of sub-national governments and determines the division of functions and powers between the central and local state organs. The division of powers is guided by the principle of giving full scope to the initiative and enthusiasm of the local authorities under the unified leadership of the central authorities. The split of responsibilities is set out in the Constitution. Local governments at and above the county level conduct administrative work concerning the economy, education, science, culture, public health, physical culture, urban and rural development, finance, civil affairs, public security, ethnic affairs, judicial administration and family planning in their respective administrative areas. They also appoint or remove administrative functionaries. Local governments at and above the county level also direct the work of their subordinate departments and of lower level governments, and have the power to alter or annul inappropriate decisions of their subordinate departments and of lower-level governments. At the same time, they have some autonomy within the limits of their authority and implement the laws and policies of the state in light of the existing local situation. This hierarchical structure limits the extent to which decentralisation leads to policies that differ markedly across the country. A close look at local government

expenditure decisions reveals a highly centralised system in which local governments act as agents of the central government. A comparison of the share of spending by sub-national governments in total public spending appear to show that China has amongst the most decentralised public sectors in the world, but this is misleading.

The assignment of expenditure responsibility across different tiers of governments has the following prominent features: (a) sub-national governments, particularly at the county and township levels, are excessively burdened as can be seen from table 3.7. In practice, education and health care are concentrated mostly at the county and the lower levels of government, although at least parts of these public services would be more appropriately assigned to the central and provincial levels in view of their spillover effects for the society as a whole and the need for standardization. The redistributive government function for social security is mainly administered at the provincial and prefecture levels, whereas it should be assigned to central government in order to reap the benefits of risk pooling and equalization; and (b) the assignment of responsibility is ambiguous, given the wide concurrent expenditure assignments. The vague definition has created a loophole for each level of government to push its responsibilities downward while retaining as much revenue as possible. In fact the lowest levels of governments are bearing disproportionately large share of responsibilities but have very limited revenue base.

Table 3.8: Share of each Government Level by Expenditure type (2009)

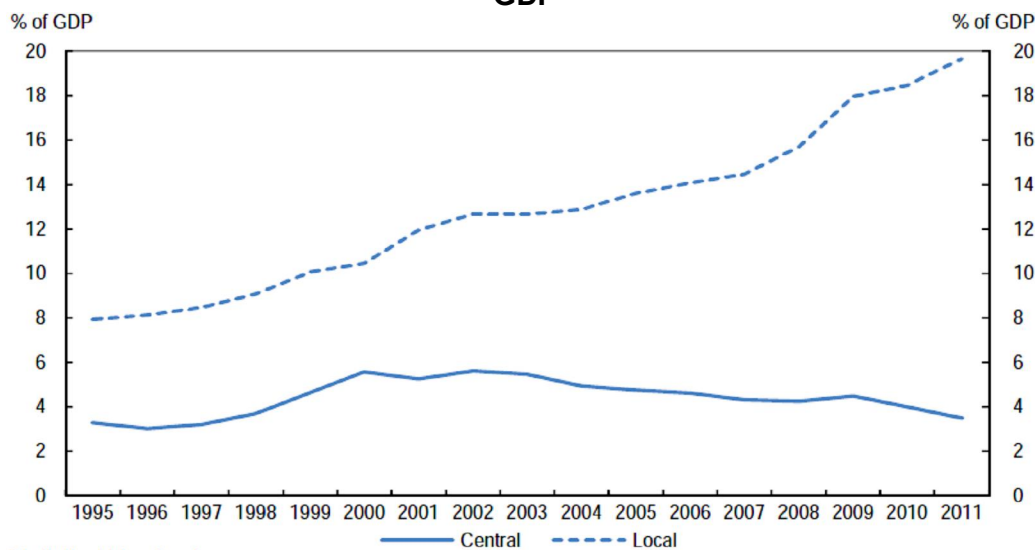
	Central	All sub-national	Provincial	Prefecture	County	Township	% Total
	<i>(% of each expenditure category)</i>						
1 Predominately central government	94.6	5.4	1.9	2.5	0.9	0	8.3
Foreign affairs	97.4	2.6	1.2	0.7	0.6	0	0.3
National defence	97.3	2.7	0.9	1	0.7	0	4.9
Financial affairs	91.5	8.5	3.7	3.7	1.1	0	1.6
Payments on government bonds	88.5	11.5	3.5	6.2	1.7	0	1.5
2 Mixed central and provincial	35.4	64.6	34	15.1	14.7	0.8	11.8
Science and technology	51.5	48.5	17.7	16	13.7	1	2.8
Reserve for cereals and oils	34.8	65.2	28.6	12.5	22.4	1.7	6.6
Transportation	28.9	71.1	42.9	15.2	12.7	0.4	2.2
Affordable housing	25.7	74.3	24.3	40.5	9.4	0.1	0.1
3 Mainly prefecture and province	19	81	20.8	29.3	28.3	2.7	14.2
Mining, quarrying, electricity and IT	22.2	77.8	17.5	32.6	23.9	3.9	4.8
Public security	17.4	82.6	18.5	28.9	34.1	1	2.2
Culture, sport and media	16.7	83.3	27.4	28.4	25.4	2.1	3.6
Other expenditure	19.3	80.7	23.1	27	26.5	4.1	3.6
4 Mainly county/district/township	5.1	94.9	15.5	28.7	44.5	6.2	65.7
Urban and rural community affairs	1.1	98.9	5.6	46.8	42.2	4.3	9.7

	Central	All sub-national	Provincial	Prefecture	County	Township	% Total
	(% of each expenditure category)						
Social safety net and employment	5.4	94.6	20.5	27.4	42	4.7	12.9
General public services	11.3	88.7	18.3	21.4	36.1	12.8	8.5
Environment protection	1.9	98.1	21.5	26.6	46.9	3	4.2
Agriculture and water conservancy	6.5	93.5	24.3	14.8	45.3	9	2
Education	6.7	93.3	18.4	19.3	50.3	5.4	19.4
Post-earthquake recovery	10.4	89.6	21.6	10.6	53.1	4.3	7.7
Medical and healthcare	1.5	98.5	14.8	25.4	55.9	2.5	1.3
5 All types of expenditure	18.1	81.9	17.3	25	35.1	4.6	100

Source: Wang, X. and R. Herd (2013)

Table 3.8 shows the share of expenditures incurred by different levels of government in 2009. The sub-national governments together account for more than 80 percent of the total government expenditure in 2009, while the central government only spends around 18 percent of the total outlays. Among the various sub-national governments, the country level government accounts for about 35 percent while the prefecture level of government accounts for 25 percent of the total government expenditure. Moreover, local (or sub-national) governments finance many public infrastructure investment projects through off-budget financing platforms. Adding such quasi-government spending would result in a further increase in the share of sub-national spending.

Figure 3.3: Central and Local Government Expenditure as Percent of GDP



Note: Government expenditure excludes spending on social security.
Source: Wang, X. and R. Herd (2013)

Over the years, since 1994, the spending undertaken by sub-national governments has increased considerably while expenditure by the central government (as percentage of GDP) has remained largely unchanged as can be seen from Fig 3.3. The increase in sub-national public spending was particularly pronounced at the prefectural and county levels as these are the levels of government that deliver services to people.

The distribution of public expenditure by different levels of governments in China (in 2009) reveals that the central government which accounts for only 18 percent of the total government expenditure allocates most of its financial resources on national defence, (26.6 percent), financial affairs (8.1 percent), science and technology (8 percent), servicing the interest on public debt (7.3 percent) etc as can be seen from table 3.9. The most important spending items at the sub-national level include education, provision of social safety and employment, urban and rural community affairs, general public services etc.

Table 3.9: Public Expenditure by Level of Government (2009)

	Central	All sub-national	Provincial	Prefecture	County	Township	% total
	% of each type of expenditure in total of each government level						
1 Predominantly central government	43.4	0.5	0.9	0.8	0.2	0.0	8.3
Foreign affairs	1.4	0.0	0.0	0.0	0.0	0.0	0.3
National defense	26.6	0.2	0.3	0.2	0.1	0.0	4.9
Financial affairs	8.1	0.2	0.3	0.2	0.0	0.0	1.6
Payments on government bonds	7.3	0.2	0.3	0.4	0.1	0.0	1.5
2 Mixed central and provincial	23.1	9.3	23.2	7.1	5.0	2.0	11.8
Science and technology	8.0	1.7	2.9	1.8	1.1	0.6	2.8
Reserve for cereals and oils	10.6	5.8	16.4	4.0	2.4	0.5	6.6
Transportation	4.3	1.8	3.7	1.1	1.4	0.8	2.2
Affordable housing	0.1	0.1	0.1	0.2	0.0	0.0	0.1
3 Prefecture and province	14.9	14.1	17.1	16.6	11.5	8.4	14.2
Mining, quarrying, electricity and IT	4.7	4.9	5.2	5.6	4.7	1.1	4.8
Public security	2.0	2.3	3.5	2.5	1.6	1.0	2.2
Culture, sport and media	4.4	3.4	3.6	4.6	2.4	3.0	3.6
Other expenditure	3.8	3.5	4.8	3.9	2.7	3.2	3.6
4 County/district/township	18.6	76.1	58.8	75.4	83.4	89.6	65.7
Urban and rural community affairs	6.1	10.5	10.2	8.3	10.0	27.2	9.7
Social safety net & employment effort	4.8	14.7	13.7	9.9	18.5	15.2	12.9
General public services	2.6	9.8	10.1	9.3	10.2	8.8	8.5
Environment protection	0.4	5.1	3.6	4.3	6.8	2.3	4.2
Agriculture and water conservancy	0.2	2.4	2.5	2.1	2.7	1.3	2.0
Education	1.1	23.5	6.3	36.4	23.4	18.4	19.4
Post-earthquake recovery	2.8	8.8	10.8	4.5	9.9	15.2	7.7

	Central	All sub-national	Provincial	Prefecture	County	Township	% total
medical and healthcare	0.7	1.4	1.6	0.5	1.9	1.2	1.3
5 All types of expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Wang, X. and R. Herd (2013)

E. Overlapping jurisdictions and intergovernmental bargaining

In the specific political-administrative structure of China with strong domination of the centre, the nebulous functional allocation that would otherwise engender jurisdictional disputes and possible conflicts does not actually do so because most of such issues are essentially sorted out through a process of bargaining and use of political clout. In a top-down system as in China, the hierarchy of governments substitutes for arbitrating institutions. In the immediate post-reform years after 1994, in the case of overlapping sectors, for example, when the central government financed projects like power plants, railways and telecommunications networks etc., the provinces were often required to co-finance these projects. There were both central and local universities, making education both a local and a central responsibility, and a hospital or a bridge could be financed by central government, by provincial government or by city government. Since a substantial part of investment outlay came from the central budget, location of projects became a matter of importance. Provinces competed with each other for a greater share of this outlay. Both before and after the state budget plan was formally approved, intensive lobbying from local governments for allocating more projects to their own jurisdiction took place. One typical form of such lobbying was that local leaders sought help from a senior leader in the central government or the Central Party Committee, and this senior leader wrote a note to State Planning Commission or Ministry of Finance suggesting consideration of a project in favour of this region. In fact almost every project approved to be listed in the budget plan or added to the plan later was backed by some kind of "note". Although there were official guidelines for allocating projects, such as achieving balance between production and consumption, between industry and agriculture, between heavy and light industry, and between coastal and inland areas, these criteria were usually rather vague and the actual allocation depended upon the bargaining powers of localities.

Subsequently, after revenue assignments were firmed up, such bargaining was supplemented by the process of pushing expenditure responsibilities downwards to the extent feasible, taking advantage of the unclear functional assignments. The

motivation for it was mainly to conserve resources to finance projects/schemes of their choice that were not otherwise supported. The lower level governments, saddled with such expenditure responsibilities well in excess of their assigned revenues, solved this problem of fiscal imbalance by developing irregular, and sometimes illegal, sources of funds. This is discussed in greater detail below while discussing extra-budgetary funds.

F. Intergovernmental Transfers

In the first phase, transfers from the central government to the lower levels of government were basically to fill the gaps. When for a province its base expenditure was larger than its fixed local revenues, the province was allowed to keep all its fixed revenues, and in addition was entitled to shared revenues, which filled its fiscal gap. But when its base expenditure was lower than its base local fixed revenues it had to remit the surplus to the central government. And when its base expenditure was greater than both the base fixed revenues and shared revenues, then the province was permitted to keep both and the fiscal gap was met by a fixed subsidy grant from the central government.

The system of intergovernmental transfers consisted of four kinds of central-local grants: (i) fixed subsidies (subsidies were given to provinces for which the base year expenditures were larger than base year revenues); (ii) special purpose grants (initially given for disaster relief, poverty reduction, and other specific purposes, but were later expanded to cover a whole range of programmes); (iii) annual account closing transfers (acted as an adjustment to net revenues and expenditures, taking into account transfers between central and local governments and were determined at the end of each fiscal year) and (iv) capital grants (conditional grants disbursed by central government mainly for local capital construction and other investment activities)

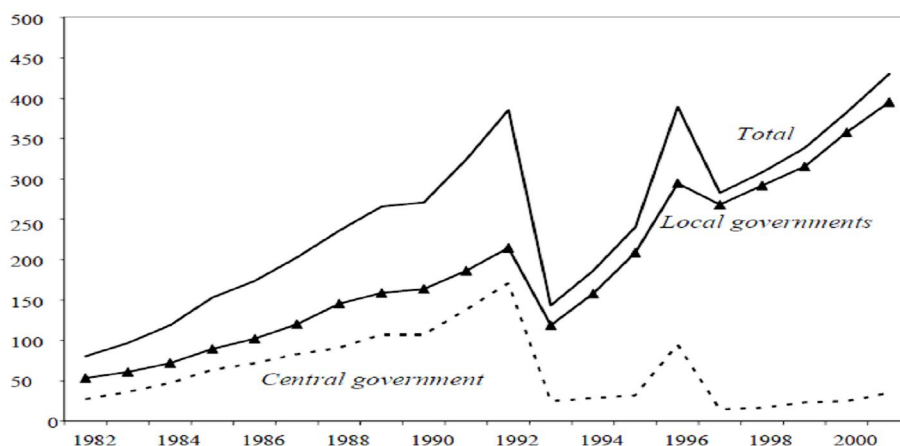
China's fiscal reform from 1979-1993 was characterized by decentralization which effectively delegated fiscal powers to the local governments. While the local governments did not have the authority to decide the tax categories, tax rates and tax base, they were given the authority to collect all taxes and also to retain a substantial portion according to the fiscal contracts. The central government depended a great deal on transfers received from the better-off provinces. However, such fiscal arrangements suffered from many problems. Since the assignment of revenue was not clear, sub-national governments continued to appropriate central revenues thereby dampening the fiscal power of the centre. The central government relied on

local tax collection, which was primarily subject to the policies of the local authorities who frequently granted tax exemptions without proper central authorization. In reality the local governments controlled the effective tax rates and tax bases by offering varying degrees of tax concessions to enterprises and shifting budgetary funds to extra-budgetary funds.

The waning central fiscal control and distorted local incentives prompted a conspicuous falling trend of central revenues and a significant reduction in fiscal revenue collection as a percentage of GDP. The ratio of total government revenue to GDP declined from 31 percent to about 12 percent over the period 1979-1993. The share of central government's revenue in the total revenue also fell from about 41 percent in 1984 to about 22 percent in 1993 (Figure 3.2).

To meet its expenditure obligations, the central government had to resort to various *ad hoc* instruments, including arbitrary shifting of expenditure responsibilities to local governments, cutting intergovernmental transfers, forcing local governments to purchase bonds at rates lower than the market rate, and recentralizing locally-owned enterprises (Ma and Norregaard 1998). However, these instruments only created a vicious cycle of perverse reactions from local governments. Local governments, with distrust for the central government and also under increasing pressure to meet new spending responsibilities, began collecting a wide variety of extra-budgetary revenues, and even levying illegal fees and charges for providing basic public services.

Figure 3.4: Extra-Budgetary Funds (in billions of Yuan)



Source: Reproduced from Dabla-Norris (2005)

Fiscal stress at the centre forced the central government to cut transfers to lower level of governments and transfer more spending responsibilities to the sub-

national governments. The share of local expenditure rose from 45 percent of the total in 1981 to about 72 percent in 1993. The role of local governments shifted from that of providing services to acting as both the financier and also provider. There was a climate of distrust on the intergovernmental fiscal relations in the early 1990s. The central government recognized that the continuing fiscal decline was partly due to local governments' unwillingness to collect taxes, while local governments were also diverting funds from budgetary to various extra-budgetary channels. From the local governments' perspective, repeated changes in revenue-sharing rules were viewed as a sign of weak commitment of the centre towards building solid local finances. In order to absorb local excess revenues, the central government started borrowing from the sub-national governments and these borrowed revenues were never repaid. The amounts borrowed were added into the regions' remittance requirement. The central government also resorted to reclaiming ownership of locally owned enterprises in high-growth industries, so that revenues from these enterprises became part of centrally fixed revenues. The manipulative actions by the centre convinced local governments that surplus revenues were not safe from the centre's predatory behaviour thereby forcing them to shift revenues into myriad extra-budgetary funds (Figure 3.4).¹⁸

With the introduction of the fiscal contract system, there was a fundamental change in the fiscal system. By delinking revenue sharing from expenditure needs, fiscal contracts put local governments on a self-financing basis for the first time . a *de facto* devolution of responsibilities that was later codified in the 1994 Budget Law. But the fiscal contracting system also contributed to greater regional disparities. With a variety of fiscal contracts in use, the system was primarily the result of political negotiation between the central government and individual provinces. Rich provinces, like Canton, Shanghai, and Shandong, were able to have more advantageous contracts due to their development strategies and political leverage. These provinces accumulated a substantial and growing revenue base by retaining most of the incremental revenues within the province. Net remittances from wealthier provinces declined sharply with Shanghai in 1993 turning over only about 8.5 percent of its GDP, and Guangdong only 0.4 percent of its GDP over this period. This resulted in a decline in subsidies to poor regions by the central government. Inequities in the spread of resources across regions translated into growing disparities in service delivery, particularly in rural areas.

¹⁸ This was also called the period of predatory fiscal federalism.

While the fiscal reforms of the 1980s failed to reverse the trend of falling fiscal revenues, on the positive side, fiscal reforms during this period provided a device to mobilize local revenue collection in an effort to promote local economic development. In 1991 when the fiscal contract system was supposed to expire, the central government found that it was unable to negotiate with the local governments and hence it was unable to pursue alternative approaches and the contract system was extended until the end of 1993. A radical new reform process with the primary objective of fixing the intergovernmental fiscal system was introduced in 1994. A comprehensive package of reforms was implemented in 1994 to arrest the decline in revenues and restore central control over fiscal instruments.

The assignment of revenues and expenditure responsibilities in the latest phase across different levels of government in China has resulted in a situation where for the sub-national governments expenditures far exceed their revenues. The gap between the revenues (tax and non-tax revenues) and expenditures across different levels of government in China for 2009 is illustrated in table 3.10. For sub-national governments as a whole, expenditures grew much faster than revenues. The gap between revenue and expenditure is particularly marked for rural counties, where the revenue amounts to only slightly more than one quarter of their expenditure. The gap is much lower for the more urban county cities and falls yet again in the urban districts of prefectural level cities.

Table 3.10: Balance between Expenditure and Revenues (2009)

	Revenue	Expenditure	Balance (Revenue – Expenditure)		
	<i>CNY billion</i>		<i>CNY billion</i>	<i>% of revenues</i>	<i>% of national GDP</i>
Central	3878	1814	2064	53	6.1
Sub-National	5543	8220	-2677	-48	-7.9
Provincial	1220	1736	-516	-42	-1.5
Prefecture	2063	2510	-447	-22	-1.3
District	957	1291	-334	-35	-1
County city	383	710	-327	-85	-1
County	403	1498	-1094	-271	-3.2
Township	410	458	-47.2	-11	-0.1

Note: Revenues includes Tax revenue and Non-tax revenue

Source: Wang, X. and R. Herd (2013)

The 1994 reforms simplified the intergovernmental fiscal system by replacing the previous system which consisted of six types of fiscal contracts with unequivocal system of tax sharing and a predetermined policy regarding transfers. The new system not only put a stop to the enduring misappropriation of revenues between the

central and local governments, but also provided the right incentives for the sub-national governments. The extant system of intergovernmental transfers can be discussed under the two major categories: tax sharing and transfers (grants).

1. Tax sharing

Details of the present tax sharing system have been provided above in sections B and C. In China, almost half of national tax revenue is allocated to local governments through tax-sharing agreements. There is a well-defined formula for allocating different taxes, which has been slightly changed three times since 1994. It has not been altered since 2003, when the central share in income taxes was raised from 50 to 60 percent, the share of stamp duty on financial transactions rose from 50 to 97 percent, and the business tax on the financial industry was assigned to the central government.

Since the 1990s, the proportion of total expenditure undertaken by sub-national government has risen considerably. The discrepancy between a fixed revenue share and rising expenditure share has driven much of the growth in vertical fiscal inequalities: by the time the system devised in 1994 was fully operational in 1999, the aggregate tax share of sub-national government was 46 percent while their expenditure share was 69 percent; and by 2011, the tax share had remained constant at 46 percent of total tax revenues, while the expenditure share had risen to 85 percent.¹⁹

2. Transfers

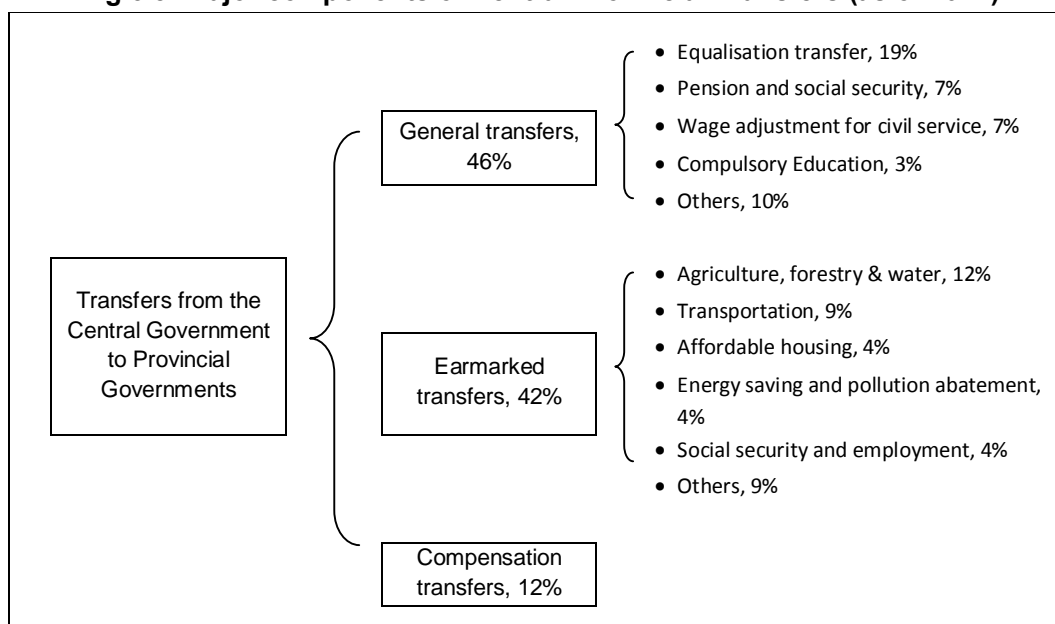
One of the stated objectives of the 1994 tax reform was to recentralise decision-making and enable the central government to better control policy implementation across the country. In order to accommodate a substantial increase in the share of expenditure in areas covered by sub-national government not matched by increased tax revenues, the government designed a new transfer system. Under the new system of intergovernmental transfers, Central transfers can be broadly classified into three components. These are:

- i) *General transfers*: these are used to lower disparities in expenditure;
- ii) *Earmarked transfers*: these are used to subsidise local projects in certain regions subject to matching outlays by local governments; and

¹⁹ Simple calculation suggests that if the average tax share were raised to 62 percent, the gap between expenditure and revenue would be lowered to the level observed in 1999. This would eliminate the gap between revenue and expenditure for the aggregate of provincial, prefecture, urban districts and county cities. The remaining fiscal gaps would be found almost exclusively at the county level and would presumably be concentrated in the poorest counties (Wang and Herd 2013).

iii) *Compensation transfers*: these are designed to reduce the revenue loss accruing to some local governments after the 1994 reforms.

Fig 3.5: Major components of Central-Provincial Transfers (as of 2011)



Source: Wang, X. and R. Herd (2013).

Figure 3.5 shows the different sub-components of the three types of transfers. The general transfers accounted for about 46 percent of the total transfers in 2011 followed by earmarked transfers (42 percent) and compensation transfers (12 percent). The main form of general transfer is the equalization transfer which accounted for about 19 percent of the total transfers in 2011. It is the first formula based grant devised in 1995 to bridge the widening regional disparities (and also lower spending inequalities across the country). The quantum of equalization transfer for a province is determined by three factors - standard revenue of the province, standard expenditure of the province, and the share of provincial standard fiscal gap of the total fiscal gap. The size of the pool for equalization transfer is determined by the central government on an ad-hoc basis, subject to annual funding availability. Originally only 18 provinces were eligible for equalisation transfers. This was widened to 25 in 2002 and has remained constant since.

Box: Equalization Transfers

The quantum of equalization transfer for a province is determined by the gap between standard revenue capacity and standard current expenditures. The standard revenue capacity is estimated using the tax bases and standard tax rates, while the standard current expenditure is calculated based on different per capita spending for different categories of outlays for adjusted cost factors such as altitude, population density, temperature, transport distance and the proportion of the population

belonging to minority groups. The categories of spending include administration services, public safety, education, urban maintenance, healthcare, environmental protection and social assistance. The transfer amount is also adjusted for coefficients that take into account the size of the standard gap, the actual gap, and the total amount allocated from central government revenue. Moreover, rewards in terms of additional grants are given to provinces that achieve better fiscal equalisation results at sub-provincial levels. The amount of equalization transfer to the i^{th} province (ET_i) is calculated as

$$ET_i = TET * \left(\frac{SE_i - SR_i}{SE - SR} \right) * \sigma_i + \Delta_i + RE_i$$

where,

TET = total equalisation grant available in the budget year. The size is determined by the increase in the shared income tax allotted to the central government, plus an extra amount allocated on an ad-hoc basis, subject to annual funding availability;

SE_i = standard expenditure of the i^{th} province. It is the sum of total standardised spending for 14 sectors. For each sector, the standard national average standard expenditure per registered inhabitant is calculated. The national average is then converted to a provincial average by adjusting for cost differences caused by the difference from the national average of altitude, population density, temperature, transport distances, the number of civil servants, regional wage differentials, number of students and the prevalence of minority groups. The cost factors vary according to the spending category. Total standardised spending was calculated as the product of standardised spending per registered inhabitant and the number of registered inhabitants irrespective of where they actually live) during 1995 to 2011.

Since 2012, the method of calculating the equalisation grant was changed to take the number of migrants into account. The population used to calculate the per capita data was now defined as the registered population plus 15 percent of the difference between the actual population and the registered population.

SE = total standard expenditure of the country;

SR_i = standard revenue of the i^{th} province. For each type of tax, standard tax revenue is determined by multiplying the standard tax base with the standard tax rate.

SR = total standard revenue of the country;

σ_i = fiscal difficulty index of province i , calculated as the sum of spending on wages for civil servants, operating expenses and payments for the basic livelihood allowance as percent to standard revenue

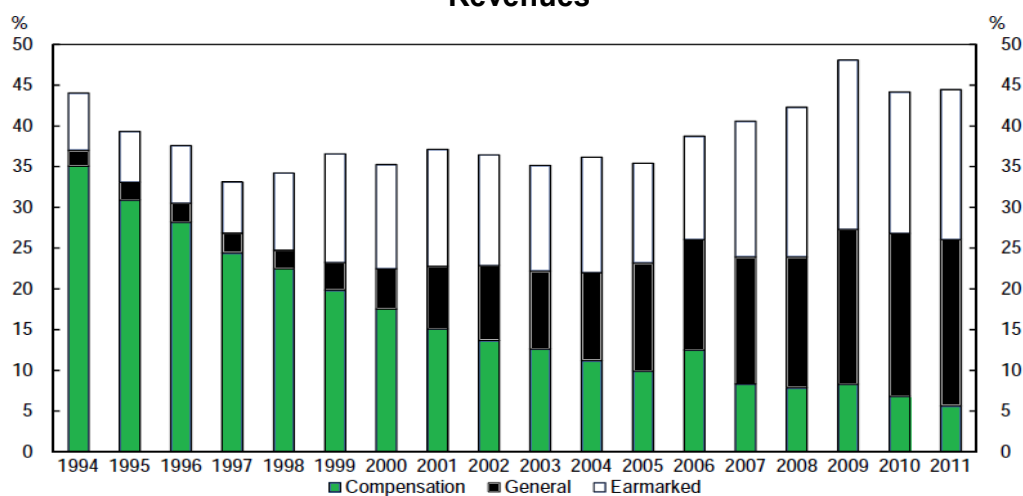
Δ_i = adjustment index of province i based on the difference between the change in the actual grant and the baseline predicted amount;

RE_i = reward grant allotted to the i^{th} province, if any (only to top five performers of fiscal equalisation results at sub-provincial levels)

There are over 100 different types of earmarked grants, which are allocated on an ad hoc or negotiated basis. Moreover, many of these grants are determined by individual Ministries and are not controlled by the Ministry of Finance. This undermines transparency relative to a rule-based system. The system favours localities that lobby harder rather than those in greater need. Furthermore, the centre lacks the monitoring mechanisms to ensure the effective use of these earmarked resources, especially at sub-provincial levels (Ahmad et al., 2004; Shen et al., 2012).

Some of the grants under the general transfer component resemble earmarked grants. However, they do not require matching funds. Moreover they accrue to provinces according to their GDP per capita. The wage adjustment grant varies by a factor of four between eastern and western provinces. Central government increased wage rates of public sector employees in 1999 and 2001. In order to support the implementation of its wage rate increase policy in western and central regions of the country, it introduced a special grant. The objective of this transfer is to fill the fiscal gap caused by the central policy mandate of increasing wages of public sector employees. Provinces which were having difficulties in paying wages of teachers in rural elementary and middle schools were also compensated under this transfer. The compulsory education grant is only paid to rural counties and compensated for the abolition of the agricultural tax, previously used to fund education.

Figure 3.6: Intergovernmental Transfers as Ratio of National Tax Revenues



Source: Wang, X. and R. Herd (2013)

Post 1994 tax reform, the predominant form of transfer was that which compensated regions that had lost as a result of the tax reform (i.e., the compensation transfers). The formula was designed to ensure that the grant component fell gradually relative to GDP. As local tax receipts failed to keep up with expenditure, the share of general and earmarked transfers rose. By 2011, general and earmarked transfers dominated. Fig 3.6 shows the importance of the three types of transfers in China. There are some 20 categories of over 100 different types of

recurrent transfers classified as earmarked transfers while there are 18 types of relatively fixed types of grants in China defined as general transfers.

The sub-provincial transfer design is also quite similar to that of central transfers to provincial governments, though the grant composition varies significantly across provinces due to diversity of regional fiscal resources.

G. Off-budget and extra-budgetary finance

With the introduction of the Tax Sharing System (TSS) in 1994 which recentralised revenues, the local governments were left with huge gaps between their expenditures and revenues. The centralized collection and division of tax revenue considerably decreased the autonomous budgetary income but not fiscal responsibilities for local governments. Although the central government established a transfer system to address the vertical fiscal imbalance, many local governments, especially at county level and below, suffered serious fiscal shortages and tried desperately to make their ends meet.

Under such circumstances, revenues generated outside the budgetary system managed by fiscal and taxation departments provided an expedient rescue for fiscally distressed local governments. While local governments and their agencies do not have the formal power to establish taxes or determine tax rates, they could levy non-tax charges on the public and generate revenue on ad hoc bases under the so-called extra-budgetary system, an important but fragmented and under-regulated part of China's fiscal system. Since 1994, the volume of local extra-budgetary revenue has increased rapidly and continuously except for a couple of years. In 2009, local extra-budgetary revenue amounted to over 606 billion yuan, nearly one fifth of local budgetary revenue.

The local extra-budgetary practices generate a two-pronged consequence. On the one hand, extra-budgetary revenue provides a crucial funding source to sustain the proper functioning of local governments and their agencies, including the provision of public services and infrastructural construction etc. On the other hand, however, extra-budgetary practices tend to generate distortive and harmful effects, in particular for overall macro-fiscal stability and control. In particular, the dispersed and often chaotic management of funds encroaches on budgetary revenue, impedes budgetary reform and transparency, undermines macro control of the national economy, and breeds corruption. Despite these negative consequences, extra-

budgetary funds are officially recognized and accepted as an indispensable funding source for local public finance.

