OECD Fiscal Federalism Studies

Fiscal Decentralisation and Inclusive Growth in Asia

Edited by Junghun Kim and Sean Dougherty

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Please cite this publication as:
Kim, J. and S. Dougherty (eds.) (2019), *Fiscal Decentralisation and Inclusive Growth in Asia*, OECD Fiscal Federalism Studies, OECD Publishing, Paris, *https://doi.org/10.1787/25cf7545-en*.

ISBN 978-92-64-46995-2 (print)
ISBN 978-92-64-89790-8 (pdf)

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

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Preface

The theme of this volume is "Fiscal Decentralisation and Inclusive Growth in Asia". Given the current economic context around the world, inclusive growth is a hugely important topic and has been made a key national policy objective in many countries. It is also promoted by international organisations – especially the OECD – as well as the ADB, the IMF, the World Bank, and the UN. The OECD has been a leading promoter of inclusive growth policies, and frameworks for analysis.

Since sub-national governments are involved in so many aspects of policymaking, it is important to investigate how and to what extent sub-national governments can play a role for inclusive growth. However, there has been little research on the links between fiscal decentralisation and inclusive growth. As an initiative to address this issue, the OECD and the KIPF held a workshop on the theme of "Inclusive Growth and Fiscal Decentralisation" in Paris in May 2017 as a special session of the OECD Network on Fiscal Relations across Levels of Government (an OECD committee on fiscal decentralisation established in 2004) involving experts from OECD countries. However, achieving inclusive growth is arguably even more important for developing and emerging economies, because the inclusiveness of economic growth affects economic growth trajectories and the pace of convergence. Without sufficiently inclusive economic growth, it can be hard for a converging economy to sustain economic growth.

The concepts of inclusive growth and fiscal decentralisation are both broad and general. Yet for each individual country, there are specific and pressing challenges related to inclusive growth and fiscal decentralisation. This is especially the case for many developing countries in Asia for which the success of inclusive growth and sustainable development is particularly important and the design of fiscal decentralisation is still being shaped. Following up on the May 2017 workshop and to extend its policy dialogue to the Asian region, the OECD and the KIPF held a workshop (Roundtable of the Network on Fiscal Relations in Asia – RoNFRA) on 21-22 December 2017 in Seoul. This volume is the outcome of the 1st RoNFRA.

The chapters of this volume show that the challenges faced by Asian countries in addressing inclusive growth and fiscal decentralisation are indeed diverse and country-specific. They also show that the challenges faced by each country evolve in accordance with the changes in demography and the economic environment. The main question is how to get the institutions right, and overcome political economy constraints, in addition to getting the design of intergovernmental fiscal framework right. In order to facilitate a deeper understanding of these issues, we hope they will be further addressed in future RoNFRA workshops.

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

Foreword

Sub-national governments are a crucial part of the public sector. In many countries, sub-national governments are almost as large as or even larger than the central government in terms of their shares in government spending and revenue. In almost all areas of the government, such as education, infrastructure, poverty reduction and public health, sub-national governments are a major player in improving the effectiveness of the public sector. Therefore, understanding the nature of intergovernmental fiscal relations and its optimal design is a key policy challenge in both developed and developing countries.

Decentralisation has a political, fiscal and administrative dimension. The analysis of fiscal decentralisation of a country inevitably involves understanding the political and administrative institutions of that country. This is why comparative analysis of fiscal decentralisation across different countries, based on both qualitative and quantitative indicators, provides a rich environment for studying different aspects of fiscal decentralisation. Ultimately, this process enhances our appreciation for various forms of fiscal decentralisation that often correspond to differing political and economic institutions.

Countries have greatly benefited from the activities of the OECD Network on Fiscal Relations across Levels of Government (the "Fiscal Network"), which has carried out a comparative analysis of various fiscal decentralisation issues. However, a good understanding of the nature of fiscal decentralisation is arguably even more important for developing countries, because the design of fiscal decentralisation is still evolving in many of these countries. Many OECD directorates, including the Public Governance Directorate, the Centre for Tax Policy and Administration, the Centre for Entrepreneurship, SMEs, Regions and Cities, and the Economics Department deal with fiscal decentralisation issues. Therefore, given the wide knowledge base of the Fiscal Network on fiscal decentralisation, there is great potential for collaborative work between the Fiscal Network and developing countries in the Asia-Pacific region.

In order to maximise this potential, the Korea Institute of Public Finance (KIPF) and the Fiscal Network launched the Roundtable of the Network on Fiscal Relations in Asia (RoNFRA) in 2017 to start a policy dialogue on fiscal decentralisation in the Asia-Pacific region. This volume is the outcome of the first RoNFRA and provides expert views and policy analysis on the interaction between fiscal decentralisation and inclusive growth in the Asia-Pacific region. We are grateful to the authors who contributed to this volume. We also thank country delegates who participated in the first RoNFRA meeting for their interest and contributions to the Roundtable.

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Executive summary

Many countries have made inclusive growth a major national policy objective. This volume looks at the relationship between fiscal decentralisation and inclusive growth in the Asia-Pacific region. It begins with a chapter that provides a perspective on decentralisation in a globalised world. The authors (Robin Boadway and Sean Dougherty) discuss the challenges posed by globalisation accompanied by the growing importance of information technology and its implications on fiscal decentralisation and inclusive growth. The authors then discuss that the roles of various levels of governments should change in response to increasing pressure for innovation and widening inequalities, and that the role of large urban governments is becoming particularly important in this new environment. They suggest that new thinking on the design of fiscal decentralisation (revenue decentralisation, policy harmonisation, and the structure of intergovernmental transfers) is required to help cities meet the new challenges.

The chapter by Isabelle Chatry and Rose Camille Vincent documents a detailed and comprehensive database on sub-national government structure and finance in sixteen countries in the Asia-Pacific region, which is based on an ambitious project by the OECD and the United Cities and Local Governments (UCLG) that constructs a World Observatory on Sub-national Government Finance and Investment in more than 100 countries. As expected, this study finds high diversity of socioeconomic characteristics and complexity of sub-national government's structure and role. But this study also finds that, for many countries surveyed in the study, there is generally lack of sub-national fiscal power. This indicates that strengthening fiscal autonomy of sub-national governments and adequate vertical and horizontal equalisation mechanisms are an important element of fiscal decentralisation for many countries in the Asia-Pacific region.

The chapter by Paul Smoke notes that in order to know how decentralisation contributes to promoting inclusive and equitable development, it is important to understand how country characteristics, history and political economy forces affect the way decentralisation is organized and operates. Smoke further notes that the results of the interaction of intergovernmental system structure, decentralisation framework, the level of accountability reflected in the local political system may differ across countries. He emphasises that, given the diversity, complexity and information gaps involved, there are limitations of policy generalisations on fiscal decentralisation. So Smoke's chapter again confirms that understanding country-specific institutional and policy environments is a key to gaining the benefits of fiscal decentralisation.

The chapters by Christine Wong, Masayoshi Hayashi and Hyun-A Kim nicely show how country characteristics, history and political economy forces interact with the challenges of fiscal decentralisation and inclusive growth in China, Japan, and Korea. Wong notes that the major challenges China faces today is the divide between urban residents with local registration (*hukou*) and rural migrants without local registration (non-*hukou*). The children of rural migrants have limited access to urban schooling. One solution Wong suggests is to use education funds less for salaries in rural schools and more for non-*hukou* children in cities. A better alternative she suggests is to wholly revise the revenue and expenditure assignments. Such reform is desirable and important for inclusive growth in China, but not an easy challenge due to political economy constraints. The chapter by Hayashi discusses the challenges caused by rapid pace of ageing, population decrease, and aggravating regional disparities in Japan. Hayashi notes that given the inevitability of population decrease especially in rural areas, a "balanced development policy" is not sustainable and does not contribute to economic growth either. So he suggests that Japan's growth policy should be through agglomeration and compactisation (relocation of residents and facilities to more compact areas). Hyun-A Kim addresses education and fiscal decentralisation in Korea. Korea has the record of a very successful education policy – in terms of inclusiveness and productivity – backed up by the co-ordination of central and local governments in financing and implementation. However, Kim notes that given the widening income and regional disparities, sustaining inclusiveness of local education is an increasingly challenging issue in Korea.

The chapters by Petar Vujanovic, Jocelyn Cuaresma, Michael Alexeev & Hansjörg Blöchliger, and Duangmanee Laovakul address the challenges faced by countries with a relatively short history of fiscal decentralisation (Indonesia, the Philippines, the Russian Federation, and Thailand). The chapter by Vujanovic discusses the case of Indonesia which embarked on an ambitious decentralisation process in the late 1990s; the chapter by Cuaresma discusses the importance and limitations of general grants (IRA) in the Philippines; the chapter by Alexeev and Blöchliger discusses the intergovernmental fiscal framework in the Russia Federation; and the chapter by Laovakul discusses the issues of expenditure and revenue assignment in Thailand. While the challenges these countries face are very diverse, they share a common nature: enhancing institutional functionalities and complementarities and strengthening local capacities so as to reap the benefits of fiscal decentralisation by making it more inclusive and productive.

1. Decentralisation in a globalised world: Consequences and opportunities

by

Robin Boadway and Sean Dougherty *

Globalisation accompanied by the growing importance of information technology and knowledge-based production pose challenging problems for federations. The chapter summarises the difficulties that traditional decentralised federations face in addressing problems of competitiveness, innovation and inequality brought on by globalisation. Adapting to these challenges involves rethinking the roles of various levels of government and rebalancing them appropriately. On the one hand, responding to inequality enhances the policy role of the federal government. On the other hand, state and local governments must respond to the imperative of providing education and business services to equip citizens and firms to compete in the knowledge economy. Perhaps most important, large urban governments are best placed to provide the physical and social capital to support innovation hubs. A key challenge for fiscal federalism is to facilitate the decentralisation of responsibilities to urban governments. This entails new thinking about revenue decentralisation, policy harmonisation and the structure of intergovernmental transfers so that cities can implement their policies effectively and accountably.

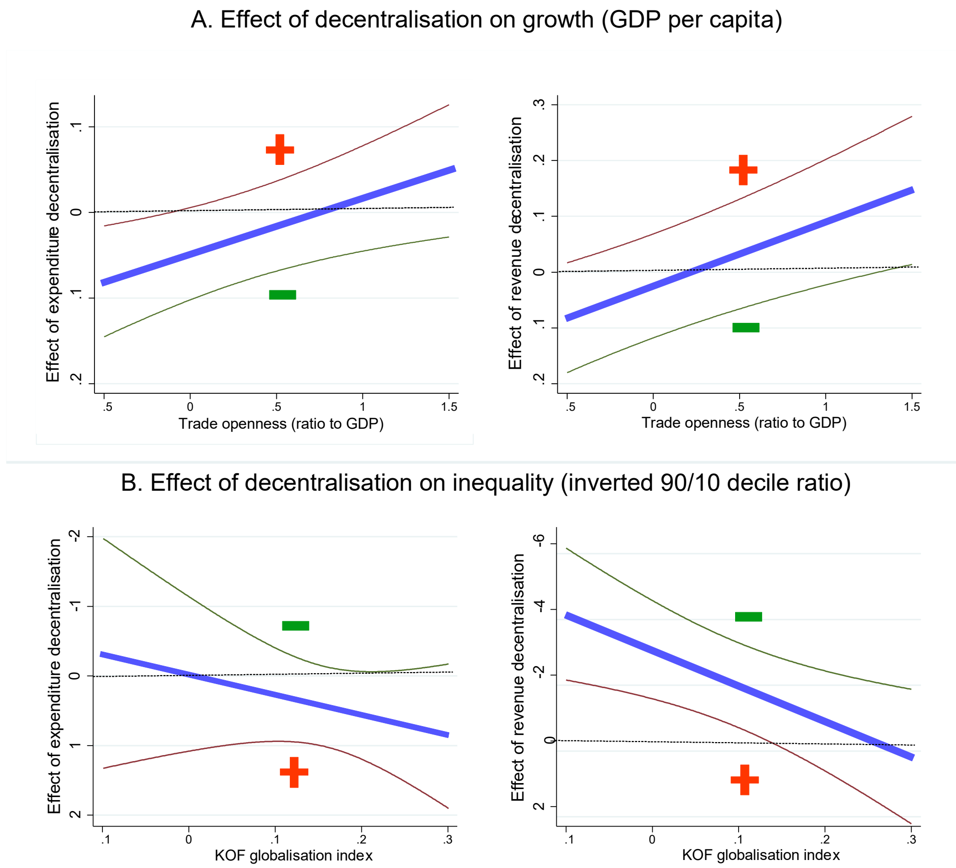
* Robin Boadway is Professor Emeritus at Queen's University, Canada, while Sean Dougherty is Senior Advisor to the OECD Network on Fiscal Relations across Levels of Government, France. This chapter draws on collaborative work with Anwar Shah, particularly Boadway and Shah (2009), and with Oguzhan Akgun, particularly Dougherty and Akgun (2018). It incorporates feedback from delegates at the 2017 annual meeting of the Network on Fiscal Relations and the 1st meeting of the Roundtable of the Network on Fiscal Relations in Asia in December 2017.

1.1. Introduction

Modern nation-states face a globalised world characterised by challenging features. Globalisation implies that markets for capital and skilled persons are international, and that much of production is organised on a transnational supply-chain basis. Advances in information technology mean that a growing proportion of production is knowledge-intensive and "footloose". International patterns of specialisation and the mobility of skills result in growing inequality within nations, as the gains from growth accrue to top income groups, although international inequality becomes moderated as workers in developing economies are lifted out of poverty. OECD economies are becoming more urbanised, and technological innovation is especially concentrated in urban innovation hubs. Nation-states are prone to economic shocks transmitted from abroad, often regionally specific in the case of heterogeneous nations, and the nature of employment itself becomes increasingly precarious. National governments are constrained by globalised markets, as well as by the instantaneous flow of information to citizens to whom they must account (see Boadway and Shah, 2009).

Our objective is to explore the consequences of these developments for decentralised nations. Globalisation and decentralisation may influence each other (Alesina et al., 2005). Decentralisation can help or hinder the challenges posed by globalisation, while the extent and nature of decentralisation should adjust with globalisation, urbanisation and information innovation. Our discussion is in terms of federations with federal, state and local governments, though similar considerations apply in unitary nations with active local and regional governments. Our approach complements that of Sean Dougherty (in OECD/KIPF, 2018) who finds that fiscal decentralisation—especially both expenditure and revenue decentralisation combined—encourages economic growth in highly open economies, but that it also can induce economic inequality (see Figure 1.1).

Figure 1.1. Growth and inequality effects of decentralisation, conditional on globalisation



Note: Growth elasticities are based on a time series regression framework, with government size fixed; inequality effects are analogous, but based on an inverted 90/10 decile ratio, also with government size fixed. Red and green lines are 95% confidence intervals around the estimated elasticity (in blue).

Source: Adapted from Dougherty and Akgun (2018).

Federations are both economic unions in which factors of production and producers flow freely across internal borders and social unions with common citizenship rights and some degree of solidarity. The extent and form of decentralisation vary from country to country, but some common features can be noted. The level of combined state and local expenditures in most federations tends to be comparable with that of the central/federal government (Watts, 1999). The proportion of expenditures consisting of transfers is much higher at the federal level, including transfers to lower levels of government. State and local expenditures are dominated by goods and services, and local governments are especially important in the provision of infrastructure. The extent of decentralisation of revenue-raising varies greatly among federations, and this is reflected in the extent to which sub-national governments rely on transfers from higher levels of government. In many federations, states have access to at least one broad-based tax, such as income or consumption taxation, and they have significant discretion to borrow from capital markets. Local governments are generally more reliant on states for their finances, and have only limited discretion to borrow. In addition, localities face significant oversight from state governments.

Relations among governments are typically hierarchical, with the federal government engaging fiscally with the states, and the states in turn with localities. Vertical fiscal gaps exist between levels of government and are the outcomes of interdependent tax and fiscal transfer choices. Despite what the fiscal federalism literature would suggest, there is considerable institutional co-operation between the federal government and the states, albeit with the federal government exercising leadership and with both levels of government enjoying legislative autonomy. The federal government can influence state decisions by a variety of means that vary by federation, such as conditional transfers, mandates, the disallowance of state legislation, and moral suasion. Sub-national governments with more revenue-raising ability are better able to deal with adverse fiscal shocks, although this will depend upon how federal-state transfers respond to shocks. There are no fail-safe mechanisms to guarantee that higher governments will not bail out lower ones who fall into fiscal distress. The design of formula-based transfer systems, however, offers some protection.

1.2. Decentralisation in heterogeneous federations

It is useful to summarize briefly some standard arguments from the fiscal federalism literature on the pros and cons of decentralisation. By decentralisation we mean the devolving of responsibilities to state and local governments. This includes especially legislative responsibilities, but can also include state governments administering or designing programs legislated by the federal government. We consider mainly fiscal responsibilities: raising revenues through taxes, user fees and borrowing; spending on goods and services, infrastructure and transfers to individuals and firms; social insurance; and intergovernmental transfers. State responsibilities may be exclusive to the state, or they may be subject to oversight by federal legislation or regulation. Moreover, federal and state governments may share some fiscal responsibilities, with paramountcy given to one level. And, governments may enter into bilateral or multilateral agreements, for example, to harmonize taxation or spending programs, or to facilitate internal free trade. Dispute settlement mechanisms necessarily accompany such agreements, although sometimes the federal government is the final authority.

Decentralisation contributes to the efficient delivery of public services to residents, including those that are important for competitiveness, growth and fairness. Indeed, state spending programs are critical components of government policies for redistributive equity and equality of opportunity. State programme responsibilities typically include: important public services delivered to individuals, such as education and health; targeted transfers such as welfare; in-kind transfers like childcare and elderly care; and employment and training services. State governments, along with local governments, undertake the bulk of infrastructure spending. Local governments also provide some social programs like low-income housing and transportation, and care programs for children and the elderly. States generally have access to discretionary revenue sources, although they rely in varying amounts on federal transfers. Local governments have less buoyant revenue sources and enjoy limited discretion for spending on infrastructure programs.

The arguments for decentralisation anticipate its consequences. Beneficial consequences of decentralisation include the following:

1. good governance by locating decisions at a level close to those being served;
2. respect for local preferences and for diversity of needs, while abiding by national standards;

3. holding governments to account via exit (migration) and voice (local participation by citizens, community leaders and politicians);
4. innovation and experimentation in service delivery (laboratory federalism); and
5. beneficial fiscal competition with other jurisdictions including through yardstick competition and mimicking best practices.

The responsiveness and accountability of state and local programs to citizens' needs and preferences varies with the amount of legislative and financial discretion these governments enjoy. State governments enjoy more discretion than local governments.

Decentralisation also has some potentially adverse consequences. It creates horizontal imbalances such that states and localities differ in their ability to provide public services at comparable levels of taxation. To the extent that this causes fiscally-induced migration, labour and business will be inefficiently allocated among jurisdictions. Horizontal imbalances also lead to horizontal inequities in the federation, that is, with otherwise identical persons being treated differently depending on their state of residence. Whether this is a serious issue depends on the weight society puts on solidarity or social citizenship. On the other hand, horizontal imbalances may reflect agglomeration and scale economies, in which case undoing them can be counter-productive. Also, while decentralisation allows states to differentiate their policies in accordance with local preferences and needs, it may also detract from national standards of fairness and distort inter-provincial movements of products and factors of production. In particular, fiscal competition can lead to a race-to-the-bottom in redistributive policies and in sub-optimal tax rates and levels of public services, due to mobility of capital and labour, especially skilled labour. As well, the decentralisation of broad tax bases and major public services to the states can lead to distortions in the internal economic union simply because policies are not harmonised among states. Finally, decentralisation of spending responsibilities that is not accompanied by sufficient revenue-raising discretion can leave state and local finances without adequate ability to respond to fiscal shocks and face the federal government with deciding whether to come to their aid. The expectation that the federal government will bail out state and/or local governments that are in financial trouble can encourage behaviour by the latter that is not fiscally sustainable.

A variety of measures can be taken to address the adverse consequences of decentralisation without sacrificing its advantages. Fiscal equalisation transfers from the federal government can undo the horizontal imbalances created by decentralisation without unduly influencing state behaviour provided they are well-designed. This requires that the transfers to a state not be too responsive to its fiscal decisions. Block transfers with broad but non-intrusive conditions can be used to close whatever gap remains between sub-national spending responsibilities and their revenue-raising abilities as well as to encourage states to abide by minimum national standards in the design of their public service programs. Detrimental effects of decentralised decision-making on the internal economic and social union can be ameliorated by fiscal harmonisation agreements between the federal and state governments. Institutional arrangements such as fiscal rules and fiscal councils can be used to encourage governments to be fiscally responsible and to minimise the chances of bailouts. In some federations, more decentralisation of revenue-raising to the states can induce greater fiscal accountability and responsiveness to local needs and shocks.

Enhancing the effectiveness of local governments, especially in larger urban areas, is more challenging but crucially important. The demands on urban government for infrastructure and other public services are substantial, but getting fiscal tools to them is difficult. Cities vary greatly in size, and within states one or two cities can dominate the populations. The case for asymmetric treatment is strong, for example, giving only larger cities access to selected revenue sources. Local equalisation systems that are based on need and that distinguish among cities by population size are relatively straightforward to design. An open question is the extent to which the federal government should have direct fiscal relations with larger cities, especially since their policies can have national implications.

1.3. Challenges of globalisation for decentralisation

Globalisation accompanied by the movement of populations to large urban areas and the growing importance of knowledge-based production poses an enormous challenge for national economies and national governments. Competitive pressure puts a premium on innovation, entrepreneurship and investment in physical, intangible and human capital. Governments at all levels are constrained by the openness of markets for capital, products and highly skilled labour. They increasingly compete with one another to attract economic activity, and this limits their control over tax bases and tax rates. Moreover, open economies are vulnerable to economic shocks, both aggregate and sector-specific, and this affects the fiscal fortunes of all levels of government. Advances in information technology increase the rapidity with which change occurs and propagates, and result in more disruptive and precarious labour markets facing workers. This is on top of the tendencies for inequality to increase as wages of low-income workers face increasing competition from abroad, and the fruits of information-based innovation and transnational production accrue to the already better off.

New forms of information technology also serve to empower citizens by enhancing their ability to hold governments to account and by enabling novel forms of citizen activism. This bottom-up accountability has the potential to induce more responsive and efficient service delivery and reduce the costs of citizens transacting with their governments, particularly local government. Information technology also improves the voice of non-government entities and offers the possibility of enlisting them in local service delivery. There is also greater awareness of neighbouring jurisdictions leading to more competition and innovation since local performance can be judged by benchmarks established elsewhere (so-called yardstick competition). The upshot is an enhancement of the role of local governments at the expense of state governments, especially as the federal government takes on some of the responsibilities of the latter in response to globalisation pressures.

Policy responses to these challenges involve all levels of government, and especially call for reinvigorating the role of local governments. The federal government has a prime role to play in responding to the challenges of inequality. It dominates the personal tax-transfer system, which is the first line of attack on income and wealth inequality. It can also use the corporate tax system to both encourage innovative investment and to tax economic rents at source, albeit constrained by corporate profit shifting using tax avoidance devices. Though profit shifting is often not illegal, it nonetheless exploits tax loopholes that exist unintentionally. The federal government also controls the main elements of social insurance, especially the unemployment insurance system.