A broad definition of extra budgetary funds (EBF) is that they constitute all resources managed directly or indirectly by administrative branches of the government outside the normal budgetary process. Following the Soviet practice, explicit EBF were first created in the early 1950s as small amounts of funds set aside from centralized management and control. However, as the concept evolved EBF came to refer to fees and funds that were not taxes or budgetary items but that nonetheless were specifically authorized by some government body. This definition leaves out significant public resources that were neither budgetary nor extra-budgetary in this sense. Such funds were variously called self-raised funds, extra-budgetary funds, off-budgetary funds, or extra-system revenues. One important example is the revenue from the sale of land leases: because of the irregular, non-recurrent nature of such revenue, the Ministry of Finance agreed that it should not be included in local budgetary revenues to avoid affecting the revenue-sharing base. However, no treatment was clearly specified for such funds. In some localities, such revenues were called extra-budgetary revenue; elsewhere, they were listed as self-raised funds. It was only in the late 1990s that they began to be treated as fund revenues and reported in the budget as a below-the-line item. For all these reasons, it is far from simple to tell just what is being counted in references to extra-budgetary resources in China.

Although local extra-budgetary charges and levies must, in principle, be established and collected under the guidance and with the approval of the central government via the State Council, Ministry of Finance or other central ministries, under most conditions they are largely the autonomous decisions made by provincial and sub-provincial governments and their agencies. Unless the central government steps in to overrule local practices by abolishing or adjusting the standard of certain charges, local governments enjoy great discretion in establishing and collecting extra-budgetary revenue (EBR). This is especially true for sub-provincial governments and agencies. They can set up extra-budgetary charges with the approval of provincial fiscal and price-control authorities but do not need to obtain central approval. So when the central government does not intervene, the collection of EBR is completely local autonomous behaviour.

Although local governments can decide what kind of and how much EBR to collect, the central government (represented by the State Council and the Ministry of

Finance) has the formal authority to overrule locally established extra-budgetary exactions. When the central government intervenes, it can revoke or decrease the amount of extra-budgetary levies that local governments collect, or put certain local extra-budgetary funds under budgetary management, which may decrease the volume of local EBR and/or the governments' reliance on it. Therefore, local extra-budgetary practices are subject to central interventions.

Since its inception in the 1950s, EBRs has served as a supplementary funding source for government departments and agencies in China. Although it remained a small part of China's fiscal system for a few decades, it became increasingly important in the 1980s and 1990s, when support for public services fell across the board. Public service providers, including primary and middle schools, received, on average, only one-half of their operating revenues from the budget, and had to find the rest through fees and other incomes. Even local police departments typically received only budgetary support for salaries, and had to buy their uniforms, batons and other equipment from revenues collected through fines and penalties (Bai, 2004). To keep services going, local governments and public agencies were encouraged to find supplementary sources of revenue (Wong, 2009). With incentives that allowed the collecting agencies to use a part of the receipts for bonuses and topping-up salaries, they obliged by levying fees, user charges, fines and penalties (Wong, 2009). Fees and other levies proliferated; by the late 1990s revenue from these sources totalled 8-10 per cent of GDP, and they were reportedly financing half or more of local government expenditures (Fan 1998, Wong 1998, and Wong and Bird 2008).

Between 1982 and 2009, the total amount of local EBR increased by more than ten times (figure 3.7). Despite the reforms on the extra-budgetary system that led to occasional drops in EBR, most notably in 1993, local EBR maintained a remarkable growth rate. Between 1994 and 2009, the total amount of local EBR almost quadrupled, with an average annual growth rate of 9.4 percent. Under the fiscal contract system throughout the 1980s and early 1990s, EBR was almost on a par with budgetary revenue, the major funding source for local governments and their agencies. But the reform in 1993 brought a sharp turning point.

Since 1998, the government has taken a number of measures to reverse this trend. The strategy was to clamp down on unauthorised fees and levies, bring administrative fees collected by government departments and agencies into the budget as much as possible, improve monitoring of revenues and expenditures of the

major items of the reported EBF, and to gradually convert them to taxes. The efforts have achieved some measure of success. After a brief resurgence from 1994 to 1996, the weight of EBR gradually declined in the following years. In 2009, local EBR was equal to 18.6 percent of local budgetary revenue (figure 3.7). Many fees have been abolished and replaced by budgetary support, including all rural levies under the Rural Fee Reform campaign that was implemented during 2001-2003. Administrative fees continued to grow, but are now incorporated into budget accounting, though not unified budgeting. Reclassifying and removing some of the biggest sources of EBF also helped the government whittle down what is reported in the formal category of EBF. Finally, in 2010, the Ministry of Finance renamed them non-tax revenues (NTR), ending the existence of extra-budgetary funds as an official category. In 2012 NTR were 1.66 trillion yuan (or 3.2 percent of GDP).

Figure 3.7: Local extra-budgetary revenue (1982–2009).



Source: Zhan (2013)

H. Sub-National Debt

Under China's 1994 budget law, sub-national governments are not allowed to borrow from either domestic or international sources unless otherwise permitted by the law. However, in reality many sub-national entities are on the verge of bankruptcy due to high debt service liabilities. It is estimated that the total sub-national borrowing was over US\$120 billion by the end of 2004 (Wei, 2004; Shen et al., 2012). The total debt of the grassroots governments was around US\$40 billion by the end of 2001, over half of which was borrowed by the townships. Total debts should be much higher if implicit debt such as unpaid civil servants salaries and farmers' services were included.

In China, borrowings by sub-national governments can be broadly categorized as:

- a) **Direct Borrowing and Loan Guarantee:** Almost all sub-national governments at different tiers have incurred direct borrowing and the borrowing could be from any department of the government. Local governments (particularly the county and township level governments) are unable to pay full salaries to elementary and secondary school teachers. The unpaid part of such salaries becomes the debt of local governments. On many occasions, grass-root level governments issue informal debt papers (*baitiao*) to farmers as they are unable to pay them for their produce due to financial constraints, this is also debt of local governments. All sub-national governments provide loan guarantees to SOEs directly or indirectly, though it is not permissible. They also provide loan guarantees to the central bank for financial institutions at their level to avoid financial risk.
- b) **Borrowings from Commercial Banks:** Sub-national governments have used their powers of appointing heads of regional banks and also through other intangible influences like supply of water, electricity, housing, recruitment of bank employees, schooling of children etc. to get easy access to borrowing from commercial banks. Such control of credit supply of commercial banks by these governments has resulted in over-lending and under-pricing of loans and excessive expansion of bank credit thereby resulting in mounting number of bad and non-performing loans. In 1998, the central government had to bail out several sub-national units by issuing 270 billion Yuan of government bonds to recapitalize the state-owned banks (Jin and Zou, 2003).
- c) **Indirect borrowings:** Sub-national governments borrow indirectly through various channels such as their public enterprises or Trust and Investment Companies (TICs). Public enterprises owned by sub-national governments which are responsible for the provision of public services often borrow from banks and also from capital market. These governments may also borrow through collective financing in which various groups of people, like government employees and employees of local SOEs, are selected to be borrowers on behalf of their employer governments. The borrowing could be voluntary, but most of the time it was forced by sub-national governments. Most of these borrowings were used to start local enterprises. However, a significant part of these projects were not successful and the bankruptcy of these enterprises due to lack of management skills and experience imposed serious debts on the concerned governments.
- d) **Foreign borrowings:** External borrowing is only by the central and other government-owned financial institutions; but a part of the latter type of debt are

part of sub-national government borrowing as most of these financial institutions are TICs controlled by the sub-national governments.

Although practiced informally or illegally, local borrowing played an important role in local economic development and in alleviating local fiscal pressure, particularly for those jurisdictions struggling to make ends meet. The significant improvement of local infrastructure in almost all jurisdictions in the last decade is partially attributed to local borrowing.

Local governments in China are in principle subject to strict borrowing constraints. According to the 1994 Budget Law, local governments are not allowed to borrow from banks or issue bonds without prior authorization of the State Council. Similarly, the 1995 Guarantee Law requires prior authorization of the State Council for issuance of guarantees. On-lending from central government has been the main financing channel available to local governments, mainly via the external loans and treasury bonds issued by the central government. This channel has been used more intensely in the years following the 1998 Asian crisis, in particular to finance investment projects in specific sectors.

I. Sub-national impact of the global financial crisis

In the wake of global financial crisis China introduced a massive stimulus programme in the fourth quarter of 2008 and implemented through 2009 and 2010. A stimulus of 4 trillion yuan was announced comprising 1.18 trillion yuan through central government funding (from the budget) and the remaining 2.8 trillion yuan to be provided by local governments, enterprises and banks. The package amounted to 12.5 percent of China's GDP in 2008, to be spent over 27 months.²⁰ The stimulus focused on seven priority areas, (i) transport and power infrastructure (railroads, roads, airports, electricity grids); (ii) earthquake reconstruction; (iii) rural village infrastructure; (iv) environment, energy efficiency and carbon emission reduction; (v) affordable housing; (vi) technological innovation and restructuring; and (vii) health and education. Along with the huge fiscal injection, state-owned banks opened their spigots, and total credit grew by more than one-third in 2009. Local governments also contributed extensively to the stimulus. Altogether the total stimulus grew to an estimated 27 percent of GDP, with an injection of 19 percent in 2009 alone.

²⁰ In relative terms, it was the biggest stimulus package in the world, equal to 3 times the size of the US effort.

The fiscal stimulus programme was to be largely implemented by local governments, and they embraced it with great enthusiasm. Although the central government did not spell out in details the division of responsibilities for undertaking and financing the stimulus investments, anecdotal evidence suggests that the usual rules were applied both for the assignment of projects and for cost sharing between central and local governments. Under the normal process, the National Development and Reform Commission (NDRC) is responsible for formulating the national investment plan and approving the list of projects to be included. With guidance from NDRC on priority areas in which funding is available, local governments (and central ministries) prepare project lists to be submitted each year for inclusion in the national investment plan. Once chosen, a project becomes eligible for budgetary funding as well as bank credit, which is available only for approved projects. While local governments and ministries compete for national investment funds, the competition is constrained by the availability of funding at localities, since virtually all projects implemented by local governments require counterpart funding, the proportions of which vary by sector and by region.²¹ Eligibility for application usually requires proof of funding availability from the local government. To be eligible for bank credit, the banks also require proof of requisite own funding in the form of equity or paid-in capital (usually 25-35 percent).

With the fiscal stimulus programme, the available pool of central funding was vastly expanded, but the goal for quick implementation of the ambitious investment programme required the NDRC to be especially vigilant in ensuring that projects would be allocated only to local governments that have sufficient funds to meet co-financing needs. From the outset, the worry was that with three-quarters of the projects assigned to localities, local governments would struggle to meet this burden of counterpart funding. The government introduced several new measures to make it easier for local governments to meet the co-financing requirements. As part of the fiscal stimulus measures, *inter alia*, the following measures were taken:

- In March 2009, the State Council approved a special 200 billion Yuan issue of treasury bonds by the Ministry of Finance on behalf of local governments, and stipulated an accelerated disbursement of the funds to the provinces. The purpose of this bond issue was to allow local governments to raise debt for funding capital investments. Until an institutional framework is installed to

²¹ For example, school construction requires a one third contribution from local governments, and for low-cost housing the central input is a flat rate of 300 yuan per square metre for the central provinces and 400 yuan for the western provinces.

monitor and control local debt issue, the government issued debt centrally, through the Ministry of Finance, but under the names of recipient provinces.

- The central government officially endorsed the use of local government financial platforms and other means of raising debt. In March 2009, a document was jointly issued by the People's Bank of China and the China Banking Regulatory Commission, calling for supporting localities with appropriate conditions to organise and build financial platforms, issue corporate debt and medium-term notes and other financial products, to broaden the channels of funding for providing counterpart funds for central government investment projects.
- The Ministry of Finance relaxed the standards on what is eligible as counterpart funds to qualify for stimulus projects, specifying that local governments can use the following sources: budgetary resources, land revenues, proceeds from local bonds issued by the Ministry of Finance, funds raised by local financial platforms, and all other resources at the discretion of local governments. These changes greatly expanded the space for local governments. Within less than a month of the announcement of the stimulus package, local governments, in aggregate, had proposed a total of 18 trillion Yuan in investment projects which later increased to 25 trillion Yuan for the first 18 provinces reporting their plans.

On the supply side, China's state-owned banks also responded with frenzied enthusiasm to the stimulus programme by providing increased lending for investment in a long list of sectors, projects and conditions including public infrastructure, earthquake reconstruction, energy saving, technical renovation and technology upgrading, regional development, small and medium-sized enterprises, and rural projects. After all, the directives from the government and political leaders effectively eliminated all personal responsibility for the lending decisions, and credit growth exploded. Especially favoured were projects backed by local governments.

The recent surge in local government debt was actually triggered by the central government's massive economic stimulus program. Though the central government announced a 4 trillion Yuan stimulus package to spend its way out of a recession, it only committed to funding 1.18 trillion Yuan, leaving the rest to local governments and banks. An investigation by China's central bank found local governments nationwide saddled with more than 7 trillion Yuan in debt - both on and off the books.

With the central government actively encouraging their creation, local government investment corporations (LICs) spread like wildfire under the stimulus programme and were on the front line in competing for investment funding and bank credit. With three quarters of the stimulus investments made by local governments, the LICs played a leading role in investing in infrastructure and were, as a group, the biggest players. According to the China Banking Regulatory Commission (CBRC), LICs grabbed nearly one-third of all new loans issued in 2009 and increased their total debt by 3 trillion to 7.38 trillion Yuan by the end of 2009. In the first quarter of 2010, LICs accounted for 40 percent of all new bank loans. More recent estimates, based on findings by the National Audit Office and the central bank, are that the total debt of LICs is likely to have reached 10-14 trillion Yuan by the end of 2010.

The super-sized stimulus programme has left in its wake a huge run-up in local government debt whose dimensions and potential effects can only be guessed. This is because China has no reliable national figures on local government debt despite a decade long effort at building a debt-reporting system in the Ministry of Finance. A major reason is that, aside from the bonds issued by the Ministry of Finance on behalf of local governments, local government debt is primarily accumulated through LICs. Investigators at the CBRC estimated that local government debt totalled 11 trillion Yuan at the end of 2009, of which LIC debt accounted for 7.38 trillion Yuan. In aggregate terms, the implied level of local government debt (of 15-20 trillion Yuan in total) equalled around 40 percent of GDP in 2010.

Servicing the debt, though, may pose problems for local governments, given how highly constrained their budgets are under the present intergovernmental fiscal system, where they have no taxing powers and are already straining to meet growing expenditure needs. Efforts are now being made to address this problem. Draft amendments to the budget law were submitted in the month of April 2014 to the 12th National People's Congress Standing Committee for a third reading. The draft bill has proposed to allow the governments of provinces, autonomous regions and municipalities to issue bonds, subject to State Council approval. The funds raised must be used for infrastructure investments, but not for recurrent public spending.²²

²² Putting Government Spending Power into Cage, available at <http://english.caixin.com/2014-04-30/100672328.html> (accessed on 10 May 2014)

Since 2012, a few local governments were allowed to issue bonds on their own, but repayments were to be handled through their accounts with the Ministry of Finance. Very recently in May 2014 a notification was issued by the Ministry of Finance providing the details of bond issuance by ten local governments: Shanghai, Zhejiang, Guangdong, Shenzhen, Jiangsu, Shandong, Beijing, Qingdao, Ningxia, and Jiangxi, pursuant to such issuance envisaged in the budget in March 2014. In principle, State Council will allocate quotas for bond issuance every year (without carryover), and local governments can issue and service bonds within the quotas. The present issue is of fixed rate coupon bonds with varying maturity (3 categories). The issue will be based on market principle, with credit rating required; the interest rate will be based on the prevailing central government bond rate and market rate, and determined through either underwriting or tendering. This is the first time local governments are being allowed to issue bonds and service them completely on their own. The proceeds are to be used for non-profit capital investment or replacing earlier irregular debt.²³

J. Service delivery at sub-national level and subsidies

Although government revenues in China are centralized, government expenditure is highly decentralized across five levels of government, namely the central, provincial, prefecture, county and township levels. Aligning incentives, responsibilities and resources across government levels has been a long-standing challenge. In social sectors, including health, sub-national governments account for 90 percent of the total budgetary expenditures and bear responsibility for the provision of essential services including health and education. Government expenditure on health is largely determined by local fiscal capacity (Feltenstein and Iwata 2005; Yip et al. 2012). The county and township governments, the lowest two of the five tiers, bear the main responsibility for financing essential public services including health. Their fiscal capacity differs widely across China even after adjusting for equalization transfers, which are formula-based grants by central government calculated according to local expenditure needs and fiscal capacity. On average, revenues through the tax revenue-sharing mechanism and intergovernmental fiscal transfers from the centre finance up to 50 percent of sub-national government expenditure (World Bank 2012). China's decentralization and intergovernmental system gives unusually high discretionary power to provincial governments and imposes a significant fiscal stress at the lowest government levels. County and township governments receive public resources through a cascading arrangement, in

²³ Citi Research - Economics, China Macro Flash, 21 May 2014.

which each level of government has considerable discretion in transferring resources to the lower-level government. In particular, provincial governments, the main recipients of the central government equalization and tax sharing grants, have significant autonomy in transferring resources to prefecture governments, which in turn determine the transfers to county governments which decide on the transfers to the townships. In this system, poorer jurisdictions at the township and county levels tend to face an imbalance between their available resources and responsibility for public service delivery.

A recent study by Brixi et al. (2013) analyzes government expenditure on health in the context of China's decentralization and intergovernmental model to assess whether national, provincial and sub-provincial public resource allocations and local government accountability relationships are aligned with the goals. The analysis reveals that government expenditure on health at sub-national levels, which accounts for 90 percent of total government expenditure on health, is increasingly regressive across provinces, and across prefectures within provinces. Increasing inequity in public expenditure at sub-national levels indicates that resources and responsibilities at sub-national levels in China are not well aligned with national priorities. Promoting equity and efficiency in public resource allocation at sub-national levels is a particular challenge that has yet to receive appropriate attention in China.

Brixi et al. (2013) point out that surveys and insights based on discussion with government officials suggest that governments at each level may partly withhold public resources originally envisaged to cover expenditure responsibilities of counties, townships and villages in need. It has been observed that beyond the earmarked transfers and selected nationwide priorities, provincial and lower levels of governments favour spending close to home (i.e., mainly in the provincial capital city and at the prefecture and municipal level). This kind of bias at sub-national levels could undermine progress towards national development goals set by the central government. Transfers, even if earmarked for specific counties are transmitted through provincial and prefecture governments and are disproportionately spent on urban development, particularly urban infrastructure, leaving a shortage of resources at the county level and below to spend on essential social services. To supplement resources received from the higher levels, sub-national governments raise resources from various fees, the sale of land-use rights and taxes on real estate transactions (World Bank 2012). Such locally generated revenues, however, may further exacerbate inequalities as poor localities tend to have a more limited scope for revenue-generating transactions. The continuing imbalance between resources and

expenditure responsibilities at county and township levels, particularly in poor jurisdictions, has negatively affected the quality of services provided like health care (Yang 2011), and raised the burden of household health expenditure (Meng et al. 2012) in poor rural localities (Blumenthal and Hsiao 2005; World Bank 2012). China's current health system reform (HSR) is striving to resolve deep inequities in health outcomes. Achieving this goal is difficult not only because of continuously increasing income disparities in China but also because of weaknesses in healthcare financing and delivery at the local level.

Direct Subsidies under the “Three Rurals”²⁴: In the 21st century the Chinese government shifted its focus to ensuring that more of the fruits of development reach the country's poor. It directed many public resources toward addressing issues related to agriculture, rural areas and farmers, and gradually implemented the rural tax-for-fee reform, abolishing fees and levies as well as agricultural taxes. The 2003 rural work policy of “Give More, Take Less and Liberalize” fundamentally changed the relationship between the state and farmers.

To support these changes, the government's financial inputs increased significantly. A new category for fiscal reporting, “the three rurals” (*sannong*), was created which brought all public expenditures on the rural sector together for the first time. According to data published by the Ministry of Finance, central government funding for the three rurals increased from CNY 77.4 billion in 1996 to CNY 214.4 billion in 2003, and to CNY 725.3 billion in 2009. In addition to the rapid growth in funding, the government departed from traditional supply-side approaches which directed expenditures to state agencies and institutions. Three-rural expenditures have increasingly been targeted directly to farmers.²⁵ The government also sought to improve the targeting of subsidies.

Under the new three-rural strategy, initiatives come from various ministries and agencies to provide direct subsidies to the rural populace, and the programs reflect a diverse range of objectives. Some subsidies are aimed at promoting production or improving productivity, some at improving farmers' social welfare, and others at improving farmers' living conditions. The major direct-subsidy programs are presented and described briefly in table 3.11. Following the government's three-rural

²⁴ The three rurals are agriculture, rural villages and farmers.

²⁵ For example, subsidies for grain production went previously to state-owned grain trading enterprises to offset their trading losses from subsidizing procurement; under the new strategy, subsidies are paid directly to farmers for adopting improved seeds

terminology, the programs are divided into production subsidies (agriculture), social welfare and public services (farmers livelihood) and living conditions (villages).

Table 3.11: Overview of Major Direct Subsidy Programmes for Farmers

Subsidy Type	Program and Objectives	Responsible Agency	Year of Launch
1. Production	Well-bred seeds subsidy: to promote adoption of improved varieties	Min of Agriculture	2002
	Direct subsidy for grain production: to increase income of grain farmers	Min of Finance	2002
	Subsidy for the purchase of agricultural machinery: to encourage mechanization	Min of Agriculture	2004
	Subsidy for the purchase of agricultural production inputs: to offset price inflation	Min of Finance	2006
	Subsidy for agricultural insurance: to promote use of insurance	Min of Finance	2004
2. Social Welfare and Public Services	Two Exemptions and One Subsidy: to reduce out-of-pocket costs for rural compulsory education	Min of Education	2001
	New Cooperative Medical Scheme (NCMS): to promote enrolment in health insurance programs through large subsidies to cover premium payments	Min of Health	2003
	Medical Care Relief Fund: to provide assistance to eligible poor families by paying health-care costs and NCMS premium	Min of Civil Affairs	2003
	Minimum Living Allowance: a top-up scheme to provide income support for the rural poor	Min of Civil Affairs	2007
	New Rural Social Pension Insurance: for farmers who have lost their land to urbanization	Min of Human resource and Social Security	2009
3. Living Conditions	Subsidy for biogas digesters: to promote the use of biogas by rural households	Min of Agriculture	2003
	Subsidy for the purchase of household electrical appliances: to stimulate demand during the financial crisis	Min of Commerce	2007

Source: Lin and Wong (2012)

The direct-subsidy programs are huge and have large pools of beneficiaries. For example, there are some 835 million participants in the New Cooperative Medical Scheme (NCMS) and some 130 million children benefit from the TEOS. Table 3.12 presents data on the main types of direct subsidies to farmers financed by the central government. The central government expenditures for direct subsidies to farm households grew from CNY 12.2 billion in 2003 to CNY 234.7 billion in 2009.²⁶

Table 3.12: Central Government Funding of Direct Subsidies for Farmers
(Billion Yuan)

Items	2003	2004	2005	2006	2007	2008	2009
1. Production Subsidy	10.60	14.52	17.39	31.05	55.35	111.26	139.02
2. Subsidies for social welfare and public services	0.59	1.47	4.88	19.01	46.45	78.8	83.16
3. Subsidies for improving living conditions	1.02	1.01	1.01	2.46	2.5	8.22	12.54
Total	12.21	17.00	23.28	52.52	104.3	198.28	234.72

Source: Lin and Wong (2012)

²⁶ It should be noted that the overall scale of the program is in fact larger than presented here, since these figures represent only central government inputs. The total scale of government inputs to direct-subsidy programs is estimated to be CNY 300 billion, or 4 per cent of total budgetary expenditures, in 2009.

Studies have revealed that the contribution of direct subsidies to the actual income of farm households has become increasingly significant. These subsidies, although not yet reversing the widening rural-urban income gap, are clearly making a contribution towards curbing it. It has also been pointed out that there are significant problems in the distribution of subsidies. Lin and Wong (2012) have shown that the rural subsidy program has a generally regressive impact: poorer households receive less money, and households in poorer provinces, regardless of income level, receive less money. This finding is consistent with that of an internal report by the Poverty Reduction Office of the Chinese State Council, which similarly found that the distribution of direct subsidies for farmers does not serve the most vulnerable groups. In their view what stands out in the Chinese case is the dominant role played by the intergovernmental fiscal system in thwarting the redistributive impact of the pro-poor subsidy programs. This is due to the highly decentralized nature of the Chinese fiscal system, where so many vital responsibilities are assigned to low levels of government - many with limited fiscal resources - and where the central government's capacity to direct intergovernmental transfers to areas where they are needed remains woefully inadequate. The result is that differences in fiscal capacity across provinces overwhelm the central government subsidies and farm households in the richer provinces receive more subsidies, thus further widening regional income and wealth gaps. The regressive inter-personal distribution of subsidies is due partly to the design of some of the programs, by which the farmers must first incur expenses, the costs of which may constrain the ability of poor to access subsidies.

In China's intergovernmental system, sub-national governments have insufficient downward accountability. Local elections are limited and citizens' feedback does not directly determine their outcomes (Zhou 2010). The central government evaluates performance of sub-national governments according to specific criteria (which emphasize public order and economic growth and selected policy priorities). Such evaluation tends to determine promotion decisions for government officials across government levels. Efficiency and particularly equity in public resource allocation have not been included among the core performance indicators for governments at sub-national levels. Local government officials are not held accountable for equity in local health outcomes and for equity and efficiency in public resource allocation within their jurisdiction. There is no mechanism for independent, province-level evaluation of output- or outcome-level indicators in the health sector. Sub-national governments are yet to become truly accountable for

local performance in the areas of regulatory and law enforcement, policy implementation and the financing and delivery of services, such as health care.

Fiscal decentralization in the context of uneven economic development across geographic areas has resulted in greatly varied fiscal capacity to fund social services (Bloom 2011; Meng et al. 2012). Moreover, the extent of inequity in public spending on health per capita across provinces has risen since 2001. Within provinces and also within prefectures, evidence also suggests that inequity in spending on health is rising. Across provinces, government health resources are not matching the needs. Provinces with a proportionally larger rural population spent less on health per capita. This situation is a reflection of both incentives and fiscal space at the provincial level. It prevailed despite increasing central government earmarked allocations notionally targeting the rural poor (hospital delivery subsidies for rural women; the introduction of fee-free vaccination; increasing and tiered RCMS payments; and basic public health payments indexed by provincial ability to pay), and despite official data indicating the poorer health status of the rural population and the lower affordability of health services for the rural poor.

The 1994 Tax Sharing Reform was a turning point. It streamlined the tax system, improved its buoyancy, strengthened tax administration, and also public expenditure management. However, many challenges remain. These shortcomings pose challenges for equity and effectiveness of service delivery and for the transparency and accountability of the fiscal system as a whole.

K. Concluding observations

Despite improvements in revenue sharing arrangements instituted in the 1994 reforms, there are marked differences in revenue generating capacity across provinces and within provinces at the local level. These differences largely stem from the structure of taxation and the failure of the 1994 reforms to put in place a well-defined assignment for sub-provincial governments. Provincial governments differ significantly with respect to their revenue raising capabilities. Revenue-sharing for VAT and enterprise profit tax on a derivation basis has further increased the disparities in revenue distribution in favour of the richest provinces. The bases for these taxes typically cover the manufacturing and services sectors. Hence, coastal regions, where the share of GDP of these sectors is the highest, benefited more from the current fiscal system than central and western provinces, whose economic structure relies more heavily on agriculture (Dabla-Norris, 2005). A similar pattern applies to the personal income tax.

The recentralization of tax revenues in 1994 was not accompanied by revisions to expenditure responsibilities, which remained the same as under the centrally planned system, with local governments acting as agents of central government. As a result, the pattern of expenditure assignments in China continues to suffer from several problems. There is no formal, legal assignment of expenditure responsibilities at the sub-provincial level. This has resulted in high incidence of concurrent expenditure assignments and has created potential for higher-level governments to shift financing responsibilities downwards (Bahl and Vazquez, 2003). Local governments at the sub-provincial level are assigned responsibilities for the provision of education and health services, unemployment insurance, and social security. Local governments account for over 90 percent of total spending in culture, education and health, and for virtually all the social relief and welfare expenditure, including pension payments which are decentralized all the way up to the county level. Many of these are designed with co-financing requirements or have minimum service standards set by the centre and are unsustainable for many poor regions in the light of current revenue assignments.

The process of recentralizing revenues upwards and devolving expenditures downward extended from central to the provincial to the prefectural to the county and ultimately to the township and village level governments. Each level of government pushes fiscal responsibilities down to lower levels while asserting the largest possible claim on revenue residuals. At the grassroots level, the county and township governments are left with no choice but to either predate on local residents, enterprises, and financial institutions or to cut back on primary public services.

The expenditure assignment, particularly at the county and township levels, requires immediate policy attention. According to widely accepted and practiced rules of responsibility division, local governments should focus on public services and social affairs while the central government emphasize on such national issues as national defence, foreign affairs, macro-economic stability, and functions of regional equalization. China's local governments need to gradually withdraw from the responsibility of local economic development and assume a major role in public services provision. Some of the existing expenditure assignments need to be centralized. The responsibilities assigned to county-level governments for pensions and income support schemes are generally central government functions in most countries, as the social security programs generally entail a certain level of risk pooling and redistribution. In some cases, there are significant economies of scale to

be reaped by higher level provision. The financing of basic public services like education and health cannot heavily depend on sub-provincial governments and the central and provincial governments should take more responsibility in ensuring the national minimum standards of the core public services.

The phenomenon of shifting down expenditure responsibilities to lower levels of government without providing adequate financial support has generated an increasingly widening fiscal gap and intensified local fiscal stress, leaving local governments highly dependent on fiscal transfers from upper-level in fulfilling their spending needs. The fiscal gap at lower level governments especially at the county and township governments is high and is worsening over the years. Consequently, the core public services are generally underfunded. In China, there is growing evidence of significant disparities in the provision of social assistance between richer and poorer regions. Many local governments, especially those in poor western regions, are providing fewer and lower quality public services and passing along a higher proportion of the costs to their constituents.

Faced with tight budgetary constraints due to low levels of formal taxation and skyrocketing spending requirements generated by local development and public services delivery, lower authorities usually cannot meet their budgets by formal taxation alone and thus have to resort to raising resources using informal channels, diverting resources from the budget to extra-budgetary channels, protecting local enterprises, and imposing an array of arbitrary fees making schooling and medical care too costly for poor households. Illegal fees, the main source of extra-budgetary funds at the local level, range from surcharges on household utility bills/ road maintenance/ vehicle purchases to hospitals and school charges.

The current system of intergovernmental transfers, in spite of the large volume of flows does not sufficiently redistribute resources across provinces. Earmarked transfers, which are allocated on an ad hoc and discretionary basis, represent a growing share of transfers. The importance of these types of transfers not only reflects the proactive stance of regional policy carried out by the centre, but is also a reflection of unsustainable expenditure assignments, and was mandated by the emergence in recent years of pension and other arrears, bailouts for local government social protection programs, and fiscal stimulus packages. The ad hoc and discretionary nature of earmarked transfers make the transfer system less transparent and also undermine the rules-based character of the transfer system that the 1994 reform aimed to introduce. The 1994 reforms correctly designed an

equalization transfer system, based on expenditure needs and revenue capacities. However, the resources subsequently available were inadequate to make any significant equalization impact.

The 1994 reform measures have also not addressed the issue of equity in intergovernmental transfers. The tax sharing system does not address the equity issue as revenues are distributed on the principle of origin and there are few equitable grants to offset this. Earmarked grants could address this to some extent, but it is pointed out that many of these grants are allocated in an arbitrary and non-transparent manner. With each level of local government deciding on the system of transfers to the level immediately below, there are problems of both vertical and horizontal coordination in public spending as well (Rao, 2003).

A more complete and effective solution might lie in a complete overhaul of the intergovernmental fiscal system. Currently, almost all tax rates and bases are nationally set, even for those where revenue entirely goes to local governments. Tax reforms are needed to provide provinces and counties with some control over rates of assigned taxes at the margin. This is a key element of fiscal accountability. The choice of taxes, where some local control is envisaged, should be such as not to lead to excessive economic distortions and tax competition (Ahmed et al, 2004). Given the objective of improving local public services and promoting balanced economic development, the present system of fiscal decentralization fails to promote fairness and equity, not enabling all the people to share the fruits of reform and development. The aspects of post 1994-reform system that require policy attention include opaque and inappropriate expenditure assignment, particularly at the sub-provincial levels; growing vertical fiscal gap and widening fiscal disparities; complex and malfunctioning intergovernmental transfer system; neglected sub-provincial fiscal arrangements; and weakness in the vertical accountability of local governments to the Centre as well as the horizontal accountability of local administrations to the local needs and preferences.

Chapter IV: Decentralization in Indonesia

A. Introduction

Indonesia has been in the past a highly centralized polity, probably a result of its earlier political system. It is only after democracy in the real sense became the norm that the idea of decentralization took hold in the late nineties, and sub-national tiers of government started playing a significant role in public supply of several services after what is known as the *big bang* decentralization since 1999. It is interesting to note that the term *federalism* is as yet absent from the literature on Indonesian decentralization, possibly because much of the new responsibilities and powers of the sub-national governments actually result from various Laws adopted by the centre, and not from a Constitution that covers the entire structure of government. Thus, the present structure is not guaranteed; it remains valid only as long as the centre wishes it to be so. Whatever autonomy that the sub-national tiers of government enjoy today is only that granted by the central government.

Nevertheless, the fact of more than one layer of government with assigned responsibilities and revenue sources, and intergovernmental transfers makes the Indonesian fiscal system somewhat comparable to federal systems, particularly because its late start on the path of fiscal decentralization has had the benefit of the experience of many federal systems and a substantial amount of international advice. These, of course, have been adapted to the ground realities in Indonesia, and the system is still evolving. The whole business of decentralization in Indonesia is a work-in-progress. As such, the review below is only a snapshot at a particular point of time; how much of it will remain valid over time cannot be predicted with certainty.

1. Pre-1999 structure of government

Government administration was processed through descending levels of administrative subunits. Indonesia was made up of twenty-seven provincial-level units. In 1992 there actually were only twenty-four provinces (*propinsi*), two special regions (*daerah istimewa*) . Aceh and Yogyakarta . and a special capital city region (*daerah khusus ibukota*) . Jakarta. The provinces in turn were subdivided into districts (*kabupaten*), and below that into sub-districts (*kecamatan*). There were forty municipalities or city governments (*kotamadya*) that were at the same administrative level as a *kabupaten*. At the lowest tier of the administrative hierarchy was the village (*desa*). According to 1991 statistics, Indonesia had 241 districts, 3,625 sub-districts, 56 cities, and 66,979 villages.

Since its independence from the Dutch colonial government, Indonesia has had a highly centralized system of governance till 1999. In this system, the lines of authority, budget, and personnel appointment ran outward and downward from the centre. Regional and local governments enjoyed little autonomy and their role was largely administrative: implementing policies, rules, and regulations framed by the centre. Even the regional bureaucracy was only an extension of the central setup. The political goal was to maintain the command framework of the unitary state, even at the cost of developmental efficiency. Governments below the national level, therefore, served essentially as subordinate administrative units used to implement centrally determined functional activities. This system was in some sense a legacy of history, because for a long time after independence, the overriding considerations were national integration (interpreted as central control) and political stability . both conditioned by perceived Dutch plot to deny the Indonesian nationalists authority over the entire country, the cultural and ethnic diversity of the nation and as a clincher, regional rebellions in the 1950s. Civil control was maintained through a hierarchy of the army's territorial commands, each level of which paralleled a political subdivision--from the highest regional command levels down to non-commissioned officers stationed in the *desa* for "village guidance." Lateral coordination of civilian administration, police, justice, and military affairs was provided at each provincial, district, and sub-district level by a Regional Security Council (*Muspida*).

Even in established federal polities, centralization of revenues is not uncommon (witness the case of Australia); in Indonesia, the inevitable corollary of the political centralization was the centralization of public finances. Adding to this tendency, the economic reality of the unequal endowment of natural resources in the archipelago, especially during and after the development of oil and natural gas extraction, and the mismatch of population density to resources²⁷ provided further impetus for centralization that still endures. Thus, the absence of an independent funding base limited autonomy for provincial and local governments.

About 80 percent of total public expenditure in the provinces was disbursed from the national budget controlled by departments and agencies headquartered in Jakarta. Of the 20 percent administered by the provinces, about half came from *Inpres* (Presidential Instruction) grants for infrastructure and other developmental purposes. Beginning in 1969, the *Inpres* grant programs at provincial, district, and village levels channelled about 20 percent of the

²⁷ The least populated parts of the country were the richest in primary resources. A basic task of the national government was to ensure that the wealth produced by resource exploitation be fairly shared by all Indonesians.

development budget to small-scale projects for local development, with an emphasis on roads, irrigation, schools, and public health. Only about 10 percent of regional government revenue was derived from local taxes and fees.

2. Present structure of government

After the fall of the Soeharto regime in 1998, democracy was established in 1999 along with a number of initiatives for decentralisation contained mostly in Law numbers 22 and 25 of 1999.²⁸ All executive powers rest with the President as before, but the *Majelis Permusyawaratan Rakyat* (MPR or People's Consultative Assembly . highest authority of the State) approved in 2002 a series of amendments to the Constitution. These provided for: direct election of the President and the Vice-President, termination of all non-elected representation in the *Dewan Perwakilan Rakyat* (DPR or the House of Representatives) and the MPR; creation of *Dewan Perwakilan Daerah* (DPD or the House of Regional Representatives), which was one of the two parts of MPR, the other being DPR. An important change was that the Provincial Governors are now elected for a five-year term by the Provincial Assembly. The Governor of the special district of Jakarta was chosen by direct election (so is the case for Aceh and Yogyakarta) for the first time in August 2007.

The three-tier local government system remains intact, but their number, particularly at the sub-provincial level has exploded. This has even generated a special term to describe the process . *pemekaran* or proliferation. Even the number of provinces had increased to 33 by 2008, while the number of sub-provincial units had gone up between 1999 and 2008 by about 67 percent (206 new units). This could have been at least partly a fallout of the fiscal arrangement as discussed later, but the primary reason was the relaxed conditions for creation of these new units under the new laws (even these were conveniently bypassed through the political route by obtaining direct approval of the DPR to the formation of the new units as a shortcut), coupled with several likely gainers (vested interests) but only a vague disquiet about possible wastage of resources against the trend. The conditions for creating new units have again been tightened somewhat in 2009. The Laws 22 and 25 conferred substantial autonomy on the sub-national units and also decentralized public finances (at least in terms of expenditures). Subsequently, new legislations (Law no. 32 and 33 of 2004, replacing Law 22 dealing with decentralized administration and Law 25 dealing with inter-governmental fiscal relations respectively) were passed to consolidate the gains from decentralization, and also revise the initial framework where felt necessary.

²⁸ This was despite, or perhaps as a response to, the re-emergence of separatist tendencies that were strongest in areas richly endowed with natural resources, like Aceh, Papua and Riau, taking advantage of the unsettled political conditions in 1998-99. But it was only in 2002, after things settled down somewhat, that Aceh and Papua got their special status and greater autonomy.

3. Regional economies

Indonesia is a large nation consisting of numerous islands, and huge regional variations in terms of endowment of natural resources, population density, economic development and social progress. Table 4.1 presents some data on all the regional economies of Indonesia.

Table 4.1: Regional Economies of Indonesia

Region	GDP (2007) (Rp. Trillion)	GDP Per Capita (2007) (Rp. Million)	Growth of GDP Per Capita (%) (1987-2007)	Percentage of Poor Persons (2007)
Aceh	73.87	17.49	0.1	26.7
North Sumatra	181.82	14.17	4.7	13.9
West Sumatra	59.80	12.73	4.2	11.9
Riau	210.00	41.41	-0.3	11.2
Jambi	32.08	11.70	3.8	10.3
South Sumatra	109.90	15.66	2.5	19.2
Bengkulu	12.74	7.88	3.2	22.1
Lampung	61.82	8.48	5.3	22.2
Sumatra	742.02	17.98	2.8	18.5
Jakarta	566.45	62.49	5.4	4.6
West Java	528.45	13.10	3.2	13.6
Central Java	310.63	9.59	4.2	20.4
Yogyakarta	32.83	9.56	3.7	19.0
East Java	534.92	14.50	4.1	20.0
Bali	42.34	12.17	4.5	6.6
Java-Bali	2015.62	16.05	4.1	16.5
West Kalimantan	42.48	10.17	4.5	12.9
Central Kalimantan	27.92	13.77	2.9	9.4
South Kalimantan	39.45	11.61	4.5	7.0
East Kalimantan	212.10	70.12	1.1	11.0
Kalimantan	321.94	25.49	2.8	10.3
North Sulawesi	23.45	10.72	5.7	11.4
Central Sulawesi	21.74	9.07	4.5	22.4
South Sulawesi	69.27	9.00	4.8	14.1
Southeast Sulawesi	17.81	8.77	3.8	21.3
Sulawesi	132.28	9.24	4.7	16.1
West Nusa Tenggara	32.17	7.49	4.9	25.0
East Nusa Tenggara	19.14	4.30	3.7	27.5
Maluku	5.70	4.32	4.2	31.1
Papua	55.37	58.63	13.6	40.8
Eastern Indonesia	112.37	10.21	4.8	28.1
Indonesia (total)	3324.23	16.23	3.8	16.6

Note: GDP refers to regional GDP. All GDP data are in current prices, while growth rates are for per capita GDP in constant prices.

Source: Resosudarmo, Yusuf, Hartono, and Nurdianto (2011)

The table indicates clearly that the Java-Bali regional is the most developed region in general, though even within this region, Yogyakarta is relatively worse-off. The Eastern Indonesian region, in contrast, is relatively poor in terms of regional GDP as well as

substantially higher incidence of poverty compared to the average for the country, or for that matter, any other region of the nation. The GDP figures can sometimes be misleading, particularly in mineral rich areas, because the value of the minerals (including oil) can push up the regional GDP without much of it accruing to the citizens of that region. A good example of this is Papua, with the second-highest per capita income in the nation but with the highest poverty incidence. The dynamics of the regions are also varied, an extreme being the long term stagnancy of Riau, despite a relatively high level of GDP and per capita GDP. There is a long-term decline in regional inequality and -convergence in terms of the convergence/ divergence literature, driven particularly by revenue from natural resources (Aritenang, 2008), but there is enough inequality among the regions of the nation at present to warrant fiscal equalization, and to make uniform treatment of all regions in economic and administrative matters a controversial proposition.

B. Assignment of Responsibilities and Revenue Sources

1. Functional responsibilities

Assignment of functional responsibilities is one of the weakest areas in the Indonesian decentralization programme. There is a substantial amount of *de facto* overlapping functional domain with respect to all three levels of government, and this is because the line departments of the central government tend to have controls through administrative structures that parallel the sub-national governments in a tussle for turf. The provincial governments are relatively minor players (the Indonesian polity has deliberately kept them so to minimise provincial identification of citizens and thereby keep divisive tendencies at bay); it is the district/ city level where this tussle is more evident.

Formally, the central government has kept only a few nationally important functions within its own exclusive domain . these include foreign policy, defence, internal security, monetary policy and macroeconomic matters, as also judicial and religious matters, together characterised as the strict minimum of competences which need to remain at national level to run a state+(Harjowiryo, 2012). There is concurrent jurisdiction in some areas; in all these, the centre is the authority and the local governments undertake special functions in the area under central direction. There are a number of important areas like most of the social services, roads, water supply, farming and forestry that are in the local governments domain. The local government domain has two parts . the mandatory functions and the discretionary ones, the latter depending upon the concerned local governments decision about the need for public intervention given the communities specific circumstances (Table

4.2). Given the nation's earlier highly centralised system, the extent of decentralisation on the expenditure side is truly substantial.

Table 4.2: Mandatory Functions of Local Governments

Under Law 22 (1999)	Under Law 32 (2004)
Infrastructure (public works)	Development Planning and Control
Health	Planning, utilization, and supervision of zoning
Education	Public order and peace
Agriculture	Providing public means and facilities
Communication	Handling of Health sector
Industry and Trade	Education
Co-operatives	Social affairs
Land administration and Zoning	Employment promotion
Environment	Facilitating development of co-operatives, and small and medium business
Employment promotion	Environment
Capital investments	Agriculture
	Demographics and civil registry
	Administrative affairs
	Capital investment
	Others as specified in laws and regulations

Source: Shah (2012)

The provincial governments are expected to play a dual role, as an autonomous level of government and also as regional representatives of the central government. They have limited functional responsibilities, the most important being supervisory in nature and regarding those projects which are cross-jurisdictional.

In practice, there are a number of sectoral laws (some of which strictly speaking conflict with the laws on local autonomy), central regulations and ministerial decrees that make for a substantive role of central line departments in decentralized functional areas. This continues to create jurisdictional confusion. Often, the central government delegates responsibilities to the provincial governor as a measure of deconcentration of functions that are already decentralized to local governments. A number of cases in the Ministry of National Education and the Ministry of Forestry, wherein functions supposedly managed by district/city governments are deconcentrated to governors, strongly indicate the confusion in the application of regional autonomy principles (Dwiyanto, 2011). On the other hand, there are probably decentralized functions that should have stayed with the centre (e.g., control of narcotics and major epidemics), because the local governments generally find themselves incapable of handling them. There are no clear criteria governing assignment of functional responsibility, nor is there any mechanism specified in the relevant laws to revise the same. Some amount of central oversight is probably necessary and even desirable for at least equity reasons (say to ensure minimum standards of basic services), but the actual

involvement of the central government is perhaps much more than that, given that the bulk of development expenditures are still under the central line departments in the national budget. The expenditures of the local governments are dominated by wage costs of various types of employees, and badly needed capital expenditures on social as well as physical infrastructure have not been forthcoming.

The differential capacity of the local governments to manage the decentralized functions has been an important issue, particularly because Indonesia has had in the past a system of asymmetric decentralization among jurisdictions at the same level, within a system of supervised and gradual decentralization for communities that were not fully equipped to handle the same responsibilities as others.²⁹ Uniform and standardized decentralization across all jurisdictions is seen by some as unnecessary and possibly inadvisable.

2. Intergovernmental Bargaining and Conflict Resolution

Given the work-in-progress nature of the process of decentralization in Indonesia, the development of institutions to oversee the working of the system and arbitrate when necessary has yet to take place. The rapid pace of decentralization has thrown up plenty of jurisdictional confusion in terms of intended and unintended overlapping, even sometimes a free-for-all. But it must not be forgotten that decentralization is not a basic ingredient of the Constitution of the nation but the result of a deliberate devolution process initiated by the centre, after a long period of highly centralized system. As such, central line departments do carry a veto in cases of jurisdictional overlapping, partly from tradition and partly backed by rules of the game, even if sometimes the rules are made by the same line departments. In cases of intergovernmental conflicts, judicial recourse is theoretically available, but such recourses are practically unknown as yet; alternative methods of resolution including bribing and occasionally even violence³⁰, has been the norm. Thus, in brief, resolution of intergovernmental disputes is through exercise of central authority, bribing and violence in that order, with little recourse to the judicial system.

The above apply to intergovernmental disputes when different levels of government are involved. When agencies or governments at the same tier are involved, the resolution process has been smoother. Typically, such disputes are either between two or more local governments or two or more line departments of the central government. The latter is

²⁹ This was known as *urusan pangkal* and was codified in Law no.5, 1974 (Dwiyanto, 2010).

³⁰ This has, for example, been occasionally happening in some areas where different levels of government, or rather their employees, have resorted to violence while claiming their respective governments' rights with respect to land and even forest exploitation rights. Bribing all the claimant governments by the interested private parties for smoother operations, of course, is a more common occurrence.

resolved through a process of inter-ministerial discussions, and failing a resolution through discussions, by Presidential order. In the case of disputes between local governments, the provincial government, by virtue of its co-ordinating role conferred by law, usually arbitrates. In rare cases of inter-provincial disputes, the concerned central line ministry usually steps in to resolve the same.

In this context, the more important task is to reassess the laws for possible confusion that leaves scope for disputes. Unfortunately, there are many such cases. This should take priority over development of agencies tasked with resolution of disputes because any institution for dispute resolution must have the backing of clear legal provisions covering the dispute; unclear or conflicting legal provisions will only undermine the authority of the institution concerned.

3. Assignment of taxes and other revenue sources

Unlike functional responsibilities, revenues are highly centralized in Indonesia. All broad-based taxes (personal and corporate income tax, VAT, customs) remain with the centre after decentralization. In terms of collection, around 95 per cent of the total tax revenues collected in Indonesia is by the central government. However, a large part of it is shared with the sub-national governments (details provided later). A notable recent development has been the decision to transfer of all property taxes to the local government level from the central government by the end of 2014. This tax is potentially a major revenue source for the local governments, provided they are able to implement it as effectively as the centre. Unfortunately, this move is likely to have a downside. The relatively poor regions are going to lose because their share from central collections has been larger than what they can hope to collect from these taxes themselves.

There is also a strong qualitative aspect of centralization of tax revenues. The local governments are not at liberty to change tax bases or rates at their own discretion. All such changes have to be approved by the centre, making decentralization on the revenue side qualitatively suspect. But this could be an interim status until the sub-national governments attain maturity in administering taxes. On the other hand, during 2000-2009, the division of taxing powers was based on an open-list system (Law No. 34 of 2000), whereby the local governments could levy special taxes within their own jurisdiction at their own initiative. But this resulted in too many such taxes of numerous kinds without any consideration of economic effects, and this in turn created substantial complexities for business decisions. Eventually, Law No. 28 was promulgated in 1999, changing the system of tax assignment from open list to closed list the latter implying withdrawal of the power of sub-national

governments to levy any tax other those allocated to them by law. Table 4.3 provides a list of taxes allocated to the sub-national governments from just before the big bangq decentralization of 1999 to date.

Table 4.3: Provincial and Local Taxes over Time in Indonesia

Law No. 18 (1997)	Law No. 34 (2000)	Law No. 28 (2009)	Comments
Provincial Level Taxes			
Motor Vehicle Tax	Motor Vehicle and Sea Vessel Tax	Motor Vehicle Tax	Continues to include sea vessels
Motor Vehicle Transfer of Ownership Tax	Motor Vehicle and Sea Vessels Transfer of Ownership Tax	Motor Vehicle Transfer of Ownership Tax	Continues to include sea vessels
Motor Vehicle Fuel Tax	Motor Vehicle Fuel Tax	Motor Vehicle Fuel Tax	No Change
Surface and Ground Water Tax	Surface and Ground Water Tax	Surface Water Tax	Ground water tax transferred to local Government level
NA	NA	Cigarette Tax	New tax
Local Level (Kota/Kabupaten) Taxes			
NA	NA	Rural and Urban Property Tax (PBB)	Transferred from centre
NA	NA	Property Transfer Tax	Transferred from centre
Hotel and Restaurant Tax	Hotel Tax	Hotel Tax	No change
NA	Restaurant Tax	Restaurant Tax	No change
Entertainment Tax	Entertainment Tax	Entertainment Tax	No change
Advertisement Tax	Advertisement Tax	Advertisement Tax	No change
Street Lighting Tax	Street Lighting Tax	Street Lighting Tax	No change
NA	Parking Tax	Parking Tax	No change
Bahan Galian C	Bahan Galian C	Non-Metallic Minerals and Rocks Tax	No change
NA	NA	Ground Water Tax	Transferred from provincial level to local government
NA	NA	Swallows Nest Tax	New Tax

Source: Kelly (2012)

The provincial level taxes are reasonably lucrative, with all motor vehicle related taxes being collected at that level. The new cigarette tax is also expected to generate a reasonable amount of revenue. But the provinces do not get to keep the entire revenue from any of the taxes they administer. For example, 30 per cent of the revenue from motor vehicle tax has to be passed on to the local governments in their jurisdiction (not on origin basis but equal amounts). 70 per cent of the cigarette tax is also shared with the local government, with the stipulation that at least 50 per cent of the revenue should be spent on health services and law enforcement. In the case of the earlier (surface and ground) water tax levied by the provincial government, the tax itself was split in 2009 and the ground water tax

was shifted to local government. The hotel and restaurant tax levied by the local government was also split, but the likely reason was purely administrative.

A final point to be noted is that most of the local level taxes are quite urban biased (Kelly, 2012). Most of the tax bases with higher revenue potential are located in urban areas only, providing some advantage to the more urbanized local governments. Only three of the list – ground water tax, swallow nest tax and the tax on non-metallic minerals and rocks – are not predominantly urban in nature, but revenue potential from these could be small, unless a local body has a concentration of quarries of expensive stones like granite or marble.

Local governments also collect several types of non-tax revenue which have been allocated to them. These primarily include various kinds of fees and charges. Collection from these are not large, but not negligible relative to their total own revenues either. Such revenues for provincial governments, however, are minimal.

4. Revenue from Natural Resources

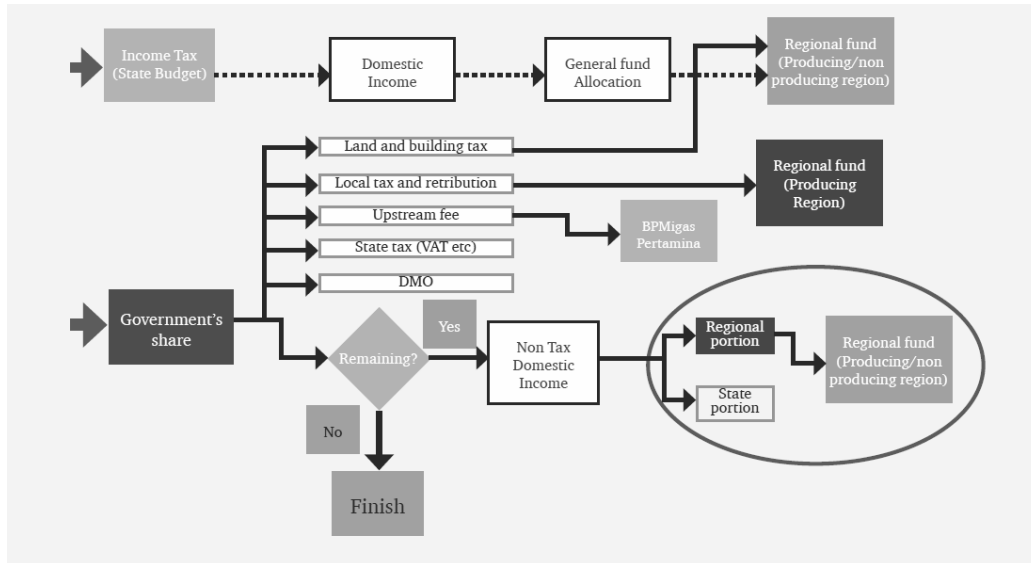
Natural resources constitute a major source of GDP in Indonesia. The primary sources are of four categories: oil and natural gas, other minerals (like gold, copper, nickel and tin), forest resources, and water resources (fishing). While the last is quite important for the country from several angles, being largely unorganised and often unregulated, the first three are more important for the purposes of government revenue because of the largely organised commercial nature of the exploitation of these sectors. Of these, oil and gas sector was considerably larger than the other sectors even 10 years ago with a share of around 25 percent in the GDP, but this share is slowly becoming smaller while that of other minerals increases.³¹

Much of the oil and gas production in Indonesia is by subsidiaries of foreign companies under production sharing contracts. As Indonesia's oil production has decreased, the country has attempted to shift towards natural gas (and to a lesser extent, geothermal), especially for power generation (PWC, 2012). This sector is completely controlled and regulated by the designated agency of the central government (called BP Migas for upstream activities). Upstream (exploration and production) and downstream activities are defined by law and are differently treated. For example, branches of foreign entities are allowed in upstream activities but not in downstream. Apart from the income tax

³¹ Very recently, the national government has been slowing down the rate of exploitation in this sector also through taxation and other more direct methods.

and excise duty/VAT, the main take of the government consists of its share of production as specified by law or by specific contracts. This sector is the largest contributor to domestic revenues at over 20 percent of the total in 2011 (significantly up from previous years). Figure 4.1 schematically depicts the retention or distribution of the government take from this sector. Details of sharing between national and other levels of government are provided in a subsequent section on intergovernmental revenue sharing.

Figure 4.1: Flow of Government Revenues in the Oil and Gas Sector



Source: PWC (2012)

Note: State refers to the National government; DMO stands for domestic marketing obligation.

In the minerals sector, exploitation is regulated by all levels of government on the basis of mining rights or authorisations (known as *kuasa pertambangan* or KPs) or contracts (*kontrak karya* or contracts of work, KK or COW) between government and private sector contractors. COWs are in theory negotiated but in practice have followed a series of evolving standard form. In 1999, decentralization and regional administration laws (Law No. 22/1999 regarding regional government, replaced by Law No. 32/2004) transferred substantial authority over hardrock mining from the central government level to all of the sub-national levels. Further, vide Government Regulation (GR) No. 75/2001, mining rights in the form of KPs may be issued, administered and regulated at the central, provincial, regional or municipal level, depending primarily on whether the mine in question is located fully within the geographical area of a particular level of government or not. At the same time, Law No. 25/1999 and 33/2004 confirmed significant increases in the share of revenues allocated to provincial, regional and municipal governments from dead rent, tax and royalty payments made by holders of mining rights. But the relevant laws do leave scope for varying

interpretation and confusion, including with respect to provisions regarding obligations of the holders of KPs or COWs. Further, other laws like the law regarding protected forests can conflict with some provisions of mining law, leading to interdepartmental conflicts and tussle for authority. Revenues from mining consist of dead rent, royalty and taxes. Royalties for KP holders are specified by government regulations while those for COWs are negotiated (usually between 2-7 percent *ad valorem* for both, depending on the type of mineral).³² Usual taxes applicable to business entities also apply. As per extant provisions, decentralization has allowed the sub-national governments to directly receive revenues from holders of mining rights provided they fall under their authority, as well as receive shares of centrally collected revenue from the mining sector. The details of sharing are provided in the subsequent section on revenue sharing.

In the forestry sector, although the first round of decentralization in 1999 allowed sub-national governments authority over management of forests, the alarming explosion of grants for logging licenses caused a hasty retraction of some of the sub-national authority in the same year. In 2002, the Ministry of Forestry retracted most local governments' authorities over forest resources, particularly by revoking their rights to issue permits for forest exploitation. With this and the subsequent revision of the legal framework, the ministry took back legal control over most activities in the state forest. (Ardiansyah and Jotzo, 2013, pp 285-86) However, revenues from forests are shared with sub-national governments (details in section on revenue sharing).

It needs to be mentioned here that both in the mining and forestry sector, there are still problems of overlapping assignment, requiring exercise of deciding authority of the central government. Further, illegal mining and to a larger extent, forest exploitation is a serious problem, particularly because it is sometimes carried out within the knowledge of the local governments who are either bribed or are simply indifferent. An important issue in the forestry sector is to incentivise them to contain deforestation; the central government also has not been particularly successful in preventing it.

C. Vertical and Horizontal Imbalances

Given that almost 95 percent of the tax revenues are collected at the national level and non-tax revenues are relatively small, while around 40 percent of the total public expenditures are being incurred at the sub-national level, the existence of substantial vertical

³² The royalty rates (and government take in general) are often thought to be rather low in Indonesia (Arnold, 2012).

imbalance is axiomatic.³³ The relevant figures are given in Table 4.4. This is particularly large in Indonesia because of the relatively more lopsided decentralization than most other countries. Of course, one must remember that substantive decentralization is only 13-years old, and because of its top-down nature, the local governments have to convince the national government about their ability to administer revenues successfully before they can expect to be trusted with more lucrative and broad-based taxes.

Table 4.4: Vertical Imbalance in Indonesia

Year	Share of Sub-national Governments'..	
	Own Revenue in Total National Revenues	Expenditure in Total National Expenditure
2000	4.6	16.2
2001	5.0	27.3
2002	7.5	36.3
2003	7.6	39.2
2004	7.9	35.2
2005	7.7	31.6
2006	6.0	33.0
2007	7.4	40.9
2008	6.6	36.2
2009	7.2	40.8
2010	7.2	39.4
2011	7.7	39.0

Source: Harjowiryono (2012)

The fact that Indonesia has a system that is reluctant to allow a substantially larger role for the provincial government also creates a problem, because concerns of tax harmonization become more acute and the related problems even less tractable when a large number of local governments are involved instead of a smaller number of provincial governments. Also, taxation by local governments rather than the provincial creates additional problems of cross-jurisdictional issues. Altogether, if provincial governments are to be deliberately kept under restraint, the central government may have valid economic and administrative reasons not to decentralize revenue sources very much; the huge vertical imbalance may be a more permanent feature than one would think.

There is no readily available data to directly show horizontal imbalance, but such can be easily inferred from the data on socio-economic inequalities. Table 4.1 provided some of these data across regions. Local governments differ vastly in their geographic and socioeconomic characteristics. Per capita incomes in the richest 20% of districts are more

³³ In short, Indonesia has decentralized, especially on the expenditure side, but is still centralized on the revenue side. (Harjowiryono, 2012)

than three times higher than in the poorest 20% of districts. This uneven distribution of economic activity is reflected in the large disparities seen in living conditions. Poverty rates range from about 7% in the industrialized district of Bekasi at the fringe of Jakarta, to more than 40% in the West Sumba district in the eastern part of Indonesia. Illiteracy in the East Javanese district of Sampang is still more than 40%, though it has decreased to 12% for Indonesia as a whole. And though about 98% of people in Tanjung Jabung Barat in the province of Jambi have access to primary health care, only 22% do in Sintang in West Kalimantan. This heterogeneity potentially increases the benefits of decentralization, but it also places considerable pressure on the fiscal system to ensure minimum standards are met+(Shah, 2012). The significant inter-jurisdictional inequalities actually provide an added reason for the vertical imbalance, because the central government has to address this issue through the intergovernmental grants system, to which we now turn.

D. Intergovernmental Transfers

The intergovernmental transfers in Indonesia are predominantly prompted by the large vertical and horizontal imbalances, as also a desire to focus on local government (district and city) rather than the provinces, which have been allotted a relatively small share of functional responsibilities. These transfers take the form of revenue sharing through (a) tax sharing and (b) sharing of non-tax revenue from minerals and some others, and general purpose grants called *Dana Alokasi Umum* (or DAU in short), specific purpose structured grants called *Dana Alokasi Khusus* (DAK), other (discretionary) specific purpose grants.³⁴ The relative position of these different types of transfers is indicated in Table 4.5. It shows the district level governments to be most dependent on central transfers, while provincial level governments as a group are least dependent. Of course, the extent of dependence does vary greatly among individual provinces/districts/cities.

Table 4.5: Central-Provincial/Local Transfers in Indonesia - 2010

	(%)	
Type of Transfer	Share of Total Transfers	Share of Sub-national Expenditure
Tax Sharing	25	20
Gap filling (DAU)	56	46
Specific Purpose (DAK)	6	5
Other Specific Purpose	13	10
All	100	90 (Provinces: 54; Cities: 86; Districts: 93)

Source: Shah (2012)

³⁴ As per Law No. 33 of 2004.

1. Revenue Sharing

Before 2009, tax revenue transfers consisted of sub-national shares of personal income tax, property tax, and tax on transfer of property. The last mentioned has now been transferred to the districts and property tax is being gradually shifted to the local governments, the process to be completed in 2014. At the same time, excise tax has been brought into the ambit of revenue transfers, thus leaving two taxes to be shared with sub-national governments. The sharing of non-tax revenues included revenues from forestry, fishery, general mining, oil extraction and gas, to which geothermal energy has been added in 2009.

20 percent of the personal income tax is shared, completely on the basis of origin. Out of this, the originating province gets 8 percent, the originating district gets 8.4 percent, and the rest of the 20 percent is distributed equally among all other local governments in the province. These transfers are unconditional. So are the shared revenues from natural resources, unless specifically earmarked.

Among the non-tax revenue transfers, the largest amounts are from the oil and gas sector. 15 percent of oil revenues are transferable to sub-national governments on an origin basis, with 3 percent going to the province, 6 percent to the originating district(s), and the remaining 6 percent distributed equally among other districts within the province. For gas, the sharing percentage is larger at 30, with the distribution pattern remaining the same as for oil and the actual percentages simply doubling. For forestry and general mining, the share of sub-national governments is much larger at 80 percent. Out of this, the originating province gets 16 percent, the originating district gets 32 percent (64 percent in the case of exploitation permit fee), and 32 percent distributed equally among all other districts in the province (nil for exploitation permit fee). Some of these activities are charged for reforestation, and 40 percent of the reforestation revenue is transferred to sub-national governments as earmarked funds. Similarly, an additional 0.5 percent of oil revenue is transferred as earmarked for basic education. The three provinces with special autonomy status get higher percentages of oil and gas revenue . 55 and 40 respectively. Table 4.6 lays out the pattern of revenue sharing relating to revenues from natural resources. It can be seen that the sub-national shares are primarily origin-based except in the case of fisheries. The reason, of course, is to prevent possibilities of resource curse given that the natural resource-rich areas are also relatively less developed and have relatively larger shares of the poor in their population. Unfortunately, because of the way the overall transfer system operates, in particular the general purpose transfer scheme (DAU), these considerations become, in

practice, irrelevant. This is explained in detail below while discussing intergovernmental grants.