At the same time, state and local government policies complement federal redistributive equity policies. To the extent that public expenditures are used to address redistribution—and arguably they are at least as important as taxes and transfers—sub-national governments are largely responsible for them. Such policies include education and training, health, social services, childcare and housing.

Pursuing economic growth involves policies to enhance productivity, innovation and entrepreneurship. Federal tax policy can partly address this by making both business and personal taxes friendly to investment and innovation. However, a growth agenda will also involve investments in human capital, in public capital and in information technology, and sub-national governments have a role to play. State governments influence human capital investment through the universities and colleges that they typically operate. They also control much of the transportation facilities and communications technology. As previously mentioned, local governments are responsible for the bulk of infrastructure spending. Most important, cities are home to innovation hubs and to the high-tech sector and the highly skilled persons it employs. Cities are also home to capital markets, including those for venture capital. More generally, urban areas are where agglomeration economies and technology networks are found, and local governments provide the public infrastructure that supports them.

For state and local governments to play their part in complementing the redistributive policies of the federal government, and in providing infrastructure and other public investments that support innovation and growth, discretion in revenue-raising is important. The ability to decentralise revenue-raising effectively and efficiently to the states has been well established in many federations. Systems of federal-state tax harmonisation can achieve that. Income and sales tax bases and rate structures can be harmonised, while giving discretion to the states for the level of state tax rates. Provided this is accompanied by an effective revenue equalisation system, states will have comparable fiscal capacities with which to pursue fiscal programs that best suit their needs and preferences, while at the same time abiding by national norms of efficiency and equity.

It is rather more difficult to decentralise revenue-raising to local governments in a way that enables them sufficient discretion to choose their tax rates while at the same time retaining balance in the fiscal capacities of what are highly heterogeneous jurisdictions. Given the crucial role that large cities play in growth and innovation, a high priority must be given to establishing financing mechanisms that leave them with the ability and the discretion to implement the important infrastructure programs and local services in support of knowledge-intensive economic activity. Devolving income or sales taxes to local governments is one possibility, although it poses administrative and economic challenges. Alternatively, block-grant programs or revenue-sharing mechanisms could be devised to ensure that local governments have sufficient discretionary funds to fulfil their growing responsibilities. As mentioned, asymmetric solutions are important to consider.

The discussion so far reinforces the importance of decentralised decision-making combined with inter-governmental co-operation as organising features of multi-level government in a globalised world. Decentralisation poses two further challenges for policy design. The first is that economic shocks will apply asymmetrically to different regions, leaving some states with difficulties in meeting their fiscal obligations. In a decentralised federation, there are various mechanisms for addressing these shocks. An important one is the fiscal equalisation system, which automatically boosts the revenues of states facing an adverse fiscal shock. The more decentralised the system, the more important is a well-functioning equalisation system. Yet there are many challenges involved in designing an effective equalisation system, including that the system is bound to operate with lags and this cannot be avoided. In addition, as local governments take on greater responsibilities, devising an equalisation system to include them becomes harder.

The second challenge for policy in a decentralised federation, in which sub-national governments rely on federal transfers to some extent, is to avoid soft-budget constraints (see Herold, 2018). There is no easy answer to this problem since in principle it involves the federal government being able to commit not to bail out a state or local government that faces a funding crisis. At best, the possibility of a soft-budget constraint can be mitigated. Decentralisation of revenue-raising responsibility is one element of this. Sub-national governments that have such discretion can be expected to respond to fiscal crises on their own at least to some extent. Fiscal councils can also be set up whose role is to enhance the transparency and sustainability of sub-national budgets. They can also help to provide early warning of fiscal problems, or of the risk of such problems.

Ideally, fiscal councils ought to encompass both federal and state government fiscal behaviour. Fiscal shocks and fiscal profligacy are sometimes difficult to distinguish. Both can lead to fiscal crises in particular states as well as imbalances between federal and state finances. Fiscal councils, like parliamentary or congressional budget offices, can forestall unexpected difficulties by recording fiscal sustainability measures for both levels of government.

1.4. Future reforms and research

The above discussion emphasises that globalisation, combined with the growing importance of information and knowledge-based technology, poses challenges for traditional structures of authority in multi-level governments. While national governments cede decision-making ability to supra-national bodies and to international and global markets, they are expected to deal with the inequality induced by globalisation and the imperative of enhancing the skills needed to thrive in a knowledge-based economy. This requires assuming greater responsibility for improving the social safety net, for educating and training citizens and for encouraging innovation. This entails federal leadership as well as co-operation with sub-national governments, given that many of these policies are best delivered by levels of government that are closer to their citizens. These strengthened federal responsibilities will come especially at the expense of state governments, which have traditionally taken responsibility for social program design and delivery and for education. At the same time, the responsibilities of local governments grow in importance as urban areas expand and densify, especially in larger urban areas. Local governments will be called upon to provide the infrastructure and social capital—possibly in collaboration with non-government institutions—to support this growth as well as to serve as hubs where innovation and human capital development is most likely to occur. Overall, this represents a fundamental shift in government responsibilities from state governments, both upwards to central governments and downward to local governments, a phenomenon referred to as "hourglass" federalism (see Allain-Dupré, 2018).

Responding to the need for re-alignment of responsibilities will be challenging. It will require a fundamental shift in state-level responsibilities from primary providers of public services to overseers of services that are delivered by local governments. States will be called upon to co-operate with both the federal government and with the localities, and possibly to act as a conduit between them. States can assume a coordinating role with local governments in the provision of infrastructure, transportation and education where spillovers are important. Similarly, the roles of local governments will be enhanced considerably, both as providers of essential services and as builders and maintainers of infrastructure.

Means will have to be found to establish mechanisms of financing local governments in ways that foster local autonomy. This will inevitably involve a role for state-local transfers that will not only provide sufficient finance to localities in a way that recognises their varying fiscal needs, but will also encourage efficient and results-based accountability (see Phillips, 2018). Moreover, care must be taken to avoid as much as possible soft-budget constraints. In principle, giving enough revenue-raising ability to local governments so that they are held responsible for any budget shortfalls would be ideal. This can include piggy-backing on state taxes. Other sources of local finance should be sought, such as revenue-sharing and fiscal transfers. In the case of infrastructure finance, private financing can be enhanced, possibly through infrastructure banks or direct access to pension funds. To the extent that localities rely on state-local transfers for their financing, measures such as fiscal rules or fiscal councils are desirable to maintain transparency and anticipate fiscal problems. In addition, such transfers should be formula-based rather than discretionary so that state governments are not tempted to pass their fiscal problems onto localities and local governments can engage in long-term planning.

These realignments of responsibilities and the imperative of responding to the joint challenges of globalisation-induced inequality and the need to compete in knowledge-based economies requires re-thinking federal decision-making structures and evaluating their performance. This suggests a forward-looking research strategy that focusses on how best to reform fiscal structures. Some combination of qualitative research and empirical analysis would be useful.

A qualitative approach would be useful to explore options for realigning fiscal responsibilities in ways that:

1. recognise the importance of the federal government role in addressing inequality, innovation and human capital investment,
2. recognise the need for local governments to have the ability to provide infrastructure and innovative hubs possibly in collaboration with non-government actors; and
3. foster appropriate levels of cooperation among levels of government and explore especially the relationship between the federal government and local governments.

Importantly, options for revenue-raising and intergovernmental transfers would be considered, as well as mechanisms for inter-governmental agreements, either bilaterally or multilaterally. What might come out of such research would be a menu of "best practices", including some that may not have been tested in practice. It will be important to recognise that one size does not fit all, and that history, diversity, political institutions and culture will influence what is right for any country or autonomous region.

It is more difficult to suggest empirical analyses. One might want to investigate the role of decentralisation to local governments and particularly local infrastructure on growth, inequality and other dimensions of inclusive growth (see OECD, 2015). One could also look at how urbanisation has influenced the design of local government finances, both revenue-raising and grants. It would also be useful to study the performance record of institutions like private-public partnerships, infrastructure banks, and fiscal councils, among others.

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2. A global view of sub-national governments in Asia: Structure and finance

by

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This chapter provides insights into the potential impact of sub-national government's involvement in achieving inclusive growth and sustainable development in the Asia-Pacific Region. Based on data collected by a pilot study entitled "Sub-national governments around the world: structure and finance", it provides a comparative analysis of sub-national government organisation, responsibilities and finances across the 16 selected countries. The preliminary findings highlight the high diversity of the sample in terms of socio-economic characteristics and institutional settings as well as the complex nature of sub-national government structure with many asymmetric situations. They also stress significant fiscal imbalances in the region. While sub-national governments are involved in the provision of a wide range of public goods, services and infrastructure, in particular for social cohesion, they have in practice very limited discretionary power over their revenues, most particularly tax revenues, confirming that fiscal decentralisation is still lagging behind in many countries of the Asia-Pacific Region. This situation delays the empowerment of sub-national governments as key actors in the developing process of their countries, in particular for inclusive growth.

2.1. Introduction

Decentralisation has been one of the most prominent public reforms around the world over the last two decades, particularly in Asian countries. It encompasses devolving a range of powers, responsibilities and resources from central government to elected sub-national governments. Engaging in a decentralisation process is grounded in theoretical premises that, under certain conditions, a varied pattern of local outputs in accordance with local tastes will be *pareto superior* to an outcome characterised by a centrally determined, uniform level of output across all jurisdictions (Oates, 2005). Decentralisation is often presented as a way to increase efficiency in public service provision, especially in remote areas, leading to a better use of public resources and effective spending, increasing equity in access and services, tailoring policies to local contexts and population preferences and needs, improving local democracy and citizen participation, and creating greater accountability and transparency, given that citizens can better monitor their elected representatives (OECD, 2017).

The recent emphasis on inclusive growth and sustainable development calls for a much deeper understanding of how decentralisation can contribute to the global development agenda and the elaboration and implementation of pro-poor urban and rural development strategies. Because sub-national governments are responsible for the delivery of basic services, investment and policies that are essential for development, the debate requires a comprehensive analysis of the organisation, powers, capacity and fiscal resources of sub-national governments to effectively contribute to inclusive growth in their respective countries.

Yet, until recently, there has been limited comparable information on sub-national governments covering a large number of countries in the world, from developing, emerging and more developed economies. While there is a significant lack of data in this area, the OECD and the United Cities and Local Governments (UCLG) have joined forces to start filling the gaps by carrying out a pilot study in 2016 that resulted in the publication of *Sub-national Governments around the World: Structure and Finance.*[1] This ground-breaking report comprises a comparative synthesis analysis and 101 country profiles - 17 federations and 84 unitary countries - covering seven main regional areas in the world and representing almost 6 billion inhabitants, i.e. 82% of the world's population and around 88% of the world's gross domestic product (GDP), from low- to high-income economies. This study was a first exploratory step towards a more ambitious initiative as it helped set up in 2017 the "World Observatory on Sub-national Government Finance and Investment", a multi-partner initiative aimed at providing reliable and comparable data and information on sub-national government organisation, responsibilities and finance for around 130 countries around the world, with a new report expected in 2019.

This chapter is based on the 2016 pilot study. Data have been extracted and analysed for 16 countries located in northern, central and south-eastern Asia in addition to New Zealand and Australia to provide a comparative analysis of sub-national government organisation, responsibilities and finances across countries of the Asia-Pacific region. This group is also compared to three other major regions – namely Europe, Africa and Latin America.

The preliminary findings of this research show that the sample of countries is very diverse in terms of socio-economic characteristics and institutional settings. The group presents a complex sub-national government structure with many asymmetric situations, both in terms of territorial organisation and responsibilities. This results from territorial and decentralisation reforms that took place in numerous Asia-Pacific countries (see the next part of this chapter, Section 3.2).

The progress of decentralisation also explains the high level of sub-national government spending on average in the Asia-Pacific region, which is however uneven across countries and restricted in terms of "real spending power". General public services, education and economic affairs/transport expenditure represent the bulk of sub-national government spending, but sub-national governments' involvement in social cohesion is quite high, varying greatly from country to country, however. Sub-national investment is particularly significant in the Asia-Pacific region, but it is driven by half of the country sample and seems to be correlated with a country's wealth (see Section 3.3 of this chapter).

On the revenue side, tax revenue is the first source of revenue on average, just before grants and subsidies, in contrast with the world average. However, this average is driven by only some countries that have a high level of tax revenues, yet mainly composed of shared taxes, with no or limited sub-national government taxing power. While Asia-Pacific sub-national governments are involved in the provision of a wide range of public goods and services, they have in practice very limited discretionary power over their revenues, most particularly tax revenues, resulting in significant fiscal imbalances in the region.

Sub-national debt is high on average, despite disparities across countries and restrictions with a higher level of bonds in the Asia-Pacific region than in Europe and at the global level (see Section 3.4 of this chapter).

2.2. Overview of the Asia-Pacific region: A highly diverse group of countries that face common decentralisation challenges

The target group of the selected 16 countries from Asia and the Pacific[2] is very diverse in terms of geography, population and economy as well as in terms of multi-level governance frameworks and sub-national government organisation. Despite this diversity, there are a number of similarities and common trends and challenges, in particular for more inclusive growth.

2.2.1. Asia-Pacific countries are socially and economically diverse

The Asia-Pacific target group represents 26% of global land area (inhabited), but with some very large countries: two (China and the Russian Federation – hereafter, Russia), accounting for 57% of the whole area of the target group (Table 2.1). These two countries are respectively the largest and the third largest countries in the world. At the opposite end, the target group comprises small countries such as Cambodia and Korea. It regroups some of the most populated countries in the world: China, India and Indonesia combined represent almost 3 billion inhabitants, i.e. 50% of the entire world population. Meanwhile, Mongolia and New Zealand have fewer than 5 million inhabitants. The target group countries are also very diverse in terms of density, with countries with very low population density (Australia, Kazakhstan) to densely populated countries such as Korea.

Table 2.1. The geographic and socio-economic diversity of selected Asia-Pacific countries

2014	Income level	Area (km²)	Population (million inhabitants)	Density (inhabitants/km²)	Urban population (% population)	GDP per capita (USD PPP)	GDP growth rate 2014 vs. 2013	HDI	HDI group	HDI global rank
Australia	High income: OECD	7 703 354	23.7	3	89.3%	45 550	2.5%	0.935	Very high	2
Cambodia	Lower middle income	181 035	15.2	85	20.7%	3 282	7.1%	0.555	Medium	143
China	Upper middle income	9 596 961	1 401.6	146	55.6%	12 855	7.3%	0.727	High	90
India	Lower middle income	3 287 263	1 295.3	394	32.7%	5 701	7.3%	0.609	Medium	130
Indonesia	Lower middle income	1 910 930	254.5	133	53.0%	10 517	5.0%	0.684	Medium	110
Japan	High income: OECD	373 530	127.1	340	93.0%	36 623	-0.1%	0.891	Very high	20
Kazakhstan	Upper middle income	2 724 900	16.6	6	53.3%	25 223	4.4%	0.788	high	56
Korea	High income: OECD	99 461	50.4	507	82.4%	33 395	3.3%	0.898	Very high	17
Kyrgyzstan	Lower middle income	199 900	5.8	29	35.7%	3 325	3.6%	0.655	Medium	120
Malaysia	Upper middle income	330 800	29.9	90	74.7%	25 639	6.0%	0.779	High	62
Mongolia	Lower middle income	1 564 120	2.9	2	72.0%	11 892	7.8%	0.727	High	90
New Zealand	High income: OECD	264 944	4.5	17	86.3%	37 477	3.0%	0.913	Very high	9
Philippines	Lower middle income	300 000	101.8	339	44.4%	6 969	6.1%	0.668	Medium	115
Russia	Upper middle income	17 098 240	143.8	8	73.9%	23 353	0.64%	0.798	High	50
Thailand	Upper middle income	513 120	67.7	132	50.4%	14 242	0.9%	0.726	High	93
Viet Nam	Lower middle income	331 041	93.4	289	33.6%	5 629	6.0%	0.666	Medium	116

Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, http://www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

The region encompasses some of the most urbanised countries in the world: in Australia and Japan, urban population represents more than 89% of the national population. By contrast, there are several countries in the target group where the rural population is dominant, such as Cambodia, India, Kyrgyzstan and Viet Nam (more than 60% of population). However, there is a rapid urbanisation in the region, which adds to the challenges for urban governments, which can be further addressed by decentralisation policies.

The region is also diverse in terms of wealth: they range from the four OECD high-income economies (Australia, Japan, Korea and New Zealand) with high GDP per capita and a "very high" human development index (HDI) to lower-middle income countries (seven countries), with low GDP per capita and a medium HDI index, such as Cambodia, India Indonesia, Kyrgyzstan, Philippines and Viet Nam. Five countries are classified as upper-middle income economies (China, Kazakhstan, Malaysia, Russia and Thailand), ranging from the 50th rank (Russia) to the 93rd rank in terms of HDI. Seven countries had a very high growth rate in 2014 vs. 2013, above 6% (Cambodia, China, India, Malaysia, Mongolia, Philippines, Viet Nam), while the four OECD countries, Russia and Thailand had the lowest growth rates, particularly Japan, Russia and Thailand (below 1%) .

2.2.2. Sub-national government structures are very diverse across and within countries

The country sample also provides an interesting case for studying the diversity in terms of multi-level governance frameworks and sub-national government structure. Among the 16 countries, 4 are federal - namely Australia, India, Malaysia and Russia - while the remaining 12 countries are unitary states (Table 2.2). Nonetheless, this categorisation often does not hold when one considers the degree of sub-national involvement in public provisions or revenue collection. By most decentralisation-related measurements, unitary countries like China or Indonesia may appear far more decentralised than Malaysia.

Table 2.2. State and sub-national government organisation within selected Asia-Pacific countries

2013-14	Country	Form of the state	Number of municipalities	Number of intermediate governments	Number of regions	Total number of sub-national governments
Three-tiered sub-national government countries	Cambodia	Unitary	1 621	185	24	1 830
	China	Unitary	2 852	334	31	3 217
	Kazakhstan	Unitary	2 445	215	16	2 676
	Kyrgyzstan	Unitary	459	63	9	531
	Mongolia	Unitary	1 744	339	22	2 105
	Philippines	Unitary	42 028	1 594	81	43 703
	Russia	Federal	20 055	2 351	83	22 489
	Thailand	Unitary	2 232	209	76	2 517
	Viet Nam	Unitary	11 145	700	64	11 909
Two-tiered sub-national government countries	Australia	Federal	571		8	579
	India	Federal	250 671		35	250 705
	Indonesia	Unitary	508		34	542
	Japan	Unitary	1 741		47	1 788
	Korea	Unitary	228		17	245
	Malaysia	Federal	149		13	162
	New Zealand	Unitary	67		11	78
Total			338 516	5 990	571	345 076

Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, http://www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

Overall, there are around 345 000 sub-national governments in the target group belonging to the municipal, intermediate and regional levels. In comparison to other regions (Africa, Europe and Latin America), the Asia-Pacific region has the largest number of sub-national governments: Europe counts around 92 000 sub-national governments, Latin America 15 000 and Africa nearly 9 000.

These numbers should be interpreted with caution, however, as India alone counts around 250 700 sub-national governments, i.e. almost three-quarters of the target group total. In fact, India has a singular structure, as sub-national governments include around 250 000 villages and small towns (*panchayat*), which are the cornerstone of local self-government in the country.

The country sample comprises around 571 state governments (in federal countries) and regions, 5 990 intermediate governments and around 338 500 municipal-level authorities. In several Asia-Pacific countries, there is also, below the municipal level, an additional level of entities set up by municipalities for administrative and representation purposes. In general, these sub-municipal localities (civil parishes, villages, wards, community boards, settlements, etc.) are not autonomous or self-governing (except the *panchayat* in India or the *barangays* in the Philippines), as they depend on the "mother" municipality, even if they can be managed by elected representatives and have delegated budget and staff. The situation of these villages can, however, evolve, such as in Indonesia where the new Village Law will now consider villages as self-governing entities.

The majority of countries in the sample (9 out of 16) have a three-tiered structure of sub-national governments, made of regions, municipalities and an intermediate level between them. The others have a two-tiered structure with municipal-level entities and regional governments. There is no country with only one level, unlike among OECD countries, which count eight single-tiered countries. While in the OECD, most federations have three sub-national layers, it is not the case in the Asia-Pacific region, as only Russia has three layers (depending however on the regions, as some have only one tier of local government).

Behind this apparent, clear structure, the reality of the sub-national government system is far more complex in the Asia-Pacific region. This complexity seems to be higher than in Europe or Latin America, where there is more uniformity. It reflects the great diversity of countries in terms of geography, ethnic and linguistic make-up, socio-economic characteristics, and historical trajectories as well as different socio-political paths. Some are former colonies, which have integrated, to a greater or lesser extent, part of their colonial legacy into their current institutional structure – be it French, British or Dutch. Others have retained pieces of more recent dominant political or ideological movements such as the Marxist-Leninist ideology of the former Soviet Union and China and Viet Nam socialist models.

In some countries, we can find four or even five sub-national government levels, such as in China. Countries frequently have a differentiated organisation within the same sub-national level, which may comprise several sub-categories. This often results in asymmetric decentralisation, when these sub-categories do not have the same assignment of responsibilities and revenues (see below). Regions may have different self-governing status, some being more autonomous than others and having a special status (Malaysia, Russia). Some large municipalities may also have the status of an intermediate government or even of a regional government, e.g. cities of regional or republican significance or capital cities (Cambodia, Kazakhstan, Korea, Mongolia, Thailand or Viet Nam, etc.). In Japan, the municipalities are also not uniform, being subdivided into 20 designated cities, 42 core cities, 40 special cities, and 688 other cities. Korea has a composite municipal structure, including cities, counties (mostly rural) and autonomous districts, which are further divided into sub-municipal localities. In some countries, there are also significant differences between urban and rural areas (in structure, powers and capacities). In India, for example, urban areas can be organised in a single tier (urban councils), while the *panchayat* system in rural areas may have three tiers, depending on the population of the states.

To add to this complexity, some Asian countries have a dual or "mixed" system of a deconcentrated local administration, representing the central government on one side, and local autonomous self-governments on the other side, such as in Thailand (before the military coup in 2014, as local elections have been suspended since), Cambodia, Kazakhstan or Kyrgyzstan, which inherited this mixed political-administrative system from its Soviet past. In some cases, the same entity has an executive body appointed by the central government and a deliberative body (councils) elected by the population.

Malaysia is a singular case: it has a federal structure that would suggest substantial decentralisation. In practice, however, the autonomy of sub-national tiers has been systematically undermined through a range of mechanisms, creating a system that is highly centralised in practice. States and at local level, local councillors and mayors are appointed by state governments since the suspension of local elections in 1965 (Ostwald, 2017).

This diversity of institutional settings within the same country allows for some degree of differentiation and adaptation according to local characteristics and needs (geographic, ethnic, linguistic, historical, urban/rural), which is quite positive. However, this situation of "puzzle" or "patchwork" can also result in a complex sub-national system with an unclear definition of responsibilities across layers and risks of overlap in public service provision.