**Table 4.6: Sharing of Revenue from Natural Resources
(based on Law 25/1999)**

Revenue Sector	Central	Province of Origin	District of Origin	Other Districts in the Province	Overall Districts
Oil & Natural Gas					
Oil revenue after tax	85%	3%	6%	6%	--
Natural Gas revenue after tax	70%	6%	12%	12%	--
Mining					
Land Rent	20%	16%	64%	--	--
Royalty	20%	16%	32%	32%	--
Forestry					
Forest product royalty (PSDH)	20%	16%	32%	32%	--
Forest Concession license fee (IHPH)	20%	16%	64%	--	--
Reforestation Fund	60%	--	40%	--	--
Fisheries	20%	--	--	--	80%

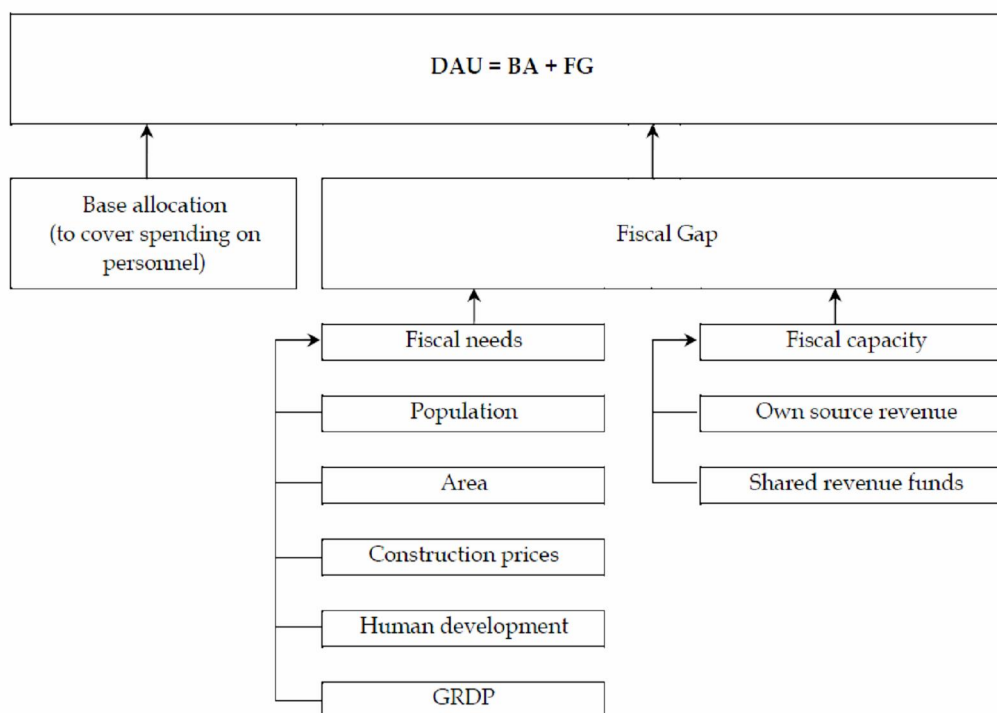
Source: Komarulzaman and Alisjahbana (2006).

The beginning of the year allocations of these transfers are based on projected revenues for the ensuing year, but are eventually corrected to correspond to actual revenues collected.

2. The general purpose grant (DAU)

The largest amounts of central transfers to provincial/local governments are through DAU, which is a general purpose transfer doubling as an equalizing grant to reduce horizontal imbalances as well. Formally, it is based on two parts . the basic allocation (BA) essentially covers the wage costs of the grantee government, while the fiscal gap (FG) grant part is the equalizing tool. The latter part is based on one of the most complicated, and perhaps not fully understood by many, methods used for the purpose, but it is apparently an objective formula. The total divisible pool is decided every year by the central government, of which 10 percent is allocated for provinces and 90 percent for local governments. The formula used for computing the FG grants is detailed below with the help of figure 4.2.

Figure 4.2



Source: Fadliya and McLeod (2010)

The fiscal gap is defined as the difference between expenditure needs and fiscal capacity for all the sub-national governments. The factors that determine the needs and capacity are the same for all sub-national governments, but there are differences in the weights used with these factors for provincial and other local governments. As Figure 4.2 shows, the factors that determine fiscal needs are population, geographical area, construction price index, human development index, and gross regional domestic product (GRDP) per capita index.³⁵ The fiscal capacity is a sum of own revenues and shared revenues (both tax and non-tax). The weights attached to each of these factors are decided every year, and the weights can be different for provincial and other grantee governments. The annual variations in the weights are reportedly tuned to achieving a particular target value of the Williamson index (population weighted coefficient of variation) for these grants across the grantee governments. Table 4.7 provides information on the weights used in recent years.

³⁵ It is presumably the inverses of the last two factors that are used to compute fiscal need.

Table 4.7: Weights for Fiscal Capacity and Needs for DAU

Jurisdiction/ Factor	2006	2007	2008	2009	2010	2011
Provinces						
<i>Factors for Expenditure Needs</i>						
Population	30.00	30.00	30.00	30.00	30.00	30.00
Geographical Area	15.00	15.00	15.00	15.00	15.00	15.00
Construction Prices	30.00	30.00	30.00	30.00	30.00	30.00
Human Development Index	10.00	10.00	10.00	10.00	10.00	10.00
Gross Regional Domestic Product	15.00	15.00	15.00	15.00	15.00	15.00
<i>Fiscal Capacity Factors</i>						
Own Source Revenues	50.00	50.00	50.00	50.00	50.00	50.00
Shared Taxes	100.00	75.00	75.00	95.00	73.00	80.00
Shared Non-tax Revenues	100.00	50.00	41.25	70.00	95.00	95.00
Districts/Cities						
<i>Factors for Expenditure Needs</i>						
Population	30.00	30.00	30.00	30.00	30.00	30.00
Geographical Area	15.00	15.00	15.00	15.00	13.25	13.50
Construction Prices	30.00	30.00	30.00	30.00	30.00	30.00
Human Development Index	10.00	10.00	10.00	10.00	10.00	10.00
Gross Regional Domestic Product	15.00	15.00	15.00	15.00	15.75	16.50
<i>Fiscal Capacity Factors</i>						
Own Source Revenues	100.00	75.00	75.00	70.00	93.00	93.00
Shared Taxes	100.00	75.00	75.00	73.25	100.00	100.00
Shared Non-tax Revenues	100.00	50.00	50.00	100.00	100.00	63.00

Source: Shah (2012); original source: Ministry of Finance, Government of Indonesia

The factors determining needs in the formula are combined to form a composite index, which is multiplied by per capita aggregate public expenditure in the previous year to estimate expenditure requirement for each jurisdiction. The weights for the fiscal capacity factors are simply the percentages of the relevant type of revenue; the resultant amounts are added together to arrive at the fiscal capacity. The basic allocation part is available to all sub-national governments by its very nature; negative fiscal gaps are treated as zero. There is no resultant negative grant.

The central government also uses the transfers under DAU to promote timely preparation of local government budgets; this aspect had seen some indiscipline in the past. Unless the budgets are submitted within a given timeframe, DAU transfers are delayed, which naturally affects utilization.

Possibly designed to be an objective system for equalization, the DAU programme suffers from several loopholes. The apparent objectivity is suspect and so is the equalizing

aspect in practice. Moreover, it appears to have some undesirable incentive effects. The following points would sum up a critical assessment of the system.

- The current system of DAU transfers has too many degrees of freedom to be called objective and leaves plenty of scope for political wrangling. This is particularly because of the variable weights attached to the determinants of fiscal needs and capacity; by manipulating the weights, almost any pattern of distribution that one wishes for can be achieved. The use of Williamson's index is no guarantee of equitable transfers; first of all, in practice, it has fluctuated considerably from year to year, indicating political gamesmanship in the background. But even if its value was constrained to fall, such an outcome can be easily achieved by simple redistribution among the top few, for example. If such a constraint was operative for a long time, eventually the bottom-placed jurisdictions would benefit, but that could take a long time indeed. The system is unnecessarily complicated without achieving the stated objectives.
- The full coverage of wage bill of the grantees has an obvious incentive problem. The recipients have no incentive to economize on personnel. It is of course true that appointments at all levels are strictly controlled by the centre and standardized wages are applicable, and so there is a low probability of the recipients going on an employment spree or paying high wages, but the fact remains that they have no reason to try and cut down wage costs. The downside of this system is apparent in remote areas of the nation, where it remains extremely difficult to attract qualified and experienced employees. It also provides a disincentive for experimenting with cost-saving or efficiency-enhancing management practices like contracting out or public-private partnerships (Hofman, Kadjamiko, Kaiser and Sjahrir, 2006). Combined with the fact of proliferation of local governments, which invariably adds to the number of total government employees, this surely caused avoidable increases in total transfers, or unpredictable changes in the distribution of grants. Since by splitting, a local government could get larger grants for the parts together as compared to the original, the system also provided an impetus to the observed proliferation, alluded to earlier.
- The program treats all the sub-national governments as comparable, which is far from the truth. It implicitly takes the fiscal capacity and needs of diverse jurisdictions as of the same type, determined by similar factors and having a similar pattern. This is obviously not so, and this could cause serious injustice.
- There is some confusion regarding the use of own revenues as a part of fiscal capacity. It is unclear whether actual or some estimated normative revenues are being used for this purpose. If it is the actual revenues, then it constitutes a poor incentive for revenue effort by the recipient governments since any additional own revenue gets neutralized by

a reduction in DAU. This is indeed the criticism voiced by several researchers [Shah (2012), Harjowiryo (2012) and Fadliya and McLeod (2010)], but Lewis (2007) asserts that the own revenues used were normative estimates arrived at using the predicted values of a regression between own revenues and GRDP across a group of jurisdictions at the same level.³⁶ In this was truly the case, the disincentive did not exist, provided the recipients understood and appreciated the difference.

- GRDP is used twice in estimating the fiscal need index, once on its own and also as a part of the HDI. Besides, in Indonesia, GRDP is not necessarily a good proxy for expenditure needs. Several foreign owned companies in the natural resources sector hardly contribute to the local economy (essentially a dual economy situation), and may actually cause financial losses for the local population, although their production adds hugely to the GRDP. In such cases, depriving the concerned government from transfers on the basis of higher per capita GRDP can be inequitable.
- Finally, the system of DAU in practice substantially negates the system of sharing of revenues from natural resources, because any increase in the latter are offset by reduction in DAU through reduction in fiscal gap (to the extent of the weight attached). More serious, it actually undermines special arrangements with Aceh, Papua and West Papua to provide them larger shares of natural resource revenues, which actually get offset to a great extent by smaller DAU transfers. This would be all right if the normative expenditures took care of the special requirements of these regions (to compensate for which the larger revenue shares are presumably given), but that does not seem to be the case. As such, it would probably be fair to keep the special revenue sharing for these regions outside the computation of the fiscal gap.

3. The Structured specific-purpose grants (DAK)

DAK grants are provided for selected purposes as decided by the central government from time to time and are targeted geographically by restricting them to selected sub-national governments. The objective of this programme is to finance capital expenditures for infrastructure and related operational and maintenance costs for a limited period in the selected sectors. This is a matching grant system, with at least 10 percent matching funds required from the recipient governments, primarily to ensure their ownership over the projects. However, the projects must accord with national priorities while remaining within the competence of the sub-national governments in terms of functional assignment. The actual selection of projects is based on proposals from the line ministries as well as the grantee governments. In 2011, the central government established 19 national priority areas

³⁶ Lewis (2007) also mentions that the use of normative own revenues have been recently discontinued. If true, it signifies a change for the worse.

for DAK assistance. These include: education, health, road infrastructure, drinking water infrastructure, sanitation infrastructure, government infrastructure, maritime affairs and fisheries, agriculture, environment, family planning, forestry, infrastructure in less developed regions, trade facilities, rural electrification, housing and settlement, land transport safety, rural transport, and border area infrastructure. It may be noted here that this listing represents a substantial gradual widening of the scope of DAK from the initial (2004) six sectors only. There are stringent conditions attached to the grants, and the sub-national governments have little flexibility in the manner the funds received under DAK are spent.

The eligibility criteria for sub-national governments to receive DAK transfers consist of (i) general fiscal, (ii) special and (iii) technical criteria. The first examines fiscal position of sub-national governments net of employee compensation and benefits, and only those below the average are deemed eligible. The special criteria are intended to provide preferential access to local governments in Papua and West Papua; coastal areas and islands; areas that border other countries; regions of interest for food security or tourism reasons; disaster prone areas; and less developed areas. Relevant line ministries determine the special criteria to be employed. Similarly, the technical criteria are set by line agencies, in consultation with the Ministry of Finance, the Ministry of Home Affairs and the Ministry of Planning. These criteria contain a host of macro, service-related, administrative and needs indicators. The three sets of criteria are used by progressively combining them and setting cut-offs to eliminate some of the local governments at each stage. Although the total amount of DAK transfers and their sectoral allocation is unilaterally decided by the central government, the allocation across eligible local governments is formula driven, using a differently weighted combination of the three sets of criteria from what is used to ascertain eligibility. This is a fairly cumbersome and information-intensive process that could perhaps be simplified, but it is sometimes believed that it has insulated the system from political interference and bargaining.

Reflecting the reality that most central government ministries have been reluctant to accept the diminution of their power and authority implied by decentralisation, and that virtually any local government activity can be deemed a national priority there has been a significant and steady increase in both the size and scope of DAK funding over the years since decentralisation occurred (Fadliya and McLeod, 2010). Given its steadily increasing importance, it needs careful attention to its design and implementation. But the system of DAK transfers remains a combination of arbitrariness and objectivity, albeit in a rather complicated way. The fact that the major parameters of the system are arbitrary should be easily discernible from the description of the system provided above. Even within the

objective part of selection and distribution, the choice of the weights, the choice of the technical criteria and the manner of combining the special criteria for each sector . all these aspects have a substantial element of arbitrariness and logical gaps.

The system is not driven by any overall planning framework; as such, there is nothing to ensure internal consistency of the system. A hospital may be constructed and made operational, but it may lack an approach road. A particular service facility, say a water supply project, may be completed but remain non-operational because of lack of power. The system completely relies on line departments of the central government, without any mechanism in place for co-ordinating activities supported by them at the sub-national level.

In practice, the matching ratio is variable across jurisdictions ranging from the minimum of 10 percent to 90 percent. This is linked to the assessed financial capacity of the grantee governments, but the link is not clearly specified. While it corresponds to the idea of fiscal equalization, the range of variation for the matching ratio is probably too large, given that the difference in own revenue generation among them is small . the overwhelming centralization of revenues ensures that.

Infrastructure financing, by its very nature, is a long-term concept. If DAK has to bear this responsibility, it must have at least a medium-term framework. Unfortunately, DAK has become an annual fund-distribution ritual that fluctuates from year to year, with no temporal consistency. This is possibly another outcome of a lack of planning framework mentioned above. As such, its success in achieving its basic objectives is possibly less than what it could be.

There is a serious flaw in the allocation mechanism that actually causes inefficiencies in meeting the stated objectives of the system. This is because the indicators selected by the line departments are indicative of general needs in the concerned sector, but do not succeed in geographically mapping the requirements to fit into the national objectives that the transfers are supposed to fulfil. Eventually, the system neither corresponds to local needs properly (since regional priorities can be different from national priorities), nor does it serve to meet the national objectives efficiently. With the majority of local governments receiving some amount, the selection process also ends up being too liberal (Wibowo, Dendi and Zulhanif, 2011).

Complaints are now being voiced by the grantee governments that the matching requirements of DAK are placing them into the rather untenable position of exhausting much

of their own revenues, leaving little to meet the local demands for public services. They cannot afford to ignore the DAK funds, but at the same time, they have a valid point that if they are not able to cater to local demands and meet their core functional responsibilities, then the whole point of decentralization is lost.

In practice, DAK has become riddled with corruption, given the arbitrariness involved. The absence of a clear and transparent indicator on national priorities and their corresponding regional priorities has made DAK allocation in several ministries prone to rent seeking by actors in the ministries, members of legislative councils, project brokers, and actors in the region. DAK allocation is thus determined largely by the ability of regions to conduct lobbying rather than the compatibility between actual issues faced in regions and the national priorities. Meanwhile, the ability to lobby is determined by the fiscal capacity and connection with politicians, parliamentarians, and high-level officials at the ministries. Several heads of regional governments have been found guilty in corruption trials as they provided lobbying funds+[from their own budgets] (Dwiyanto, 2011).

Empirical estimates show that DAK has succeeded in stimulating capital spending by local governments, as would be theoretically expected of a matching grant scheme. But its stimulation is considerably less with respect to physical infrastructure as compared to other capital expenditure (Lewis, 2013). This could be partly explained by the persistently falling share of DAK allocations meant for infrastructure over the last decade.

The data provided in Table 4.5 show that other specific purpose transfers are still much larger than DAK, and therefore merit greater attention than DAK from the researchers. That this is not the case is probably explained by the fact that (a) a part of these constitute special grants (Special Autonomy Fund) to only three sub-national governments, Aceh, Papua and West Papua, and (b) the rest of these grants are completely discretionary and *ad hoc*. Given the absence of any specified system for determining these, there is nothing to assess barring a general exhortation to limit these.

E. Service Delivery at Sub-national Levels and Conditional Cash Transfers

Assessments of changes in delivery of public services since decentralization of 1999 are generally mixed in nature; provision of some services in most localities appears to have expanded (e.g. education), while other services (e.g. health) have not. The impact of decentralization *per se* on the supply of public services also is unclear. Moreover, for most services, quality of the service provided is relatively poor in terms of objective assessments

(Lewis, 2013a and Schulze & Sjahrir, 2013). When all these different strands are pulled together, only a weak conclusion can be drawn . that decentralization has not resulted in as much of an improvement in public service delivery at the local level as could be hoped for. Resource constraint was not really a major issue as the accumulation of idle cash reserves by a large number of local governments show, although efficiency of local public expenditure and capacity constraints (the two could be linked) could have played a role, but not a decisive one.

At the same time, surveys show that the citizens appear to be reasonably satisfied with the quantity and quality of public services (Lewis 2013a). The contradictory and confusing evidence can only be resolved by hypothesizing that the expectations of the citizens from the local governments are low, and hence they are too easily satisfied. Also, because of this, the pressure on local public officials to improve service delivery is weak, allowing them to continue with their inefficiencies. In this situation, only a long-term policy of educating the citizens about their rights and strengthening the demand for public services of appropriate quality could provide a solution to the problem (Lewis, 2013a).

An important policy tool to strengthen demand for public services that was introduced in 2007 in Indonesia was the Program Keluarga Harapan (PKH) . a conditional cash transfer program on the lines of similar programs in Latin America. At the beginning, the program covered only 7 out of 33 provinces, 48 out of 497 districts and 0.388 million households. The coverage had expanded to all 33 provinces, 169 districts, and 1.454 million households by 2012. Essentially, the program consisted of cash transfers to identified poor households provided they fulfilled some conditions regarding the children in the family attending appropriate schools on a regular basis and regarding specified measures for child and maternal health. Households with no children and pregnant women are excluded from this program. Table 4.8 lays out the actual conditions imposed on the beneficiaries of the program. In case of delinquency in meeting the conditions, the benefits are progressively curtailed for two months, and after third month of continued delinquency, benefits are completely withheld.

The involvement of the sub-national governments in this program, however, is not extensive. Since the schools and health facilities are operated by sub-national governments, their co-operation is absolutely necessary for monitoring purposes, but lacking a substantive, well-defined role in the implementation of this program except being drawn into it through co-ordinating agencies at each level, the program does not fully use the potential benefits of greater involvement of sub-national governments. Broadly speaking, it is run by the Ministry

of Social Welfare which has set up its own units at each level that are operating as parallel agencies with the help of field level facilitators (*pendampings*) appointed by them. It is these *pendampings* that bear the main burden of field level implementation of the program. Starting from identification of beneficiaries by central agencies collecting household information and preparing the master database to payment through national postal system, the local governments have no major role except as advisers and facilitators. As such, the implementation of this program in Indonesia cannot be taken as an example of significant intergovernmental cooperation.

Table 4.8: Conditions for Receiving PKH Benefits

Health and Nutrition
Children aged 0-6
Infant age of 0-11 months: (i) complete immunization protocol (BCG, DPT, Polio, measles, Hepatitis B); (ii) Weighed every month
Infant age of 6-11 months: Vitamin A minimum twice a year (February, August) Infant age of 12-59 months: (i) complementary immunization; (ii) weighed every 3 months
Children age of 5-6 years: (i) measured for weight; or (ii) participate in early childhood education program (PAUD) when there is PAUD facility at the closest location/integrated services post
Pregnant and Lactating mothers
Pregnant mother (i) undergoes pregnancy examinations at any public health facility up to 4 (four) times and (ii) obtains Fe (Iron) tablet supplements.
Professionally assisted delivery; The health conditions of post-delivery mothers checked at least twice (2) prior to the baby reaching age 28 days
Education
Children 6-15 should be enrolled at SD/MI (Elementary school) or SMP/MTS (Junior High School) and comply with attendance requirements at least 85 percent of school days per month
Children 15-18 who have not completed elementary school, should (i) be enrolled in the nearest school, (ii) participate in an equalization education program in accordance with current legislation; or (iii) undertake remedial classes

Source: Hickling Corporation (2008)

There is no unanimity on the impact of the program. While official evaluations predictably list the positives (see Nazara and Rahayu, 2013), evaluations by the World Bank (an important adviser that advocated the introduction of such a program) are also broadly upbeat. Other evaluations are less enthusiastic (Hutagalung, Arif and Suharyo, 2009 and, Febriani and Suryahadi, 2012). Actually, most evaluations agree that with respect to basic education, improvements in the indicators may not mean much as they were quite high to begin with; improvements in junior high school indicators would have been more important, but no significant improvement is actually recorded. No significant change in the utilization of health facilities is recorded among the beneficiary households as compared to control households. There certainly is a positive change in consumption of the beneficiary households as would be expected from an increase in disposable funds, but the pattern of spending is no different from beneficiaries of unconditional transfers. Finally, a very serious shortcoming of the program as implemented in Indonesia that has been pointed out is that

such a program may be useful when there is underused capacity in health and education services; with the admittedly poor quality of education and shortcomings in health services with respect to both quality and quantity (or access), the relevance of a **conditional** cash transfer program in Indonesia is rather limited.

F. Sub-national Debt and Fiscal Rules

Law 33 of 2004 allows sub-national governments to borrow in both domestic and international markets, and allows issue of municipal bonds. Moreover, it allows sub-national governments to guarantee third-party loans also (Suhendra and Amir, 2006). Notwithstanding the legal provisions, sub-national borrowing is severely restricted in Indonesia with the central government wielding complete control on such borrowings through pre-approval requirements based on both micro and macro restrictions. The micro restrictions include rules like (a) outstanding debt of any individual sub-national government cannot exceed 75 percent of the previous year's general revenues, and (b) its debt service ratio (general revenues net of wages and parliamentary expenditures as a multiple of the debt servicing costs) must be at least 2.5. Further, a sub-national government cannot incur additional debt as long as its debt repayments to the centre are in arrears. There are two major macro restrictions . consolidated public sector debt cannot exceed 60 percent of GDP and consolidated public sector deficit to be financed through borrowing cannot exceed 3 percent of GDP.³⁷

With all these restrictions, it is not surprising that the sub-national debt has been quite small, both in comparison to the centre as also in terms of the GDP. The central government has not really enforced the macro restrictions (Lewis, 2007), mostly because it did not have to. As far as the sub-national debt market is concerned, it really has not developed both because of lack of demand (the sub-national governments were sitting on large cash reserves until recently) and supply constraints. However, an area of concern has been the poor repayment record of the sub-national governments, even with the small amount of borrowing that they have. The repayment arrears were reported to be in the region of almost 50 percent in 2004.

³⁷ The first stipulation has not been tested yet, but it would be interesting to see its enforcement as much of the debt is at the national level, and there is no clear enforcement mechanism for the central government. As for the second stipulation, it has been breached a few times already, with a number of justifications provided; basically, again without any appropriate enforcement mechanism, the control is expectedly loose.

G. Other Issues

Given the lack of own revenue sources and assured coverage of wage expenditures, the local government expenditures have predictably prioritised the latter in their scheme of expenditures. The tax shares and unconditional grants do provide them some flexibility, but the system of pre-approval of local budgets has *de facto* limited their autonomy. This could be a transient feature and there could be qualitative changes as the local governments mature, but that is to be seen yet. The immaturity of the local governments is apparent in their budgeting processes that lack transparency and accountability, and this is obviously a priority area for reform. The central control has created some problems also, as is best exemplified in the area of local personnel deployment and wages. As both these are tightly controlled by the centre with standard wages applicable, remote areas find it difficult to attract required personnel.

The participation of the sub-national governments in macro stabilization policy has been minimal; the last episode of recession in the economy was almost entirely handled by the central government through tax cuts and additional expenditures. Part of the additional expenditures could have been through enhanced allocations for grants to sub-national governments, but there was no official policy of this kind. In any case, possible additional allocations were probably offset to an unknown extent by lower revenue transfers resulting from the tax concessions employed by the central government.

H. Assessment

Decentralization in Indonesia since 1999 constitutes an extremely interesting case study of the process of decentralization in a developing economy with typical substantial inter-regional inequalities. A fundamental change in governance like this was certain to have gainers and losers, and the political economy of the change would certainly make for an absorbing analysis. There are some special features of the process that are special to Indonesia, the foremost being the deliberate minimization of the role of provinces, driven by secessionist apprehensions. It also serves to maintain authority of the central government since considerably smaller sub-provincial local bodies are unlikely to challenge such authority, at least until they are able to put up a united position on any issue. Even in such a case, the fact that the centre can change the structure of governance if it so desires is certain to be a dampener.

There seems to be a definite political will for decentralization, but the process is probably facing roadblocks set up by the central bureaucracy that is clearly reluctant to

share its powers and jurisdiction. The peculiar combination of objectivity and arbitrariness that was noticed above is probably a result of this tension. The fact of a larger share of sectoral transfers not flowing through DAK (despite it being intended to be so) is also an outcome of the reluctance of line departments to substantively decentralize.

Some of the problems flow from unclear formal assignment, supplemented by a refusal by some of the line departments to accept the spirit of the formal assignment in practice. This is exemplified by the still dominating role played by the central line departments in the areas of decentralized functions like education, health, and roads. This will be difficult to counter as long as the local governments are entirely dependent on the central government financially. The primary agenda for true decentralization therefore ought to consist of augmenting their own revenues; in this context, the transfer of all property-related taxes to local governments is a significant step in the right direction. Removing arbitrariness from the transfer programmes to the extent feasible would also work towards the same goal. At the same time, the central government would have to discharge its responsibilities towards equalization. This would require substantial intergovernmental transfers in the years to come given the regional inequalities, but continuous reforms to correct the system from flaws like cancelling out one type of transfer with another (the case of natural resource transfers and DAU) and to rid the system of the wrong kinds of incentives also would be needed. Simultaneously, the central government will have to continue guiding the local governments towards maturity through appropriate monitoring mechanisms and controls (e.g., in the areas of financial management and expenditure prioritization).

Chapter V: Intergovernmental Fiscal Relations in the Russian Federation

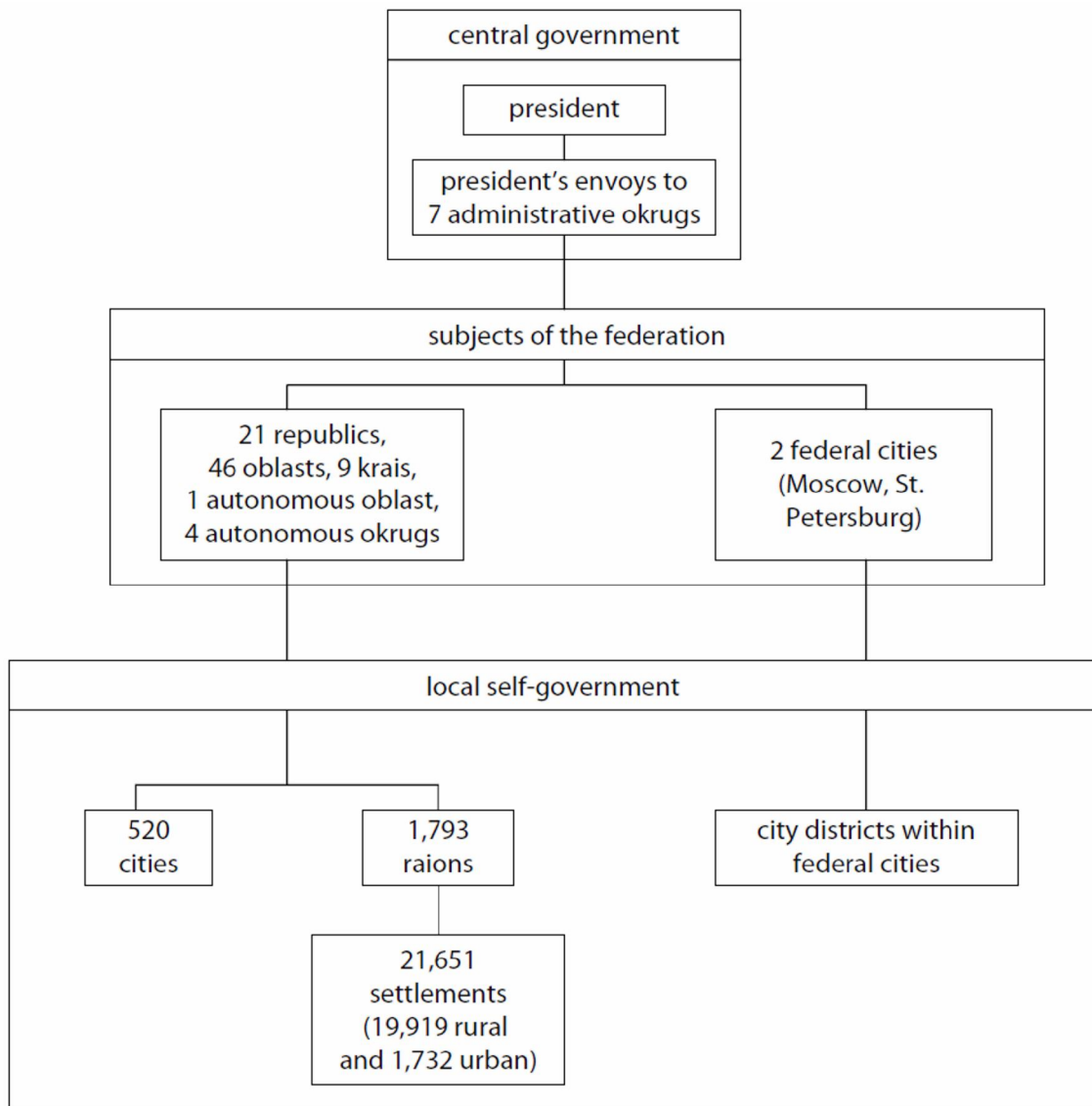
A. Governmental Structure

In 1991, the huge Soviet Union collapsed with a number its constituent states breaking away to form independent nations, and the smaller modern Russian federation emerged. The economic system shifted from a command and control-based one to a market-oriented one. The Russian federation is now a little more than twenty years old and various reforms have been undertaken during this period to restructure the economy. The reforms initiated are not only in the direction to economically liberalize and democratize the country but also to make a transition from a highly centralized unitary system to a decentralized federal system.

The major commitment to adopt a federal governance structure in Russia came with the adoption of the Constitution in 1993. Russia's Constitution is based on the principles of territorial integrity of the country, unity of the system of state authority, differentiation of responsibilities and power among governmental structures, and the equality and right of self-determination of all Russians. The country has a Presidential system of governance, with a bicameral Parliament (the Lower House or the Dumas is the main legislative body, although the President also has legislative powers) and a cabinet headed by a Prime Minister.

The Russian Constitution establishes two levels of governments: federal and regional. It also identifies and divides the areas of expenditure responsibilities between the federal and regional governments. Local governments form an independent layer of public authority that is not subordinate to the regional government. Formally, local governments have separate responsibilities and powers, and they formulate and approve their budget without approval of regional governments. However, in practice, they depend heavily on regional governments' transfers and public investment policies. Federal law (Federal Law No. 184-FZ on General Principle of the Organization of Government in Subjects of the Federation) establishes principles for the organization of government bodies in regions (called subjects), whereas federal law (Federal Law No. 131-FZ on General Principles of the Organization of Local Self-Government) does the same for local governments. Both laws have undergone substantial changes in recent years. Figure 5.1 presents the schematic governance structure of the Russian Federation.

Figure 5.1: Structure of Russian Federation



Source: De Silva et al. (2009).

In practice, Russia's sub-national governance structure has four layers. Until recently, the first layer consisted of 83 regions and they are referred to as subjects of the federation.³⁸ These subjects include 21 republics (native territories), 46 oblasts, 9 krais, 4 autonomous okrugs, 1 autonomous oblast, and the 2 federal cities of Moscow and St. Petersburg. All subjects have equal rights, but the powers of autonomous okrugs are limited by federal laws. Recently, the whole country was divided into seven administrative districts

³⁸ Since March 18, 2014 the number has gone up to 85 (officially, for Russia) with the inclusion of Crimea as an oblast and Sevastopol as a federal city. The international community, however, is yet to recognize these claims of Russia on these two territories that have so far been considered parts of Ukraine.

and they are referred as federal okrugs (federal administrative districts). The purpose of forming these federal okrugs is to oversee and control the functioning of the regions, although the legal status of these units is questionable. The regions are subdivided into 520 larger cities (known as gorodskoi okrugs) and 1,793 rural areas (municipal raions). The raions are further subdivided into smaller settlements (poselenie), which include towns and smaller rural areas that combine two or three villages. As per the Federal State Statistics Service, 2007, Russia had 21,651 such smaller settlements. In principle, all local governments are independent of regional governments in terms of their budgetary and administrative status.

In the Parliament, the regional governments are represented by the upper house; two representatives of each subject, the chief executive and the head of the legislature, are ex officio Members of the upper house. The lower house (Dumas) is the real national level legislative body with formal primacy between the two houses, but the upper house can exert its influence through the collective political clout that it represents, particularly when it is able to align the President on its side.

B. Assignment of functional responsibilities and revenues

1. Allocation of expenditure responsibilities

Successful implementation of decentralization policies often requires certain preconditions such as: a strong capacity-building and political consensus, dialogue, and consultation among different levels of governments. Decentralization policies that simply aim to devolve fiscal responsibilities to sub-national governments are found to be less effective. During the early years of the transition, from 1992 to 1994, the Russian federal government assigned various federal expenditure responsibilities to the sub-national governments, particularly in the areas of social welfare, with an objective of balancing the federal budget. But the first federal Constitution was often ambiguous regarding functional assignments, the ambiguity further increased by bilateral agreements between the Centre represented by the President and the sub-national heads of government, mostly dictated by political considerations. Even the subsequent clarifying/modifying provisions left a number of gaps, probably hoping to fill them through developing conventions over time and also through clarification/amplification of constitutional provisions. It must be appreciated that the federal system in Russia followed an authoritarian socialist system with no history of usual democratic federal system, and hence had to evolve its own system of federalism suited to the nation's requirements. This could not be expected to happen quickly. The process, by its very nature, involves some trial and error and takes time to settle. The reform of expenditure

assignments in Russia has so far focused more on the division of responsibilities between the federal and regional governments and less on the division between the regional and local governments. Defining sub-national government expenditure responsibilities is a very recent phenomenon.

The first law on local government, Federal Law (No. 1550-1) on Local Self-Government in the RSFSR (July 6, 1991), defined the scope for the intervention of each tier and type of local government. Article 71 of the new Constitution, which was established in 1993, assigns exclusive authority to the federal government over broad areas such as defence, common market, railways, and telecommunications, whereas functions such as education, healthcare, and social protection are assigned jointly to the federal and regional levels. The new Constitution ensured the local governments autonomy in governing local affairs but did not provide the list of direct responsibilities for them. The new Budget Code, adopted in 1998, came into force in 2000, provided somewhat more specific assignments for local governments.

The assignment of expenditure responsibilities in the Budget Code is an improvement over the responsibilities that were assigned in the 1993 constitution. Chapter 11 of budget code defines exclusive and joint responsibilities for each level of government (federal, regional, and local). The Budget Code specifies the exclusive responsibility of the federal government for national defence, tax collection, space exploration, federal courts, financial support to regional governments, and official statistics. For the regional level, the Budget Code specifies exclusive responsibility of region-specific items such as: mass media, public transport, fire protection, housing, and providing financial aid to local governments. Finally, for the local level, the Budget Code enumerates municipal housing and utilities, construction and maintenance of local roads, waste utilization, transit, and earmarked subsidies to population. The expenditure responsibilities of items such as education, health, culture (museums and theatres), road construction, library, police services, environment, and welfare compensation are allocated to all levels of governments (joint responsibilities). Present expenditure responsibilities of regional and local governments are mentioned below in a more detailed fashion.

The major functions assigned to regional governments are:

- Providing health care in specialized hospitals (for tuberculosis, cancer, psychiatric conditions, and so on);
- Providing funds to municipalities for preschool, primary, secondary, and afterschool education;
- Providing vocational education;

- Protecting the environment and nature reserves;
- Preventing disasters and emergencies and dealing with their aftermath;
- Providing fire protection;
- Providing veterinary clinics;
- Providing welfare services to senior citizens and persons with disabilities;
- Paying allowances to families with children and to low-income households (for housing and utilities);
- Supporting victims of Stalin's regime and workers in defence enterprises during World War II;
- Providing medical insurance for the unemployed;
- Running orphanages;
- Preventing terrorism;
- Constructing and maintaining regional roads and other infrastructure;
- Providing intercity public transportation;
- Maintaining regional public libraries and regional museums; and
- Organizing cultural and sports events.

The list of local government functions is determined by the Law on General Principles of the Organization of Local Self-Government. The major functions assigned to municipal raions are:

- Providing pre-school, primary, and secondary education along with supplementary after-class education, using subsidies from the regional budget;
- Providing health care in general hospitals, maternity care, and ambulance services;
- Providing municipal police services;
- Protecting the environment;
- Managing waste disposal;
- Maintaining *raion* libraries;
- Organizing recreational, cultural, and sports events;
- Providing electricity and gas;
- Constructing and maintaining inter-settlement roads; and
- Providing inter-settlement public transportation.

The major functions assigned to settlements are:

- Delivering housing and utilities (electricity, heating, water, gas, streetlights) and providing waste collection;
- Constructing and maintaining housing for low-income households;
- Providing basic fire protection;
- Maintaining cemeteries;
- Maintaining parks and gardens;
- Maintaining settlement libraries;

- Organizing recreational, cultural, and sports events and recreational activities for teenagers;
- Constructing and maintaining intra-settlement roads; and
- Providing intra-settlement public transportation.

Table 5.1: Expenditure Shares of Different Levels of Government

<i>Government function</i>	<i>Federal budget (%)</i>	<i>Regional budgets (%)</i>	<i>Local budgets (%)</i>
Total outlays	54	29	17
General public services	64	20	16
Public administration	9	21	70
Courts	89	11	0
Fiscal authorities	86	8	6
Debt service	85	13	2
National defence	100	0	0
National security and law enforcement	77	20	3
Police	62	33	5
National economy	36	56	3
Fuel and energy	41	39	20
Agriculture and fishing	24	70	6
Transport	32	59	9
Communication	30	67	3
Housing and public utilities	8	49	43
Environmental protection	29	57	14
Education	22	26	52
Primary and secondary	1	21	78
Vocational	28	70	2
Higher professional	95	5	0
Culture and mass media support	29	39	32
Health care and sports	22	59	19
Health care	13	69	18
Social welfare	81	14	5
Pensions	100	0	0

Source: De Silva et al. (2009).

Regional and local governments can add more functions to the federal list provided they have their own resources to support them. The federal government can assign specific federal government functions to regional and local governments with the financial and

material resources to support them. Budget code of Russia has divided all expenditure responsibilities into ten broad categories: general public services, national defence, national security and law enforcement, national economy, housing and public utilities, environmental protection, education, culture and mass media support, health care and sports, and social welfare. Table 5.1 provides a detailed picture of the formal assignment of expenditure responsibilities across different levels of government for the year 2006.

The table suggests that the entire spending responsibility of defence and pensions is on the federal government. Among the shared items, the federal government spends more on general public services (public administration is an exception where sub-national governments spend more), national security and law enforcement, and social welfare, whereas the sub-national governments contribute more to the spending on areas such as major production sectors of the Russian economy, housing and utilities, environmental protection, education, culture and mass media support, and health care. However, higher spending shares of the sub-national governments do not necessarily imply higher autonomy as the sub-national governments receive a significant amount of earmarked transfers from the federal government to execute its mandates.

Though many reforms have been undertaken aiming at enhancing regional expenditure autonomy, legal control of expenditure responsibilities over almost all of the major items are still with the federal government. Therefore, the present Russian practice can be summarised as: the assignments of spending responsibilities and the monitoring of budget execution are controlled by the federal government, whereas the sub-national governments help the federal government in undertaking spending obligations and budget execution.

2. Allocation of resources

In a federation, assigning revenue sources to different levels of governments is as important as assigning expenditure responsibilities. However, in practice, expenditure responsibilities are more heavily decentralized than revenue sources (Ebel and Yilmaz, 2002). The Russian federation is not an exception in this regard (Martinez-Vazquez et al., 2006; De Silva et al., 2009).

Before 1991, the tax system in Russia was very centralized. Russia's transition to a market economy paved the way for major changes in the tax system, but these changes were mostly applicable only to the taxpayers, not to the recipients of taxes. The central government not only constrains sub-national governments' revenue options, but also

decides their tax bases. Therefore, all taxpayers pay taxes to governments through the offices of the Federal Treasury, while the Federal Tax Service administers the collection of all taxes. Neither the regional nor the local governments have the power to levy taxes other than those specified in the federal legislation. The federal government also has the discretion to unilaterally levy or cancel regional or local taxes, change tax rates, and grant tax breaks. Hence, most of the time this results in under-collection of sub-national taxes as the Federal Tax Service, a federal body, is largely interested in collecting the taxes that accrue to the federal budget (Deryugin and Kurlyandskaya, 2007).

The *Russian Tax Code* defines the tax law of the Russian Federation. The most important changes in the taxation law were introduced as a part of Putin's tax reforms in 2001. Measures related to simplification of the tax structure, rationalization of tax rates, abolition of tax breaks, and broadening the tax base were introduced. Since then some minor changes are made in the tax law of the Russian Federation, but the basic structure of the Tax Code has remained more or less the same since the major amendments of 2001. As per the recent Tax Code and Budget Code of Russia, it has 15 main taxes: 10 federal taxes, 3 regional taxes, and 2 local taxes (see Table 5.2).

Among the federal taxes, Value Added Tax (VAT) contributes the most (32 percent in 2008). Before 2001, VAT was a shared tax. The decision to retain 100 percent VAT by the federal government was taken in 2001. The justification was that the VAT has an uneven tax base, concentrated mostly in a few wealthiest regions, and VAT revenue cannot be distributed in proportion to the value added produced in the regions (De Silva et al., 2009). Other major shared federal taxes are corporate profit tax, personal income tax, and excise duties on alcohol products and gasoline and diesel fuel (shared ratios are mentioned in table 5.2). All regional and local taxes in Russia are asset-based: business property tax, vehicle tax, and tax on gambling businesses are with the regional governments, and personal property tax and land tax are with the local governments. Though the rates of these taxes are determined by the respective sub-national governments, their tax bases are determined by the federal government. In practice, corporate profit tax and business property tax are considered to be the two most important taxes regulated by the regional governments, with former alone contributing about 2/5th to total regional tax revenue.

Table 5.2: Tax Assignment for Various Levels of Government

Tax	<i>Determination of</i>		<i>Tax collection and administration</i>	<i>Revenue assignment (%)</i>			
	<i>Base</i>	<i>Rate</i>		<i>Federal</i>	<i>Regional</i>	<i>Local/Municipal</i>	
						<i>Raions</i>	<i>Settlements</i>
Federal taxes							
Corporate profit tax	F	F	F	27	73		
Value added tax	F	F	F	100			
Personal income tax	F	F	F		70	20	10
Excise taxes							
On alcohol and alcohol-based products	F	F	F	50	50		
On gasoline, motor oil, and diesel fuel	F	F	F		100		
On alcoholic products, beer	F	F	F		100		
Other	F	F	F	100			
Mineral resource extraction tax							
Fuel gas	F	F	F	100			
Hydrocarbons other than fuel gas	F	F	F	95	5		
Common minerals	F	F	F		100		
Other minerals	F	F	F	40	60		
Fee for the use of aquatic biological resources	F	F	F	20	80		
Fee for the use of fauna	F	F	F		100		
Water tax	F	F	F	100			
Single social tax	F	F	F	100			
Special federal tax regimes							
Single tax on imputed income	F	F	F	10		90	
Single tax levied under simplified taxation system for small businesses	L(F)	F	F	10	90		
Single tax on agricultural enterprises	F	F	F	10	30	30	30
Regional taxes							
Business property tax	F	R	F		100		
Vehicle tax	F	R	F		100		
Tax on gambling businesses	F	R	F		100		
Local taxes							
Personal property tax	F	L	F				100
Land tax	F	L	F				100

Note: F = federal, R = regional, L = local governments.

Source: Budget Code.

Formally, the federal government sets the tax base for all taxes, but sub-national governments can grant tax exemptions with respect to their own taxes. Since the federal

government sets tax bases, sub-national governments lack the legal rights to monitor and collect taxes. Most of the sub-national governments in Russia levy regional and local taxes at the maximum rates allowed by the federal laws and this has limited revenue autonomy of the sub-national governments (Deryugin and Kurlyandskaya, 2007). As a consequence, the sub-national governments do not have much freedom in using the tax structure as a source to attract private-sector investment to their regions. For comparison, De Silva et al. (2009) have calculated that, for year 2006, on average, regional taxes collect 3 percent of total tax revenues from the taxes allocated to the regional governments and local taxes collect 1 percent from the local taxes, with federal taxes collect the remaining 96 percent.

Apart from collecting taxes and receiving transfers from the higher governments, regional and local governments receive revenues from various other sources. Major sources of non-tax revenues for the regional governments are: payments from the profits of regional public enterprises, a share of payments from the profits of central public enterprises located within their jurisdiction, state duties, revenues from movies shown within their territories, small amounts from local taxes and duties, revenues from selling land plots and immovable properties, and revenues from letting land plots on lease. Local governments receive non-tax revenues from share of the profits of local enterprises, revenues from selling property under municipal ownership, fees for issuance of licences for the retail sale of alcoholic products issued by local bodies, and charge for negative impacts on the environment. Usually, regional and local governments either underreport or do not report some of their non-tax incomes in their budgets as the disclosure of these revenue sources may lead the federal government (or regions, in the case of local governments) to reduce the amount of allocated transfers (Alexeev and Kurlyandskaya 2003; Zhuravskaya 2000). There is also a possibility that the higher government may confiscate revenue-generating resources from the lower government. However, tax assignments of sub-national governments have become more stable and predictable since the 2005 intergovernmental reforms.

On average, regional governments generate about a half of their revenue by themselves and the remaining is received as transfers and shared taxes. On the other hand, local governments are found to be generating only about one-sixth of their budgets through own revenues, whereas transfers and shared taxes account of the rest. Table 5.3 presents a more detailed picture of sub-national government revenue structure in 2006.

Table 5.3: Revenue Structure of Sub-national Governments

<i>Revenue category</i>	<i>Share in total budget revenues (%)</i>	
	<i>Regional government</i>	<i>Local government</i>
Own revenues	51.3	15.6
Own tax revenues which include	42.9	3.6
Enterprise profit tax	34.8	-
Regional taxes	7.9	-
Local taxes	0.1	3.0
Own nontax revenues (including entrepreneurial activity)	8.4	12.6
Shared revenues	29.3	27.4
General-purpose transfers	8.8	15.1
Earmarked transfers	10.6	41.9
Total	100	100

Note: Extra-budgetary funds are not included.

Source: De Silva et al. (2009).

3. Sharing Revenue from Natural Resources

Production of oil and gas accounts for about 9 percent of Russia's GDP. Extraction of oil and gas is carried out in 39 of Russia's 83 regions. About 90 per cent of Russia's gas production is concentrated in Yamalo-Nenetskiy Autonomous Okrug, while almost 60 per cent of oil is extracted in two neighbouring regions Khanty-Mansiyskiy Autonomous Okrug and Nenetskiy Autonomous Okrug. These regions account for 8.5 per cent of the territory of Russia and a mere 1.3 percent of the country's population. Since the spread of oil and gas resources possession is so unevenly distributed across the regions of Russia, like VAT, it presented a very good case for the centralization of revenues collected from oil and gas in the Russian federation. Gradually, over a period of five years during 2001-05, the regional share of tax revenues earned from oil and gas resources was reduced from 60 percent to 5 percent for oil and to zero for gas. At present, tax on oil and gas extraction constitutes the second largest source of federal revenue.

This centralization of revenues from the oil and gas sector was prompted to a significant extent by the burgeoning prices; the rising prices were yielding large windfall gains that were causing spending spikes and leading to inflation. To counter this, a Stabilization Fund has been created. Whenever oil and gas prices are higher than a prescribed threshold level, the additional tax revenues ascribable to the excess price is transferred to the fund. The proceeds are used for supporting investment activities all across the country. Also, given the uneven natural resource base of Russia, leaving even a small

share for the producing regions was boosting their revenues significantly, leading to high levels of expenditure in those regions. This in turn implied larger equalization transfers to all other regions from the central government because of the way these transfers were calculated. By centralizing the revenues from oil and gas, the central government also kept the amount of equalization transfers at a reasonable level. Simultaneously, this measure helped the economy in achieving equalization to some extent. Freinkman and Plekhanov (2009a) provide another reason for centralization of these revenues: they find regions with high rent-type incomes less decentralized internally.

Despite the centralization of oil and gas revenues the major oil producing regions enjoy a revenue advantage. This is achieved through the tax on the large profits of the oil- and gas-producing companies, and income taxes collected from the high wages of workers involved in oil and gas production. All income taxes paid by workers of these companies within a given region flow into the budget of that region, as does a portion of the taxes on profits of these companies, at a rate ranging from 13.5 per cent to 17.5 per cent. As a result, the Autonomous Areas of Nenetskiy, Yamalo-Nenetskiy and Khanty-Mansiyskiy rank first, second and third among Russian regions in terms of revenue per capita. (Kurlyandskaya, 2007). Interestingly, there is some empirical research output to show that a combination of weak democracy and poor quality of bureaucracy in a region can hinder its economic development despite higher revenues from oil and gas as compared to other regions (Libman, 2013).

Apart from oil and gas, different regions of Russia also possess rich reserves of iron ore, manganese, chromium, nickel, platinum, titanium, copper, tin, lead, tungsten, diamonds, phosphates, and gold. Revenues earned from these resources are shared between the federal and the regional governments in a ratio of 40:60. Revenue collected from common minerals such as sand, gravel, and clay etc. is retained entirely by the regional governments.

C. Overlapping jurisdictions, intergovernmental conflicts and institutions for their resolution

The latest Constitution, as adopted in 1993 after a referendum cleared its way, was originally somewhat ambiguous regarding the jurisdiction of different tiers. There were several provisions that practically allowed any tier to do anything. This might not have been an error of omission because subsequent to the adoption of the Constitution, in several areas of operation, central executive fiat defined the jurisdictions. Even these were not uniformly applied, because there were some bilateral agreements between the President

and regional heads that sometimes conceded special powers to the respective regions. This process was essentially driven by political considerations . special concessions for some of the provinces for political support for President Yeltsin who was consolidating his position against the supporters of the previous socialist system.

During 1994 to 1998, intergovernmental financial relation reforms were introduced. In 1994, the sub-national governments were given more revenue-raising powers and they were also allowed to introduce new regional taxes. The federal government set up Federal Fund for Financial Support of Regions (FFFSR) and the equalization grants were allocated based on one formula. Transfers were distributed using the principle of gap-filling, difference between the estimated revenues and expenditure needs. However, due to non-availability of accurate regional data till 1999, regular adjustments were made in the formula, often in effect to favour the more powerful regions. In addition to gap-filling transfers, the federal government used to allocate transfers to compensate the regional governments for carrying out federal government mandates and these transfers were easier to negotiate. During this period, regions also received interest-free loans that were to be paid by an unspecified future date. This is the reason why Russia had a serious debt crisis in 1998 to 2000 as many regions defaulted on their debt.

In 1998 the Budget Code was adopted and put into effect in 2000. This was an important initiative because it regulated the expenditure responsibilities and fiscal powers of the Russian federation. New intergovernmental financial relation reforms were introduced during 1999 to 2001 and the first change was to introduce a new grant allocation formula. The new formula, dealing with equalization grants allocation, took the adjustment that reflected regions capacity to raise sufficient taxes to cover the costs of delivering public services in their jurisdiction into account. It reduced the gap in budget revenues between rich and poor regions significantly, and put an end to the negotiation between the federal government and individual regions. During this period some of the unfunded federal government mandates were abolished which has caused tension between the federal government and regions in the past. The other important reform which was introduced during this period was that the federal Ministry of Finance was put in charge of developing these rules. Though these rules could not be legally imposed on the regional governments immediately, approval of these rules by the federal government resolution helped the subsequent central governments to deal with the intergovernmental financial relation through the ministry.

Vladimir Putin was elected as the president of Russia in 2000 and the intergovernmental financial relation in Russia took a different turn. During his first term, from 2000 to 2004, gradually the federal government increased its share in the revenues collected from VAT and extraction of oil and gas. At present, the federal government gets all revenues collected from VAT and gas extraction, and 95 percent revenue from oil extraction. Moreover, the power of regional governments in introducing regional taxes, which was allowed during the earlier years, was also taken away. As a result, the revenue collection of the regions has reduced significantly and measures of recentralization of revenue collection were established. Changes also have been made in the composition of federal council and in the method of appointing regional governors, heads of the regions. Since 2004, regional governors of Russia are no longer elected by direct vote; instead they are appointed by the regional legislatures following a nomination of the candidate by the president of Russia. This change has made the bargaining positions of the regions very weak, and it has helped the federal government to dominate the regional governments and dictate its terms. Even so, while carrying out major intergovernmental reforms the federal government still seeks the opinion of the representatives of the regional legislatures. However, this practice has become a mere formality. As a consequence, the proposals of the federal Ministry of Finance, which deals with the intergovernmental financial relations in Russia, have been approved by the federal council more easily and without substantive changes (Kadochnikov et al., 2005). Therefore, the decision-making process related to intergovernmental financial arrangements has become heavily dominated by the federal government, particularly by its presidency. Considering these facts, Watts (2007) has argued that Russia resembles more like a decentralized unitary system rather than like a decentralized federal system.

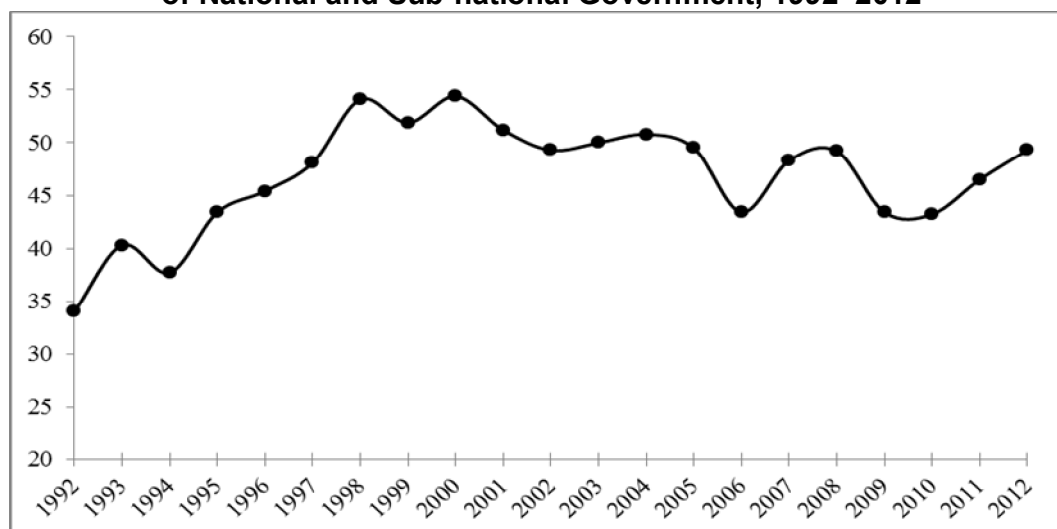
Thus, after the system settled down somewhat, there was a clear recentralization, particularly of revenue sources. Having made the subjects heavily dependent on the centre for resources, it was relatively easy to ensure that the sub-national governments were not too adventurous in terms of functional domain, particularly when block or unconditional grants were only a part of the system. As such, the issue of domain overlapping has been primarily resolved through central dominance. Being an evolving federation, institutions for this purpose are yet to develop; disputes, if any, are resolved through the offices of the central ministries and the upper house of the Parliament, failing which the President has the final say. Theoretically, constitutional disputes can be taken to the judiciary, but disputes of inter-governmental nature rarely are. Realizing the essentially political nature of the problem, each type of sub-national governments now has an association to put up a united front to enhance their bargaining strength vis-à-vis the centre, and sometimes against a different type of sub-national government as well.

D. Fiscal Imbalances (vertical and horizontal)

Like in many other federations, the Russian sub-national expenditure responsibilities are not well matched with revenue assignments. There is an increasing consensus among scholars that, though the initiatives undertaken in the beginning were to decentralize the governance structure of the Russian Federation, it has moved more towards recentralization in recent years, particularly under Vladimir Putin's presidency.³⁹ As a consequence, the vertical imbalance has increased over the years.

Figures 5.2 and 5.3 present the expenditure and revenue shares of sub-national governments in total government expenditure and revenue respectively, over the period 1992–2012. The figures suggest that the expenditure share of the sub-national governments increased substantially till 1998 and has stabilized since then (hovering around 50%), whereas the revenue share of the sub-national governments increased in tandem with expenditure share till 1998 reaching a high of 55 percent, but has continuously fallen to hit a low level of 33 percent in 2012. The increasing gap between expenditure and revenue is largely met by intergovernmental transfers. These figures substantiate the fact that the level of vertical fiscal imbalance has increased in recent years and this is attributed to the systematic implementation of the fiscal recentralization policies.

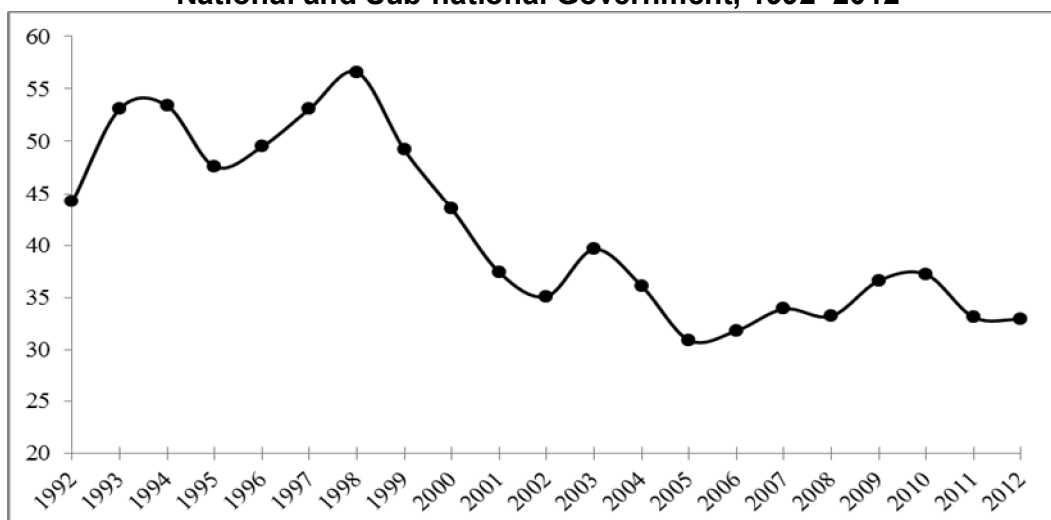
Figure 5.2: Share of Sub-national Expenditures in Total Outlays of National and Sub-national Government, 1992–2012



Source: Based on data provided by various issues of *Russian Economy: Trends and outlooks*.

³⁹ Martinez-Vazquez et al. (2006), Watts (2007), De Silva et al. (2009), and Koolae (2010) have discussed this issue in greater detail.

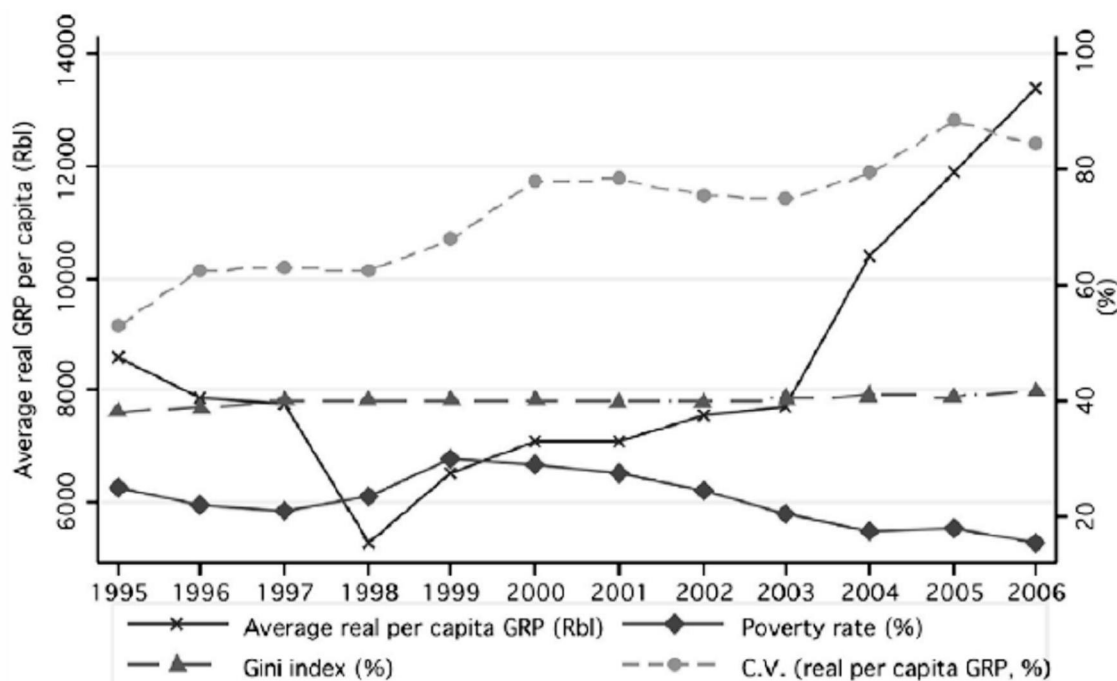
Figure 5.3: Share of Sub-national Revenues in Total Revenues of National and Sub-national Government, 1992–2012



Source: Based on data provided by various issues of *Russian Economy: Trends and outlooks*.

The Russian Federation also suffers from severe horizontal fiscal imbalance as the demographic structure, resource endowment, industrial location, weather, geographic location and conditions, and level of socioeconomic development varies enormously across the sub-national units (Figure 5.4). For instance, in many regions of Russia, the population does not exceed 75000, though they are geographically as big as Germany. In contrast, the population of the most densely populated region is 6000 times that of the least populated region, even after excluding two federal cities of Moscow and St. Petersburg. Majority of the industries are located in the European part of Russia, such as in Moscow and St. Petersburg and around these cities, along the Volga River, and in the Urals, whereas the bulk of Russia's natural and oil resources are located in the north of the European part of Russia and in the north of Western Siberia. In 1995, 75 per cent of metals and 74 per cent of fuels were produced in only 10 out of 89 regions in Russia. More than 50 per cent of machinery was also produced in the top 10 regions. It was estimated that these top 10 regions were contributing about 44 per cent to the country's total GDP, with Moscow city alone contributing for 13.1 per cent (Dabla-Norris and Weber, 2001). Interregional disparity is generally seen to have increased significantly over the years. However, the interpersonal equity does not seem to have suffered much as the Gini index is stable and poverty rate shows a downward trend.

Figure 5.4: Socio-economic indicators in Russia, 1995-2006



Note: GRP . Gross regional product; Rbl . Russian currency Rouble

Source: Takeda (2010).