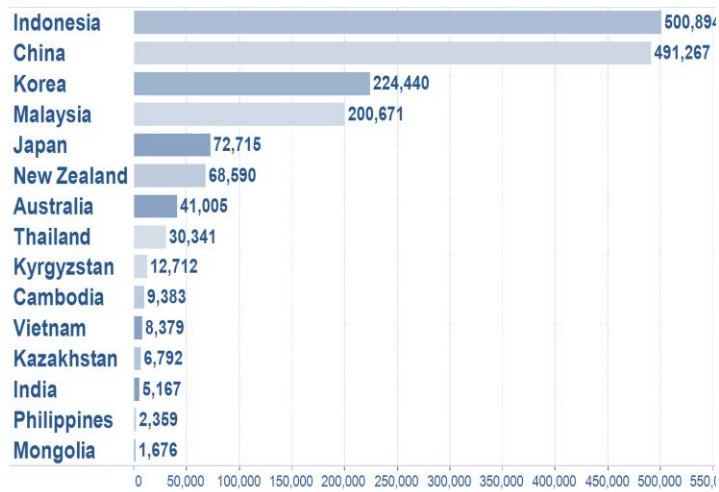
The target group has the largest average municipal size across all four regions, Africa ranking second and Europe last with an average municipal size four times smaller. At the global level, the average municipal size is around 56 000 inhabitants (Figure 2.1). Although this type of average remains quite theoretical, especially in Asia given the high diversity of municipal organisation within the same country and huge disparities across countries, it reflects a certain reality.

Asia-Pacific countries range from having a highly fragmented municipal landscape with fewer than 2 000 inhabitants (Mongolia) to highly populated municipalities with over 400 000 inhabitants, as in the case of Indonesia and China (Figure 2.2). There are permanent territorial reforms at the municipal level in the different countries that aim to find the right scale. In fact, the issue of municipal size matters because it affects the ability of local governments to reap the benefits of scale economies in service provision. It appears however that there are some diverging trends in the Asia-Pacific region: in Australia, Japan, Korea and New Zealand, the trend is towards the reduction of the number of municipalities through amalgamation policies. In Japan, several waves of mergers (Great Shōwa from 1953 to 1999, Great Heisi consolidation, new "Basic Policy for Promoting Municipal Mergers" since 2006) have drastically reduced the number of municipalities, from 9 868 in 1953 to 1 718 today. In Mongolia, a development programme has been introduced to reduce municipal fragmentation. In some other countries, the trend seems to be the reverse, for example through the recognition of villages as self-governments with more autonomous powers like in Indonesia (Village Law), Russia (from 12 000 in 2005 to more than 20 000 municipalities today), a process which is also ongoing in Kazakhstan (2013 Law).

Figure 2.1. Average municipal size by geographical area (number of inhabitants)

Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

Figure 2.2. Average municipal size by country (number of inhabitants)



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

2.2.3. Decentralisation has become a primary goal of reform agendas in the Asia-Pacific region

In recent years, Asia-Pacific countries have been particularly active in the design and implementation of multi-level governance reforms to enhance the degree of decentralisation and empower lower-tier governments (Table 2.3). Before 1990, most Asian countries were highly centralised, for example, and decentralisation reforms only gained significant momentum in the 1990s (Smoke, 2015; World Bank, 2005).

Table 2.3. Multi-level governance reforms and decentralisation processes in selected Asia-Pacific countries

	Past and recent reforms
Cambodia	• Following political turmoil in 2001, the country launched a decentralisation process through the law on Commune Administrative Management and Elections (establishment of elected commune councils, with political autonomy and an independent budget). • In 2008, a new decentralisation process was launched, based on the 2005 "Strategic Framework for Decentralization and Deconcentration Reforms". It was supervised by the National Committee for Democratic Development of Sub-national Administrations (NCDD): establishment of elected councils at provincial and district level and transfer of new powers (2008 Law on Administrative Management of the Capital, Provinces, Municipalities, Districts and Khans). However, higher levels are indirectly elected, and they remain under central government scope (the budget was still integrated within state budget). • Adoption in 2010 of the National Program for Sub-National Democratic Development (NP-SNDD), a comprehensive local governance reform agenda for ten years (2010-19), to be developed in three stages.
Indonesia	• Foundation for decentralisation was established through several laws adopted in 1999 (basic institutional and administrative provisions, fiscal framework), amended in 2004 (establishment of district and provincial

	Past and recent reforms
	autonomy - no longer subordinate to provinces) and 2009 (fiscal revenues allocated to sub-national governments). In 2014, a new Local Government Law was adopted to rearrange decentralisation for a more effective public sector. The 2014 Village Law granted autonomy to over 83 000 villages.The 2014 Village Law granted autonomy to over 83 000 villages.
Japan	• Decentralisation was carried out step by step, supported by a Decentralisation Promotion Committee set up in July 1995. • The first "Decentralisation Promotion Reform" (1995) led to the adoption of the Omnibus Decentralisation law in 2000. • This law was followed by the Trinity Reform in 2004-06, which laid out the fiscal decentralisation component. • The Second Decentralisation Promotion Reform started in 2006: new sets of recommendations led to the adoption of a new set of bills, in 2011 and 2012. • Further decentralisation reforms are still on the agenda. In parallel, reform of the prefectural level and the creation of a *Doshusei* Regional System were considered, but have not been implemented yet.
Kazakhstan	• The 2001 Law on Local Public Administration and Self-Government established a complex sub-national government system and defined the general division of responsibilities across levels of government. • The 2012 Concept for Development of Local Self-Government and "Strategy Kazakhstan-2050" consider decentralisation reform to be a high priority. • A 2013 law, amending the 2001 law, increased decentralisation, with the election of local akims through indirect suffrage by local level councils and the expansion of local financial and economic independence. Direct election by citizens is planned instead at some point in the future, and a new division of powers and responsibilities between the central government and sub-national governments is currently being developed.
Korea	• Decentralisation started in 1987 with the "Declaration for Democratisation" and gained momentum in 1988 with the reform of the Local Autonomy Act, the Local Finance Act and the first local elections (1991 for local councillors; 1995 for the chief executives of local governments). • Decentralisation continued with a vast public sector reform, implemented in 1999 and with the 2004 Special Act on the Promotion of Decentralisation. • Fiscal tax reform was implemented in 2011, in order to simplify the local tax mix. • New decentralisation process launched in 2017 by the Moo Jae-In administration.
Kyrgyzstan	• The 1991 Law of Local Government in the Kyrgyz Republic was one of the first laws adopted after the country gained its independence in 1991, laying grounds for the decentralisation process. • Several decentralisation reforms have been adopted since in a piecemeal approach. A national strategy on "Decentralisation of State Government and Development of Local Self-Governance in the Kyrgyz Republic until 2010" was adopted in 2002. • In 2008, the new Law on Local Self-Government and Local State Administration devolved a list of 23 competences of local importance covering all public utilities and local administration. • The new Constitution (2010) and the National Sustainable Development Strategy for the Kyrgyz Republic 2013-2017 aim at improving the decentralisation framework.
Malaysia	• Malaysia has been a federation for decades (Federation of Malaya in 1948), and achieved independence on 31 August 1957, adopting a federal constitution. • Local government elections were discontinued in 1965 and suspension became permanent in 1976, when the Parliament passed the Local Government Act, which provided for appointed councillors and mayors by state governments. • Local council elections might be implemented within three years, according to a declaration of the Housing and Local Government Minister in 2018.
Mongolia	• The decentralisation process launched after the political system changeover of 1990: the 1992 Constitution and the Law on Administrative and Territorial Units Governance (LATUG) established local self-governing bodies and territorial administrative units. • Until 2002, a significant decentralisation process of most social services was underway, but a process of recentralisation took place with the 2002 Public Sector Finance and Management Law (PSFML), which retransferred functions to line ministries.

	Past and recent reforms
	• A new trend towards decentralisation emerged in 2011 with the New Budget Law, which created the Local Development Fund and introduced requirements for citizens' participation in decision making on the use of the Fund (effective from 2013).
New Zealand	• Local government reforms are strongly influenced by the New Public Management movement. • The Local Government Act 2002 redefined sub-national government responsibilities and increased their autonomy regarding the activities they undertake, by providing them with a general power of competence. • This 2002 Act was amended in 2010 and 2014, in line with the Better Local Government New Zealand reform with the aim, among others, to clarify responsibilities between regional councils and territorial authorities. The Local Government (Financial Reporting and Prudence) Regulations 2014 introduced new benchmarks and indicators for financial management.
Philippines	• The 1987 Constitution established decentralisation, local autonomy and popular participation. • The 1991 Local Government Code set up legal and regulatory provisions for the local governments' operating framework. • In 2018, the consultative committee (Con-Com) was created to revise the 1987 Constitution and set up a federal system. It is proposed to establish 17 federated regions and the National Capital Region.
Thailand	• Decentralisation is enshrined in the Constitution since 1997, which resulted in a significant move towards decentralisation, based on a Decentralisation Plan and Process Act. • The 2007 Constitution reaffirmed the key principles of decentralisation, guaranteeing local autonomy and setting out strict delineation of responsibilities and tax revenues between central and local governments and among local authorities. • The Coup d'Etat in 2014 suspended local elections. • A new constitution was issued on 6 April 2017.

Source: OECD (2017), *Multi-level Governance Reforms: Overview of OECD Country Experiences*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264272866-en; OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm; Smoke, P. (2015), "Quality Support Facilities in the Field of Decentralisation, Local Governance and Local Development: Overview of the Asia Decentralisation Case Studies".

Structural economic and demographic transformations are often regarded as some of the common dynamics and main catalysts of decentralisation reforms in the region. In East-Asian countries more particularly, decentralisation reforms seem to have been preceded by significant and continuous periods of economic growth and urbanisation (World Bank, 2005), but also by an economic crisis, such as the 1997 Asian Financial Crisis (World Bank, 2005). Improving economic competitiveness and responding to globalisation challenges thanks to the adoption of new public management models, oriented towards more efficiency of public policies and service delivery, are considered as the main drivers of decentralisation in countries such as India, Indonesia, Japan, Korea, Thailand, as well as China (Shin, 2016). Achieving more democratic political outcomes has also been a strong incentive for decentralisation in several countries such as India, Indonesia, Korea, the Philippines and Thailand, with pro-democratic movements and popular mobilisation rejecting centralised autocratic governments and dictatorships. Finally, decentralisation was also a way to address ethnic and religious conflicts as well as preserving historical, linguistic, and cultural specificities (e.g. Cambodia, Indonesia and the Philippines). Granting local autonomy to regional and local governments may prevent the disintegration of the "nation-state" and ensure more political stability. In Japan, among the rationales behind the 1995 decentralisation reform were also regional development and spatial planning considerations (decentralisation was viewed as a way to correct the excessive concentration in Tokyo) as well as a way to address the consequences of its ageing population (OECD, 2017). Finally, the strong support of the international community has played a crucial role in pushing decentralisation forward in several Asia-Pacific countries.

Yet, many countries have approached decentralisation in many different ways. While remaining unitary, Indonesia and the Philippines have empowered their local tiers through recent reforms. Mongolia and Thailand, on the other hand, have experienced a back and forth between decentralising and recentralising their countries. While there exists an incomplete policy framework for decentralisation in China, the transition of the country to the market economy contributed to empowering local authorities and making them key stakeholders in the development process and the provision of local public services.

In most Asia-Pacific countries, decentralisation is now anchored in the constitution, with parallel or subsequent legal provisions. Some of these legal provisions date back to the 1950s or earlier, but they have been revised and amended over the years, granting less or more power to sub-national authorities.

Despite the constitutional, subsequent or adjacent legal mandates, decentralisation reform remains fragmentary and incomplete. While these mandates delineate the resources and responsibilities of each government tier, a consistent trend with regard to overlapping of responsibilities across layers of government exists. In some cases, the legal provisions may have been either not implemented or have resulted in policy inconsistencies that prevent sub-national governments from effectively carrying out their responsibilities. In addition, fiscal decentralisation has not always accompanied political and administrative decentralisation, resulting in under- or un-funded mandates as well as a limited autonomy of sub-national governments to raise and manage their own revenues. Most sub-national governments of the Asia-Pacific region are highly constrained by federal or central control over financial resources as well as over human resources.

While some past decentralisation reforms may have been more successful than others, the pattern shows that decentralisation is still part of the national debate and public administration reforms. Many countries continue to implement institutional changes with the aim of strengthening the institutional setting in support of sub-national governments, better delineating the competencies across government layers (with more or less success) or expanding fiscal decentralisation in order to increase sub-national fiscal autonomy and improve sub-national government financing (e.g. the 2011 Law in Kazakhstan, the 2007 Constitution of Thailand, the 2010 National Program for Sub-National Democratic Development in Cambodia, although it has not been fully implemented). The Philippines are currently in the process of switching to a federal system of government, viewed as a remedy to counterbalance the concentration of power and resources in Manila that has left provinces in poverty.

2.2.4. Assignment of responsibilities varies across and within countries, resulting in asymmetric decentralisation

The assignment of responsibilities across levels of government varies greatly across countries, depending on the degree of decentralisation. It may also vary within countries for the same category of sub-national governments, resulting in asymmetric decentralisation.

In federal countries, this situation is quite common as asymmetric arrangements between federated states can be the very essence of the federal system (but not always, as some federations tend to favour symmetry, e.g. Austria or Switzerland). It is particularly the case in Asia where asymmetric federalism is a means to maintain diversity together with unity. India, Malaysia and Russia are highly asymmetrical, while Australia has some forms of regional asymmetry. Russia, for example, is divided into 83 regions ("subjects of the federation") with various degrees of autonomy. In India, the division of powers between sub-states is not symmetric: the Indian Constitution makes special provisions for nine states. In Malaysia, Sabah and Sarawak, which became part of the federation in 1963, has since retained a higher degree of autonomy than the other 11 states.

In addition, asymmetric arrangements within sub-states are a near universal rule as local governments are governed by the state constitution and/or legislation. In Russia, India, Australia and Malaysia (to a lesser extent, however), state governments set their own municipal regulations provided that they are compatible with federal regulations. Therefore, deriving from a state-level structure, local governments' status, powers, responsibilities and funding mechanisms often vary from one state to another.

In India, each state has its own local government legislation, devolving functions to the local level with wide variation, and in many cases, Indian municipalities have few expenditure assignments, often limited to the provision of basic public services. However, the 73rd and 74th amendments of the Indian Constitution adopted in 1992 ensure recognition and protection to local government and provide a basis for the state legislatures to guide the state governments in the assignment of municipal responsibilities and governance, pushing for greater functional responsibilities at the municipal level.

In Malaysia, the situation is more "mixed" in terms of asymmetry: on the one hand, local governments are under the purview of the state governments (and appointed by them since the suspension of local elections in 1965). On the other hand, the constitution of Malaysia and federal legislation (e.g. Local Government Act 1976 for Peninsular Malaysia) make provisions for all Malaysian local governments. In addition, the Federal Ministry of Housing and Local Government and the Ministry of Federal Territory and Urban Well-Being plays a role in co-ordinating and standardising the practices of local governments across the country.

In the Asia-Pacific region, asymmetric arrangements are not only for federations; they are also widespread in unitary countries, reflecting the diversity in terms of territorial organisation (see above). Autonomous regions, capital cities, cities with special status, and other specific categories of local governments may have different responsibilities, revenue assignments or special rights (e.g. to borrow) than those of "ordinary" status. In Thailand, for example, the three types of municipalities (i.e. sub-district municipality, town municipality and city municipality) have different responsibilities. In addition, they may also exercise differentiated tasks within the same sub-type, e.g. "Must-Do" and "May-Do" duties. In New Zealand, functions of the 67 "territorial authorities" (city, district and unitary councils) are approved through consultation with their communities, therefore differing from one council to another. In Japan, the 20 designated cities and the 23 Metropolitan Tokyo special wards enjoy more administrative and fiscal autonomy than the other municipalities.

The assignment of responsibilities across levels of government is generally defined in the constitution and/or in local government legislation. While these regulations might be clear on paper, the reality is somewhat different, in particular in the Asia-Pacific region, where there is a frequent overlap in responsibilities, both vertically (between central/federal and sub-national governments) and horizontally (within the different sub-national layers). This results from shared competencies as well as a complex system of delegation, as in several countries such as China or Viet Nam, local governments may be delegated additional responsibilities by higher levels of government.

There are several examples of an unclear breakdown of responsibilities, both in federal and unitary countries. In Australia, the 2008 Intergovernmental Agreement on Federal

Financial Relations (IGAFFR) attempted to better specify responsibilities between the federal government and the states, but there is significant overlap in mandates. In Russia, there is a prevalence of shared competencies, rather than a clear delineation of tasks. In Malaysia, there is a federal list of competences, a state list and a concurrent list as well as vertically shared responsibilities between states and municipalities.

In unitary countries, cases of overlapping competences and redundancies are also common. In Korea, the functions of local governments are not clearly defined by the Local Autonomy Act, which only makes the distinction between functions delegated by the central government and those that are local by nature. There is a large degree of overlap in the division of responsibilities, as the regional and local levels have the same functions, but at different scales, and the central government can use its own power and control over any function. In Japan, there is also no clear-cut delineation of tasks between the responsibilities of prefectures and municipalities. In Kyrgyzstan, the 2008 Law on Local Self-Government and Local State administration defined a list of 23 competences to be decentralised at local government, but despite this effort, it did not provide a clear definition of functions, nor a clear vertical and horizontal division of responsibilities. In the Philippines, despite the specifications included in the 1991 Local Government Code, responsibilities of provinces, cities, municipalities and *barangays* tend to intersect, a situation that is exacerbated by the existence of various other public agencies that provide public services and carry out public works at the local level.

China is often regarded as a special case, not just because of the size of its population or land area, but also because the delegation of responsibilities and power came mainly through economic reforms and not necessarily through a legal provision that clearly defines the functions of each level of local government. The 1979 Organic Law of the Local People's Congresses and the Local People's Governments of the People's Republic of China do not define precise functional responsibilities that sub-national governments are expected to fulfil. The legal framework only refers to general functions and powers of the local people's congresses and governments. However, there is no mention of the specific areas for which each level has competence. In addition to being unclear, responsibilities are uneven and can differ according to the province, upon which the municipal governments depends, as the delegation of responsibilities to sub-national governments is by administrative fiat from the central and provincial executives (OECD, 2015).

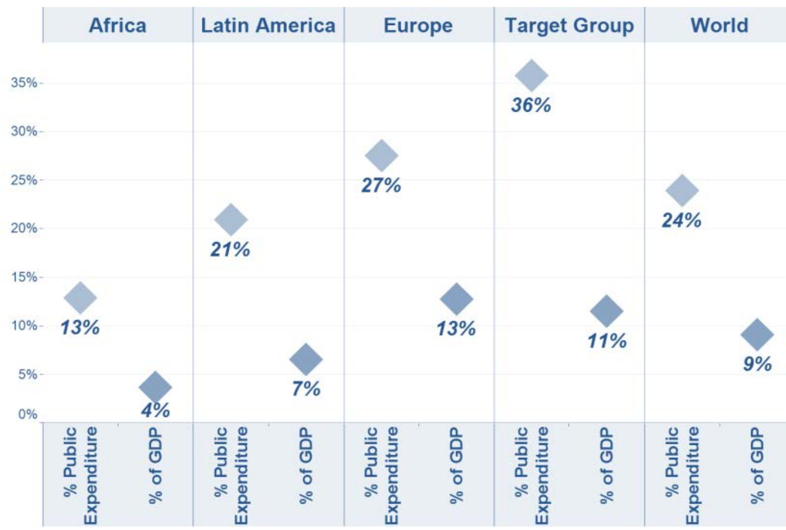
2.3. Sub-national governments are key social and economic actors in the Asia-Pacific region

Sub-national governments are key economic and social actors in numerous countries of the Asia-Pacific region. Federalism and significant decentralisation processes result in a high level of sub-national government spending on average. It is, however, necessary to put this into perspective, as the importance of sub-national spending is uneven across countries and tends to be often overestimated: in a number of countries, spending is frequently "deconcentrated" or "delegated" and not really "decentralised". However, sub-national governments are particularly involved in key areas, especially in those areas related to social cohesion, while they are key investors, albeit to a varying degree.

2.3.1. Asia-Pacific sub-national spending is significant on average, but uneven across countries and in terms of decision-making authority

Sub-national government expenditure accounts for more than 11% of GDP on average, a ratio that is slightly lower than in Europe, but higher than in Africa, Latin America and at the global level. As a share of public expenditure, it accounts for 36% in the Asia-Pacific region, i.e. the highest ratio in all four geographical areas (Figure 2.3).

Figure 2.3. Sub-national government expenditure as a percentage of GDP and public expenditure by geographical area

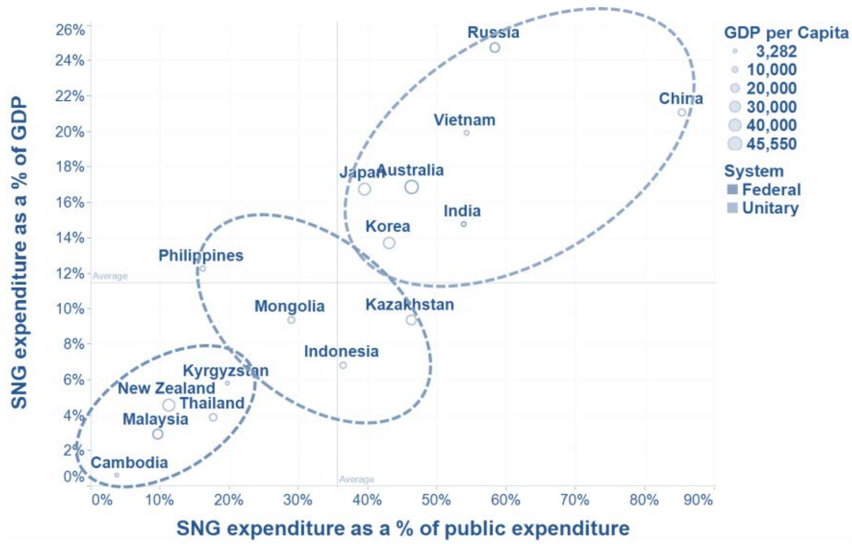


Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, http://www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

These high levels are explained by the fact that many countries of the region have undertaken a decentralisation process over the last decades, devolving new powers and spending responsibilities to sub-national governments in many critical areas, including for inclusive growth (see above).

The average, however, hides wide disparities across countries (Figure 2.4). China, Russia, Viet Nam, India, Australia, on the extreme position at the top right of the figure are driving the high average of the region.