As the population share, resource endowment, and industrial development are so unevenly distributed, allowing the regions too many own revenue sources or taxes would lead to large fiscal disparities across the sub-national governments. Apart from these factors, other regional characteristics related to ethnicity, political power, and historical advantages makes the situation even more complicated. These diversities seem to have played a major role in preventing the development of symmetric federalism between the regions and the federal government. Addressing regional disparities, including horizontal fiscal imbalances, is one of the reasons for the systematic fiscal recentralization in the Russian Federation in the recent years.

The huge disparities in degree of economic development among the regions have caused severe horizontal fiscal imbalances in Russia. The horizontal disparity between the regions in Russia, in fact, is much larger than in most of the mature federations and even most of the transitional federations (Watts, 2007). Therefore, the formula-based equalization transfers were introduced in 1999 to address the growing horizontal fiscal imbalances in Russia. The methodology used to distribute these transfers aims at bridging the gap between the potential tax revenues and the necessary expenditure in the regional budgets. In 2007, for example, the richest region was 38 times richer than the poorest region and the

federal equalization transfers brought down the fiscal capacity gap between the richest and the poorest regions to eight times (Kurlyandskaya, 2011).

E. Intergovernmental Transfers

The role of intergovernmental transfers is well recognized in the Russian Federation and a number of reforms related to the intergovernmental transfer system were pursued during the early transition, particularly from 1994 onward (Martinez-Vazquez and Boex 2001). However, the major reforms of intergovernmental transfer system were introduced as a part of the Budget Code of 2000. Since the implementation of the Budget Code in 2000, the balance of revenue distribution between the different tiers of the budget system has changed significantly. The size of federal revenues has consistently exceeded the sub-national budgets revenues. The revenue gap between two tiers of governments has increased. The Budget Code also has imposed binding restrictions on borrowing limits of sub-national governments. Therefore, over the years, the sub-national governments have become over reliant on intergovernmental transfers.

Increasing recentralization of the tax revenue assignments and regional disparities has hindered the achievement of vertical balance. This can be inferred from the widening gap between the share of sub-national revenues and the share of sub-national spending (see table 5.4). This gap is filled by intergovernmental transfers. Last row of table 5.4 shows that the sub-national governments receive at least 1/5th of their revenue as federal transfers. The share of transfer was less than 1/5th during year 2008 as the Russian economy was very badly affected by the global financial crisis in 2008.

Table 5.4: Vertical imbalance and intergovernmental transfers, 2008-2012

	(Percentages)				
	2008	2009	2010	2011	2012
Federal budget					
Expenditure share	50.8	56.6	56.8	53.5	50.7
Revenue share	66.8	63.4	62.8	66.9	67.1
Consolidated sub-national budget					
Expenditure share	49.2	43.4	43.2	46.5	49.3
Revenue share	33.2	36.6	37.2	33.1	32.9
Transfers as percentage of sub-national revenue [*]	18.1	25.1	21.4	21.5	20.1

Note: ^{*} Transfers do not include shared taxes.

Source: Based on data provided by the *Russian Economy 2012: Trends and outlooks*.

In Russia, the pool of intergovernmental transfers, known as Federal Fund for Financial Support of Regions (FFFSR), constitutes the transferable fund and the amount is determined based on previous year's figure, with adjustments in changes in budget and tax legislation. All intergovernmental transfers in Russia can be divided into four broad categories: (a) general grants, (b) earmarked transfers for cofinancing regional programs, (c) earmarked transfers for execution of federal mandates, and (d) other transfers.⁴⁰

General transfers include *equalization grants* and *gap-filling subsidies*. *Equalization grants* are formula-based, and per capita fiscal capacity of a region and differences in costs of providing public services across the regions are taken into account for the allocation of such grants. The fiscal capacity index (per capita revenues before transfers) measures the potential tax collections compared to the average level of tax collection. The index of expenditure needs measures differences in costs of providing public services, and is calculated by taking a number of factors into account such as income, population, land area, geographic and climate conditions. Finally, equalization grants are allocated in proportion to the gap between the fiscal capacity and the expenditure needs of the regions. Allocation of *equalization grants* is determined by the Federal Ministry of Finance subject to the approval by the federation council.⁴¹ Introduction of formula-based transfer guaranteed a certain level of budget revenues to the poorest regions, and is intended to reduce the per capita revenue gap between the rich and poor regions significantly. This practice also has put an end to the negotiations between the central and regional governments for transfers.

Equalization grants are allocated on the basis of a formula that is rather complex, but essentially tries to do the job in two stages, comparing the ratio of own revenue capacity with expenditure needs of each jurisdiction with an average for the group. In the first stage, only 60 percent equalization is attempted, and in the second stage 100 percent, subject to availability of funds in the FFFSR. The revenue capacity and expenditure needs are not actual, but normative estimates. In recent years (after 2007) economic growth is also a determinant of equalization grants, though such a factor really has no place in an equalization formula. Also, since the taxable capacity is reckoned on the basis of tax bases, the process of attracting only the tax payment through tax rate undercutting (this is possible because irrespective of production facilities, tax can be paid anywhere by simply setting up

⁴⁰ This is based on Kurlyandskaya's (2011) classification.

⁴¹ Federal council of Russia is the upper house of the parliament. Each of the 83 subjects of Russia sends 2 senators to the council, one from the representative branch of regional government and one from the executive branch of regional government, for a total member of 166 councillors. The council is not directly elected. It is chosen by territorial politicians. The chairman of the federation council is the third most important position after the President and the Prime Minister.

the head office) is encouraged. There is also some conflict between the revenue growth and equalization objectives of the compensatory grants, because it is the richer states that have high revenue growth as a consequence of concentration of economic activity (Dhingra and Nazarov, 2008).

From time to time, revenue assignments and expenditure responsibilities change in Russia. To account for such changes, *gap-filling subsidies*, introduced first in 2004, are allocated across the regions. These subsidies compensate regions for losses of tax revenues or increased expenditure burdens that result due to changes in the federal policies.

Earmarked transfers for cofinancing regional programs are matching transfers where the federal government estimates the regions' expenditure needs under certain programmes and provides transfers to the regions to cover a fixed share of those needs. These transfers usually include cofinancing of certain social expenditures, national projects, and regional development programmes. For instance, the main areas of co-financing of the expenditures of sub-national budgets in 2012 were: construction and upgrading of roads; improvement of the regional general education programmes; state programme for agricultural development and the regulation of agricultural products, raw materials and food markets; and financial support for additional health care provided by district doctors.

Earmarked transfers for execution of federal mandates are provided to regional governments for the implementation of federal mandates with 100 percent expenditure responsibilities on the federal government.⁴² Such transfers are based on estimated expenditure needs and do not depend on the per capita fiscal capacity of the regions. The major federal mandates which are financed through sub-national governments are: the rental subsidy granted to certain categories of federal beneficiaries (such as war veterans and victims of irradiation catastrophes), benefits for blood donors, and compensation of regional governments for civil status registration. Allocation of majority of the transfers under this category usually lack transparency, and the strong regions find ways to influence the allocation of such transfers. For instance, two developed regions of Russia, Bashkortostan and Tatarstan, managed to get lion's share of regional finance reform grants in 2006. Strictly speaking, these grants are not financial aids to the regions, rather these are federal

⁴² In Russia, the practice of allocating the expenditure responsibilities of the unfunded federal mandates to the sub-national governments was abolished in 2005, the year of expenditure assignment reform. Since 2005, the sub-national governments perform the expenditure responsibilities of federal mandates on behalf of the federal government with 100 percent financing through federal transfers.

governments; regional functions performed at the regional level through sub-national governments.

The miscellaneous category of **other transfers** constitutes operating transfers to special territories (e.g., irradiation sites, restricted access cities, research and development centres), ad hoc subsidies (e.g., best-run city award, compensation for the regions affected by natural calamities etc.), and transfers to restricted cities (i.e., direct general-purpose subsidies to centres of the defense industry and research and development).

Table 5.5 presents a category-wise break-up of intergovernmental transfers in Russia for the recent years. The figures suggest that the share of general-purpose transfers (unconditional) has gone down over the years, and increasingly transfers have become purpose-specific (conditional). Among the transfers, equalization grants are allocated most transparently. However, its share in total transfers has declined over the years, from 43 percent in 2004 to 28 percent in 2012. On the contrary, the share of all other transfers, where political discretion and regional power play major role and their allocation lack transparency, has increased significantly over the same period. It suggests that though transfers in the Russian federation have become more purpose-specific over the years, they also have become increasingly subject to political discretion and regional bargaining.

Table 5.5: Federal Grants to Sub-national Governments, 2004-2012

(Percentages)

Transfers	2004	2005	2006	2007	2008	2009	2010	2011	2012
General transfers	54	61	61	40	35	39	38	39	36
<i>Of which equalization grants</i>	43	39	47	31	29	25	29	28	28
<i>Of which gap-filling subsidies</i>	11	22	14	9	6	14	9	11	8
Earmarked transfers for co-financing regional programs	26	27	17	38	38	36	30	33	40
Earmarked transfers for execution of federal mandates	10	10	20	22	16	19	27	23	20
Other transfers	0	2	1	0	11	6	5	5	4
Total	100	100	100	100	100	100	100	100	100

Source: Based on data provided by various issues of *Russian Economy: Trends and outlooks*.

F. Public service delivery in Russia

In Russia, only a handful of regions publish comprehensive data regularly on the performance indicators at the sub-national level. Moreover, the federal authorities strongly

prefer not to disclose information on certain performance indicators. The sub-national governments in Russia do not have much fiscal autonomy. As a result, they play a limited role in providing public goods and services in the Russian federation. Given these limitations, it is not very surprising to see that not many systematic studies are attempted to evaluate the public service delivery status at the sub-national level in Russia.

In one of the initial studies, evaluating the ability of the local governments in providing infrastructure for private business development in Russia, Zhuravskaya (2000) found that centralized revenue collection structure hinders local governments' incentives to provide infrastructure for private business. She also found that centralized fiscal structure has reduced health and education spending at the local level and this, in turn, has a negative effect on infant mortality rate and school attendance. In another study, linking fiscal autonomy with business environment in Russia, Desai et al. (2005) found that the regions associated with increasing retention rate, which is the share of regionally generated taxes that are left with the regional budgets, are more likely to improve the business environment and to support new business entry and genuine enterprise restructuring. Using Afonso *et al.* (2005) methodology, Hauner (2008) has calculated public sector efficiency scores for the health, education, and social protection sectors at the sub-national level in Russia. He found that the regions which are more reliant on intergovernmental transfers are also the ones associated with less efficient public sector performance. Focusing on very specific performance indicators, Freinkman and Plekhanov (2009b) found that fiscal decentralization in the Russian regions (measured by the higher share of revenues with respect to which municipalities have some control over spending) is associated with better public sector outcomes in two different sectors, secondary education and municipal utilities (water, sewerage, and district (central) heating). In Russia, both sectors are the responsibility of sub-national governments. Thus, in the Russian context, true decentralization in the sense of independent policy making appears to improve service delivery. On the other hand, while analysing the effects of decentralization on clinical healthcare outcomes, Kinnunen *et al.* (2007) have argued that recentralization has reduced the regional disparities in healthcare outcomes, and also has ensured universal access to basic healthcare facilities of uniform quality.

In recent times, many countries across the world have used Conditional Cash Transfers (CCT) mechanism for target-specific and effective use of public money. However, the Russian federation is yet to use CCT mechanism in their economy.

G. *Sub-national borrowing*

The evolution of the Russian legal framework for sub-national borrowing has been a gradual introduction of constraints on regional and local governments' borrowing powers. Until 1998 Budget Code, various federal laws were passed to deal with the budgetary rights of different levels of government and they had barely served the purpose. The 1998 Budget Code, which developed an entire body of budget legislation applicable to federal and sub-national governments, came into force in 2000 and was amended in 2004. Before 2000 the sub-national governments were allowed to borrow from the international market. Against the previous practices, the Budget Code prevents the sub-national governments from borrowing from the international market and allows the sub-national budget deficits only to be financed through domestic borrowing.

The Budget Code imposes restrictions on domestic borrowing by sub-national governments too: a region's deficit cannot exceed 15 percent of its revenues, and a local government's deficit cannot exceed 10 percent of its revenues, excluding transfers from higher levels of government and the proceeds from sales of property. These limits on borrowing amounts were imposed after the 1998 financial crisis, when a number of regions had defaulted on their debt. Further, the Budget Code was amended in 2007 to tighten the budget deficit limits for highly subsidized regions and municipalities. The highly subsidized regions are those whose share of intergovernmental transfers (excluding earmarked transfers) exceeded 60 percent of a region's revenue (excluding earmarked transfers). For such regions, the deficits should not exceed 10 percent of their revenues, excluding all intergovernmental transfers. Similarly, for highly subsidized municipalities whose share of intergovernmental transfers exceeded 70 percent of revenue excluding earmarked transfers, the deficit limit was set at 5 percent of revenues, excluding all intergovernmental transfers. In effect, these conditions restrict sub-national deficits to negligible levels.

The amended Budget Code emphasized that the outstanding debt of a region or municipality should not exceed its revenues, excluding intergovernmental transfers. The 2007 amendments mentioned that the outstanding debt of the highly subsidized regions and municipalities should not exceed 50 percent of their revenues, excluding intergovernmental transfers. The Budget Code stipulated that the debt service of a region or municipality must not exceed 15 percent of expenditures. The Budget Code also defined the structure of regional and municipal debt and their maturity. The debt structure of regions and municipalities is confined to intergovernmental loans, loans from financial institutions, government securities, and guarantees. The maximum maturity of debt obligations is set at

30 years for the regions and 10 years for municipalities. Table 5.6 summarizes the fiscal and debt rules for sub-national governments in Russia.

Table 5.6: Fiscal and debt rules for sub-national governments

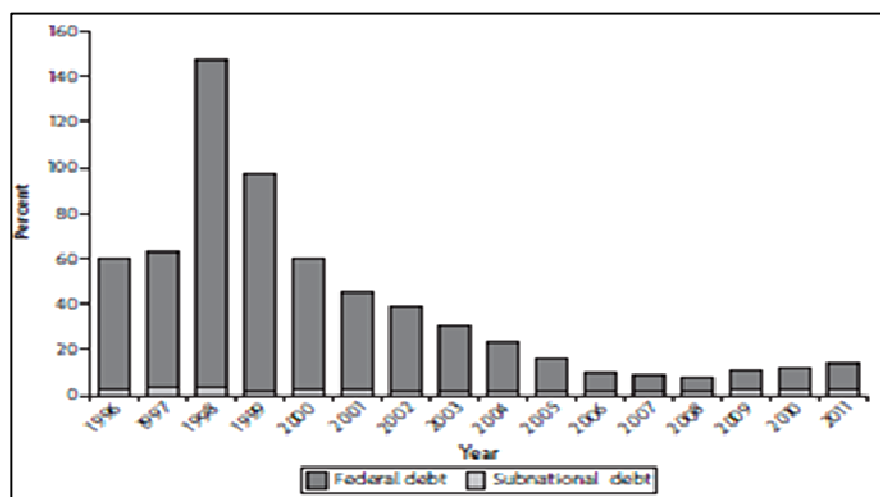
Rule	Regions	Highly subsidized regions	Municipalities	Highly subsidized municipalities
Deficit/revenue (excluding transfers) ceiling	10%	10%	10%	5%
Debt service/expenditure ceiling	15%	15%	15%	15%
Total debt/revenue (excluding transfers) ceiling	100%	50%	100%	50%
Term of borrowing ceiling	30 years	30 years	10 years	10 years

Source: Kurlyandskaya (2011)

The Ministry of Finance of Russia monitors the debt positions of the sub-national governments. In case a region or municipality violates the constraints imposed by Budget Code, it is not permitted to issue new debt until the situation once again meets the requirements of the Budget Code. These limitations on sub-national public finance in Russia are somewhat similar in size and scope to the restrictions imposed by the Maastricht Treaty for European Monetary Union (EMU) members.⁴³ The Budget Code is adjusted to enforce the strong golden rule criterion, which means the sub-national government borrowing is restricted to financing capital expenditures and recurrent deficits are not allowed.

Figure 5.5: Accumulated Debt of Federal and Sub-national Governments

(Percentage of GDP)



Source: Kurlyandskaya (2011)

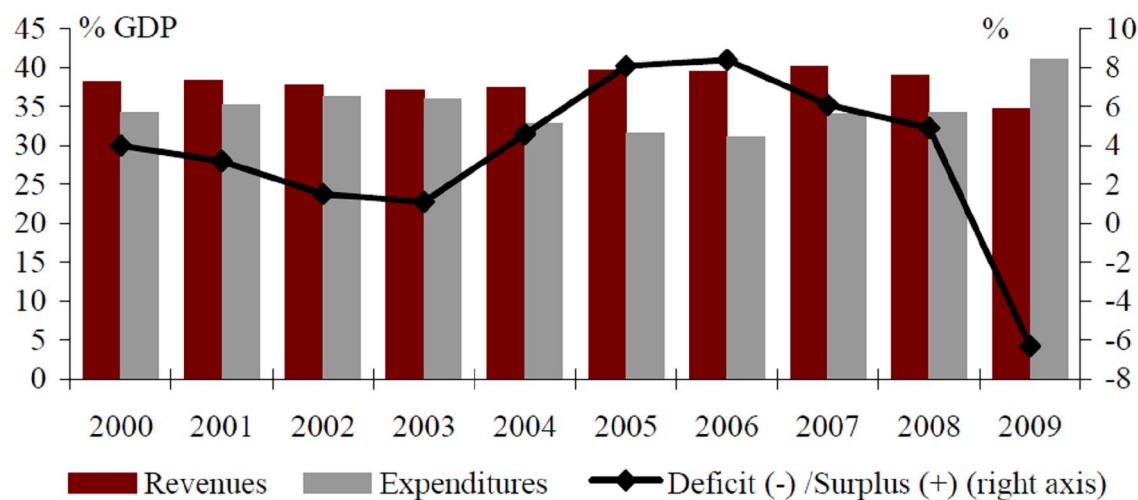
⁴³ The Maastricht rules allow member states to run a deficit of 3 percent of GDP, and a public debt level of up to 60 percent of GDP.

At the aggregate level, the impact of restrictions imposed by the Budget Code on the sub-national governments' borrowing abilities has been quite substantial. The regional governments' debt burden has continued to shrink since the year 1998. As of the end of 2011, the regional governments' debt burden was about 2 percent of the GDP (Figure 5.5). Even during the recent global financial crisis, though the share of federal debt increased marginally, the contribution of sub-national debt to total debt remained very small. During the crisis period from 1998 to 2000, 57 of 89 regions had defaulted on their debt, whereas there were no regional defaults during the 2008-09 global financial crisis (Kurlyandskaya, 2011). This confirms the degree of effectiveness that the Budget Code has imparted to limiting the deficits of the sub-national governments in the Russian Federation.

H. Global Financial Crisis and Sub-national Finance in Russia

Russia's high economic growth rate over the first decade of 21st century has played a crucial role for the impressive changes in the country's socio-economic development over the same period. Because of the high growth, the size of Russian GDP increased by 83 percent during the period 1999-2008 and the GDP per capita (PPP) increased from \$6758 in 1999 to \$14692 in 2007. Persistent increase in oil prices had played a very important role in achieving rapid economic growth of 1999-2007. During this period, the revenue that the federal government received from oil and gas increased from about a quarter of federal budget revenues in 2000 to 40 percent in 2007. The export performance of the Russian economy was also very impressive during the rapid growth period and it was largely on account of increase in export of raw materials such as metals, timber, and coal. As a result, Russia did not have many difficulties in managing its public finance. In fact, Russia had maintained a surplus budget till 2008 (see Figure 5.6). However, the situation started to change dramatically with the advent of the financial crisis in 2008-09. The revenues from taxes and levies, which directly depend on the prices of energy resources and demand for Russian exports, and revenues from foreign economic activity declined most drastically . by 1.3 percent and 1.7 percent of GDP respectively. The spending structure of the economy also changed dramatically during the crisis period. In response to the crisis, counter-cyclical expenditure policies were implemented. No expenditure cutbacks were made and additional expenditures were initiated to execute anti-crisis measures. As a result, for the first time in many years, the Russian economy's output declined sharply and it had to deal with a budget deficit of more than 6 percent of GDP.

Figure 5.6: Revenues and expenditures of the consolidated budget (% of GDP)



Source: Sinitsina (2011)

Though the sub-national governments in Russia are heavily transfer dependent, the financial crisis has affected the revenue generation ability of each region differently. In particular, the own revenue collection of highly developed regions, federal cities and regions producing oil, natural gas and metallurgical products, decreased as they were highly dependent on personal income tax and enterprise profit tax. Since most of the regions have experienced dramatic declines in tax and non-tax revenue collections in 2009, they became more dependent on borrowing and faced significantly larger budget deficits. Given the deterioration of financial market conditions and high interest rates on commercial credits, budgetary loans became one of the key sources of borrowing for the regions. As a result, the volumes of federal transfers and subsidies to regions increased by 35 percent and 12 percent respectively in 2009 in comparison to 2008. This was a crucial difference from the 1998 crisis, when the federal government provided no support to the regions and left them alone to deal with the situation on their own. On the whole, the responsibility of meeting revenue requirements of regions during the recent global financial crisis fell largely on the federal government. The structure of expenditures of the regional governments also underwent substantial changes in 2009, although the total size of regional expenditures remained more or less the same. For instance, investment expenditures were reduced and the spending on social policy items had increased considerably. Also, between 2008 and 2009, expenditure on wages and salaries increased by 10 percent. The number of deficit-ridden regions increased from 44 in 2008 to 62 in 2009, and the regional and local budget deficits resulted in an increase of indebtedness.

In 2009, a series of measures were initiated by the Ministry of Finance aiming at minimizing the impact of the crisis at the sub-national level. These measures were in the direction of: (1) containing the size of regional expenditures; (2) stimulating the growth of sub-national revenues; and (3) relaxing the restrictions on borrowing and deficit. The Ministry of Finance recommended that the expenditure budget must be based on the forecast of tax revenues and current year's surplus revenue should be kept as a reserve for the next year, instead of using it to finance current expenditures. A number of articles were amended related to Tax and Budget Codes. The enterprise profit tax rate was reduced from 24 percent to 20 percent since January 1, 2009, and the entire rate reduction was borne by the federal government. An additional 0.5 percent of the rate was also transferred to the regions. All revenues collected from excise taxes on motor gasoline, straight gasoline, diesel fuel and motor oil were shifted to the regional budgets, against 60% previously. For the better utilization of subsidy, the subsidies allocated from the federal government to the sub-national governments were made more target-specific.

In 2010, after 18 months of crisis, the Russian economy showed signs of recovery; economic growth recovered from -7.8 percent in 2009 to 4.3 percent in 2010, and export growth increased from -35 percent in 2009 to 32 percent in 2010. As a result, the tax collection increased, especially from the personal income tax and enterprise profit taxes, which are two important revenue sources for the regional governments in Russia, helping the regional governments become less dependent on intergovernmental transfers in 2010 compared to the previous year. Improved revenue situation led to increase in aggregate spending of the regions in 2010. The debt markets situation improved, and the costs of borrowing decreased. Though the debt share of the regions continued to increase, its growth rate declined. The aggregate regional debt remained moderate at 20 percent of total revenue in 2010. The fiscal position of the sub-national governments continued improving in the subsequent years owing to the improvements in the overall macroeconomic position of the Russian economy. For instance, the consolidated budget deficit of the Russian regions decreased to 0.45 percent of their revenues (excluding intergovernmental transfers) in 2011 from 1.53 percent in 2010.

I. Russian experience with fiscal federalism and lessons for India

The practice of fiscal federalism in Russia has been a little more than two decades old and it has a long way to go to be recognized as a federation in true sense. Russia's practice of intergovernmental financial relations appears to be similar to that of many federations, including of India, on many accounts. From the point of view of India, the major

similarities are: taking both revenue capacities and expenditure needs into account while allocating equalization transfers based on a formula; using gap-filling grants to compensate for revenue losses; using earmarked transfers for both execution of federal mandates (100 percent financed by the central government) and cofinancing regional programs (a certain percent of the funding is borne by the sub-national governments); and monitoring sub-national debt and deficit by imposing fiscal rules at the sub-national level (Budget Code in Russia and Fiscal Responsibility Act in India). Though there are these similarities between the two federations, the recent developments undertaken in Russia to establish a federal structure are not very encouraging. After making some progress towards decentralizing the governance structure in the initial years, the Russian federation started moving in the opposite direction by recentralizing the decision-making power on key issues related to intergovernmental financial arrangements. Initiatives undertaken towards recentralization are often justified on the ground that the regional disparities in Russia are very high in comparison to other federations and there is also a threat of national disintegration, and a powerful central government only can address these concerns. Given the fact that the sub-national governments in Russia have very little fiscal autonomy, they are considered as the mere agencies of the federal government to execute federally assigned responsibilities. In the light of these facts, there are not many insights that India can draw from the Russian experience with fiscal federalism to improve its own intergovernmental financial arrangements.

Appendix

Allocation of the Equalization Grants

The aim of the equalization transfers is to minimize the gap in per capita revenue between the richest and the poorest regions. The formulas used for the allocation of transfers in 2001. 04 and 2005-10 are presented in table A1.

For 2001. 04, all regions were ranked in ascending order by ratio of the fiscal capacity index to the expenditure needs index. The fiscal capacity index shows potential tax collections compared to the average level of tax collection. Per capita fiscal capacity (per capita revenues before transfers) was calculated using Federal State Statistics Service data. The index of expenditure needs is estimated by taking a number of factors into account, including nonmarket factors such as population, land area, climatic conditions, transportation distances, and so on. Finally, 80 percent of the equalization grants were allocated to regions whose per capita fiscal capacity (tax base) was below average, while the remaining 20 percent were distributed among the poorest regions.

In 2005, the allocation principle was changed. During the first stage, all regions that collected less than 60 percent of average tax collections received transfers which covered 85 percent of the fiscal gap. During the second stage, the remainder of the fund was distributed among all regions that collected less-than-average taxes in proportion to the difference between their level of collections and the average level. A transition was made to multiyear budgeting period (three years) in 2008. As a result, the size of the equalization fund was determined based on the minimal per capita fiscal capacity requirement that all regions should meet after the allocation of equalization grants. Earlier, the size of the fund used to be determined on an *ad hoc* basis. This minimal fiscal capacity level was estimated as the average fiscal capacity of all regions barring the richest 10 regions and the poorest 10 regions.

Table A1: Equalization Grant Formula

2001-04	2005-10
F is the total amount of funds (exogenous).	F is the total amount of the fund (exogenous for 2005. 06, endogenous for 2008. 10).
$K1, K2$ are per capita equalization criteria.	$K1, K2$ are per capita equalization criteria.
$K1 = 1.00$; $K2$ is endogenous.	$K1 = 0.60$; $K2 = 1.00$.
$F_i = T1_i + T2_i$	$F_i = T1_i + T2_i$
$\sum T1_i = 0.30 \times F$	for 2008. 10 after equalization $\left[\frac{FCI_i}{ENI_i} + \frac{T1_i + T2_i}{ENI_i + N_i \times A} \right] \geq$
$\sum T2_i = 0.20 \times F$	\geq <i>average</i> without 10 richest and 10 poorest regions $\left(\frac{FCI_i}{ENI_i} \right)$
$T1_i = 0.80 \times F \times \frac{D1_i}{\sum D1_i}$, if $D1_i > 0$,	$T1_i = 0.85 \times D1_i$, if $D1_i > 0$,
else $T1_i = 0$	else $T1_i = 0$
$D1_i = A \times \left(K1 - \frac{FCI_i}{ENI_i} \right) \times ENI_i \times N_i$	$D1_i = A \times \left(K1 - \frac{FCI_i}{ENI_i} \right) \times ENI_i \times N_i$
$T2_i = D2_i$, if $D2_i > 0$	$T2_i = (F - \sum T1_i) \times \frac{D2_i}{\sum D2_i}$, if $D2_i > 0$
else $T2_i = 0$	else $T2_i = 0$
$D2_i = \left(k2 - \frac{A \times FCI_i + T1_i}{ENI_i} \right) \times ENI_i \times N_i$	$D2_i = A \times \left(k2 - \frac{T1_i}{ENI_i \times N_i \times A} \right) \times ENI_i \times N_i$
F_i is the equalization grant to region i .	FCI_i is the fiscal capacity index, which shows potential tax collections compared with the average level of tax collection.
$T1_i$ is the first part of the grant for region i .	
$T2_i$ is the second part of the grant region i .	
A is per capita average tax capacity.	ENI_i is the index of expenditure needs, which shows relative costs of providing public services compared with the average level.
N_i is population of region i .	

Source: De Silva et al. (2009).

Chapter VI: Fiscal Aspects of South African Decentralization

A. Introduction

The devolution of taxing and spending powers to lower levels of government has become an important theme of governance in many developing countries in recent years. Accordingly, restructuring of governmental functions and finances between the national and lower levels of government has entered the core of the development debate. A general conclusion emerging from a review of theoretical and empirical literature on intergovernmental fiscal relations is that sub-national governments need to be given access to adequate resources to do the job with which they are entrusted. At the same time they must also be accountable for what they do with these resources. Moreover, like all public policies, intergovernmental fiscal policies must take into account both political constraints, such as the strength of different provinces and groups in political decisions, and economic ones facing policy makers.

The South African government system is fundamentally based on the principles of consensus and negotiated settlement, seeking agreement on several contested issues, namely: political participation, representation, integration, good governance, transformation and democratization, as well as many topical or unresolved issues that still confront the administration. All these topical issues were enshrined in the Interim Constitution Act 200 of 1993 which was adopted as a building block to a system of government. The 1993 Constitution created a platform for further deliberations and negotiations on the various unresolved and contested issues. The end result of such negotiation was the adoption of the Final Constitution Act 108 of 1996.

The Constitution of the Republic of South Africa (Act No. 108 of 1996) has features of unitary and federal system of government. It has a highly decentralized system of government with three spheres of government - national, provincial and local governments which are distinctive, interdependent and interrelated. In terms of chapter six of the Constitution, which deals with provincial matters and chapter seven which deals with local government issues, the latter two spheres of government are supposedly autonomous or independent entities. The intergovernmental system is based on the principle of cooperation between these three spheres of government

(local, provincial and national). While responsibility for certain functions is allocated to a specific sphere, many other functions are shared among the three spheres. The Constitution describes the three spheres as being ~~a~~ distinctive, interdependent and interrelated and enjoins them to ~~u~~ cooperate with one another in mutual trust and good faith. An important element of this cooperative relationship is that there needs to be a clear understanding of each sphere of government's powers and functions to ensure that a sphere of government or organ of state ~~u~~ does not encroach on the geographical, functional or institutional integrity of government in another sphere.

Analysis of the intergovernmental fiscal system in the Republic of South Africa (RSA) is important for students of fiscal decentralization for a number of reasons. First, the troubled history of apartheid and the extreme inter-personal and inter-regional inequality and poverty has underlined the importance of instituting an efficient and a fair fiscal system. Second, in the post-apartheid period and after the adoption of the new Constitution in 1996, the country has experienced large-scale reorganisation of boundaries at both provincial and municipal levels. Alongside reorganisation, there has been a significant increase in the roles and responsibilities of sub-national governments in providing public services. This has brought to the fore the need to build institutional capacity for both raising revenues and implementing expenditure decisions at provincial and even more at municipal levels. Third, the fiscal arrangement involves designing and implementing general purpose and specific purpose transfer system. While the objective of the former is to provide opportunities to the residents in various jurisdictions to exercise their choices of public service levels and tax-prices, the latter should ensure minimum levels of ~~u~~ meritorious services in all jurisdictions. Besides there are non-economic objectives and that includes the nation-building role of intergovernmental finance. Therefore, it is necessary that the system should be objective, simple, and incentive compatible. The success and/or failure of the system in meeting the objectives can provide valuable lessons in designing decentralized or federal systems.

The rest of the chapter is organized as follows: description of the structure of the government and the major institutions in South Africa is provided in section B while section C details of the system of intergovernmental fiscal system in terms of expenditure and revenue assignment to the three spheres of government; section D covers fiscal imbalances, section E provides a review of intergovernmental transfers, followed by a discussion of sub-national debt and some concluding observations in sections F and G.

B. The Structure of Government

The Republic of South Africa (RSA) is a constitutional democracy. It consists of three tiers of government, namely: national, provincial and local governments. There are nine provinces, each with its own provincial legislature and about 278 municipalities or local level governments. Local level government in South Africa consists of municipalities of various types. The largest metropolitan areas are governed by metropolitan municipalities, while the rest of the country is divided into district municipalities, each of which consists of several local municipalities. After the municipal election of 18 May 2011, there were eight metropolitan municipalities, 44 district municipalities and 226 local municipalities. All these structures of government derive their powers and functions from the Constitution of the RSA.