Figure 2.4. Sub-national government expenditure as a percentage of GDP and public expenditure by country



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

Three of these countries are federal (Russia, India and Australia). Their high level of spending results from the fact that the calculation combines spending by the federated states with spending by the local public sector. Malaysia, despite being a federation, is strongly centralised, with a limited role for its states and local governments, whose expenditure accounted for 3% of GDP and 7% of public expenditure (to be compared to 18% of GDP and 48% of public expenditure on average at the global level). Australia and India are two federations where the power and responsibilities of states are significantly higher than the lower government level. State governments represent a significantly larger share of sub-national spending compared to that of local governments. In Australia, local governments have fewer cost-intensive responsibilities than in most other OECD country federations, handling community needs and providing property-related services such as waste collection, road maintenance, street cleaning and lighting, stormwater drainage and flood control, recreation and cultural facilities and town planning (depending on the state/territory). Local government expenditure accounted for only 2% of GDP and 6% of public expenditure in 2014, well below that of states (respectively, 17% and 40% for the states alone).

Several unitary states, in particular, China, Viet Nam, Japan and Korea, also have a high level of sub-national government spending. China has the highest ratio globally, sub-national spending representing 86% of public spending and 25% of GDP.

The situation of certain countries confirms that high spending ratios do not necessarily reflect a high degree of spending power. In many cases, sub-national expenditure can be just "delegated" or "deconcentrated" by the centre to the sub-national governments, rather than being "decentralised". In fact, the assignment of responsibilities to sub-national governments does not mean that they have full autonomy and decision-making authority in exercising them and regarding the choice of how and where expenses are allocated. They may simply act as a "paying agent" or "agencies", carrying out a centrally defined spending agenda with little or no decision-making power or room for manoeuvre. It is often the case when sub-national governments are in charge of paying teachers or health staff wages or social benefits on behalf of central government, without control of their development (OECD/UCLG, 2016).

This reality can be observed world wide and is not specific to the Asia-Pacific region. However, countries in the region that have a very high level of sub-national spending are particularly representative of this "magnifying effect", which can distort the reality of spending autonomy. China and Viet Nam, where most public goods are provided by lower-tier governments on behalf of the central government, are a good example, although not the only ones. In fact, in these countries, there is no real distinction between central and sub-national levels, as the latter is part of the national governmental system.

At the opposite end of the spectrum, a group of countries stands out with regard to the limited role of local governments in public spending, especially Cambodia, Thailand, New Zealand and Kyrgyzstan. The low level of local expenditure in Cambodia is explained by the fact that the country is historically centralised and that the decentralisation process is still in its infancy (elected communal councils since 2002 having few functions and resources); and provinces, municipalities and districts having (indirectly) elected councils since 2008, but are still integrated in the state budget and largely under central ministries (with the recent transfer of responsibilities not being fully implemented).

Between the two groups, we find Indonesia, Mongolia, Kazakhstan and the Philippines with spending ratios relatively high compared to the world average, between 20% and 50% of public expenditure and between 7% and 12% of GDP. Indonesia, for example, is one of the most decentralised unitary countries in the region. In 1999, provinces and municipalities gained responsibility for the provision of a wide range of public goods and service in healthcare, education, cultural and social affairs, labour, environment protection, land use, citizenship and investment.

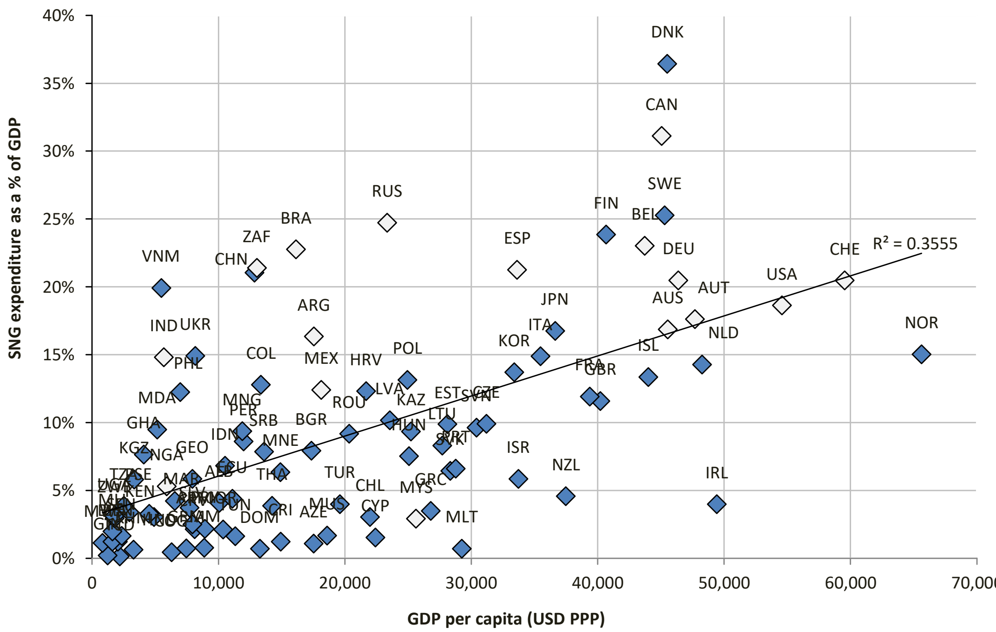
Beyond national averages, it is also worth noting that there can be significant disparities within countries across sub-national governments. Some regions or cities may concentrate most of the sub-national spending: for example, in Mongolia, the capital city accounts for 75% of all sub-national expenditure.

2.3.2. Spending and income ratios are not correlated in the Asia-Pacific region

The OECD-UCLG 2016 study indicates a positive correlation between sub-national expenditure as a percentage of GDP and GDP per capita (Figure 2.5), suggesting that wealthier countries tend to be more decentralised and implying, by contrast, that centralised countries tend to be less wealthy. Of course, correlation does not imply causation, and therefore, it is not possible to say if decentralisation raises income per capita or if it is income per capita that tends to favour decentralisation.

It is interesting to note that for the Asia-Pacific group, the correlation does not hold: the link between GDP per capita and the level of sub-national spending is not verified. This confirms that, beyond the income level, there are many other geographic, socio-economic, historical and institutional factors that explain why a country is centralised or decentralised or why a country is wealthy or not. In the case of the Asia-Pacific group, this absence of correlation suggests that sub-national government involvement in the economic and social development might rather be the function of regulations and policy-decision making rather than the level of country's GDP per capita.

Figure 2.5. Sub-national government expenditure as a percentage of GDP compared to GDP per capita

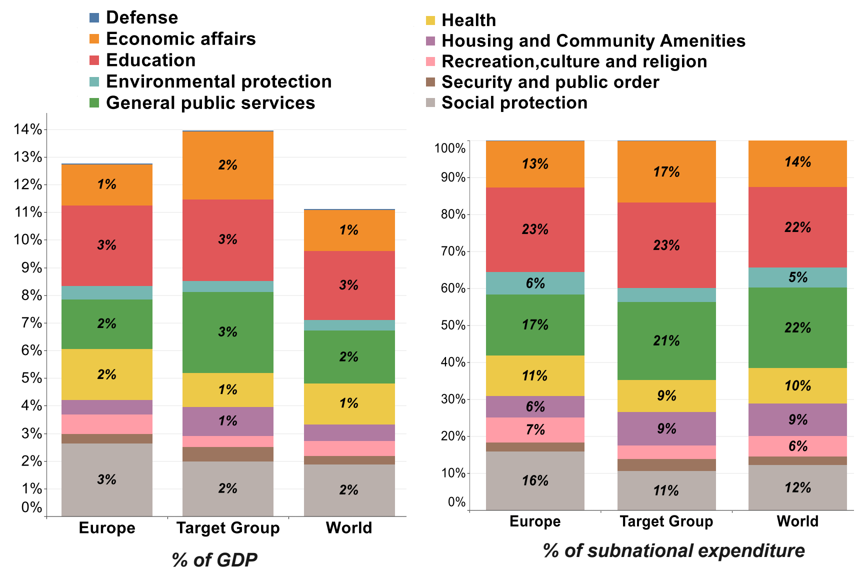


Note: Federal countries are shown as white diamonds, while unitary countries are shown in blue.
Source: OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

2.3.3. Administration, education and economic affairs/transport are the three priority spending areas

General public services (administrative expenditure), education and economic affairs/transport represent the bulk of sub-national spending as a percentage of GDP in the Asia-Pacific region (near 9% of GDP based in a sample of 10 countries). These areas are then followed by social protection expenditure, health, housing and community amenities (which include potable water). The weight of housing and community amenities in GDP is more significant in the Asia-Pacific region than in Europe and at the global level (Figure 2.6). As a share in total sub-national spending, the same three priority sectors (general public services, education and economic affairs/transport) stand out, but education spending comes in at first place, representing 23% of sub-national spending on average. All together, these three sectors represent more than 60% of sub-national expenditure. In Europe, the three priority items are education, general public services and social protection.

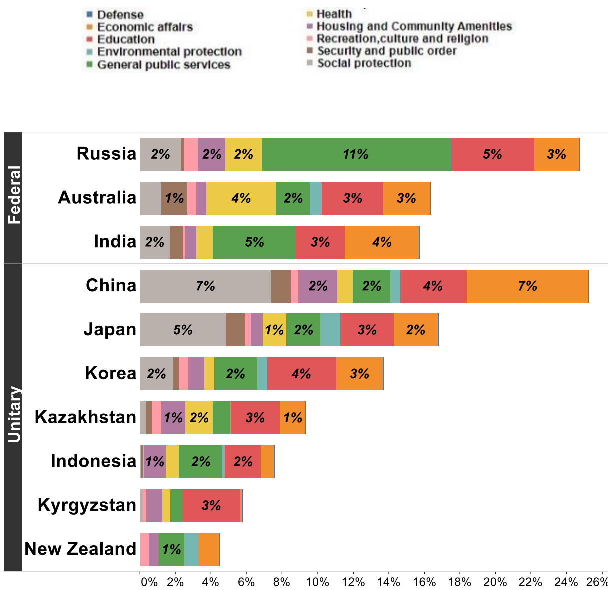
Figure 2.6. Sub-national government expenditure by economic function and by geographical area as a percentage of GDP and percentage of sub-national expenditure



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

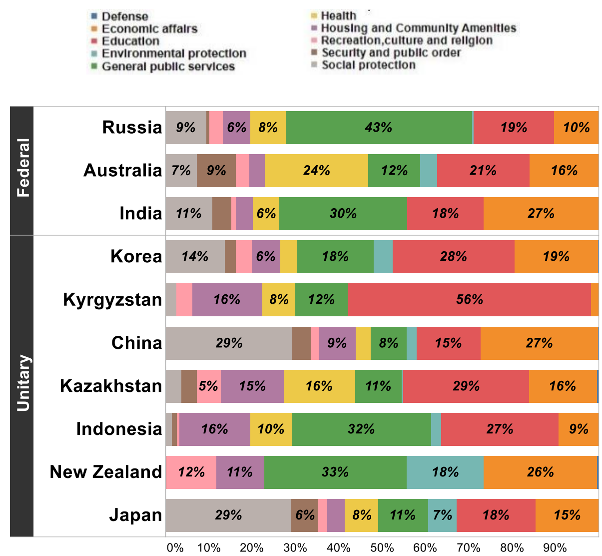
Data by country show that only a few countries in the region influence the averages significantly. As a share of GDP, the general public services spending average is driven almost entirely by Russia; that of education is driven by Russia but also by China, Korea, Australia and Kyrgyzstan and that of economic affairs/transport is driven by China and India (Figure 2.7). It is interesting to note that most countries in the Asia-Pacific region have a low ratio of social protection spending at the sub-national level, with the exception of China and Japan.

Figure 2.7. Breakdown of sub-national expenditure by economic function as a percentage of GDP by country



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, http://www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

Figure 2.8. Breakdown of sub-national expenditure by economic function as a percentage of sub-national expenditure

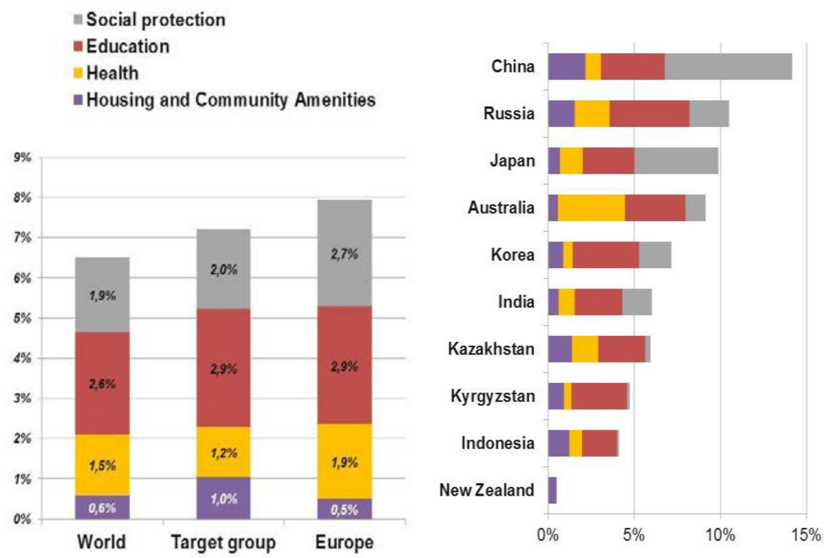


Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, http://www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

Looking at the share of total public expenditure, other findings emerge (Figure 2.8). Expenditure related to general public services dominate in Russia, India, Indonesia and New Zealand. Education represents a substantial proportion of expenditure in Kyrgyzstan, Kazakhstan, Korea and Indonesia. Spending on economic affairs/transport has a significant share in a number of countries, but especially China, India and New Zealand. Social protection spending is the highest in China, followed by Japan. Health is the primary budgetary item in Australia, amounting to 24%, the highest share across all the countries, while housing and community amenities are particularly significant in Indonesia and Kazakhstan. Finally, it is interesting to note that environment (sewerage, waste collection and treatment, protection of green areas, etc.) does not appear to figure among the spending priorities of sub-national governments in the region, with the exception of Japan, Korea and especially New Zealand, which are all OECD countries.

Looking more closely at expenditure related to inclusive growth, COFOG (Classification of the functions of government) data suggest a relatively significant involvement of Asia-Pacific sub-national governments in social cohesion. The fours sectors that can be linked to “social cohesion”, i.e. education, health, housing/community amenities and social protection, amount to 7.2% of GDP, less than in Europe, but higher than the global level (Figure 2.9). However, as already stressed, the analysis by country shows that only some countries (China, Russia, Japan and Australia) tend to spend most on social inclusion spending.

Figure 2.9. Sub-national expenditure for social cohesion in the Asia-Pacific region (percentage of GDP)

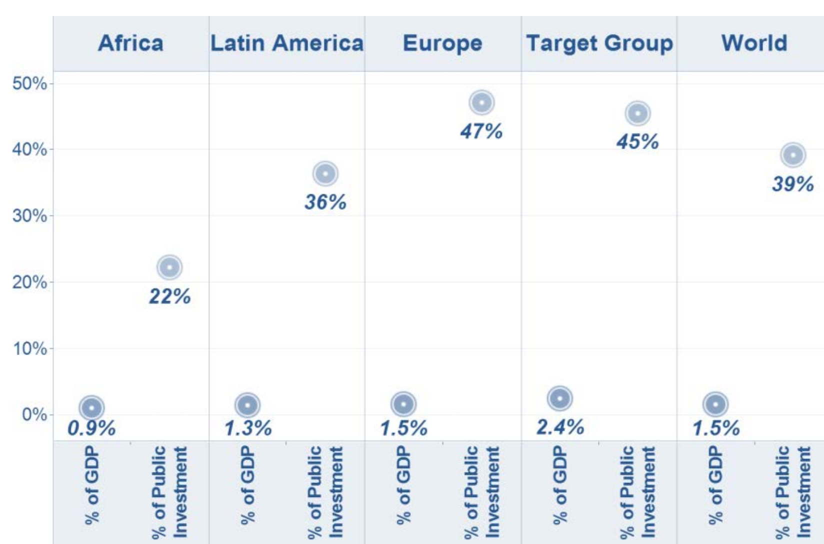


Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

2.3.4. Asia-Pacific sub-national governments are key public investors

Sub-national governments in the Asia-Pacific region represent 45% of total public investment, i.e. the second largest ratio after Europe, and well above Latin America (Figure 2.10). Their investments represent 2.4% of GDP on average, the largest ratio in the world, far ahead of European and world averages.

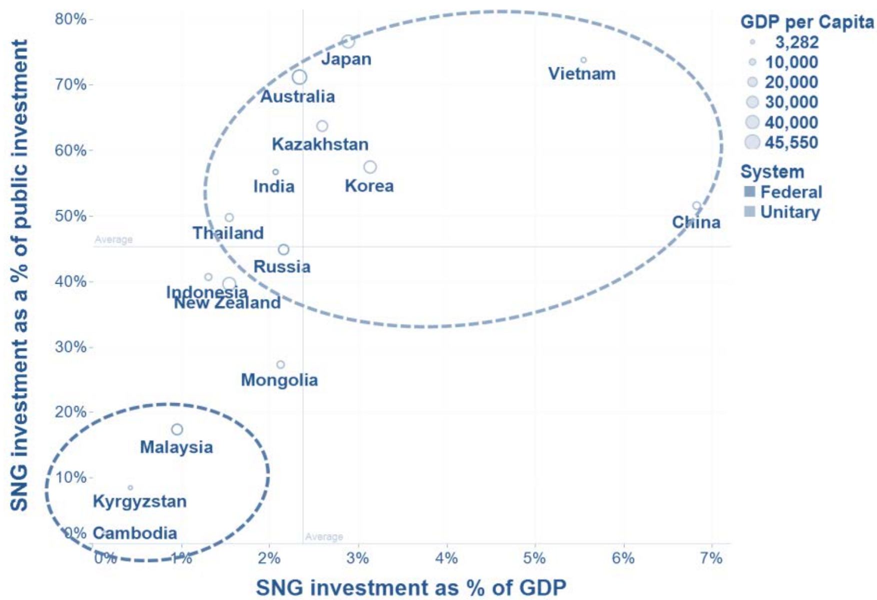
Figure 2.10. Sub-national investment as a percentage of GDP and percentage of public investment



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

This high level of investment shows that Asia-Pacific sub-national governments are investing heavily in public infrastructure. Again, the regional averages do not capture the cross-country differences, and there are large disparities across the Asia-Pacific region. The sub-national investment contribution to GDP reaches its highest level in China (more than 7%), Viet Nam, Korea, Japan and Kazakhstan (Figure 2.11). These countries are also above the regional average concerning the share of sub-national investment in public investment, with Japan having the highest level (up to 75% of total public investment), just above Viet Nam and Australia. In all these countries, sub-national governments are the driver of public investment. By contrast, sub-national governments invest very little in Cambodia, Kyrgyzstan and Malaysia. Mongolia, Russia, Indonesia and New Zealand score better but remain below the regional averages for both measures.

Figure 2.11. Sub-national investment as a percentage of GDP and public investment by country



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

While there was not a clear correlation between the level of sub-national spending and country wealth measured by GDP per capita, we find a different situation as far as investment is concerned: there is a statistically positive and significant correlation between sub-national investment as a share of total public investment and GDP per capita. This would imply that in countries with a high level of GDP per capita, sub-national governments tend to be particularly involved in public investment. The reverse conclusion could also hold, such that sub-national investment as a share of total public investment positively affects GDP. It is, however, difficult to draw any inference from these measures.

In any case, the importance of sub-national investment in many countries around the world, and especially in the Asia-Pacific region, shows that public investment is a shared responsibility across levels of government (OECD, 2014). This situation makes the governance of public investment particularly complex and challenging. Public investment, when correctly done, can be a powerful tool to boost growth and provide a solid infrastructure to leverage private investment. The OECD Recommendation on Effective

Public Investment across Levels of Government adopted by the Council in 2014 (OECD, 2014) (OECD, 2015) is therefore highly relevant for Asia-Pacific countries as it focuses on three main challenges: co-ordination across governments and policy areas; strengthened capacities for public investment; and sound framework conditions at all levels of government.

2.4. The level of sub-national tax revenue is high but uneven, and there are still significant fiscal imbalances in the Asia-Pacific region

Adopting an "open-system" perspective is necessary to design a decentralisation reform. This means that a systemic approach that links the three core dimensions of decentralisation - political (distribution of powers), administrative (distribution of responsibilities) and fiscal (distribution of resources) - should be followed. Each component cannot be considered in isolation and to ensure effective decentralisation, they should be taken into account in a comprehensive manner: they are closely interconnected, complementary and interdependent. This approach involves two major challenges: one is to find the right balance between the three core dimensions; the second is to find the right sequencing, i.e. to decide when to deal with each dimension in the course of a long-term decentralisation process (OECD, 2017).

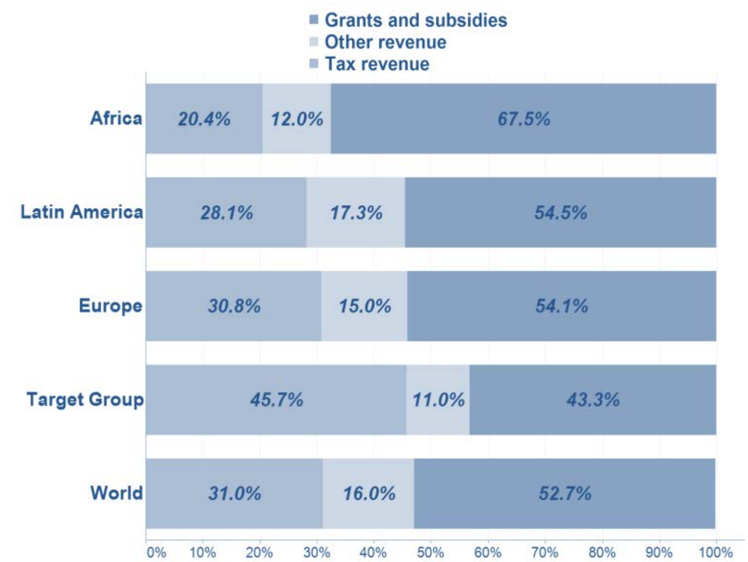
Country experiences at the international level show that in practice, this integrated approach is difficult to put into practice, and, in fact, is rarely applied. Countries from the Asia-Pacific region are certainly no exception to the rule. In particular, there is often a forgotten – or underestimated – dimension, which is the fiscal dimension.

Fiscal decentralisation is often the "weak link" of decentralisation policies, and this holds true for the Asia-Pacific region where there are often imbalances between the assignment of spending responsibilities and that of revenues, both in terms of "quantity" (the "connection principle", which involves that transferred resources should "match" with transferred functions) and "quality". Quality, in this context, means that beyond the number of resources, the type of resources also matters. It is important to provide sub-national governments with sufficient ability to raise and manage their resources. It implies that fiscal decentralisation should also be done through a certain level of revenue autonomy, i.e. tax autonomy, the extent of discretion in intergovernmental transfers, ability to set user charges and raise income from property assets, etc. More tax autonomy in particular may improve the quality and efficiency of spending to respond to community preferences, increase democratic accountability to citizens, ensure better mobilisation of local resources, improve budget management, promote fiscal responsibility, and ensure better access to credit, when borrowing is allowed (OECD, 2017).