1. National Government

The National Assembly is the supreme law-making body in the RSA. Laws made by the National Assembly are applicable throughout the RSA. The same is true of policies made by the Cabinet of the National Government. While there are areas of exclusive legislative competence for the National Assembly, it shares its legislative authority with provincial legislatures. The Parliament consists of two Houses: the National Assembly and the National Council of Provinces (NCOP). The National Assembly is elected for a five year term and consists of no fewer than 350 and no more than 400 Members. Members are elected in accordance with an electoral system, based on a common voters' roll with a minimum age of 18 years, resulting in a system of proportional representation. The NCOP consists of 90 delegates, 10 from each province. The primary function of the NCOP is to ensure that provinces are represented in the national legislative process.

2. Provincial Government

Provincial governments are bound by laws and policies passed at the national level, but can also develop their own laws and policies within this framework to suit their specific needs. In accordance with the Constitution, each of the nine provinces has its own legislature, consisting of between 30 and 80 members. The number of members is determined according to a formula set out in national legislation. The members are elected through proportional representation. The executive council of a province consists of a premier and a number of members (MECs). Premiers are appointed by the President of the country. Decisions are taken by consensus, as is the case in the national Cabinet. Besides being able to make provincial laws, a provincial legislature may adopt a Constitution for its province if two-thirds of its

members agree. However, a provincial constitution must correspond to the national Constitution.

3. Local Governments

Local governments consist of municipalities whose objectives are, among other things, to provide democratic and accountable government for local communities, to ensure the provision of services to communities and to promote social and economic development. There are 278 municipalities in South Africa, comprising eight metropolitan, 44 district and 226 local municipalities. They are focused on development of local economies and providing infrastructure and services. In accordance with the Constitution and the Organized Local Government Act, 1997 (Act 52 of 1997)], which formally recognizes organized local-government associations, organized local government may designate up to 10 part-time representatives to represent municipalities and to participate in proceedings of the National Council of Provinces (NCOP).

4. Financial and Fiscal Commission

An important feature of the South African fiscal decentralization system is the institution of Financial and Fiscal Commission (FFC). The framework document of the FFC (1995) defines the FFC as an independent and impartial statutory institution, accountable to the legislature, with the objective of contributing towards the creation and maintenance of an effective, equitable, and sustainable system of intergovernmental fiscal relations, rendering advice to legislatures regarding any financial and fiscal matter which has a bearing on intergovernmental fiscal relations.+ The constitutional mandate for the FFC is to make recommendations on:

- " The system of sharing of revenues with the provinces;
- " Taxes, surcharges, and user charges to be imposed by provincial governments;
- " Borrowing by provincial and local governments;
- " Guarantees of loans to the provinces.

Section 214 of the constitution provides for the enactment of legislation to divide revenues equitably between national, provincial and local spheres every year. The process, however, requires the government to consult the FFC and Section 10(5) requires an explanatory memorandum in the Division of Revenue Bill to state how the FFC's annual recommendations have been taken into account in the revenue allocation.

5. Supplementary Legislation

In addition to the Constitutional provisions, various other legislations govern the system of intergovernmental relations. These are:

- Intergovernmental Fiscal Relations Act (1997): This Act sets out the process for the division of nationally raised revenues between the three spheres of government. It establishes the Budget Forum, in which local government issues are discussed as part of the national budget process. It also requires that a Division of Revenue Bill is tabled annually, setting out (among other things) the amounts to be transferred to each municipality.
- Municipal Structures Act (1998): This Act provides for the establishment of different types of municipalities and the division of powers and functions between local and district municipalities. It also regulates the internal systems, structures and roles of office bearers of municipalities.
- The Municipal Systems Act (2000): This Act sets out detailed requirements in relation to community participation, integrated development planning, performance management, administration, service provision and debt collection. It also regulates the publication of by-laws and determines the role of national and provincial government in setting standards and monitoring local government. The Act also governs the assignment of functions to a municipality from another sphere of government.
- Intergovernmental Relations Framework Act (2005): This Act provides a framework for the establishment of intergovernmental forums and mechanisms to facilitate the settlement of intergovernmental disputes.

C. Intergovernmental Fiscal System in South Africa

1. Assignment of Expenditure Responsibilities

The assignment of functions to the three spheres of government in South Africa has been provided in the Constitution itself. The functional assignment has no surprises, and is similar to several other federal systems. It is based on spatial characteristics of various functions, and internalization of inter-jurisdictional spillovers to the extent possible within a three-tier structure. However, in South Africa, national government policies often influence provincial and local government spending indirectly through co-operative agreements and legislations setting norms and standards.

A large part of the national government expenditure is allocated to the functions that are specified in the Constitution as in the exclusive domain of the

national government. Accordingly, the national government looks after the criminal justice system (which includes police, justice, and prisons), defence, external affairs, higher education and such other functions that have nationwide coverage. It also provides social services such as school education, health, welfare and housing concurrently with the provincial governments. While the national government determines the policies relating to these sectors, the provinces implement these policies in terms of actually providing the services. Apart from providing social services like school education, health, welfare and housing concurrently with the national government, the provinces have the additional responsibility of constructing and maintaining provincial roads.

Local governments have the responsibility of providing electricity, water, housing for the poor, sanitation, municipal administration, city streets, streetlights, and garbage collection.

2. Assignment of Revenue Sources

As regards revenue assignment, the fiscal system in RSA has ruled in favour of fiscal uniformity, harmony and efficiency even as it meant lower fiscal autonomy for sub-national governments. All broad-based taxes such as income and corporate taxes, VAT, excises, fuel levy and customs are assigned to the national government. Provinces can levy minor levies such as gambling taxes, motor car licence fees, and user fees on hospital services. In terms of the Constitution, they can levy surcharge on personal income tax and fuel taxes but actually no province levies them.

A provincial legislature may impose:

- a. taxes, levies and duties other than income tax, value-added tax, general sales tax, rates on property or customs duties; and
- b. Flat-rate surcharges on any tax, levy or duty that is imposed by national legislation, other than on corporate income tax, value-added tax, rates on property or custom duties.

The power of a provincial legislature to impose taxes, levies, duties and surcharges is circumscribed by some restrictions such as being consistent with national policies, and not impacting negatively on other provinces or on mobility of products or factors of production within the country. The powers are regulated in terms of an Act of Parliament, which may be enacted only after recommendations of the Financial and Fiscal Commission, if any, have been considered.

The local governments have substantially greater tax powers than provinces. Almost two-thirds of their expenditure requirements are met by their own sources of revenues. They can levy property taxes, turnover/payroll regional levies on businesses and user charges on electricity and water. The revenue sources of local governments include:

- a. rates on property and surcharges on fees for services provided by or on behalf of the municipality; and
- b. If authorized by national legislation, other taxes, levies and duties appropriate to local government or to the category of local government into which that municipality falls, but no municipality may impose income tax, value-added tax, general sales tax or customs duty.

As in the case of provinces, the taxing powers of municipalities are also subject to similar constraints. Apart from the no negative spillover constraint and on factor and product mobility restrictions, national legislations play an important role in allocating specific powers of different municipalities in the cases of overlapping jurisdiction, based on specified criteria that include:

- The need to comply with sound principles of taxation;
- The powers and functions performed by each municipality;
- The fiscal capacity of each municipality;
- The effectiveness and efficiency of raising taxes, levies and duties; and,
- Equity.

The national legislations in this context may be enacted only after consultation with organized local government and the Financial and Fiscal Commission, and consideration of their recommendations. The Constitution also allows revenue sharing between municipalities that have overlapping jurisdictions.

3. Taxation of Minerals and Petroleum

South Africa has substantial mineral wealth that includes oil reserves, both onshore and offshore (though the production is not yet sufficient to obviate imports). Its entire mineral resources sector is governed by Mineral and Petroleum Resources Development Act 28 of 2002, while the taxation of mineral resources (including petroleum) is covered by Mineral and Petroleum Resources Royalty Act 2008 (became effective only in 2010). In brief, custody of all mineral and petroleum resources are statutorily vested in the state and only the national government has the right to enter into agreements for transferring the right to extract, process and sell them. In some cases, the national government can co-opt indigenous tribes affected by mining activities in regulating such activities.

In line with the centralization of all major revenue sources, royalties are collected by the central government only, and there is no explicit sharing of revenue from royalties with sub-national governments (See Cawood, 2010 for details). The applicable royalty rates vary according to the extent of refinement on the basis of a formula that builds in the element of profitability of the mining operation; the rates vary between a minimum of 0.5 percent and a maximum of 5 (for unrefined minerals) or 7 percent (refined) of the value of sales. As South Africa has substantial deposits of gold, platinum, diamonds, coal, manganese, iron ore, chromium, uranium and several other minerals as well as petroleum, revenue from royalties is also substantial.

D. Jurisdictional overlap and institutional structure for intergovernmental relations

The South African Constitution provides for a constitutionally entrenched distribution of powers between the national and provincial governments, and appoints the Constitutional Court to enforce the arrangements. Chapter 3 of the South African Constitution deals with the principle of cooperative government, which governs the relationship between the spheres of government. Each province may adopt its own provincial Constitution not inconsistent with the national Constitution or may choose to function solely in terms of Chapter 6 of the national Constitution. (Western Cape is the only province functioning under its own Constitution, while KwaZulu-Natal had a failed attempt to enact a provincial Constitution . rejected by the judiciary as not consistent with the national Constitution).

Provinces have exclusive powers in respect of a limited list of functional areas, whereas the national and provincial governments share powers in respect of a more extensive list of concurrent matters. A large list of functions in the concurrent domain can and does lead to differences between the views of the national and provincial governments on sharing a particular functional domain, which are normally resolved through discussions and deliberations. The Ministry of Provincial Affairs of the national government is expected to facilitate these. In cases of conflict between national and provincial legislation on a concurrent matter, the national legislation prevails if it is valid as per the constitutional provisions. In case there is a persistent conflict over jurisdiction, recourse is made to the Constitutional Court for resolution.

The domain of municipal bodies is also specified in the Constitution. However, matters are a little more complicated since the Constitution permits

national and provincial governments to delegate some functions/tasks to municipalities. There are constitutional provisions protecting the right of municipalities to govern their own affairs subject to national and provincial legislations [Section 151(3)], and preventing interference by other levels of government [Section 151(4)]. At the same time, the Constitution tasks the provincial governments with the job of monitoring municipal governance and when necessary, intervening through specified methods.

The major responsibility of providing public services *de facto* rests on municipalities and it is with respect to them that the issue of jurisdictional overlap assumes significance. The constitutional assignment system itself gives rise to some overlapping jurisdictional overlap; apart from these, delegation of implementation responsibilities and actual provision of services cause several cases of functional overlap. This often gives rise to fragmentation, potential duplication and confusion about responsibilities. Examples of such overlap include (Cameron, 2012):

- Housing is a joint national/provincial responsibility, part of which is delegated to local municipalities. The responsibility for housing is thus shared between three levels of government.
- In accordance with Schedule 5 of the Constitution, provincial roads and traffic are exclusively a provincial function, while municipal roads, traffic and parking are exclusively municipal functions. Public transport is a concurrent function of both national and provincial governments while municipal public transport is an explicitly municipal function according to Schedule 4B.
- Planning is also split between different tiers of government such that provincial planning is an exclusive provincial competence while municipal planning falls under the mandate of the municipalities.

A significant implication of constitutional supremacy is that in the exercise of their powers and the performance of their functions, the respective governments must observe and give effect to the provisions of the Constitution. This implies, first, that the supremacy of the Constitution must be respected when considering adjustments to the system and, second, that the governments in all spheres must observe the provisions of the Constitution in respect of the distribution of powers. If the relevant provisions do need adjustment because of changing needs and circumstances, the Constitution has to be amended according to the requirements of section 74 thereof. *Ad hoc* changes on the strength of executive orders that are not in consonance with constitutional provisions are simply not permissible.

The South African Constitution also assigns an important role to the National Council of Provinces (NCOP) . the second house of parliament representing the provinces in national law making process. As the representative body of the provinces in the parliamentary law making process, it can block an ordinary (non-financial) legislation passed by the National Assembly affecting the provinces; in that event, a Mediation Committee consisting of Members from both the houses of the parliament tries to work out a version acceptable to both houses. If the Mediation Committee fails to do so, or the version agreed to in the Mediation Committee fails to be passed by the NCOP, the Assembly can pass the original version of the bill again to make it law . but a two-thirds majority is necessary while passing it the second time. Provincial interests can also be reflected in a bill initiated in the NCOP. Despite all this, NCOP is not in fact a strong political entity; its powers are actually much weaker than the formal provisions suggest. % does its best to justify its existence by, for instance, setting-up shop in various locations/regions on a regular basis and opening forums around the country for general public participation. These are considered by South African observers to be token, (to give the society a sense of bringing parliament to the people), without making much difference on national policy and legislative programs as defined in the National Assembly (Picard and Mogale, 2010).

In issues of financial nature, the FFC is expected to provide a balanced view to the national government, and can *suo moto* advise changes in practice or even amendment of the constitutional provisions through the specified procedure. While its function as an arbitrator between the two tiers of government is constitutionally sanctioned, the fact remains that it is only an advisory body. Its views are given due importance, but they are not binding on the national government.

Apart from the abovementioned constitutional bodies, The Intergovernmental Relations Framework Act provides for a number of agencies to promote and give effect to cooperative intergovernmental relations. These include:

- The President's Coordinating Council (PCC);
- National Intergovernmental Forum (Ministerial-Member of Executive Committee Joint Meeting . National Inter-Governmental Forum (MINMEC)) comprising the ministers and deputy ministers of the national government, the premiers and members of executive councils of the nine provinces, and representatives of the South African Local Government Association (SALGA);

- Provincial Intergovernmental Forums (Premiers Forums);
- District Intergovernmental Forums;
- Inter-municipality Forums; and
- The South African Local Government Association (SALGA).

As a matter of fact, there is a plethora of institutions, probably much more than really required, in the area of intergovernmental relations in South Africa; their marginal contribution to the smooth functioning of decentralized governance may in some cases be doubtful.

E. Fiscal Imbalances

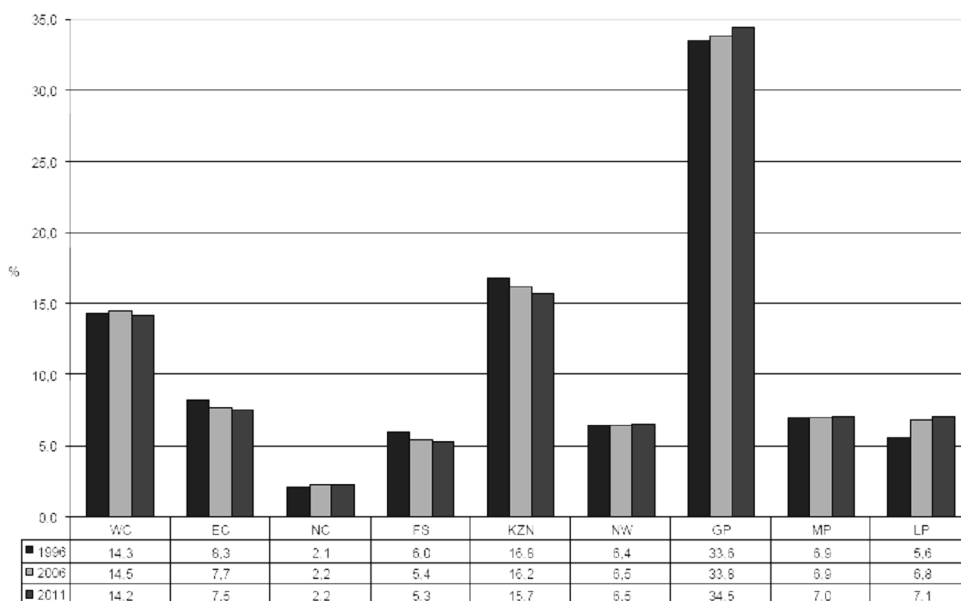
Given the centralization of all major taxes at the central level and the delegation of responsibility for implementing most of the expenditure obligations to the sub-national level, substantial vertical imbalance is an obvious and expected outcome of the system that hardly needs elaboration.⁴⁴ This has been a deliberate feature of the South African intergovernmental financial system. Momoniat (2002), one of the architects of the South African fiscal system, suggests that the design, though departing from the conventional prescriptions of fiscal federalism theory, has been advantageous. He argues for the maximisation of the revenue potential of existing revenue sources, and phasing in devolved additional taxation powers only after effective expenditure controls and efficient revenue collection procedures are firmly in place. The risk of moral hazard could then be contained with a strict no-bailout approach by the government, backed by a policy of not guaranteeing sub-national loans or deficits. While this view has undoubtedly shaped the prevalent system, whether it does progress to a different one that would correspond more to the usually advocated decentralization of *both* revenues and expenditures with some autonomy at the sub-national level is yet to be seen.

Horizontal imbalances at the provincial level are present, as in most federations, but probably to a smaller degree compared to developing economies. We have no direct evidence of this, and can only deduce it from some indications of regional imbalance . and these indicators show less dispersion than in countries like China or India. Figure 6.1 shows the persisting regional imbalance in economic

⁴⁴ It may be enough to point out that of the total provincial revenues, their own-source revenues are barely 5 percent, the rest flowing to them as transfers. Municipalities, however, have more of own revenues. In 2012, the transfers they received amounted to R72581 million while only property rates received by them were R33778 million, with other sources of revenue (including net sales of electricity and gas, and water) amounting to R52004 million.

activities with a big concentration in only Gauteng province. As the figure clearly depicts, three provinces . Gauteng, Western Cape and Kwazulu-Natal . account for almost two-thirds of the nation's GDP. What is more, this dominance has remained practically unchanged over the last 15 years. Thus, one of the major tasks before the national government is to promote greater dispersion of economic activity, to which end intergovernmental transfers can be used as a tool.

Figure 6.1: Provincial Share in GDP – 1996, 2006 and 2011



Source: Statistics South Africa

Table 6.1: Socio-Economic Indicators of Provinces in South Africa

Province	Regional GDP per capita (R) (2010)	Infant Mortality Rate (per '000) (2006)	Employment/Population (%) (2010)	Poverty Gap Ratio (%) (2008)
Eastern cape	30,249	62	30.8	8
Free State	51,480	59	41.0	4
Gauteng	80,198	38	51.4	2
Kwazulu-Natal	39,514	63	37.6	11
Limpopo	35,285	38	27.2	10
Mpumalanga	51,793	54	38.2	9
North West	55,320	44	35.4	8
Northern Cape	55,417	35	37.7	8
Western Cape	72,031	27	54.3	3

Source: Statistics South Africa

The dominance of Gauteng and Western Cape in their contribution to GDP translates into greater economic prosperity for its average citizen, but the same cannot be said for Kwazulu-Natal, whose share reflects its size rather than prosperity. Table 6.1 provides data by provinces on some socio-economic indicators; it shows Kwazulu-Natal, along with Eastern Cape and Limpopo, to be relatively less developed provinces. However, the inequalities at the provincial level are not as high as in some of the other developing countries. To that extent, equalization is a somewhat easier task. The inequalities among the local governments, of course, can be much larger and probably are given the much larger number. But it would be safe to venture a view that the vertical imbalances provide a much stronger rationale for intergovernmental transfers as compared to the horizontal imbalances.

F. Intergovernmental Transfers

1. Revenue Sharing Mechanism

South Africa introduced in 1998/99 a formula-based system of allocation which also includes an equalization component. With little fiscal autonomy at sub-national level, the South African fiscal system enables fiscal equality, harmony and efficiency at sub-national level through the transfer system (Rao, 2001).

The Medium term Expenditure framework (MTEF) proposed by the National Government guides the expenditure allocation for the assigned functions every three years. With broad-based taxes being retained by the national government, the budget process involves vertical and horizontal division of national revenues plus borrowings net of debt servicing expenditures that constitute the divisible pool. The allocations from the divisible pool to sub-national governments is done in terms of providing equitable shares and conditional grants as determined by the cabinet based on recommendations of the FFC. The conditional grants are provided to the sub-national governments for identified and prioritized national schemes.

The Constitution provides that each sphere of government is entitled to equitable share of revenue raised nationally to enable it provided basic services and perform the functions allocated to it. The equitable division of revenue takes into account the function assigned to each sphere under the Constitution and the capacity of each government to pay for the these functions through own receipts and revenues. Equitable share is an unconditional allocation of the national government to each of the provinces and local governments. Provincial and local governments are responsible for these funds and are directly accountable for how they are spent.

National government policies influence the provincial and local governments spending indirectly through cooperative agreements and the framework legislation setting norms and standards.

The government benefits from the advice of FFC in the process of reaching an agreement on the equitable division of revenue and other allocations to provincial and local governments. The FFC recommendations have been taken as the point of departure in the deliberations of the Budget Council, comprising the Minister of Finance and Members of provincial Executive Councils responsible for finance. The recommendations of FFC are aimed at a) effective and efficient distribution of resource allocation, b) fiscal equity in the provision of services and raising of provincial taxes and c) development of fiscally sound and democratically responsive provincial governments. In respect of local governments, the aim of equitable sharing is to provide a fair and transparent subsidy to municipalities to support provision of basic services to low income communities.

After consultation with provincial governments and organized local governments, proposals for the equitable division of revenue are presented to the Parliament. The Minister of Finance tables a Division of Revenue Bill with National Budget and the bill specifies: a) the equitable share for each of the three spheres of government as well as for each of the nine provinces, and b) all other conditional and unconditional grants from the national share.

This fulfils the constitutional requirement of an Act of Parliament for intergovernmental financial arrangements, and also that it take into account the needs and interest of the national government, the need to ensure that the provinces and local governments are able to provide basic services and perform the functions of allocated to them and other relevant considerations.

It can be seen from Table 6.2 that of the total divisible pool, nearly 47 percent is retained by the national government, 44 percent is transferred to the nine provincial governments and the remaining 9 percent goes to local governments. Within devolution to sub-national governments, nearly 75 percent is in the form of equitable share, 23 percent is in the form of conditional grants and the remaining 2 percent is share of local governments in Fuel Levy. Of the transfers to provinces, nearly 80 percent is in the form of equitable grants and 20 percent in the form of conditional grants. When it comes to local governments, the share of equitable grants

is around 59 percent including fuel levy and 41 percent is in the form of conditional grants, implying tighter control on the spending pattern of local governments as compared to the provincial.

Table 6.2: Vertical Division of Revenues in South Africa (R Billion)

	2009/10	2010/11	2011/12	2012/13	2013/14
Total Revenues	747.20	805.10	888.00	967.50	1051.60
Cost of Debt	57.10	66.20	76.50	88.80	98.60
Divisible Pool	690.10	738.90	811.60	878.70	953.00
Share of National Government	345.40	355.20	380.80	412.30	446.60
(Percentage of Divisible Pool)	(50.05)	(48.07)	(46.92)	(46.92)	(46.86)
Share of Provinces	293.20	322.80	362.50	388.90	417.90
(Percentage of Divisible Pool)	(42.49)	(43.69)	(44.66)	(44.26)	(43.85)
Share of Local Governments	51.50	60.90	68.30	77.50	84.50
(Percentage of Divisible Pool)	(7.46)	(8.24)	(8.42)	(8.82)	(8.87)

The horizontal distribution of national revenues are based on three different expenditure functions (Education, Health, and Social Security), along with a basic share component, backlog component, economic output component and institutional component. Each of these consists of sub-criteria with their assigned weights. The weights given for these components are provided in Table 6.3.

Table 6.3: Criteria for Interprovincial Distribution of National Revenues

Sector	Weight Assigned (percentage)		Variables chosen for distribution
	1998-99	2002-03	
Education	39	41	(i) Size of school age population (6-17years) (ii) Enrolment ratio
Health	18	19	Proportion of population without access to medical aid
Social Security	16	18	Estimated number of persons entitled to social security payments (Old, disabled and children weighed with poverty index derived from 1995 Income and Expenditure survey.
Basic Share	23	17	Population share of the province
Backlog Component			(i) Capital needs in the school register of needs (ii) Audit of hospital facilities (iii) Share of rural population.
Economic Output component			Distribution of total remuneration in the country
Institutional Component	4	5	Equal division among provinces

Source: MTBPS 2004-07, Table 3 of MTBPS 2004, p36

With little own revenue at the provincial level, equalization reduces to only expenditure equalization through the revenue sharing mechanism. As the formula indicates, such equalization is limited to the functions included in the sharing formula, *viz.* education, health, and social security, possibly because these functions are the major ones allocated to provinces. But there are other expenditures of the provinces too (e.g. on roads), and because the formula does not cover those, the fiscal equalization is partial.⁴⁵ The other parts in the formula are either equal amounts or equal per capita, and hence cannot be called equalizing.

In the case of local governments, however, equalization should not be one sided because they do have substantial own revenues. The horizontal distribution should be on the basis of expenditure needs net of own revenues . an absence of the latter from the formula would imply a bias in favour of financially better-off local governments. This important difference is recognized in the local governmentsq equitable shares. The formula takes into account basic municipal services, the number of poor households, the fiscal capacity of a municipality, and an allocation for the cost of governance based on the number of poor households in the municipality+ (Khumalo and Mokate, 2007).

2. Conditional Grants

Although the Constitution of South Africa decentralizes major functional responsibilities like education and health, there is considerable overlap among the three tiers of government, with the national government driving the policy. To ensure cooperation of the sub-national governments, there a case for the national government to use the intergovernmental transfers system to progressively provide all citizens with uniform access to basic services. This provides the basic rationale for the conditional grants.

Division of Revenue Bill, National treasury 2007 specifies three types of conditional grants. They are: a) to supplement the funding for programmes or functions funded by provincial and municipal budgets (Schedule 4), b) to finance specific programmes of national interest without any additional funding from sub-national governments (schedule 5), c) specific purpose in-kind allocations for designated special programmes (schedule 6) and d) grants for disaster management (Disaster Management Act 2002). Under the South African Constitution, grants can

⁴⁵ There is nothing inherently wrong about partial equalization; full equalization may require resources that may be unavailable, and hence prioritization of functions for equalization purposes can constitute a valid strategy.

be assigned for a particular purpose and subject to specific conditions. Based on the recommendations of the FFC and work of MTEF sectoral teams, the national government proposes the introduction of several conditional grants as part of overall share of resources to be available to the sub-national governments. The conditional grants in South Africa are distributed to various sub-national governments on the recommendations of an independent and statutory FFC, and the expenditure departments.

Table 6.4: Sector-wise Distribution of Conditional Grants

(Percent)

Tier/Sector	2005/6	2006/7	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13
Provinces (R million)	19229	27068	32613	42827	53889	57941	70892	75502
a) Agriculture and allied Activities	2.13	1.48	1.69	2.03	1.81	2.01	2.33	2.55
b) Arts and Culture	0.00	0.00	0.50	0.76	0.82	0.89	0.80	0.75
c) Basic Education	6.49	4.59	6.18	6.79	4.78	12.27	15.15	14.56
d) Cooperative Governance and Traditional Affairs	0.21	0.00	0.00	0.07	0.00	0.37	0.00	0.24
e) Health	46.32	37.71	35.28	32.90	30.46	35.35	33.68	34.53
f) Higher Education	0.00	1.74	0.00	1.86	5.88	6.57	6.17	6.42
g) Human Settlements	25.32	23.66	23.46	23.17	23.37	22.49	21.33	20.83
h) National Treasury Provincial Infrastructure	19.40	18.41	20.43	13.30	17.16	0.00	1.54	0.00
i) Public Works	0.00	0.00	2.57	2.08	2.60	3.76	3.05	3.22
j) Sports and Recreation	0.12	0.44	0.59	0.65	0.75	0.74	0.64	0.62
k) Transport	0.00	11.97	9.29	16.40	12.38	15.56	15.31	16.29
Local Governments (R million)	783	8390	18678	22234	23974	25699	29198	35230
Direct Transfers								
1) Infrastructure	0.00	88.76	80.99	83.48	78.00	81.21	84.40	79.56
2) Capacity Building for Other Programmes	0.00	0.00	8.12	6.14	9.15	7.59	6.38	7.34
Indirect Transfers								
1) Infrastructure	100.00	11.24	7.95	8.67	11.52	10.19	8.48	12.72
2) Capacity Building for Other Programmes	0.00	0.00	2.94	1.70	1.33	1.00	0.74	0.38

Source: FFC

Conditional grants are given for health, education, water supply, sanitation, as also other specific agency services to the sub-national governments. Within conditional grants to provinces the dominant ones are for health (around 30 percent) followed by those for human settlements (basically housing for poor - around 20 percent). Other prominent conditional grants to provinces are for transport, basic

education and higher education. Local governments receive conditional grants for infrastructure mainly for health, education and water supply, and a small part for capacity building. Table 6.4 provides information on distribution of conditional grants by sectors.

The main justification of the conditional grants is that sub-national governments lack the capacity to assume responsibility for the effective management of resources and delivery of services. Other justifications include perceived poor planning, poor financial management of resources and weak technical supervision. However, the system of conditional grants is also one way of the national government having control over sub-national governments and can lead to biased allocations.

Table 6.5: Expenditure Shares of Different Tiers and Financing through Transfers

(R billion)

	2007/8	2008/09	2009/10	2010/11	2011/12
Non-interest Expenditure	489.44	581.54	690.1	738.9	811.6
National Departments	246.33	291.2	345.4	355.2	380.8
Provinces	205.54	245.65	293.2	322.8	362.5
Equitable Share	172.86	204.01	236.9	265.1	291.7
Conditional Grants	32.68	41.64	52.1	57.7	70.8
Gautrain Loan			4.2	.	.
Local Governments	37.57	44.69	51.5	60.9	68.3
Equitable Share	20.68	25.56	23.8	30.5	33.2
General fuel levy sharing with metropolitan cities			6.8	7.5	8.6
Conditional Grants	16.89	19.13	20.9	22.8	26.5
Total Divisible Pool	489.44	581.54	690.1	738.9	811.6
Percentage Shares					
<i>National Departments</i>	50.33%	50.07%	50.00%	48.10%	46.90%
<i>Provinces</i>	41.99%	42.24%	42.50%	43.70%	44.70%
<i>Local Governments</i>	7.68%	7.68%	7.50%	8.20%	8.40%

Source: Ministry of Finance, Government of South Africa

The eventual distribution of non-interest government expenditure by the three tiers of government and the extent of funding through intergovernmental transfers is provided in Table 6.5. It can be seen that even in the five years covered, the share of the national government in the total is declining while that of the provincial governments is rising, with the share of the local governments rising even faster, particularly since 2010. The transfers are also rising in tandem, implying increasing

expenditure decentralization but basically stagnant revenue source decentralization. However, to the extent that equitable shares continue to dominate conditional grants, sub-national autonomy is not impaired through the mechanism of transfers.

G. Sub-national Debt

The Constitution of South Africa provides that a province or a municipality may raise loans for capital and current expenditure in accordance with reasonable conditions determined by national legislation, but loans for current expenditure may be raised only when necessary for bridging purposes during a fiscal year. The said legislation may be enacted only after recommendations from the FFC have been considered. The Borrowing Powers of Provincial Governments Act was passed in 1996. Presently, the national government borrows through the issue of financial instruments that are sold both domestically and internationally. Provinces are not allowed to borrow except for the running of overdrafts on their current accounts that are held at various commercial banks. There was also an agreement that provinces will not exercise their power to borrow until after the 1999/2000 financial year, when the agreement for Provinces not to borrow in order to increase their capacity to deliver infrastructure will be reviewed on a year to year basis. The provinces have borrowed only for bridging purposes mainly in the form of overdrafts.

Municipalities, however, are allowed to borrow for current expenditure as well as for infrastructure development. A number of municipalities are rated by outside agencies and that gives them a better standing to borrow within the country. Empowered by the Constitution and driven by the need for funds to carry out badly needed infrastructure investment, municipalities utilized their power to borrow to a significant extent. In case of financial distress in a municipality, section 139 of the Constitution provides for intervention by the provincial government, though details of such intervention was not clarified till 2003, when the Municipal Finance Management Act (MFMA) was passed.

Before this, a White Paper on Local Government was brought out by the national government to define and discuss various issues including municipal borrowing. After prolonged debate and two rounds of changes in the proposed bill introduced first in 2000, MFMA was enacted in 2003. It provided for the Member of the provincial Executive Council responsible for local governments to oversee interventions resulting from possible financial emergencies including defaults in repayment of loans. The Member would be supported by a national entity called

Municipal Financial Recovery Service in chalking out a recovery plan. The role of the courts was also clearly spelt out along with several safeguards in the system to prevent frivolous borrowing. For example, municipalities can incur debt only with the approval of the municipal council and a signed agreement by the accounting officer. Long term borrowing is restricted to financing capital expenditure to be inter-generationally fair. The Act includes contingent liabilities like guarantees within the legal category of debt. It allows for a municipality to pledge an asset as collateral for a loan, but under the restriction that the creditor may not sell or change the asset in a way that would affect the delivery of basic services. It should also be noted that municipal debt cannot normally be guaranteed by the provincial or the national government; there are only a few exceptions to this legal provision contained in Public Finance management Act 1999. Under the MFMA, debt relief and restructuring is entirely in the domain of the courts.

Total municipal outstanding debt increased from R 18.7 billion in 2005 to R 38.1 billion in 2010. Except in 2009, when global financial crisis acted as a brake on private lending, municipal borrowing from private lenders has been greater than from public sector (Brown, Motsoane and Liu, 2013). The present level of municipal borrowing is actually not large, but is likely to grow fast in view of the clear mismatch between available resources (including transfers) and spending needs, particularly capital expenditures. The challenge before the country is to facilitate the working of a capital market in an orderly manner, and to ensure appropriate utilization of municipal borrowings. The formal provisions are all designed to promote municipal borrowing on its own strength, based on their sound finances and financial practices.

H. Public Service Delivery

Poor delivery of public services has become a central issue in governance in South Africa. This is because protests over this issue . sometimes violent . have been common and widespread (Benjamin, 2012). Most commentators consider this to be a very serious issue that can disrupt governance and challenge the legitimacy of the government.⁴⁶ It is a major concern in the specific context of the nation because apartheid had condemned many of the racially segregated localities to

⁴⁶ Since 2004, South Africa has experienced a massive movement of militant local political protests. In some cases these have reached insurrectionary proportions with people momentarily taking control of their townships, and it is reasonable to describe the phenomenon as a rebellion of the poor. There are strong similarities linking the Mbeki-era and Zuma-era protests, notably in relation to issues raised, which are principally about inadequate service delivery and lack of accountability by local councilors+(Alexander, 2010).

extremely poor public services for a long time, and for many of the residents of these localities, an important connotation of democracy and dismantling of apartheid was simply better public services (Ryneveld, 2006). Thus, inadequacies in public services, mostly supplied by local governments, have become an emotive issue, the disappointment being acute and even exaggerated. The government also appreciates the importance of this issue: the official policy document brought out in 1997 entitled *The White Paper on Transforming Public Service Delivery*, also called the *Batho Pele White Paper* bears testimony to it. The use of the term *Batho Pele* (meaning *people first*) was deliberate; the paper states that the South African Public Service will be judged by only one criterion: its effectiveness in delivering services that meet the basic needs of all South African citizens. The principles this document lays down are unexceptionable; the problem lies in implementation.

The extent of failure in providing public services is assessed differently from different perspectives. While official assessments typically highlight the great successes in expanding coverage and improving access to various services, they add the qualifier that the improvements are not enough and more is needed (DPSA, 2003). Some independent assessments also reflect the same view (Naidoo and Kuye, 2005). However, other assessments point to fundamental problems like inadequate funding, ill-advised delivery methods and mechanisms, excessive reliance on output targets and lack of a demand-driven approach (World Bank, 2011). An official report in 2009 by the Department of Cooperative Governance and Traditional Affairs, as reported in Cameron (2012) lists the following issues:

- tensions between the political and administrative interface;
- poor ability of many councillors to deal with the demands of local government;
- insufficient separation of powers between political parties and municipal councils;
- lack of clear separation between the legislative and executive;
- inadequate accountability measures and support systems and resources for local democracy; and
- poor compliance with the legislative and regulatory frameworks for municipalities.

The challenges faced by the municipalities in delivering their services have been highlighted also in Municipal Demarcation Board's 2007-08 report. The board found that the municipalities manage only 25% of assigned functions. According to the Board, service delivery backlogs in disadvantaged areas and in general mostly due to lack of financial reserves and dependence on grants by national government, household indigence, managerial inexperience and increasing expectations of the

public. As the World Bank (2011) study explains, an unintended consequence of the supply-driven approach in South Africa is that citizens now expect the government to assume full responsibility for service delivery, including regular maintenance for even private assets such as household toilets. Service problems are increasingly blamed on the government (p.3). The study points out serious deficiencies in service provision too, in the areas of education, and water supply and sanitation, where the deficiencies are probably the worst. Housing is another area where public dissatisfaction is very high.

Given the high levels of interdependence between the national, provincial and local spheres of government, it is inevitable that capacity pressures experienced at one level will spill over into the other levels as well. Local government is generally facing a number of serious capacity challenges where it is even estimated that 61% of municipalities perform 50% or less of their constitutionally mandated functions⁴⁷. Although these concerns are specific to local government, one cannot talk about effective and efficient national and provincial departments outside the context of the performance of local government. The three spheres largely utilise resources from the same pool, and overall gains in efficiency and effectiveness ultimately depend on how all the spheres perform.

Given the centrality of budgets in driving programmes, information on how well budgets are expended point to the overall capacity of the administrative machinery for service delivery. The same report of the PSC points out that capital expending is much lower than that required. In addition to the lack of finances, there is lacuna in information gathering about the infrastructure and the demand for the services. Accordingly, there has to be concerted efforts to improve the quality of reporting and implementation of the programmes. Despite the importance placed on local governments, the combination of centralization of revenues and transfer-funded expenditures appears to be underfunding public services and is generating other infirmities in the delivery of the same.

Attempts by local governments to cope with the problems of service delivery often took the form of private-public partnerships (PPP). Barring a few, most of these have exacerbated the problem of public dissatisfaction, because these usually attempt to introduce market mechanism including commercial pricing. Privatisation

⁴⁷ Public Service Commission (2007), *State of the Public Service Report 2006*, Government of South Africa.

impacts negatively on those who cannot afford services, especially the poor and has met with public resistance, especially in the area of energy and water provision. It leads to increased prices and increased insecurity for the lower class workers already threatened with job cuts. (The crucial sectors of water and energy provision in developing countries like South Africa should involve local consultation, which takes the public's interests into account. The poor should not be left at the mercy of commercial operators and market forces without putting mechanisms in place to cushion them against destitution (Gray and Mubangizi, 2011). However, other experiments with active community participation may prove more useful; public information campaigns to make pricing of services more acceptable to the citizens is also being undertaken, although the results of such campaign have so far been negligible.

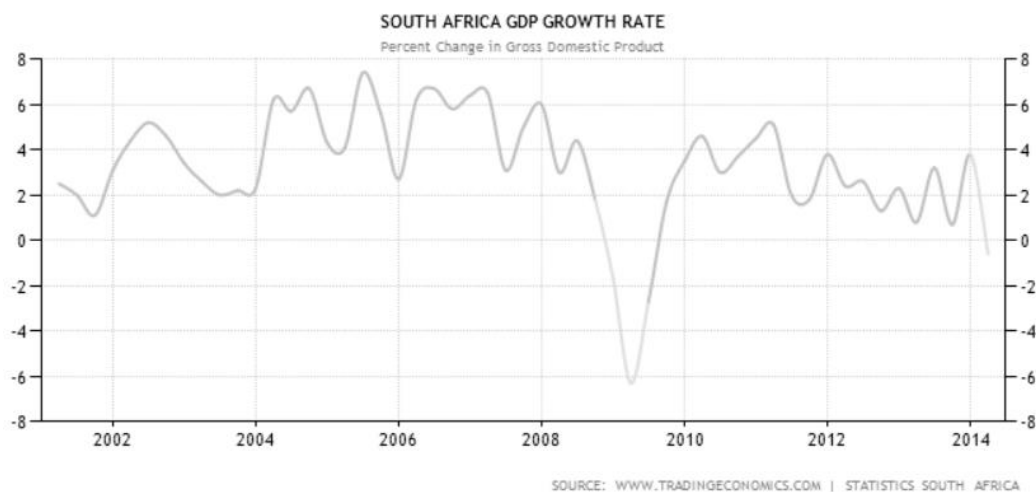
I. Impact of Global Financial Crisis

South African economy was paradoxically both vulnerable and immune to the global financial crisis in the initial period of the crisis. It was vulnerable because it was much more globally integrated than most of the developing countries and other African countries. The dependence of the economy, particularly the mining sector, on its exports was high. Also, there was a substantial amount of foreign capital that was invested in South Africa. These links with the global economy provided the channel for the global recession to affect the South African economy. Even so, South African officials and several analysts were initially quite confident of weathering the storm with little instability because of three main reasons: (a) the banking sector was quite stable and had no exposure to the toxic assets that created the problem elsewhere, (b) the capital account was heavily controlled, and (c) the country's economy was facing the crisis after a period of sustained growth, and domestic business outlook was essentially bright and positive. In the event, the confidence proved to be misplaced, with GDP growth rate plunging to less than -6 percent in the third quarter of 2009 from a healthy 6 percent in the last quarter of 2007 (Figure 6.2).

There was a huge loss of jobs within a short period, sales of real estate and motor vehicles contracted alarmingly, the current account deficit widened, the aggregate share index fell sharply, and inflation rate rose. To control inflation, the reserve bank hiked interest rates, which unfortunately acted as a dampener on the supply side of the real economy. This was also a period of political instability with factional skirmishes within the ruling African National Congress party eventually leading to a change at the helm. On the positive side, the banking sector remained

solid (Padayachee, 2010), although there was serious capital flight . primarily the financial sector of the industrialized countries vacuuming up liquidity from every possible source to shore up their own crumbling asset positions . as also a shortage of investible funds.

Figure 6.2



As a result of the crisis, the budget surplus of 1 percent of GDP in 2007-08 changed to a deficit of 7.3 percent in just two years; as counter-cyclical public expenditure (unemployment benefits, for example) shot up and revenue collections dropped, public debt rose steadily (Rena and Msoni, 2014), from a low of around 28 percent of GDP in 2008-09 to 46 percent in 2013-14 as per National Treasury figures. The impact of global financial crisis was strongly felt by all levels of government in South Africa, but it was the national government that took upon itself the responsibility of responding to it. This was only natural in the extant scenario, because it is the national government that decides policy; the sub-national governments only implement them. Despite the contracting revenues, the decision to protect expenditure on essential social services cushioned the impact of the crisis on the provincial and local orders which are responsible for service delivery. The beneficial effects of the intervention, however, came at the cost of increasing the sub-national salary bill and reinforcing already strong tendencies towards centralization within the federal system+(Steytler and Powell, 2010).

J. Concluding Remarks

South Africa, it must be remembered, is essentially a unitary nation with extensive decentralization of expenditures. It has gradually established a three-tier

structure with an emphasis on the third tier, possibly a legacy of the apartheid system that segregated habitations by race, and thus bred local level inequalities that have to be corrected now. But the system is not mature yet, calling for caution and a gradual approach in empowering sub-regional governments. This finds expression in many ways; in the fiscal sphere, an approach of first installing good expenditure management with national supervision and funding coupled with centralization of revenues, and following it up with possible revenue decentralization at a subsequent stage seems to be the one presently being applied.

The centralized revenue system has necessitated large amounts of transfers to sub-national governments that have to meet multiple objectives, although the overriding concern is to provide adequate resources to meet the expenditure obligations that are, to a significant extent, determined by the national government. The issue is further complicated by the fact that public spending on social services like education, health and housing are considered redistributive measures that should be rightfully in the central domain, and it is necessary for the central government to steer policy and its implementation in these areas through the instrument of transfers. The familiar rationale of equalization for intergovernmental grants is also used in South Africa to counter suggestions for decentralization of revenue powers; apprehensions have been expressed that devolving revenue powers would give unfair advantage to the richer, more developed jurisdictions. Unfortunately, inadequate capacity building at the sub-national level along with a lack of link between outcomes and transfer receipts . an important element of democratic governance . does not help in the process of empowering sub-national governments (Yemek, 2005).

In this process, equalization as is commonly understood in public economics has little priority . the direct inter-personal equity of the outcome is more important.⁴⁸ The absence of equalization as a major motivation in the intergovernmental transfer system, embodied by the lack of a revenue equalization component in the transfer system, has taken attention away from the need to augment revenues at sub-national level (Rao, 2003). The system has thrown up both positives and negatives. The costed norms approach for arriving at equitable shares, based on available

⁴⁸ Khumalo and Mokate (2007) put it somewhat differently: %n general, the revenue-sharing mechanism ensures that the fiscal gap between revenue and expenditure responsibilities for sub-national governments is reduced. The formula also addresses horizontal disparities within the spheres. However, *the South African approach is not an equalization approach* but, rather, an equitable sharing of nationally raised revenue+(italics ours).

information, developed by the FFC has tremendous potential in evolving a simple, objective and fair system of transfers (Rao, 2003). But the same system suffers from the disadvantage that it leaves no scope, particularly at the provincial level, for any initiative by the provincial government to redress problems unique to their jurisdiction.

The conditional transfers . an inevitable corollary of the centralized fiscal system . are necessary but need reforms. For example, they are not only too many in number, but also poorly designed: they lack clear purpose and either lack measurable outputs or have outputs or conditions that are unreasonable+(Khumalo and Mokate, 2007). The %unsystematic and unevenly applied approach to introducing, terminating and reviewing conditional grants+has a destabilizing impact on provincial expenditures and creates difficulties in medium-term planning, given their dependence on the transfers (FFC, 2013). There is a need to consolidate conditional transfers by clear goals and targets (Rao 2003). The South African government, particularly FFC, is now actively considering the reform of the conditional grants system (FFC Report on Conditional grants, 2013).

A generic problem with transfers-driven expenditures at the sub-national level is that it lacks a built-in incentive for efficiency and thus promoting accountability is not a virtue of such a system; it therefore requires a strong monitoring mechanism, the onus of which falls on the grantor government. Studies like Rao and Khumalo (2005) and Elhiraika (2007) argue for augmenting the revenue powers of sub-national governments on these grounds as also that of more efficient design of transfers through the use of matching requirements. This is conventional wisdom which is not popular in South Africa, but is quite close to the truth, nevertheless. But such a departure from the present system does not even seem to be on the anvil.

Sub-national borrowing at present is confined to the municipal bodies and not large. However, there are clear indications that municipal borrowings are on the rise and are likely to expand substantially. The delivery of public services, primarily by the local governments, has left citizens thoroughly dissatisfied, leading to even violent protests. In desperation, resource-starved municipalities are looking at all possible ways to step up expenditures on service provision including higher debt at their own level as also alternative models of public service supply like PPP. This prospect underlines the importance of sustainable municipal finance system, whether transfer-funded or funded by devolved tax powers. Some analysts predict doomsday: %While some municipalities seem to be able to cope, the sustainability of others is

questioned. Although the introduction of the Local Government: Municipal Public Finance Act, 2005 (MPFA) will certainly contribute towards more sound policy in the local sphere, ***the growing debt scenario points at a potential massive collapse of the local government system***+(Schoeman (2006), emphasis ours).

Schoeman also feels that accountability has suffered because of the transfers-funded expenditure system: Much of the discipline required to enforce hard budget constraints are undermined by life lines extended to municipalities by national and provincial governments.+But his remedy is not devolution of tax powers, but greater (more frequent and more in-depth) monitoring of municipal finances . essentially the line of reasoning that appears to be driving the MPFA and also according well with the established view in South Africa. However, there is also a view that a plethora of laws and regulations are strangulating the municipalities, and the MPFA only adds to them without really solving any of their problems. Getting this right is vitally important since the entire process of decentralization is really at stake, because there is a general feeling among the citizens that decentralization has failed in South Africa.

Chapter VII: Summary and Concluding Observations

1. Introduction

The reviews of fiscal decentralization in the five selected nations do confirm the trend towards decentralization in recent years, but they indicate that only Brazil can be considered comparable to India in terms of the stability of the political and fiscal decentralization. The others are still work-in-progress. Among the other four, the malleability of the system is probably the highest in Indonesia and China, with Russia and South Africa following in that order. Of course, work-in-progress implies that the institutional structure including legal provisions, conventions, and practices in such nations are yet to settle down, and they are trying out different policies and practices; these experimentations can possibly yield some lessons for India too.

Of the five nations covered in this report, four are large countries with South Africa the exception. It is somewhat natural for a large country to have at least a three-tier structure of government in the interest of effective and responsive governance, although the historical paths that the four larger nations have traversed to arrive at such a structure are different. In Brazil, it is to balance the power centres at the provincial level that the centre promotes local governments, while in Indonesia a desire to avoid secessionist tendencies drives the prominence of local governments. In China and Russia, the provincial governments are not so much sidelined, and the structure is probably inherited from the political structure of earlier times. The reason South Africa also has a three-tier structure is really the focus on the local government flowing from the apartheid system that centred political and developmental aspirations on the local level. But whatever be the original reason, these nations have realized that in a democratic polity and market-oriented modern economic systems, local city governments (municipalities) have an important role to play. Unfortunately, India is yet to learn this lesson and empower urban local bodies adequately to play the role they ought to. Despite being given Constitutional status, local bodies do not have clear functional responsibilities in the Constitution, nor is there adequate provision for their finances. They remain subordinate to the state governments in the true sense of the term.

2. Assignment of revenue powers and expenditure responsibilities

Assignment of functional responsibilities in all five cases show substantial decentralization on the expenditure side commensurate with the focus on local

government, but revenue decentralization is minimal, except in Brazil, which has only one major tax, ICMS, levied sub-nationally but does unconditionally share a large part of the tax revenue collected centrally. China, in fact, has centralized revenues in its latest phase. All the five nations reviewed prefer to thus share tax *revenues* rather than the *tax instrument*. It is difficult to make a case for or against this policy as there are valid reasons for both; by the same token, it would be difficult to assert that this constitutes a ~~lesson~~ for India. Similarly, while most of these nations have a system of broadly national collection and subsequent sharing (sometimes quite liberal) of revenue from natural resources, one would hesitate to recommend the same for India, which has a somewhat different system of central determination of rate and base of royalties, with collection and retention by the states. The perceived problems with the Indian system are not with the provisions but with the implementation of the same.

On assignment of functional responsibilities, formally all the five nations are fairly similar, with marginal variations. However, the Chinese and the Indonesian type of unclear assignments are better avoided. Overlapping jurisdictions are present in all the nations reviewed, but serious explicit conflicts have not been common in the countries reviewed. In South Africa and Brazil, apart from a number of institutions facilitating resolution of problems of jurisdiction, clear constitutional provisions allow judicial intermediations; the process is less formal in the other three nations. The extent of central dominance in China, Indonesia and Russia has more or less ensured little jurisdictional dispute, since central diktat quickly settles them. Also to be avoided, fudging the formal assignments through the unfunded expenditure mandate system has been shown to be a sure recipe for sub-national financial difficulties in both China and Russia.

The combination of centralized revenue collection, fairly decentralized expenditure responsibilities and matching the two by sharing revenues appears to be working fairly well in Brazil despite some recent disquiet, but much less so in the other four nations. The underlying causes can perhaps be traced to the extent and the manner of sharing revenues, which we discuss below along with the intergovernmental transfers. While sub-national governments in China are clearly resource-starved and forced to adopt various irregular methods, the problem in Indonesia seems to be that the local governments bother about only the establishment expenditure and little else, even if it means accumulating large unspent balances. Obviously, there is a capacity problem, along with a possible lack

of accountability. This does have a lesson for India in that there could arise similar capacity problems at the third tier if and when greater resources are devolved to them. Even when one accepts that the role of the third tier needs considerable augmentation, capacity building must accompany or even precede substantially greater devolution of revenues.

3. Intergovernmental transfers

All five nations reviewed are characterized by substantial vertical imbalances flowing from ill-matching decentralization of revenue-raising powers and expenditure responsibilities, as well as a high degree of regional inequality and hence horizontal imbalance. Such a situation makes sub-national governments heavily dependent on the national government for resources and makes intergovernmental transfers extremely important in terms of design and impact. The high probability of qualitative centralization of even expenditures in such a situation is almost given, unless bulk of the transfers is unconditional. These issues are equally important in India along with that of equalization, although the problem of vertical imbalance is marginally smaller, as in Brazil.

The instruments of transfer in the five nations include revenue sharing as noted above, unconditional (equalizing) transfers, and conditional transfers. Brazil has a somewhat different system compared to the others in that, it combines revenue sharing and equalization transfers in one channel by putting tax shares for each level of government into a fund and distributing the fund among individual units using the mandated formula (determinants and weights). Also, this part of the transfers dominates in the total, even though the direct sharing of provincial VAT with the third tier is also substantial. In contrast, the three types of transfer run parallel in the other four nations. The disadvantage of the latter is that it is entirely possible to cancel out the *inter se* distributional character of one type of transfer with another. In India, there is actually an added issue of transfers through multiple channels. Even within the one channel of the Finance Commission, tax revenue sharing has been determined independent of grants. The example of Brazil suggests that this need not be so, and a single scheme of general purpose transfers combined with tax sharing can be a possible alternative. If multiple channels of transfer can be collapsed into a single one, the chances of focusing on specific objectives like equalization would be even better. However, the Brazilian system of largely depending on tax revenue sharing has been shown to be fraught with the risk of pro-cyclicality, and consequently, for resource-starved jurisdictions, smallest exactly at the time they need the transfers most.

A related issue is that of the choice between devolving taxing powers, sharing tax revenues and providing grants. While all three measures can correct for any vertical imbalance, the choice depends upon several factors. One reason that can pre-empt tax power devolution is the regional concentration of economic activity or natural resources; sub-national taxation can exacerbate inequalities in such a situation. Central taxation along with revenue sharing can combine an origin basis with other (equalizing) factors in the desired manner. Revenue sharing has one advantage over grants: the divisible pool is automatically decided in the former as long as the sharing percentages are fixed, while the divisible pool for grants are nearly always decided every year. Considering the above issues, the lesson to be drawn is that there must be a judicious combination of revenue sharing and grants, and over-reliance on any one should be avoided.

The actual *inter se* distribution of transfers follows different patterns in each of the five nations. However, even considering only the part that is supposed to be equalizing, there are differences. The Brazilian system essentially is one sided in the sense that only per capita incomes (apart from population) determine the shares of individual units without any reference to their revenue capacity. Given the huge differences in revenue capacity among individual units in Brazil, the one-sided equalization is clearly inappropriate. The South African equalization transfers are also one-sided although not so simple in that normative expenditures on selected functions with prescribed weights for each of them are considered. However, in their case, the near-absence of own revenues is cited as the justification for the one-sided equalization. China, Indonesia and Russia use double sided equalization; the estimated need for transfers consider both the expenditure side as well as revenues. In India, the determinants are expected to represent both sides of the budget, but instead of estimating normative revenues and expenditures as in these three countries, the determinants are simply assigned weights based on judgment. A full-blown normative assessment of revenues and expenditures would undoubtedly be appropriate for equalization transfers, but the fact is that such assessments in practice always end up with several imperfections. The choice in India therefore is between transfers based on imperfect normative estimation of resource needs, and the same based on somewhat arbitrarily chosen determinants and attached weights. Our preferences are for the former, as we believe that it is in principle better for equalization purposes, and the imperfections in normative assessment should not

prevent its use forever; once used, the methodology can be refined and the imperfections can be reduced over time with successive iterations.

The reviews indicate that it is extremely difficult to get the design of intergovernmental transfers absolutely right. An academic discussion of such transfers would list several desirable qualities of the transfer system like simplicity, predictability, transparency, non-cyclicality, progressivity, and above all, avoiding perverse incentives. The experiences of these five nations show that in practice, it is not easy to get all of these right, and sometimes one desirable feature may conflict with another. Typically, the system has to meet several objectives, which tend to create complexities, and the transparency of the overall system suffers. Predictability requires a formula-driven system, but every national government requires some flexibility to respond to unforeseen economic conditions (as exemplified by the recent global financial crisis) and also to promote its own agenda in the principal-agent framework. However, the tendency of the conditional transfers to dominate the entire transfer system (as in China, Russia and Indonesia) has to be guarded against, perhaps through statutory restrictions.

Brazil almost entirely depends on revenue sharing for intergovernmental transfers, with the federal government transferring resources to both provinces and local governments, while the provinces also share (the revenue from ICMS or the VAT) with the municipalities. The federal government mainly uses the fund system (separate ones for the states and for the municipalities) for its equalizing transfers, but the equalizing impact is suspect; moreover, there are a number of other direct revenue sharing mechanisms, some of them origin based, that makes the extent of equalization uncertain. While the system does have the virtue of predictability and transparency as well as sub-national autonomy, it is complex and pro-cyclical. Though there are no major perverse incentives in the system, accountability at the municipal level, being largely transfer-funded, could be adversely affected.

The current Chinese system comprises of one major unconditional transfer in the form of ~~tax~~ tax rebate a tax revenue sharing system based on origin, a large amount of conditional (specific purpose) transfers, and a few small general purpose grants. The unconditional tax revenue sharing is probably disequalizing, being based on origin, and the specific purpose transfers, not being subject to any fixed method or formula, cannot be assessed except on a year-to-year basis. The overall system thus has none of the virtues sought in a intergovernmental transfer system, and can be

summed up as a corollary of a centralized governance system rather than promoting true decentralization in terms of promoting sub-national autonomy except for a few economically developed jurisdictions. The murky assignment of responsibilities and powers tainted by unfunded expenditure mandates, unauthorised revenue collections and severely revenue-constrained sub-national governments results in a system of intergovernmental finance that has little to recommend.

The Indonesian system is an evolving one, with a formula driven general purpose transfer scheme accounting for the bulk of the transfers, and another formula driven specific-purpose grant scheme gaining in importance. The formulae for horizontal distribution, however, suffer from several infirmities and are also subject to changes from year to year. This robs the system of predictability and transparency. There are incentive issues as well because of the problems in the formula . the system does not encourage own revenue generation and one component of the system (DAU) negates another (natural resource sharing). The system as is promotes sub-national autonomy to a limited extent, but the changes over time indicate the intention of granting further autonomy to keep pace with their maturity.

In Russia, the regional governments are less dependent on grants than the local governments because of the way revenue sharing has been organized in the latest system. Entire revenue sharing is unconditional; so are the equalization and compensatory grants, the two major components of the intergovernmental grants. This keeps regional autonomy in tact, but whether it goes far enough with respect to equalization is debatable. The system is also largely predictable and not particularly complex, having the advantage of transparency. But recent years have seen unwarranted fiddling with the implementation of the equalization formula. There are substantial amounts of conditional transfers also, but these are clearly in the principal-agent framework, unavoidable in a large country like Russia.

In South Africa, because of the almost complete revenue centralization, sub-national governments are heavily dependent on intergovernmental transfers. Since the provincial level has limited large expenditure responsibilities, the system of horizontal distribution of grants (the so-called equitable sharing) essentially attempts to cover those along with other smaller components that are equal amounts for all or are scaled by population. Roughly the same principles are used for local bodies, but after making adjustments for their limited own revenues. The system is internally

consistent; the sub-national governments are provided grants according to their expenditure liabilities. The conventional ideas of equalization play no role in the transfer system, and it is expected to come about through the socio-economic development that the national and sub-national governments' expenditures are intended to foster. In the process, there are some problems of accountability (as is likely in any system of largely externally funded expenditures), and problems of funding expenditures that are not covered under the transfers.

4. Sub-national Debt

Sub-national debts are small in four of the five nations reviewed, the exception being Brazil. Brazil has a history of rather excessive sub-national borrowing leading to a crisis, and the present system therefore has tight controls. Sub-national borrowing has to pass through three checks now . that of the respective legislature, the central bank (in a way that is intended to mimic the market discipline) and the senate at the federal level. There are also legal limits imposed on the debt through fiscal responsibility legislation. These checks and balances appear to be working towards the desired objective, as there has been no problems regarding debt repayment in the last ten years, but there are grumbings about non-transparency regarding the yardsticks used by the central bank to assess debt proposals. In the other four countries, sub-national debt market is small and developing, but cases of default have already been reported, calling for an appropriate control mechanism. Further, the case of extra-budgetary funds in China demonstrates the need for both appropriate levels of intergovernmental transfers and some leeway for sub-national governments to borrow with appropriate monitoring. This is also necessary in view of the likely step-up in sub-national borrowing in all the five nations.

The use of fiscal rules to control sub-national debt has so far been effective (the case of China is intrinsically different) in maintaining fiscal discipline, but a view is growing (mainly in Brazil and South Africa) that they have perhaps had adverse effects on the supply of various public services and the extent of necessary public interventions at the sub-national level. In India too, the fiscal responsibility legislations have had the desired impact on sub-national deficits and debt. As such, their continuation is almost a given; the only issue perhaps is possible modifications. The reviews indicate some relaxation of the system, possibly in combination with the golden rule of breaching limits set for capital expenditures only. Oddly enough, none of the five nations reviewed have any specific controls on the debt of national government as in India (albeit rather loose). Only Brazil has some aggregate

restrictions, and some specific prescriptions regarding expenditure allocations even for the federal government.

5. Impact of the Global Financial Crisis

The sub-national governments in all the five nations reviewed appear to be insulated from macroeconomic turbulences, thanks to the protective role of the national government. Although significant amount of details were not available on this in some cases, country responses to the recent experience of the global financial crisis indicate that: (a) the problem initially was of a short duration (one year only); (b) this was preceded by several good years so that the sub-national governments in all these countries were financially stable at the advent of the crisis; (c) the sub-national governments did suffer the negative externalities of the crisis in terms of economic downturn and consequent loss of revenue; (d) but the compensatory policy of the national government formally or informally stepped up transfers to sub-national governments, thereby largely neutralising the immediate negative impact; and (e) in many cases, the compensatory policy included a rise in the public sector wages applicable to sub-national governments also, and an increase in transfers corresponding to the same. It should also be noted that the medium-term impact of the crisis and the recession appears to be more serious than the immediate impact that was relatively easily managed. Policy responses to the longer-term impact and the continuing recessionary tendencies are proving harder to frame successfully in general. It may be noted the Indian case is not substantially different, including rise in wages of public sector employees at the sub-national level. Additionally, Indian states were allowed to breach the 3 percent limit set on fiscal deficit to GSDP ratio. At the present juncture, with growth rates relatively subdued, appropriate macroeconomic responses to improve growth prospects are being searched for, as in the cases of the nations reviewed. Liquidity crunch and shortage of investible funds caused by withdrawal of foreign direct investment may not be as much of an issue in India as in some of the countries reviewed here, but shrinking foreign demand for Indian goods, services and skilled labour does directly or indirectly affect macroeconomic recovery in India adversely.

6. Delivery of Public Services

Delivery of public services, particularly social and physical infrastructure has become a major issue in most developing economies. In South Africa, the related problems have assumed considerably larger proportions because of the political undertone meshed into this issue. In China and to a smaller extent Russia, sub-national governments have been driven to extraordinary measures to meet the

pressure on public supply of these services that have crossed the boundaries of prudent financial practices. The problems, our review shows, are mainly to do with availability of adequate resources at the local level. But there is an element of lack of capacity also, particularly in countries like Indonesia and South Africa. Both these problems are very much present in India too; the saving grace is that state governments or their agencies undertake several of the functions that are undertaken by local bodies elsewhere. The solutions of these problems being attempted . like privatization, use of PPP model and other market-based solutions like contracting out, and a more equitable distribution of revenue handles/collections . have possibilities of application in India too. Indeed, most of the usual solutions suggested are already being experimented with in India.

In this context, the use of a conditional cash transfers (CCT) in Brazil and Indonesia needs special mention. The concept was actually implemented in Latin American countries to tackle the problem of under-utilization of capacity in specific publicly provided services by stimulating the demand side through cash transfers to families conditional upon use of these underutilized public services. The initial impact for a few years was clearly positive, there is less certainty about the longer-term effects; indications are that the longer-term effects are less significant and the system becomes prone to leakages (unintended beneficiaries) over time. The Indonesian experience shows that the marginal impact may not always be significant (in cases where good progress is being made in any case); most important, one must be reasonably sure about (a) excess capacity that is underutilized (b) the underutilization being a demand side problem, and (c) no constraints on the access of the poor to the services. In India, there are some CCT already in operation (for example, *Janani Suraksha Yojana*) with admittedly much more restricted coverage, and hence demanding less administrative capacity. For implementation of broader schemes of CCT in India, a judgement regarding the above three preconditions are required. In some cases demand is not really a problem (primary education, where enrolment ratios are already high and increasing quickly anyway), and in other cases there are serious public supply constraints and access issues (primary health). As such, a broad-based CCT may not be the instrument that one is looking for (see Prabhu, 2009); however, limited purpose or limited coverage CCT can be an option.

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