2.4.1. Tax revenue is the first source of revenue in the Asia-Pacific region before grants and subsidies

Tax revenue is the primary source of sub-national revenue, representing almost 46% on average. This is much higher than at the global level and higher than in the other regions, even Europe (Figure 2.12). By contrast, the share of grants and subsidies is much lower in the Asia-Pacific than at the global level and in other world regions. The same applies for the "other revenues" category, which comprises a large diversity of resources: user charges, fees, penalties, revenues from the sale or rent of physical and financial assets, royalties, etc.

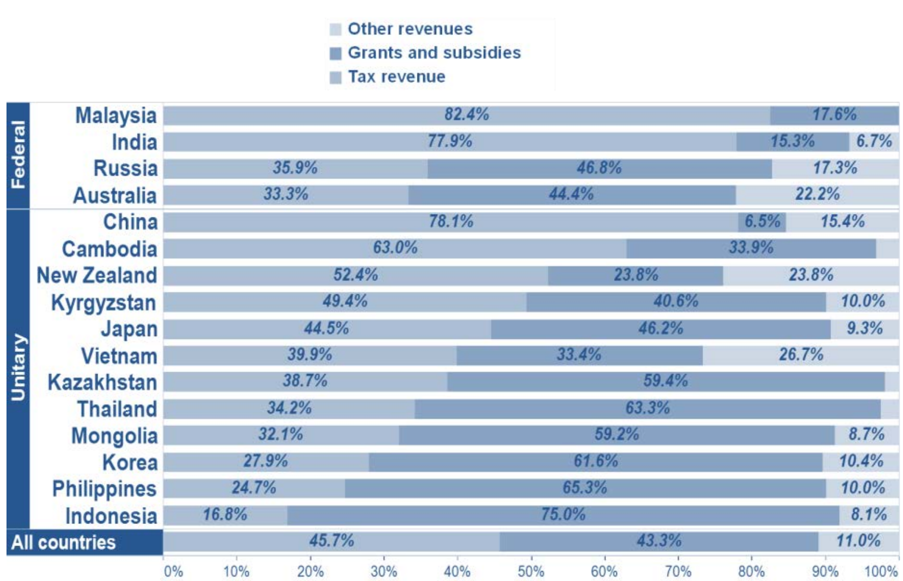
Figure 2.12. Breakdown of sub-national government revenue by category and by geographical area (percentage of revenue)



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

By country, the breakdown of sub-national government revenue by category shows considerable variation (Figure 2.13). In Malaysia, China and India, sub-national governments are almost entirely financed by tax revenue, with a share of more than 75% of total sub-national revenue. Tax revenues are quite limited in Australia and Russia despite the fact that they are both federations, which is unusual.

Figure 2.13. Breakdown of sub-national revenue by category and by country (percentage of revenue)



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

At the other end of the spectrum, grants and subsidies are the main source of revenues in Indonesia, where it accounts for more than 75% of revenues. In the Philippines, Thailand, and Korea, sub-national governments are also highly dependent on central government funding, transfers accounting for more than 60% of sub-national government revenues. In Australia, states and local councils depend heavily on transfers from the Commonwealth to finance their activities, resulting in a high degree of vertical fiscal imbalance.

The share of "other revenues" may be significant in some countries, especially those where sub-national governments receive royalties from the exploitation of minerals and other mining activities, such as in Australia and Viet Nam. In China, sub-national governments also raise significant revenues from the sale of land-use rights, and in New Zealand, such revenues come from service charges and fees, permits, licences, etc.

It is important to stress that most countries have established an equalisation system in their intergovernmental fiscal transfers, which allows central or federal governments to more or less address disparities across territories in terms of revenue or spending needs, in particular in limiting heterogeneity in service provision. These equalisation mechanisms are based on formulas that determine the redistribution of funds between richer and poorer sub-national governments.

In Indonesia, for example, where transfers account for 75% of sub-national revenue, the equalisation transfer system is based on the formula-based "general allocation fund", consisting of a base allocation and a fiscal gap allocation (which can be positive or negative), which is allocated to the provinces, districts and municipalities, accounting on average for 50% of local revenues. In Viet Nam, "balancing transfers", which account for half of the total transfers, are used to reduce horizontal and vertical imbalances across provinces, as well as across districts within provinces. In the Philippines, local governments receive 40% of national taxes through a formula-based grant, the Internal Revenue Allotment, which varies according to the type of local government, and which is calculated according to population, land area and an equal-sharing formula. In Mongolia, an important reform was introduced in 2011 with the new Budget Law to establish the Local Development Fund, a block grant fiscal transfer based on a formula taking into account the development index, population size and density, area and distance, and local tax efforts.

Equalisation instruments are crucial tools for inclusive growth if they are well conceived and implemented, with no disincentive or counterproductive side effects on local and regional development, which is, however, sometimes the case (OECD, 2017) (OECD, 2013).

2.4.2. Tax revenue comes mainly from shared taxation in several countries

In addition to being an important share of resources to sub-national governments, tax revenues are quite significant in terms of ratio to GDP and share in public tax revenues compared to other regions in the world.

In the Asia-Pacific region, sub-national tax revenues accounted for 4.7% of GDP, the highest ratio across world regions. In China, India, Japan, Russia and Viet Nam, sub-national government tax revenues account for more than 7% of GDP. By contrast, tax revenues in relation to GDP are less than 1.5% of GDP in Cambodia, Indonesia and Thailand. As a share of public tax revenue, the Asia-Pacific ratio is also the highest (23.3%), but it varies significantly across countries. In India, for instance, sub-national government tax revenue amounts to more than 56% of total tax revenues. A similar pattern is observed in China, Japan, Russia and Viet Nam. On the contrary, it is below 10% in

Cambodia, Indonesia, New Zealand, the Philippines and Thailand, as local governments in these countries are mainly funded through grants and subsidies.

The tax ratio provides some insights into the degree of tax revenue decentralisation in a country. Nonetheless, it remains imperfect because it comprises both shared taxation and own-source taxation. Own-sources taxes are taxes for which sub-national governments have a certain power to set rates and bases, while shared taxes are national taxes (mainly personal income tax [PIT], value-added tax [VAT], corporate income tax [CIT], but also excise taxes), which are redistributed to sub-national governments according to allocation criteria that are defined nationally with more or less possibility for sub-national governments to intervene or negotiate, i.e. no or little taxing power.

Tax sharing arrangements are widespread in the Asia-Pacific region, meaning that tax autonomy is limited. For example, shared taxes make up the bulk of tax revenue in China, India, Kazakhstan, Russia, Thailand and Viet Nam.

In China, for example, four taxes are shared with the provinces, with uniform sharing rates across provinces: the VAT, the CIT, the PIT and the securities trading tax. The tax sharing system only specifies how taxes should be divided between central and sub-national governments and leaves it to the provinces to divide funds among the four levels of sub-national governments further. In Russia, the regions are the main recipient of sub-national tax revenue (83%), which made up 47% or their total revenue in 2013. Shared taxes represent the bulk of sub-national tax revenue and most regional tax revenues come from the share of the PIT and CIT, redistributed according to uniform percentages. In Viet Nam, shared taxes include the VAT, the CIT, the PIT, environmental protection tax and excise tax on domestic goods and services. There is one state budget for all levels of government and revenue sharing is defined according to a “sharing rate” defined for three to five years, called the “Stability Period” and redistributed according to an equalisation scheme. In Kazakhstan, most sub-national tax revenues are shared taxes (PIT and the social tax, based on payroll), which are also redistributed through an equalisation mechanism.

In theory, own-source taxes provide more autonomy to sub-national governments. In theory, because even when taxes are own-source, tax autonomy can be restricted. In fact, in many Asia-Pacific countries, numerous taxes, although classified as “local taxes”, may have their rate and base determined by the central government. In some cases, the local leeway over rates and bases may be regulated, thus reducing tax autonomy, e.g. caps on rate increases or imposition of a minimum rate, limitation of exemptions decided locally and, conversely, an obligation to apply exemptions decided nationally by the central government, etc.

In Viet Nam for example, tax bases and rates are determined largely by the central government, local taxes being “taxes which are fully assigned to local governments”, e.g. natural resources taxes, licence tax, land use taxes and levies, etc. In China, local governments have no discretionary power to raise taxation. The central government sets the legislation governing taxation and the rate of each tax. In Kazakhstan, sub-national governments have very little taxing power over the rate or base of local taxes. They can only revise the land tax rate within a margin of 20%, depending on the characteristics of the land and fix the rate of minor local taxes. In Korea, while the 2011 tax reform aimed at simplifying the tax mix, most tax rates are determined by the central government. In Mongolia, local governments have little autonomy over their tax revenues, as any change to tax rates or bases requires the approval of central authorities.

It is interesting to note that tax autonomy can be, in some countries, large and represent a large share of local revenues, although remaining small in total tax revenues. It is the case in New Zealand, where territorial authorities enjoy a very large autonomy over property taxation, setting the tax rates and choosing how to apply the taxes (based on rental or market value). Property tax represents more than 50% of their revenues, but overall, local taxes account for only 7% of public tax revenues. A large gap also exists in Cambodia: tax revenues account for 63% of sub-national revenues, but they represent only 6% of public tax revenues. In Australia, the only tax for local governments is the land property tax (shared with the states). Rates accounted for approximately 37% of total local government revenue in 2013, while it represented just 3.3% of total public tax revenue.

The property tax on land and/or on real estate/buildings is very widespread as a local tax in the Asia-Pacific region, as in every region around the world. In fact, it is the local tax by excellence. Yet, the rates and base are often set by central authorities who are also in charge of tax collection and administration; alternatively, a sub-national government can be allowed to set a rate that falls within a range defined jointly or independently by central authorities.

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

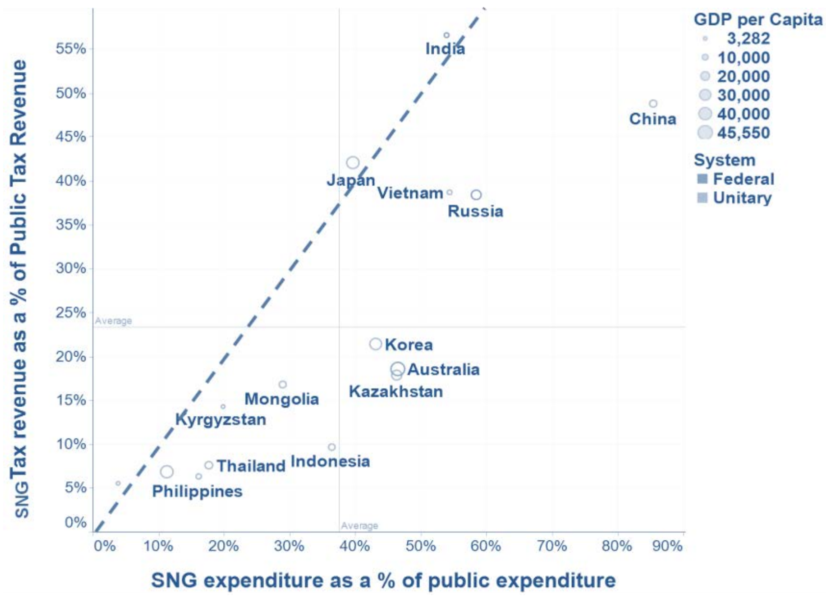
2.4.3. There are large fiscal imbalances between expenditure and tax revenue

There are great fiscal imbalances across countries between the level of sub-national expenditure and the level of sub-national tax revenue, higher than in OECD countries, because of the low level of tax autonomy.

Figure 2.14 depicts such a comparison, however imperfectly. As explained above, the tax indicator used in the figure comprises both shared and own-source tax revenues and therefore does not fully reflect tax autonomy. Such a measurement thus indicates whether sub-national government, given their spending responsibilities, are appropriately financed through the tax system.

Countries close to the dotted line are most likely to be fiscally balanced from a tax revenue perspective, with more or less comparable levels of tax revenue and expenditure decentralisation. Countries far from the line are those who are more fiscally imbalanced, undertaking a high share of public spending but with a limited share of public tax revenue, such as in China and Russia, but also Indonesia, Australia, Korea and Kazakhstan: in these last four countries, sub-national governments are in charge of near or more than 40% of total public spending, but their share in public tax revenue is below 25% and even below 10% in Indonesia.

Figure 2.14. Comparing tax revenue and expenditure of sub-national governments in the Asia-Pacific region



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

2.5. Sub-national government debt is high by international comparisons in the Asia-Pacific region

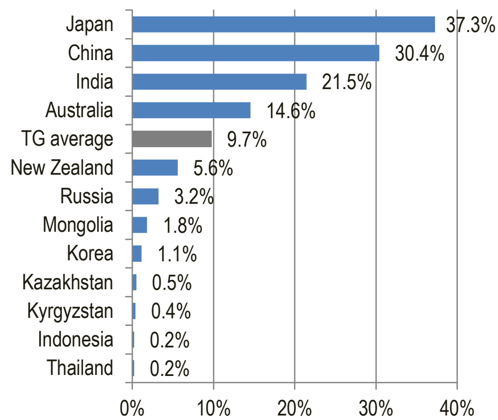
The average level of sub-national government outstanding debt[3] is higher in the Asia-Pacific region than at global and European levels: it amounts to 9.7% of GDP and 16.6% of public debt, compared with around 9% and 14%, respectively, in Europe and in the world.

With the exception of Cambodia, sub-national governments in Asian and Pacific countries have legal borrowing rights. Sub-national debt is however very uneven across countries, both as a percentage of GDP and percentage of public debt (Figure 2.15 and Figure 2.16. The average level of outstanding debt is driven by five countries: Japan, China, India, and Australia, and to a lesser extent, Russia.

There are different levels of flexibility attached to the borrowing legal framework, which can explain these differences, on top of insufficient fiscal capacity and therefore creditworthiness, which remain a major obstacle to borrowing in several Asia-Pacific countries.

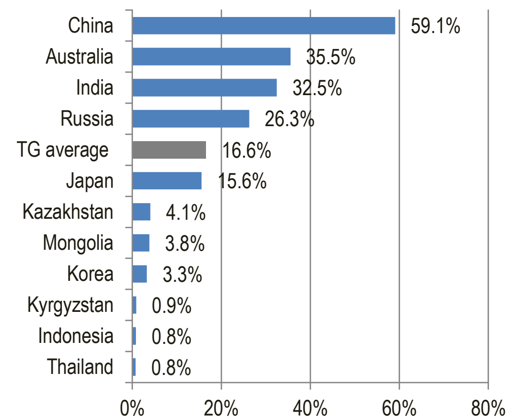
In general, sub-national government borrowing still requires central or federal government approval for many countries of the region, except for example in Australia and India (for the state level), Japan, Korea or Russia. A governmental agency, a federal or central institution, or the Ministry of Finance is in charge of overseeing the borrowing procedures, setting or enforcing the debt limit, ensuring compliance with the legal clauses of borrowing and the fiscal sustainability of lower-tier governments. In Australia, a Loan Council was set up in 1929 to co-ordinate and monitor the aggregate level of borrowings by the Commonwealth and each state and territory on the basis of fiscal positions and infrastructure needs.

Figure 2.15. Sub-national government debt as a percentage of GDP



Note: TG stands for "target group".
Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

Figure 2.16. Sub-national government debt as a percentage of public debt

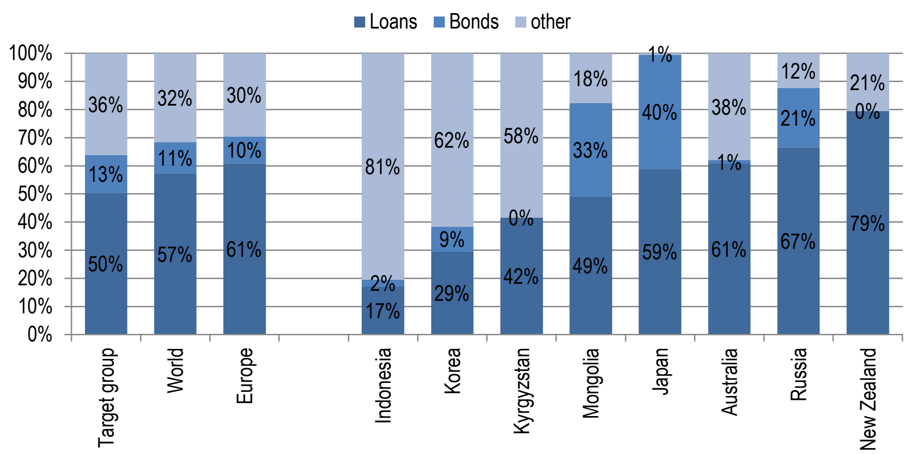


Note: TG stands for "target group".
Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

Quite often, the higher government tier (federal or central government) remains the primary lender (e.g. Kazakhstan, Malaysia and Mongolia) and borrowing may be restricted to investment projects as far as the local government level is concerned according to the "Golden Rule" (e.g. Japan, Korea, the Philippines, Thailand). A ceiling on the debt stock or service may be imposed (e.g. China, Indonesia, Kazakhstan, Kyrgyzstan, the Philippines, Russia and Viet Nam). Local governments may be forbidden to borrow internationally (e.g. Indonesia, Mongolia with the exception of Ulaanbaatar). Besides the ceiling, there are some other conditionalities attached to borrowing, such as in New Zealand (obligation to set out financial strategies to borrow), Thailand (only specific investment projects can be financed through borrowing) or the Philippines (only local infrastructures anchored in the local development plan and public investment programme can be funded via borrowing).

Loans come as the primary source of external funding (Figure 2.17). They are of particular importance in New Zealand, Russia, Australia and Japan. Non-financial debt constitutes the second source and is particularly significant in Indonesia and Korea. Bond issuance remains limited, with the exception of Japan (40% of debt stock), Mongolia and Russia. In fact, the discretion over issuing bonds is limited in most countries with a few exceptions. In China, because of the over-indebtedness of sub-national governments, a new budgetary law passed in January 2015 is dedicated to restoring local governments' finance. With this law, the only way for local governments to access borrowing is through bonds, limited to CNY 1 600 billion per year and a few wealthier municipalities are allowed direct access to capital markets under central government supervision. In Japan, a consultation system with the central government replaced a prior approval system in 2006 for the issuance of local bonds. In Kazakhstan, only Almaty and Astana are able to borrow through bond issuance to cover their budget deficits and to finance the construction of public social housing. The 14 oblasts are also allowed to issue bonds but under the supervision of the Ministry of Finance. In Viet Nam, local governments can – legally – mobilise capital through the issuance of local government bonds, but doing so depends upon central government approval and unclear regulations.

Figure 2.17. The composition of sub-national government debt stock



Source: Authors elaboration based on OECD/UCLG (2016), *Sub-national Governments around the World: Structure and Finance*, www.oecd.org/cfe/regional-policy/sngs-around-the-world.htm.

Interesting to note is the initiative taken by the central/federal government or by sub-national governments to develop the recourse to financial markets. In India, for example, the Ministry of Urban Development has introduced a State-Level Pooled Finance Development Fund (PFDF) Scheme to provide credit enhancement to Urban Local Bodies to access market borrowing. Ratings are mandatory for local governments in India when the issue maturity is more than 18 months. In New Zealand, the Local Government Funding Agency (LGFA) was created in 2011 on the initiative of local and central governments. This is a debt vehicle that regroups around 50 member councils to raise bonds on financial markets and lend to their members at competitive interest rates.

2.6. Conclusion

The analysis provides some insights into the potential impact that sub-national governments can have in achieving inclusive growth and sustainable development. Decentralisation is of interest in most countries. However, implementation, particularly of related norms and legal provisions, and of sound fiscal frameworks, remains a major issue. Compounding this can be an overlap in competencies across government levels and an increase in fiscal gaps and imbalances, delaying the empowerment of sub-national governments as key actors in the development process of their countries.

Sub-national governments, especially those in remote areas, with their proximity to citizens constitute a vector through which these countries can promote inclusive development and ensure that all residents have equitable and sustainable access to basic goods and public services. Through their expenditure and investment policies, sub-national governments can establish their own priorities and develop programmes targeted at reducing poverty in urban and rural areas, at enhancing social inclusion through education, social policy and health policies and at ensuring adequate conditions for inclusive growth.

Sub-national governments' greater involvement in the sustainable and inclusive growth development agenda implies a need for central/federal government (and state governments in some cases) to establish an adequate fiscal decentralisation framework. It should strike the right balance between, on the one hand, reinforcing fiscal autonomy, which provides regions and cities with more fiscal space to design and invest in inclusive policies and, on the other hand, limiting the risks of higher fiscal disparities, which can be the adverse effects of a badly designed decentralisation process. This can be achieved through the appropriate assignment of revenues and expenditure as well as adequate vertical and horizontal equalisation mechanisms that foster solidarity, equity, performance and economic efficiency. Building better capacities at the sub-national level in order to carry out fiscal assignments more effectively as well as strong fiscal rules, including accountability and transparency, can help, as fiscal discipline is also a necessary corollary of fiscal decentralisation. Finally, strengthening public institutions at all government levels and developing co-ordination mechanisms across levels of government would further help establish an adequate fiscal decentralisation framework. These are the preconditions the OECD has identified to make decentralisation work (Allain-Dupré, 2018; OECD, 2019).

Notes

1. This pilot study was a first step toward the OECD-UCLG World Observatory on Sub-national Government Finance and Investment (SNG-WOFI). The SNG-WOFI was officially launched at the first meeting of the Steering Committee on 17 November 2017. An updated and expanded version will be published in June 2019.

2. The 16 countries are located in northern, central, south-eastern Asia as well as in Oceania (New Zealand and Australia). The Asia-Pacific target group was constituted based on the OECD-UCLG database set up for the 2016 pilot study, *Sub-national Governments around the World: Structure and Finance*.

3. Sub-national government debt is comprised of financial debt in the form of loans and bonds, and non-financial debt amounting to other accounts payments, pension liabilities, currency and deposits.

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3. Fiscal decentralisation and inclusive growth: The role of institutional context in selected Asian economies

by
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There is increasing interest in the question of whether decentralisation promotes inclusive and equitable development. Evidence is limited and the results are highly variable. The premise of the chapter is that a first step in addressing this question is to document how decentralisation works. Although an important public sector reform in Asia, decentralisation is organized and operates in diverse ways that reflect differences in country characteristics, histories and political economy forces. This chapter briefly examines key aspects of decentralisation in selected Asian countries—the intergovernmental system structure and decentralisation framework, the degree of fiscal empowerment and decision-making autonomy, and the level of accountability reflected in the local political system, among others. Each of these features has potential implications for inclusive development, although how they interact, the results they generate, and their dependence on other public policies may differ across countries. Given the diversity, complexity and information gaps involved, few policy generalisations beyond relatively broad statements can be made. More work is needed to establish an evidence base on the role that fiscal decentralisation—supported by other institutional and political reforms—can potentially play in inclusive development in Asia.

3.1. Introduction

As in most regions of the world, decentralisation in Asia is far from a homogeneous phenomenon. There are great variations in country characteristics, ranging from physical area to the size and heterogeneity of the population. Some countries remain quite poor and have experienced limited development, while others have diversified and expanded their economies to attain middle-income status. Countries in the region also differ in terms of their experience with democratisation and decentralisation.

Despite the great variety in their conditions and priorities, many Asian countries have chosen to pursue some form of decentralisation.[1] The justification is often framed in terms of some mix of development objectives, such as to improve public services, to strengthen public management, to augment governance and accountability, to boost economic development, to enhance equity in service delivery and development outcomes, and/or to stabilise post-conflict and fragile states, among others. Countries may officially and unofficially give preference to different objectives.

How decentralisation is organised and operates can be as varied as the countries' socio-economic profiles and the developmental objectives they prioritise. This variability is seen to be a function of the extensive differences in country characteristics, histories and political economy forces that shape how public governance is structured and the results it generates. Clear patterns, however, are not well documented. Equally important, although decentralisation has been common and often prominent, its performance has been erratic, and our systematic, practical understanding of how it functions - beyond the experience of some specific cases – remains relatively limited.[2]

There has been increasing attention in recent years to the question of whether decentralisation can and does promote inclusive development. This has always been an issue of some interest in the literature, although it is probably fair to say that it has generally been secondary to concerns about the growth-enhancing efficiency effects of decentralisation reform. The growing focus on inclusiveness is likely a combination of a general reaction to the uneven effects of globalisation and growing inequality in many countries, as well as a specific response to the prominent emergence of Agenda 2030 and the Sustainable Development Goals (SDGs).

Although the evidence regarding the impacts of decentralisation on equitable and inclusive development is limited and the results highly variable,[3] it is possible to outline some features of decentralisation that might reasonably be expected to be relevant for its performance on this front. First, does the structure of the intergovernmental system matter, and if so, how? If, for example, empowerment is mostly at higher sub-national levels, it may be possible to pursue stronger growth and targeted redistributive policies, but there may be a greater distance between these governments and their constituents than when lower tiers are more directly empowered. Such a situation could potentially limit local inclusiveness.

Second, what role do the decentralisation policy framework and its underlying drivers play? Better defined frameworks make the responsibilities of different levels of government clearer and help to ensure that citizens know what to expect from each. Of course, the underlying motivations are also important – the desire to empower sub-national government may be genuine or there could be less commitment to implementing a decentralisation and intergovernmental relations policy if it was largely developed to meet immediate and less developmentally ambitious political objectives.

Third, does the national decentralisation policy provide for sufficient fiscal empowerment of sub-national governments to enable them to play a meaningful role in inclusive development? In some cases, there is a reasonably proportional relationship between functional responsibilities and government resources (through own-source revenues and transfers), while in other cases there is a severe imbalance that would constrain sub-national governments from meeting their responsibilities and pursuing inclusive development.

Fourth, do sub-national governments have sufficient autonomy to pursue their own agenda? Fiscal decentralisation is critical in this regard, but so is the ability of sub-national governments to define and manage their own budgets and staff. If sub-national governments do not have enough discretion on these matters, their ability to develop and implement inclusive policies for development could be weakened, even with strong intent.

Fifth, is political decentralisation adequately robust to allow citizens to have a meaningful say in who makes sub-national public sector decisions? If the design of the system does not allow for the regular election of reasonably representative local legislative bodies or if there is limited political competition, there is likely to be less opportunity for a broader range of citizens to push for specific local development policies and greater inclusivity.

Sixth, is there sufficient transparency of, and adequate opportunity for, civic engagement regarding sub-national government fiscal decisions? If, for example, citizens know how sub-national resources are being raised and spent and have opportunities to provide input to and feedback on sub-national fiscal decisions, there may be a higher probability that these decisions would be more inclusive.

Of course, none of these considerations – a strong intergovernmental framework that empowers sub-national governments with sufficient powers, resources and autonomy, promotes adequately representative sub-national political bodies, makes information available to citizens and allows them a voice in shaping and evaluating local expenditures – individually or collectively guarantee that decentralisation will lead to more inclusive development. It does seem likely, however, that such characteristics could improve the chances of a positive movement in that direction and their absence could hinder such results.

At the same time, decisions that expand inclusivity in public service delivery and improve citizen well-being, even if directly under the control of sub-national governments, would not necessarily result in broader improvements in livelihoods and incomes, which are affected by a range of factors. Equally important, some national and/or regional policies would typically also be needed to undertake measures beyond the scope of sub-national governments, to create appropriate incentives for sub-national government behaviour, and to alleviate inherent fiscal disparities among sub-national government jurisdictions.

Although there is limited evidence that directly speaks to the connection between fiscal decentralisation and inclusive development, it is instructive to take stock of the considerations outlined above and hypothesise about how this relationship might be affected. This chapter presents a brief overview of eight countries: Bangladesh, Cambodia, Indonesia, Nepal, Pakistan, Philippines, Sri Lanka, and Viet Nam.[4] It concisely and selectively covers basic intergovernmental structures, decentralisation frameworks, sub-national government powers and functions, the degree of sub-national government autonomy, sub-national political systems and processes, and transparency and citizen engagement mechanisms.

This overview is not intended to be comprehensive or definitive; the countries covered here are selective, complex and diverse, and there are considerable gaps and uncertainties in the information presented. The focus is more on comparatively describing decentralisation than assessing it. For each topic covered, some thoughts are offered on its relevance for understanding how decentralisation might affect inclusive development.

3.2. Basic intergovernmental institutional structures

The basic structures of intergovernmental systems vary considerably (Table 3.1). This partly reflects the type of government system (unitary versus federal). Even within different types of systems, however, the number of levels and their relative empowerment can differ.

Table 3.1. Intergovernmental institutional structures in selected Asian countries

	2018 population (millions)	National system	Sub-national levels/types of government
Bangladesh	166.4	Unitary	Rural local: *zila parishads* (districts, 64); *upazila parishads* (subdistricts, 510); *union parishads* (5 000); Urban local: city corporations (11); *pourashavas* (municipalities, 315); Hill district authorities (3)
Cambodia	16.2	Unitary	Provinces (23, including 3 municipal) and capital; Districts (159) and municipalities (26); Communes and *sangkat* (municipal communes,1 621) and villages
Indonesia	266.8	Unitary	Provinces (34, of which 5 are special regions) Local governments: *kota* (cities, 98) and *kabupaten* (districts, 410); *Kecamatan* and *desa* (sub-districts and villages, 69 249)
Nepal	29.6	Federal	Zones (14); District development committees (75); Urban: municipalities (urban including multiple new, 191) Rural: village development committees (3 276)
Pakistan	200.8	Federal (new in 2015)	Provinces (4) and Territories (4); Districts (*Zillas*, 96); *Tehsils* (337); Unions (6 022)
Philippines	106.5	Unitary	Provinces (79); Cities (112); Municipalities (1 496); *Barangays* (villages, 41 944)
Sri Lanka	21.0	Unitary	Provinces (9) Urban: municipalities (large urban, 23), urban councils (small urban, 41), Rural: *Pradeshiya Sabhas* (rural, 257)
Viet Nam	96.5	Unitary	Provincial level: Provinces (58) and municipalities (5); District level (700): Provincial cities/urban districts, towns, rural districts; Commune level (> 11 000): townships, rural communes and urban wards

Source: Author compilation.

Most countries considered here have a unitary system of government. This means that power is vested in the central government, which decides if and how to decentralise powers and functions to sub-national governments. Two of the countries (Nepal and Pakistan) have federal systems, but these were created by the national government rather than voluntarily by constituent regions. Nepal only became federal in 2015.

Many of the systems examined incorporate three types of sub-national government, but more or fewer can also be found among the cases. The types of units listed are not always at different levels – for example, they may be different types of local governments with similar status, but some are in urban areas and some in rural areas. Certain levels (as discussed later) are at least somewhat devolved entities with elected governments, while others are legally or in practice deconcentrated levels of administration. Relationships among tiers can vary from being relatively independent to relatively hierarchical. Clearly, the roles of each level and how they interact can have an important impact on inclusive development.

3.3. Decentralisation policy basics

Each country has adopted some type of formal decentralisation policy, but there are considerable differences. These include the level of detail/specificity on the system parameters, the legal basis (constitutional, legal or administrative), and the underlying motivations, among other factors (Table 3.2). The various levels of sub-national government are often endowed with different, and sometimes with, concurrent powers.

Table 3.2. Decentralisation policy basics in selected Asian countries

	Decentralisation policy basics
Bangladesh	Decentralisation to local governments provided for in the Constitution, but power remains centralised, and local government functions are managed through deconcentrated local entities. Local elections are held in urban local governments and at the sub-district and lower rural government levels. Urban local governments are responsible for a greater range of services than others.
Cambodia	The governance system has been historically centralised with some marginal decentralisation to the communes since 2001. Reforms have been instituted for provinces, municipalities and districts since 2008. Some progress has been made, but reforms are still being developed and rolled out.
Indonesia	Indonesia focused on deconcentration to provinces until the fall of the Suharto regime. This resulted in rapid and significant devolution ("big bang") to cities and districts. More recent reforms have marginally reinforced the role of higher-level governments, and further reforms are being considered.
Nepal	Local governments operated under an interim constitution and were essentially run by centrally appointed civil servants. Under the 2015 Constitution, a new federal system is in process.
Pakistan	As a recently reformed federal system, provinces have authority for local government legislation and functional assignments. Laws differ by province. The constitution mandates provinces to hold local government elections, but this has not been widespread.
Philippines	Powers were devolved by law to sub-provincial levels in the early 1990s. Due to complex politics around the reform, the system is uneven in practice, and central and provincial entities still play some significant roles.
Sri Lanka	Power is largely concentrated centrally. The provincial governments are responsible for local government oversight and have some legislative powers.
Viet Nam	Decentralisation began as part of the economic reforms (*doi moi*) of the 1980s with various policy initiatives decentralising decision making to sub-national levels. The formal framework remains fairly centralised, but with considerable *de facto* decentralisation driven by provincially-based party elites.

Source: Author compilation.

Some frameworks/policies, as in Indonesia and the Philippines, more strongly empower local tiers, while others, as in Pakistan (a federal country), Sri Lanka and Viet Nam, privilege the powers of intermediate tiers. A few countries, such as Bangladesh and Sri Lanka, formally differentially empower urban and rural areas. In many cases, there are elected sub-national governments, but in some countries (or tiers within a country), there are deconcentrated administrations.

In all countries considered here, decentralisation or local governance is to some extent enabled in a constitution. The degree of specificity, however, varies. In some cases, such as Cambodia and Pakistan, there is only general reference to local governments. In other cases, such as Sri Lanka, there is more specificity on powers and functions. Most countries with constitutional mandates still require further legislation to advance decentralisation, and attention on this front is fragmented and often incomplete. This may reflect decentralisation being in earlier stages, or it may result from the influence of prominent actors who are reluctant to push decentralisation, thus hindering the reform process. There are commonly policy inconsistencies among legal instruments (e.g. decentralisation policy versus sectoral policy) that hinder the ability of sub-national governments to meet their responsibilities.

More generally, strong power dynamics among various stakeholders play a pivotal role in the emergence and evolution of decentralisation. In most cases, decentralisation reform is fundamentally about sharing authority and funding, so as the various actors engage there are frequently explicit or hidden debates over how the system will be structured and operate, and these are reflected in the development and implementation of specific policies.

Indonesia and the Philippines are among the most decentralised countries here, and both reforms were a response to a political crisis. Reform was more rapid in Indonesia due to different political conditions and strategies. Bangladesh and Pakistan in the past had stronger provisions for local governments than they do now, but political dynamics generated policy modifications.

It is not uncommon for a national government to expect sub-national governments to pursue inclusive or equitable development, but few seem to make this an overarching policy priority. Some countries do have minimum service delivery standards and conditional fiscal transfers for basic services. If there is to be more action on this front, prevailing policy and underlying political economy drivers need to be understood and strategically considered.

3.4. Sub-national powers and functions

Most countries reviewed here assign local governments (LGs) general responsibilities for public functions (Table 3.3). The extent, clarity and specificity of these assignments vary substantially across countries. Indeed, provisions commonly remain relatively ambiguous and subject to interpretation/contestation. A few countries, such as Indonesia and the Philippines, have stronger functional clarity, although even here there are grey areas, disputes over the particulars and complex dealings with and intrusions from higher levels. On balance, there remains a strong tendency for significant oversight – at times even interference – from central and/or regional governments.

Table 3.3. Sub-national functions, revenues and fiscal importance in selected Asian countries

	Functional decentralisation	Revenue decentralisation	Fiscal importance
Bangladesh	LGs mostly have a limited direct role in providing services and largely serve as deconcentrated central agents.	LGs have some revenues in the form of taxes, fees, rates, rentals, but depend on transfers.	3% of spending by local units; other local spending centrally controlled.
Cambodia	Provinces dominate sub-national service delivery but largely under central ministries. Communes have discretion but few functions/funds. Transfer of more functions is envisaged.	Minor revenues for communes, which rely on fiscal transfers. Provinces have more but limited powers. Further sub-national revenue power is envisaged.	About 20% (2014) is sub-national, mostly provincial. Directly elected communes account for about 3%.
Indonesia	LGs assigned obligatory functions, e.g. health, education, environment, and infrastructure. Provinces originally assigned mostly co-ordination and gap-filling roles, but modestly increased and may be further rebalancing.	Cities/districts levy taxes on property, hotel/restaurant, and other bases, plus user charges, but transfer dependent. Vehicle, groundwater and cigarettes taxes that are provincial but shared with lower levels.	Approximately 35% (2015) at all sub-national levels, with about 80% of that at the local level (districts and cities).
Nepal	LGs responsible for a range of services, but actual roles less clear, better defined if local governments receive conditional funds. More clarity emerging following the 2015 Constitution.	Local bodies, especially municipal, have access to tax bases and user fees but revenues declined from 2006-12 and transfer dependence is high.	Around 11% of public expenditures by local governments (2014).

	Functional decentralisation	Revenue decentralisation	Fiscal importance
Pakistan	Functions vary by province and LG: districts (rural infrastructure, some basic social services); *tehsils* (urban services); unions assist villages; neighbourhoods propose projects.	Sources vary by type of LG (districts, *tehsils*, unions); overall local own resources are limited with most funding coming through fiscal transfers.	Local expenditures constitute around 5% of public spending (2011). Total provincial and local spending is 33%.
Philippines	LGs hold major service responsibilities, including health, social services, agriculture, environment, public works, education and tourism, among others. Some ambiguity and unevenness in functions persist due to policy inconsistencies.	LG revenues include taxes on property, businesses, and public enterprise, as well as charges and fees. Only cities may impose the full set of allowable taxes. Provinces and cities share revenues with lower levels.	24% at the sub-national level (2012), with just over half of that by cities, municipalities and *barangays*.
Sri Lanka	LGs are responsible for municipal solid waste, utilities, and markets. Other responsibilities are shared with the centre of government.	Municipal councils are allowed to levy certain taxes and user fees under rules and limits set by the centre.	Municipalities account for less than 0.5% of public spending (2006).
Viet Nam	Provinces may spend on functions not reserved by the centre and assign LG functions (e.g. waste collection, street lighting). Centre sets/monitors norms; nontrivial functional concurrency.	Local taxes (e.g. land) and fees/charges allowed, but limited discretion; bulk of revenues from shared taxes/transfers with a redistributive element.	56% of public spending at sub-national levels (2012), with nearly 80% of capital spending.

Source: Author compilation.

In most countries considered here, own-source revenues are fairly limited and of insufficient productivity, although urban areas tend to perform better. The most common local sources are property tax, taxes on certain economic activity, assorted excise taxes, and many types of fees and charges. Most revenue assignment is done by the national government, although in federal systems, such as Pakistan, provinces have some authority to assign or influence local revenues to lower-tier governments. In a few cases, there is also a degree of revenue sharing between different levels of sub-national government. Most of the countries have not much improved own revenue collection over time (particularly as a share of local revenue). In a few cases, e.g. Nepal and Pakistan, the trend has been negative. On balance, significant dependence on fiscal transfers persists.

There is considerable variation across countries in terms of sub-national shares of total public expenditures. In most cases, the share is 15-35%, but there are outliers. In Bangladesh, the share is only 3%, but it is 56% in Viet Nam. There is a tendency – except in Indonesia and the Philippines – for spending more at higher sub-national levels. In all cases, however, funds spent at the sub-national level come substantially from the national budget through shared taxes and intergovernmental transfers. Local governments also tend to face the kinds of central restrictions and interference noted above.

The relevance of this discussion for inclusive development is that sub-national governments without sufficient fiscal powers and resources are unlikely to be able to play a significant role on this front. Although higher-level regulations, standards and incentives may support more inclusive local development, adequate sub-national government empowerment seems likely to create stronger credibility with local citizens and an ability of these entities to better target local resources if there is sufficient downward accountability.

3.5. Sub-national autonomy

Many of the countries considered here do not officially grant significant operational autonomy to sub-national (especially local) governments (Table 3.4). In a few countries, local governments largely execute centrally planned and financed projects and services with relatively limited space for local discretion.

Table 3.4. Sub-national autonomy in selected Asian countries

	Overall	Budgeting	Staffing	Revenue generation
Bangladesh	Highly limited local government autonomy in most respects.	Central ministry funding dominates local budgets; local governments rely on opaque/erratic transfers.	Most hiring approved by central administration; all local staff report to central ministries.	Municipalities may set rates/charges following central guidelines, but the centre must approve.
Cambodia	Communes have high autonomy but few resources. The centre retains tight control over higher levels.	Communes prepare a budget, while a provincial or district budget is just starting to be separated from the national budget.	Commune councils are supported by few commune staff, and they are appointed and paid by central ministries.	Communes by law have a right to raise certain taxes/fees, but a legal framework to define the details is still pending.
Indonesia	Local government is reasonably empowered with a fair share of local autonomy, but central control has been tightened in recent years.	Local governments had autonomy, with the next-higher level review budget legality. Law 32/2004 expanded higher-level oversight of local budgets.	National civil service regulations provided local discretion, but Law 32/2004 expanded higher-level oversight of local civil service decisions.	Greater than in many countries. Some local governments have a greater capacity to raise own revenue than they choose to exercise.
Nepal	Powers devolved, but less in practice and shifting under the new constitution.	Budgets follow central medium-term plans; formal local autonomy, less in practice.	Local officials are hired by the central government.	All major local revenues are subject to central regulation.
Pakistan	Significant power is devolved to the provinces, but they have been slow to empower districts.	Districts allowed to form their own budgets as per district government budgeting rules.	District and *tehsil* governments may hire personnel as per formal provincial policy guidelines.	Narrow discretion; city districts/*tehsils* set (provincial) property tax rates under guidelines.
Philippines	Local governments have reasonable local autonomy, although they operate under a framework.	Local governments set their priorities and prepare budgets subject to legality review by the next-higher level.	National civil service regulations are in force but permit considerable local discretion.	Local governments subject to national guidelines but with relatively more revenue discretion
Sri Lanka	Centre retains broad powers that allow intervention in local affairs/autonomy.	Local bodies have some discretion in the budget process, but many lack technical capacity.	Provinces hire local staff; province chief nationally appointed and governors influence local hiring.	Local governments have very limited revenue autonomy.
Viet Nam	Sub-national levels part of central government; more spending autonomy at provincial and city levels.	One state budget for all levels. Provinces control relations with lower levels. Provinces/cities have some autonomy.	All public employees are under the national civil service. Local staff are selected locally with higher level approval.	Most sub-national revenues are shared rather than independent; more discretion and provincial level.

Source: Author compilation.

Again, Indonesia and the Philippines are exceptions, with local governments having substantial autonomy over a considerable portfolio of services. Another exception is Cambodia, where the lowest level of sub-national government enjoys relative autonomy, but in an unusual situation in which they have virtually no formal service delivery functions and own-source revenues. In a number of countries, including Pakistan, Sri Lanka and Viet Nam, the provincial level has non-trivial powers and at least some control over what lower levels of government are allowed to do.

The countries discussed here represent cases of both comparatively autonomous local budgets, such as in Cambodia (commune level), Indonesia and the Philippines, as well as countries where local budgets are integrated into the national budget, such as in Sri Lanka and Viet Nam. These distinctions, however, are not well defined. Local governments in Indonesia and the Philippines, for example, enjoy relatively extensive budget discretion, with higher level governments mainly ensuring legality compliance. There have, however, been changes in recent years, such as more developed oversight mechanisms and the introduction of conditional performance-based transfers, and the central government remains active in some legally devolved functions. Even where local budgets are formally part of the state budget, some discretion may be allowed. There are some intra-country variations, such that provinces or urban governments are allowed more *de facto* autonomy in budgeting.

There is non-trivial central government engagement in human resource management in many of the countries. In Bangladesh and Cambodia, local administrative and technical personnel supporting elected local governments are for the most part appointed by central authorities or even belong to the national civil service. Under such conditions, there may be concerns regarding reporting channels because local government staff may be more accountable to the central government than the local councils they are serving. In other countries, such as Indonesia, Pakistan and the Philippines, local governments have some degree of discretion to hire, promote and fire their own staff. In such cases, however, local human resource management is usually regulated by national government (or by provinces as in federal Pakistan). Even where local governments have human resource management authority, there may be significant means for influence or interference by higher levels.

Local revenue autonomy, as indicated earlier, is generally rather restricted in this set of countries. Even where local governments have access to a reasonable number of revenue sources, yields tend to lag revenue potential due to capacity constraints and weak incentives to improve revenue productivity. In most countries, local governments have limited or no discretion over local tax policy – defining tax bases, setting tax rates or bases or determining fees and charges. On balance, dependency on fiscal transfers is high, sometimes with the exception of provinces and larger urban governments.

The implications of the often extensive constraints on autonomy – in budgeting, human resource management and revenue generation – are significant. If local governments are to be able to make accountable decisions regarding the services they are charged with delivering to their constituents, they need to have sufficient discretion to act with some independence, even though they must, of course, follow certain procedures and meet reasonable standards. If improving inclusivity from a local perspective is a priority goal, success in attaining it depends on sufficient local government empowerment.

3.6. Sub-national political mechanisms

Political decentralisation is the most basic – if imprecise and broad – means of disciplining fiscal decentralisation with downward accountability. It is, of course, quite a diverse phenomenon. In some countries, local elections are an increasingly vital factor in promoting local accountability. In other cases, they are constrained by weak administrative and fiscal decentralisation, limited political competition, and/or a range of controls imposed by the central government or national political parties.

Political decentralisation – at least in official terms – seems to have advanced in most countries covered here (Table 3.5). Elections are conducted at all or most sub-national levels. There are exceptions: Nepal had not held elections for more than a decade due to political unrest (a situation the new federal constitution is addressing), and in Pakistan, local elections mandated by the constitution are rarely conducted. Sub-national councils are for the most part directly elected, with some exceptions. Cambodia, for example, uses a system in which lower level commune councils are elected directly, but district and provincial councils are elected indirectly by the members of lower level councils.

Table 3.5. Sub-national representation in selected Asian countries

	Assembly elections	Political competition	Head/chair/mayor
Bangladesh	Elections at city corporation and lower levels, but not *zilaparishad* (district).	Two main political parties dominate, but additional smaller ones exist.	All LG chairpersons and mayors of city corporations are directly elected.
Cambodia	Councils directly elected at commune level; higher levels elected indirectly by the next lower council.	Multi-party system, but competition limited due to Cambodia People's Party (CPP) dominance.	The sub-national council heads are the candidates receiving the most votes on the majority party candidate list.
Indonesia	Sub-national assemblies elected at local/provincial levels every five years.	Currently a diverse and competitive multi-party system after long single-party dominance.	Provincial governors and local mayors have been directly elected since 2005.
Nepal	Local elections not held since 2002; but reinstated in 2017 under the new constitution.	Electoral competition high with 122 registered parties, but some are very small.	Villages and municipalities have elected chairs/mayors.
Pakistan	Provincial/local elections are required (dedicated seats for women/minorities), but only one province has conducted local elections.	A multi-party system with fairly strong political competition; parties are often defined along clan or tribal lines.	Elected local councils in tehsils and districts select a chair/ mayor. Provincial governments have the authority to dismiss local officials after due process.
Philippines	All levels have direct elections; size depends on type status (province, city, etc.) and population.	Competitive multi-party system, although political parties remain fairly weak.	Provincial governors, municipal mayors, and *barangay* captains are all directly elected.
Sri Lanka	Elections are held at the provincial, municipal and village level to elect a local government council.	Multiple parties identified along ethnic or religious lines. National parties control local nominations.	President appoints provincial governors. The national majority party nominates urban government chairs.
Viet Nam	Peoples' Council elections (direct universal suffrage) at all sub-national levels; VCP (Vietnamese Communist Party) vets all candidates.	The political landscape is under the VCP, although the VCP is functionally pluralist given competing internal factions.	Leaders of sub-national People's Committees are elected by directly elected Peoples' Council members and ratified by the next higher level.

Source: Author compilation.

Some countries have chosen to adopt special features of local elections. Pakistan, for example, dedicates local government council seats to women and minorities. In the Philippines, the number of council members depends on the type of council (provincial, city, municipal, *barangay*) and the population of the jurisdiction. Nominations for local councils face close scrutiny by the ruling party in Viet Nam, a practice that limits choice. These types of specific provisions can have implications for the credibility, fairness and outcomes of local government elections – and for inclusivity.

For the most part, the countries covered here have a multi-party electoral system. At the same time, political competition varies considerably in nature and degree, even if there are legal provisions to promote it. In Cambodia, for example, genuine political competition is relatively constrained at the local level because of the strong dominance of one party and restrictions placed on political party activity at the local level.

Political competition also exhibits various idiosyncracies in other countries. There are, for example, many political parties in the Philippines. Few are particularly strong nationally, but some have become prominent locally. In a few cases, such as Indonesia, Pakistan, and

Sri Lanka, at least some political parties are defined by tribal, clan or religious affiliations. If competition is powerful and confrontational, it may result in outbreaks of violence. But even if the political landscape is dominated by one political party, such as in Viet Nam, regionally based competing party factions can help generate a functionally more pluralist environment, which in turn can help promote a stronger decentralised influence.

There is an evident trend towards elected local leadership in the countries considered here. In a few cases, e.g. Indonesia and the Philippines, governors, mayors and other local leaders are elected directly. In other cases, such as Cambodia, Pakistan and Viet Nam, local government leadership is elected indirectly by the directly elected local councillors. In the case of Pakistan, the province has some authority to dismiss leaders selected by councils, and in Viet Nam, the next higher level has to validate local leadership choices made through the various assemblies. Sri Lanka continues to seat some sub-national leaders through appointment.

Given the importance of elections for local accountability, at least in the broadest terms, it is important to understand the sub-national electoral landscape. If broad-based local accountability is seen as productive for increasing inclusivity in the benefits generated by sub-national government fiscal decisions, then electoral considerations also have clear relevance on that front.

3.7. Access to information and civic engagement

Local elections are indispensable for devolution, but they are a very imprecise instrument of accountability. Many decentralisation experts argue that they need to be augmented by complementary mechanisms to enhance transparency and nurture civic engagement (Table 3.6). Most countries covered here have passed right-to-information (RTI) / access-to-information (ATI) / freedom-of-information (FOI) laws, a number of which incorporate specific provisions for sub-national governments. A few countries, including Bangladesh, include public disclosure clauses in their local government legislation. Some countries have debated related transparency legislation for long periods: Sri Lanka and Viet Nam recently passed such laws, but Cambodia and the Philippines are still working on it.

Table 3.6. Sub-national transparency and civic engagement mechanisms in selected Asian countries

	Information access	Input mechanisms	Feedback mechanisms
Bangladesh	Local Government and RTI Acts require published plans, budgets, etc. and public access to documents.	Local Government Act created local committees to represent citizen interests and demands for LG review.	Ward meetings allow feedback to local councils but may be subject to elite capture; centre has final authority over use.
Cambodia	Draft Access to Information Law under discussion. Local councils must display official notices and information about their activities.	Local civic participation through a broad-based planning forum at all stages of local planning and budgeting. There is open access to council meetings.	Residents permitted to attend council meetings and ask questions or make comments in writing that the council is obligated to respond to.
Indonesia	Constitutional amendments and anti-corruption laws promise access to public information/transparency. The Public Information Disclosure Act was passed in 2008.	Citizen input into LG planning processes is provided for but limited and uneven in practice; generally strongest with small-scale community services provision mechanisms.	Insufficient attention to the development of effective local accountability mechanisms beyond technocratic provisions.
Nepal	The RTI Act (2007) requires access to information and documents of public consequence.	Public input is mandated as a part of local planning and budgeting, but participation is uneven and subject to political interference.	National Good Governance Unit reviews corruption charges; many types of social accountability initiatives.
Pakistan	FOI and RTI laws in Punjab/Khyber Pakhtunkhwa provinces; weaker one in Sindh; effectiveness unclear.	Citizen consultation required before budgets are issued, but civic interaction generally limited in practice.	Punjab Province instituted large-scale proactive feedback mechanisms; smaller pilots by some donors and NGOs.
Philippines	An FOI Bill has been under consideration in Congress, but it has not been able to pass both houses.	Formal participatory mechanisms and active citizens in some areas but also challenges with political patronage and elite capture.	Provisions for citizen charters, report cards and citizen monitoring, including some online mechanisms.
Sri Lanka	RTI Act passed enacted in 2017 after long legislative consideration.	During LG planning periods, citizens may submit project requests and may provide input for the budget process.	Central government issued a Citizen's Charter to support collecting and addressing local grievances.
Viet Nam	Law on Access to Information enacted in 2016.	Broadly adopted for development planning, but the centre may limit flexibility in fund use; some provinces increase participation.	Focus on standards/upward reporting, but some LGs use feedback mechanisms and efforts seem to be increasing.

Source: Author compilation.

There is variation in the strength of the laws. The Pakistani legislation, for example, has many exemptions to public access. Even where formally strong laws exist, the extent to which their provisions are adhered to (generally and by local governments) or are drawn upon by constituents is not well documented, although anecdotal evidence suggests that such legislation has not yet really taken hold. Underuse can result from weak will or capacity to enforce the legislation, or citizens may not be aware of their rights or know how to use them.

Additional measures to strengthen local accountability include creating mechanisms that offer citizens channels to participate in local government decision making. Most countries covered here have taken steps, albeit unevenly in policy and practice, to encourage avenues for citizen input in local decision making. Most are limited purpose, such as participatory planning and budgeting, but there are broader efforts, such as citizens' charter initiatives in the Philippines and Sri Lanka. A number of participatory practices are only used at certain levels, such as neighbourhood/village mechanisms in Bangladesh.

The nature and timing of participatory instruments are also diverse. Some involve organised consultation (as in Bangladesh, Cambodia, Indonesia, Philippines and

Viet Nam), while others simply offer citizens the right to attend council or committee meetings. Some occur primarily at early stages (such as providing inputs on development projects and budget priorities in Sri Lanka) while others allow commentary on preliminary priorities identified by local government (e.g. on local government plans and budgets in Nepal and Pakistan).

Other mechanisms solicit performance feedback. These include, for example, appeals processes, complaint bureaus, service ratings, satisfaction surveys, etc. Such mechanisms are not as frequently or regularly used as participatory mechanisms for providing inputs as decisions are being made, but they have been adopted in a number of countries. Citizen report cards and comparable exercises have been pursued both by governments and civil society groups and have been piloted or formally adopted in Nepal, Pakistan, Sri Lanka and Viet Nam. Further, the Punjab province in Pakistan has developed an ambitious citizen feedback process.

There is limited hard evidence about the impact of participatory mechanisms on local government behaviour and outputs; most available assessments are superficial or anecdotal. It does appear that such mechanisms are unevenly used even within countries where they are official policy, and some processes seem fairly perfunctory. There is anecdotal evidence of positive experiences, but there are also reports of weak, ineffectual mechanisms that are constrained by political patronage, elite capture, and limited civic willingness/confidence, among others.

As with the other features of the intergovernmental system reviewed here, civic awareness and engagement are essential to effective local government performance. Citizens need to be willing and able to engage with local governments, who must in turn face incentives to use citizen inputs and feedback. It is not hard to imagine the potential for such dynamics to help improve inclusivity in development.

3.8. Conclusion

There is no easy way to summarise synthetically the decentralisation patterns observed in the group of diverse Asian countries covered in this brief review, much less to robustly assess their general relevance for inclusive decentralisation. Although all of the countries are all pursuing decentralisation in some form, the specific features of the system and the dynamics underlying the shape it has taken create both opportunities and threats for sub-national government performance in general and in terms of specific objectives.

The overall structure of the intergovernmental system is a foundational consideration, and there is much variation on that front. There can be few or multiple levels/types of sub-national government. They may be similarly or differently empowered, and the relationships among them may vary: they may be substantially independent or hierarchically integrated, which obviously affects what they are able to do on their own and how they might work together.

The degree of empowerment of sub-national governments can be difficult to accurately characterise, sometimes because formal frameworks are vague or incomplete. But even where there are comparatively robust frameworks and adequate specificity regarding sub-national powers and functions, the system need not function as designed. A range of factors – constraints created by central (or in federal systems, provincial) government actors who are reluctant to genuinely empower lower levels, serious capacity deficiencies, problematic local political dynamics or limited accountability, among others – can undermine the effectiveness of the system.

Channels of accountability – both upward to central oversight mechanisms and downward to citizens – are routinely incorporated in decentralisation frameworks. Upward accountability mechanisms are more routinely developed, but may not function as intended. In terms of downward accountability, elections are typically conducted (mostly direct) in the countries reviewed here, political competition exists in some of them, and a range of non-electoral transparency and accountability mechanisms (freedom of information laws, participatory processes, citizen feedback instruments) have been implemented in assorted ways and to different degrees. These function erratically in terms of whether citizens accept and use them and the extent to which they genuinely influence sub-national government conduct.

Given the diversity, complexity and caveats involved, few policy generalisations or conclusive recommendations for reform beyond relatively broad statements can be made about the status of, or future prospects for, decentralisation in Asia. Even less can definitively be said about how to frame such reform to promote inclusive development. Yet it is clear that the institutional features covered here matter for fiscal decentralisation to function well, albeit in different combinations under different conditions. More work is clearly needed to establish an evidence base and diagnostic tools on the role that fiscal decentralisation – supported by other institutional and political decentralisation reforms – can potentially play in inclusive development.

Notes

1. See, for example World Bank (2005), (2008) (2015); Ichimura and Bahl (2009), Martinez-Vazquez (2011), Brosio (2014), Smoke (2016), Ramesh (2017) and Chapter 3 of this volume, by Chatry and Vincent.

2. Examples of historical and recent reviews of decentralisation include: Litvack, Ahmad and Bird (1998), Burki, Perry and Dillinger (1999), Smoke (2001), Ahmad and Tanzi (2002), Ahmad et. al (2005), Bardhan and Mookherjee (2006), Shah (2006), Smoke, Gomez and Peterson (2006), Cheema and Rondinelli (2007), United Cities and Local Governments (2007) and (2010), Connerley, Eaton and Smoke (2010), Eaton, Kaiser and Smoke (2011), Martinez-Vazquez and Vaillancourt (2011), Faguet (2014), Dickovick and Wunsch (2014), UN-HABITAT (2015), OECD/UCLG (2016), UNDESA and UNCDF (2017), Bahl and Bird (2018).

3. See, for example, World Bank (2004), Crawford and Hartmann (2008), Bjornestad (2009), Sridharan (2012), Ahmad (2013), Goerl and Seiferling (2014), De Mello (2016).

4. Most cases in this chapter were originally prepared for EC DEVCO (2015) using a framework developed for the Department for International Development (Local Development International, 2013). Two cases (Indonesia and the Philippines) are based in part on (Local Development International, 2013). The material on the South Asia cases is partly drawn from Chapter 3 of World Bank (2015) and Smoke (2016). Some of the information on Cambodia, Indonesia and the Philippines is updated from Smoke (2013). More detailed country references are available in these publications.

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4. Public policy for a modernising China: The challenge of providing universal access to education under fiscal decentralisation

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*One of the key inequalities in China today is the divide between urban residents with local registration (*hukou*) and those without. This chapter examines the historical and systemic causes of this divide between the* hukou *and non-*hukou *populations, focusing on the provision of basic education. The limited access to urban schooling for the children of rural migrants is a divisive issue in the debate on citizenship and social rights of migrants, and one with adverse implications for labour markets and intergenerational mobility. This chapter uses the provision of basic education to illustrate how fiscal decentralisation in China – under particular historical circumstances, produced a divisive, rather than inclusive growth outcome. Moreover, even though education policies have shifted over the past two decades to calling for inclusiveness, their impact has to date remained limited, leaving the government with an inequality it does not want and finding very difficult to reverse.*

4.1. Introduction

One of the key inequalities in China today is the divide between urban residents with local registration – *hukou*, and those without. The *hukou* was an administrative tool introduced in the 1950s to collect vital statistics on the population – age, gender, location (divided into urban or rural), ethnic and class identity, and other characteristics. Its uses evolved to meet changing government objectives in different periods. In the 1960s and 1970s, it was used as an instrument to control population movements, when the government imposed a ban on rural-urban migration and reinforced it with state control of basic consumer goods that were rationed to local *hukou* holders through the issuance of coupons.[1] With the end of migration control and state allocation of basic consumer goods, the use of *hukou* shifted from the 1980s onwards to identifying eligibility for public services. Up through the early 2000s, access to vital public services such as education, healthcare and housing was provided only to residents with local *hukou*. Under this system, hundreds of millions of migrants in Chinese cities were left out of the increasingly generous social welfare benefits provided by the government, as China's "economic miracle" brought rising standards of living.

China's transition to a market economy unleashed not only spectacular economic growth but also rapid urbanisation (Wong, 2013). Starting in the early 1980s, the dismantling of agricultural collectives freed rural labour to leave the land. With government restrictions on population movement gradually eased, the migration of rural workers into cities steadily accelerated as economic growth was creating many new jobs in the factories. With the urbanisation rate having risen from 18% to more than 57%, most people in Chinese cities today are new migrants. With the *hukou* having been turned from simply a registration of one's place of abode into a permanent and inheritable identification,[2] new migrants cannot easily obtain local – urban *hukou* – in their new homes, and the number of "non-*hukou*" urban residents has grown secularly.[3]

Nationwide, the 2010 census found 221 million non-*hukou* urban residents, nearly one in three in the urban population and almost 100 million more than in the 2000 census. In Shanghai, the proportion of population lacking a local *hukou* grew from 20% in 2000 to 39% in 2010. In the newly created export metropolises like Shenzhen and Dongguan, the proportion of the non-*hukou* population is even higher. In 2005, among the 8 million population in Shenzhen, it was estimated that only 1.82 million held a local urban *hukou* (Chan, 2009). For this huge subgroup of non-*hukou* urban residents, the lack of access to vital public services such as education, healthcare, housing and social welfare, hinders their full integration into mainstream society, distorts their participation in the labour market, and blocks their aspirations.

This chapter examines the historical and systemic causes of this divide between the *hukou* and non-*hukou* populations, tracing them to a combination of two factors. The first is the decentralised fiscal system in China that assigns the responsibility for both financing and the provision of public services to local governments. The second is the incremental, reactive policy making that has characterised China's gradualist transition to a market economy.

The focus will be on the provision of basic education, which is an especially apt case for highlighting, not only how fiscal decentralisation may exacerbate inequalities (Prud'homme, 1995), but that it can, in fact, be an obstacle to implementing national policies aimed at promoting inclusion. In China, even though the Education Law (2006) guarantees every child the right to receive nine years of education and has made it free of charge and compulsory,[4] and despite changes in national policy that require local governments to provide schooling to all children residing in the locality, with repeated exhortations and increased financial inputs from higher-level governments, migrants continue to face enormous local resistance that hinders access for their children, especially to state schools.

This chapter is organised as follows: the following section provides some background to the problem, starting with the coincidence of urbanisation with a fiscal decline during China's early transition period. This is followed by a description of the financing framework for basic education. The fourth section traces the evolution of policy responses to the growing demand for school places for migrant children. The fifth section examines changes in financing education since the turn of the century and local government responses. The final section offers some concluding remarks.

4.2. Background on China's urbanisation during the early transition period

From the start of China's transition to a market economy, urbanisation has proceeded on a scale that is unprecedented in human history. From 191 million in 1980, the urban population grew to 302 million in 1990, an increase of 110 million during the intervening decade. In the next decade, the increase grew to 157 million, and 210 million during the following decade. By 2016, the population living in cities had reached almost 800 million, fully 600 million more than at the outset of market reform. Judging from the 2016 number, urbanisation appears to be continuing apace. The dramatic pace and scale of this change can be seen in Table 4.1, which shows that in each of the three successive decades from 1980 to 2010, urban population grew by roughly half, on a rapidly growing base. The population of metropolitan Shanghai, China's largest city, grew from 16 million to 23 million between the 2000 and 2010 censuses, a 43% increase (China Statistics Press, 2011). Beijing grew at roughly the same rate during the period, from 13.6 million to 19.6 million (National Bureau of Statistics of China, 2011).

Table 4.1. Urban population and growth in China per decade, 1950-2010

	Urban population (millions)	Increase over past decade	Urbanisation rate
1980	191.4	47.16	19.4%
1990	301.95	110.55	26.4%
2000	459.06	157.11	36.2%
2010	669.78	210.72	49.9%
2016	792.98	123.2*	57.3%

Note: *since 2010 census.
Source: National Bureau of Statistics of China (2011), *China Statistical Yearbook 2011*; National Bureau of Statistics of China (2016), *China Statistical Yearbook 2016.*

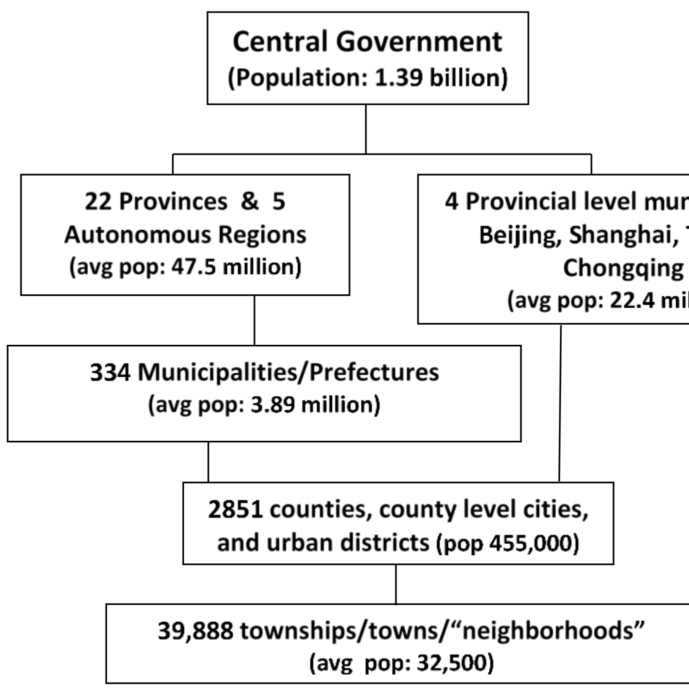
Providing infrastructure and public services to accommodate urbanisation of this scale would pose a gargantuan challenge to government finances anywhere. In China, the challenge was all the more daunting because the upturn in urbanisation coincided with a deepening fiscal crisis, as the dismantling of the planned economy brought a catastrophic collapse in the government's revenue mechanisms, and the budget fell from more than 30% of gross domestic product (GDP) at the outset to a nadir of just 10% before a new tax system was installed in 1994 and began to restore fiscal health from the late 1990s onward (World Bank, 2002) (Wong and Bird, 2008). Through the 1980s and 1990s, with the central government preoccupied with the relentless fiscal decline, cities – and indeed all local governments - were left to fend for themselves (Wong, 2009) (Wong, 2013). When the

1994 reform imposed a recentralisation of revenues without adjusting expenditure assignments, local governments were left facing a large vertical fiscal gap and great difficulty in meeting their responsibilities for providing services (World Bank, 2002[21]) (Wong, 2009). The mechanisms and strategies of Chinese municipal finance were forged in this difficult fiscal environment.

4.3. Fiscal decentralisation in China and the financing framework for basic education

China is a large country with a highly decentralised administrative structure. Below the central government are four levels: at the first level are 31 provinces, autonomous regions and municipalities with provincial status. At the second level are roughly 330 prefectures and municipalities. Below them are 2 850 counties, county-level cities and urban districts. At the bottom are 40 000 townships, towns and urban "neighbourhoods" (Figure 4.1).

Figure 4.1. China's administrative structure



Source: Chinese Statistical Yearbook (2017).

As expected in such a large country, China's regions are diverse, with large variations in the level of development and administrative capacities. For example, in 2017 per capita income ranged from USD 4 200 in the poorest province (Gansu) to over USD 19 000 in the richest (Beijing).[5]

In 1986, the government committed to providing nine years of education for all children, made it tuition-free, and compulsory.[6] Despite its high priority, this commitment was made without a special financing framework, and the arrangements were left to be worked out through the intergovernmental fiscal system.

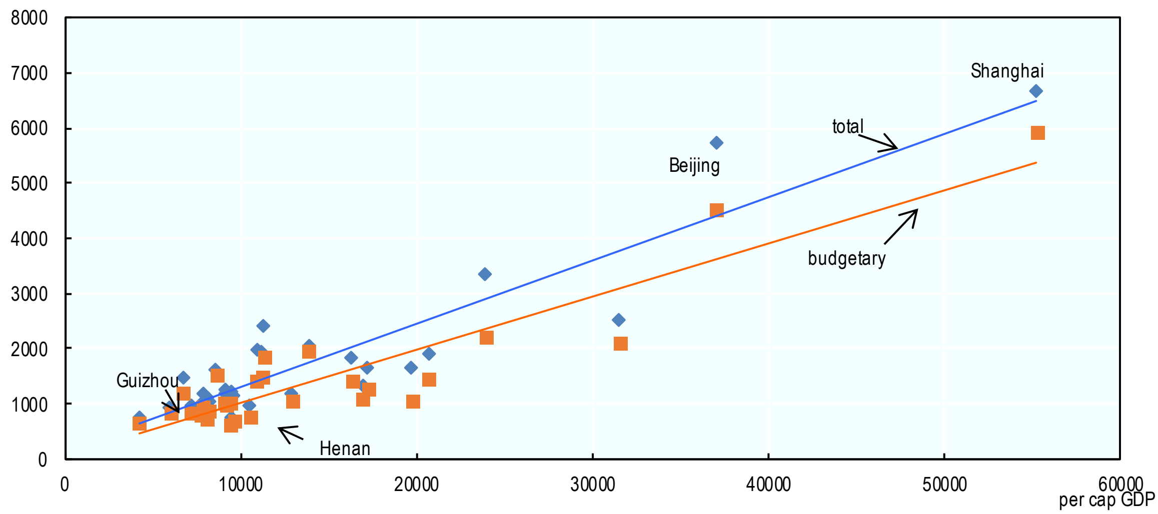
Prior to market reforms, responsibilities for providing most services were assigned to the lowest level of local governments, and these assignments formed the basis for the annual revenue-sharing arrangements that were designed to leave local governments with sufficient resources to fund them. This set-up was eroded in the 1980s and 1990s as reforms sought to impose financial discipline on local governments (World Bank, 2002[21]; Wong, 2009). The link between revenue-assignment and expenditure needs was severed in 1994 when the Tax Sharing System replaced the negotiated revenue sharing with tax assignments, and local governments had to manage their expenditures under the hard budget constraints defined by their tax bases. As a result of fiscal difficulties at the local levels, the achievement of universal compulsory education (UCE) for all children took more than two decades to realise, especially in rural areas (Brock, Hu and Wong, 2008; Wong, 2009).

Until the early part of this century, the key features of the framework for financing compulsory education were:

1. Responsibilities for providing compulsory education were assigned to local governments at the grassroots levels – districts and "neighbourhoods" for urban schools, and counties and townships for rural ones.
2. Financing was local – transfers were not targeted to ensure local governments have sufficient resources to meet their specific expenditure needs.
3. As the demand for social expenditures exceeded aggregate fiscal capacity, the central government called on local governments to mobilise extra-budgetary resources to support the continuation of service provision. Schools, hospitals, clinics and other public service providers collected fees, donations and generated other revenues, including running enterprises. In the late 1990s, extra-budgetary resources financed nearly half of total expenditures in primary and junior middle schools,[7] and school fees were often an onerous burden in the poor regions dependent on subsistence farming (World Bank, 2007; Wong, 2009).
4. Per capita funding varied widely across localities for all public services, largely corresponding to local fiscal capacities. Since fees and other extra-budgetary levies are even more tightly linked to per capita incomes than tax revenues, the high dependence on extra-budgetary funds tended to amplify regional disparities. This is illustrated in Figure 4.2, where per-student spending in primary schools is shown to be highly correlated with per capita GDP across provinces, and coastal provinces such as Shanghai and Beijing outspent the poorest inland provinces such as Guizhou and Henan by nearly ten-fold.

Figure 4.2. Per student primary school expenditures by Chinese province

In CNY, 2004*



Note: *Tibet is excluded as an outlier
Source: Ministry of Education (2004), *Chinese Education Finance Statistical Yearbook 2004*, Chinese Statistical Press, Beijing.

Since the turn of the century, new pro-poor policies and increasing central transfers have helped to vastly increase spending on education and stem the trend of growing regional disparities, but they remain large. In 2015, Beijing spent more than five times as much per student in primary schools as Henan – nearly CNY 24 000, compared to CNY 4 100 (Table 4.2). Disparities are also large across counties and districts within a province. In Guangdong, for example, while the provincial average was CNY 5 600 per student in primary schools in 2012, the average district in Shenzhen municipality spent CNY 16 000, and the province's poorest counties spent barely CNY 2 000 (Guangdong Province, 2013). In general, urban local governments can spend more on services than their rural counterparts can. In Chengdu central business districts, the average budgetary expenditure per student was CNY 12 000 in 2013, compared to the Sichuan provincial average of around CNY 5 000.[8]

Table 4.2. Disparities in provincial average per student expenditure in Chinese primary schools

In CNY

	2004	2010	2015
Highest	5 925	18 545	23 757
Lowest	620	2 170	4 575
Highest/lowest	9.6	8.5	5.2
Average	1 443	5 543	10 423
Standard deviation	1 111	3 499	4 112
Coefficient of variation	0.77	0.63	0.39
Highest province	Shanghai	Beijing	Beijing
Lowest province	Henan	Henan	Henan

Source: Ministry of Education, *Chinese Education Finance Statistical Yearbook*, various years.

This financing framework is extremely unfavourable to integrating migrant populations into urban compulsory education since municipal governments are unwilling to pay for "non-citizens". First, education is costly to provide. In Hubei, a middle-income province, expenditures on education absorbed on average 24% of county-level budgets in 2007. In the Wuhan municipality, they accounted for 25% of district expenditures and 26% in the Huangshi municipality; in some districts, they took up as much as 37%. From the turn of the century, increasing transfers from the central government began to supplement and replace some of the local government expenditures; even so, in fieldwork we found that the 13 districts in Wuhan spent on average 17% of their budget on education, and the six districts in Huangshi spent on average 18% but reaching 34% in Huangshigang District.[9] Moreover, because of better funding, urban schools are of generally higher quality than rural schools, and municipal governments fear that opening the door to including migrants may attract an unmanageable surge of new entrants. One official in a coastal city explained that "they (the migrants) will bring not only their children but their nephews and nieces and everyone else from the village!"[10]

4.4. The evolution of education policies for migrant children in China

Prior to 1990, official policy took little notice of the rapidly unfolding urbanisation and the need to accommodate a growing population of migrant children in urban schools. Under the *hukou*-based entitlement system, migrant children had few rights to education in the cities. With growing migration, the government began in the 1990s to develop a strategy of limited accommodation to enrol migrant children in urban schools, though usually in private (*minban*) schools operating at much lower standards than public schools. It was not until after 2001, but especially since 2008, that official policy shifted to emphasising the need to enrol migrant children in urban public schools. The pace of change has further accelerated since 2010, when the national Medium and Long-Term Strategic Plan for the Development of Education (July 2010) called for full incorporation of migrant children in the system and put fairness at the core of its objectives.[11] The evolution of education policy changes can be divided into three phases.

4.4.1. Phase 1: The 1990s

The first official mention of the issue of providing education opportunities for migrant children came in the implementation regulations of the compulsory education law in March 1992, which stated that, subject to approval by officials in the home jurisdiction, children may apply to enrol in urban schools on a temporary basis (Education Commission, 1992)(Article 14). More specific guidelines for the education of migrant children in urban areas were laid out in 1996, when the Education Commission called on urban local governments to take responsibility for the education of migrant children and provide opportunities for their enrolment in urban schools on an experimental basis if they could provide the required documentation (Education Commission, 1996). If the migrant children could not be accommodated in local state schools, the guidelines allowed for non-state schools to be set up, upon approval by the urban local government, to specialise in the education of migrant children with private financing (Article 11). They also stipulated that when admitting migrant children, urban state schools may collect charges and fees, the standards of which should be reported to the municipal or district education departments and price bureaus for approval (Article 15). These calls were reiterated periodically through the late 1990s to ensure educational opportunities for migrant children.[12]

The principles were laid down that:

1. Under the Compulsory Education Law, migrant children, like all school-age children in China, have a right to compulsory education.
2. The entitlement to compulsory education is *hukou*-based and not residence-based. If parents choose to enrol children in a school, not in their *hukou* jurisdiction, approval is required both from their "home" government and the receiving government, and the children's parents must bear the costs of being accommodated by the receiving schools. This lack of entitlement was reflected in the language that was used for the various "education rental fees" (*jie du fei*), "education compensation payments" (*jiaoyu buchang fei*) and school choice fee (*ze xiao fei*).
3. In line with the second principle above, it was also accepted that migrant children could be accommodated in non-state schools that impose no financial burden on the host urban governments.

4.4.2. Phase 2: 2001-05

From the turn of the century, coinciding with the government's new focus on improving livelihood and public services in the rural sector,[13] policies toward the education of migrant children became more accommodating. In 2001, for the first time, the State Council Decision on the Reform and Development of Basic Education raised the idea of the "two mainly's" – that migrant children should be accommodated mainly locally, and mainly in state schools (State Council, 2001). This was followed in quick succession by several important documents in 2003-05, starting with the No. 1 document of 2003 jointly issued by the Party Central Committee and the State Council on improving agriculture and rural work.[14] The document emphasised the need to support the migration of farmers into cities and ensure that their rights are respected and discrimination ceased (CCPCC and State Council, 2003). Equally, this includes the right of their children to basic education.

In September, the State Council Circular on Further Improving the Work on Compulsory Education for Migrant Children spelt out in detail the requirement that urban local governments in the receiving areas must include migrant children in the local education systems to ensure that they can receive compulsory education locally (State Council, 2003). Issued jointly through the Ministry of Education, the Central Post Commission, the Public Security Bureau, the National Development and Reform Commission (NDRC), the Ministry of Finance (MOF), and the Ministry of Labour and Social Security (MOLSS) and other agencies, the circular called on local governments receiving migrants to set appropriate administrative procedures to ensure the education of migrant children. It specified that local public security bureaus should provide timely information on school-age migrant children to the education departments; the education departments should incorporate migrant children into their work plans for compulsory education; the NDRC should incorporate the schooling needs of migrant children into local development plans for capital spending, the finance departments should put into the budget the needed funding; and the post commissions should allocate posts for the needed teachers, etc. The circular even calls on the city agencies responsible for community affairs to monitor migrant children's progress, and, if necessary, urge errant parents to enrol their children in compulsory education in compliance with the law.

On financing, the circular called on the host urban local governments to establish a mechanism for guaranteeing funding for the schooling of migrant children, and provide financial assistance to schools that have enrolled more of them. It directed a part of the education surcharge receipts be set aside for the education of migrant children. It called for a review of the fee levels for migrant children and that they be reduced to be more in line with those for local students. For the children of low-income migrant workers with unstable jobs and residences, the circular called for financial assistance to be provided to defray fees and provide free textbooks. In December 2003, the Joint Notification issued by MOF, MOLSS, the Ministry of Education, the Ministry of Public Security and the Family Planning Commission called for the establishment of a funding mechanism for public services for migrant workers by incorporating their expenditure needs, including for educating their children, into the scope of recurrent budgetary expenditures (Ministry of Finance, Ministry of Labor and Social Security, Ministry of Public Security, Ministry of Education and Family Planning Commission, 2003).

These changes brought an expansion of migrant children's rights to schooling in cities, and increasingly to being accommodated in state schools. The obligation to pay was retained, although measures were introduced to seek to protect children from excessive fees. At the same time, measures were introduced to set standards for *minban* schools, and to provide some subsidies for their upgrading.

4.4.3. Phase 3: 2006 – Toward inclusive education

The revised Education Law in 2006 guaranteed the right of every child to receive compulsory education free of charge. This was a radical change from the past when UCE depended on "diversified funding" whereby budgetary funds were supplemented substantially by fees and other revenues. As noted earlier, for the rural sector the central government had committed to providing funding to enable rural schools to abolish all fees from 2007 onward. By 2008, free compulsory education was extended to include urban schools (State Council, 2008). The State Council notification also called for migrant children enrolled in urban state schools to receive the same exemption from fees, including the onerous "education rental fees". It called on urban local governments to treat migrant children on the same basis as local children in allocating school expenditures, both for those enrolled in state schools, as well as those enrolled in private (*minban*) schools under urban local government sponsorship. With this, official policy on the right of children to UCE has completed its move away from being based on *hukou* to residence-based.

4.5. Changes in the financing of education in China since 2000

The financing of UCE has undergone great changes since around the turn of the century. First, under policies calling for improving public services, budgetary expenditures on education have increased rapidly, from CNY 96.5 billion in 2000 to CNY 1.4 trillion in 2010, a 14.4-fold increase in nominal terms and a 10-fold increase in real terms. The acceleration of spending became especially marked after 2006, when the new Education Law (2006) stipulated that compulsory education would be "implemented free of tuition and fees," and committed the state to "… building a system of protected funding for UCE operating costs, to guarantee that it can be implemented" (Article 2). The law also laid out a framework for financing to be shared by the government at all levels and assigning the responsibility for co-ordinating its implementation to the provinces.[15] Reflecting this change, in 2010 more than 90% of total expenditures in UCE were financed by budgetary appropriations, compared with just over 50% in 1997 (Ministry of Education, 1997[35]; Ministry of Education, 2010).

To support these changes, the central government has greatly expanded intergovernmental transfers and introduced many funding programmes for UCE. The efforts began with the rural sector, where financing problems had been the most acute.

First are the earmarked, programmatic transfers. In 2003, the central government introduced a programme to provide free textbooks, in response to survey findings that the cost of textbooks was a significant barrier to school attendance for children from the poorest households. The programme had started with modest goals. Initial plans provided a subsidy of CNY 200 million, and limited eligibility only to students from families with incomes below the poverty line living in the nationally designated poor counties.[16] Once started, it was scaled up quickly. By 2005, the textbook programme had grown to include exemptions from all fees, and, for students from poor families, a subsidy to offset the cost of boarding at school. The programme became known as the "Two Exemptions (of the textbook fee and miscellaneous fees) and One Subsidy (boarding subsidy)," or TEOS for short, and it covered an estimated 30 million students. More importantly, the government had decided to extend the TEOS to all rural students in compulsory education, beginning with the western provinces in 2006, and to all provinces beginning in 2007 (Brock, Hu and Wong, 2008).

To ensure adequate funding for schools, the government introduced a new transfer, the "rural education operating cost guarantee mechanism" (often called "the New Mechanism"), and committed to raising the standards of provisions step by step. In fact, per student allocations have risen rapidly, from CNY 80 in 2006 to CNY 750 in 2017 for primary schools, and from CNY 100 to CNY 950 for junior middle schools.[17] To put in place a long-term framework for upgrading the quality of school buildings, the School Safety Programme was introduced, under which the central government provides subsidies to cover a portion of agreed maintenance and construction costs of schools. Starting in 2006, the government also rolled out a programme to help resolve the "education debts" of local governments that had borrowed for school construction, including those for many village schools.

More important than the programmatic transfers are the general transfers that support local government payrolls. As teachers constitute the majority of public employees at the grassroots levels, and since salary payments are the biggest cost component for basic education, these transfers are the main source of support for UCE, albeit indirectly. This support started with the equalisation transfer introduced in 1994, which allocates funding to provinces according to the gap between their "standard expenditure" and "standard revenue" calculated by the Ministry of Finance using a formula that includes education and teachers' salaries as core components (Li, 2006). Funding under this transfer was negligible at the outset but has grown rapidly since 2002 to reach CNY 2.07 trillion in 2016 (Wong and Bird, 2008) (MOF final accounts for 2016).[18]

Another important transfer is the "wage adjustment transfer" (WAT). First introduced in 1999 and intended only to offset the cost of the wage increase mandated by the central government, the WAT grew rapidly as public sector wages have risen steeply, and came to cover a substantial portion of wage payments at local governments before it was folded into the equalisation transfer. In Hubei province, for example, as teachers comprise 60% of public employees at the county level, this transfer was reportedly a principal source of central government financial support for rural UCE in 2013.[19]

In addition, given the key role counties play in public service provision, there is a transfer devoted to strengthening fiscal capacity at the county level. This too is aimed at supporting salaries since "fiscal capacity" is defined as the capacity to "ensure normal payment of wages".[20] The State Council's repeated calls to ensure teachers are paid "on time and in accordance with stipulated standards" (State Council, 2005) have led to the introduction of the Rural Compulsory Education transfer, and earmarking for rural UCE 10% of the Rural Tax for Fee Reform transfer.

Given the preponderance of transfers aimed at supporting public sector payrolls at local governments, it is not possible to make a full accounting of all central transfers for basic education. What is clear is that the central government is funding a substantial and growing share of the costs. In Hubei, a middle-income province, officials estimate that two-thirds of total spending in compulsory education came from the central government.[21]

From examining these transfer types, we can identify two salient characteristics of current central government support for UCE. First, they are strongly targeted toward lower-income western and central provinces. For the TEOS and the New Mechanism, the central government provides 80% of the costs for western provinces, 60% for central provinces, but only a minor percentage for the eastern provinces, with the three metropolises of Beijing, Tianjin and Shanghai receiving no support. Second, they are targeted almost entirely at rural schools. The costs of urban schools are left to local governments, mostly at the lower administrative levels (State Council, 2008).

Despite growing awareness of the problem of migrant children at the sectoral level, transfers policy continues to lag behind. Only one small programme appears to be aimed at subsidising the costs of educating migrant children. Introduced in 2008, the programme provides fiscal incentives by rewarding provinces that have performed well in absorbing migrant children into urban schools.[22] The rewards are very small. In August 2011, the Ministry of Finance announced that CNY 4.57 billion had been earmarked for this programme (People's Daily, 2011). In 2014, it had grown to CNY 13 billion, a tiny amount compared to costs.[23]

If we turn to examine where migrant children are concentrated (Table 4.3), we can see an almost perfect mismatch between central subsidies and where the children are - predominantly concentrated in rich coastal cities that are largely outside the orbit of intergovernmental transfers. While these cities are rich, the financing of basic education takes up a significant share of municipal budgets; at the districts and counties where the expenditure occurs, it takes up an even larger portion of budgets. As a result, these local governments continue to view the education of migrant children as an unwelcomed, costly unfunded mandate, irrespective of how education policies have changed.

Table 4.3. The distribution of migrant children and the cost of financing in China

City	Education in budget expenditures (2011, %)	Share of migrant children in compulsory education (%)	Year of enrolment data
Dongguan	23.7	71.4	2010
Foshan	21.5	45.0	2011
Ningbo	15.7	42.6	2012
Beijing	16.0	40.0	2009
Hangzhou	17.7	38.9	2009
Shanghai	14.0	36.0	2009
Guangzhou	14.8	30.0	2011
Tianjin	17.2	17.9	2011
Chengdu	13.7	16.0	2010

Source: Statistics Yearbook for each city, 2012; and press reports.

4.6. Conclusion

In China, at the heart of the challenge of providing universal access to education that includes migrant children – and indeed to all social services - is the misalignment between the national government's commitment to universal provision and the decentralised financing framework, where local governments often lack adequate resources and/or incentives for implementation.

The evolution of education policies for migrant children illustrates the process and limitations of incremental, reactive policy making in China, where the top leaders were slow to respond to the dramatic change brought by rapidly unfolding urbanisation. In the absence of a set of accepted standards for equality and fairness in the process of economic change, decentralised policy making proceeded along traditional, cellular lines, and migrants had few champions to defend their rights. Three decades later, the government finds itself facing an inequality it does not want and is finding very difficult to reverse.

That this problem has persisted despite rapidly increasing central government financial injections over the past decade illustrates the sclerotic nature of decision making – central funding continues to be wholly targeted to rural schools even though rural children have decamped and moved *en masse* to cities. Since central transfers are funding fully half or more of total expenditures for compulsory education, it should in principle be possible to make the funding follow the children and finance their costs in urban schools. The New Mechanism (for non-salary operating costs) and TEOS (for fee and textbook waivers and boarding school subsidies) are well designed for this purpose since the funds are allocated on a capitation basis by enrolment. The vast majority of central funding, though – as much as three-quarters of the total – go to salary support and are largely immobile. To make the transfers better meet the needs of China's increasingly mobile population will require a fundamental revamping of the system – a considerable task involving making them more transparent, changing the basis for allocation, and shaking up the rural administrative structure. A great deal of political resistance will also have to be overcome to radically change the distribution of transfers, withdrawing them from schools in the lower income provinces such as Henan, Gansu, and Sichuan in the central and western regions and giving them to those in the richer coastal provinces like Guangdong, Jiangsu, Beijing and Shanghai that are magnets for migrants. A better solution would be to wholly revise the revenue and expenditure assignments with provinces and give them a bigger role in both financing and managing service provision – in other words, a thorough revision of the intergovernmental fiscal arrangements. Intergovernmental fiscal reform is, at long last, a priority on the government's reform agenda for 2018-20, but it will unlikely be quick or smooth.

Notes

1. During the 1960s and 1970s, coupons were required for the purchase of grain, cotton and scarce items such as bicycles and wristwatches. Local *hukou* holders picked up their monthly coupon rations at the neighbourhood public security bureau – for example, an adult male received coupons for 30 kilograms of grain per month. The coupons were required to be turned over for purchases, including for restaurant meals.

2. The *hukou* was historically passed along from mother to child, but some flexibility has been introduced in recent years, with some localities permitting urban *hukou* to be passed on from either parent (for example, see a news report from Qingdao, Shandong at http://news.163.com/14/1017/11/A8OMGIQ600014Q4P.html).

3. In legal terms, everyone in China has a *hukou*, be they rural or urban. To minimise confusion, in this chapter, we will use *hukou* as a short hand to denote the status required for access to (excludable) public services in cities.

4. Compulsory Education Law of the People's Republic of China (2006). The 1986 law was amended at the 22nd Session of the Standing Committee of the Tenth National People's Congress on 29 June 2006. For more information, see http://old.moe.gov.cn/publicfiles/business/htmlfiles/moe/moe_2803/200907/49979.html.

5. Chinese Statistical Yearbook 2017.

6. The Compulsory Education Law of the People's Republic of China was adopted at the Fourth Session of the Sixth National People's Congress on 12 April 1986 and promulgated by Order No. 38 of the President of the People's Republic of China on 12 April 12. See www.china.org.cn/government/laws/2007-04/17/content_1207402.htm.

7. Budgetary appropriations accounted for only 56% of total revenues for primary schools and 54% in junior-middle schools in 1997 (Ministry of Education, 1997).

8. Fieldwork information, June 2013.

9. Figures from 2011-12.

10. Fieldwork information, June 2013.

11. See the Outline of China's National Plan for Medium and Long-term Education Reform and Development (2010-2020) at https://internationaleducation.gov.au/News/newsarchive/2010/Documents/China_Education_Reform_pdf.pdf.

12. See, for example: (State Council, 1997) and (Education Commission, 1998).

13. These changes came under the "three rurals" strategy emphasising investments in agriculture, farmers and rural villages. Under these pro-rural policies the government introduced numerous programmes intended to improve rural incomes and raise standards of living, and improve rural public services (World Bank, 2007) (Lin and Wong, 2012).

14. The No. 1 Document of the State Council – the first one issued in the new year, usually focuses on issues representing the government's highest priority for the year.

15. Including autonomous regions and municipalities directly under the central government.

16. These are the 592 "Key Development Counties" that are the main recipients of assistance under the national poverty-reduction programme.

17. For more information, see www.xinhuanet.com/politics/2016-12/18/c_129409391.htm.

18. In the mid-1990s, the equalisation transfer provided less than 10% of the gap between "standard revenue" and "standard expenditure".

19. Interview at the Comprehensive Department, MOF, March 2013.

20. This comes under the awkwardly named "incentive funding mechanism to ensure basic functioning at the county level", which has grown to CNY 204.5 billion in 2016.

21. Fieldwork information, March 2013.

22. The rewards are to be based on several measures: the total number of migrant children enrolled in school, the proportion of migrant children enrolled in state schools, the proportion of enrolled migrant children from outside provinces, and the amount of fiscal input and subsidies provided.

23. For more information, see http://shs.ndrc.gov.cn/shfzdt/201407/t20140717_619148.html.

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5. Inclusive growth and fiscal decentralisation in Japan: Current state and challenges

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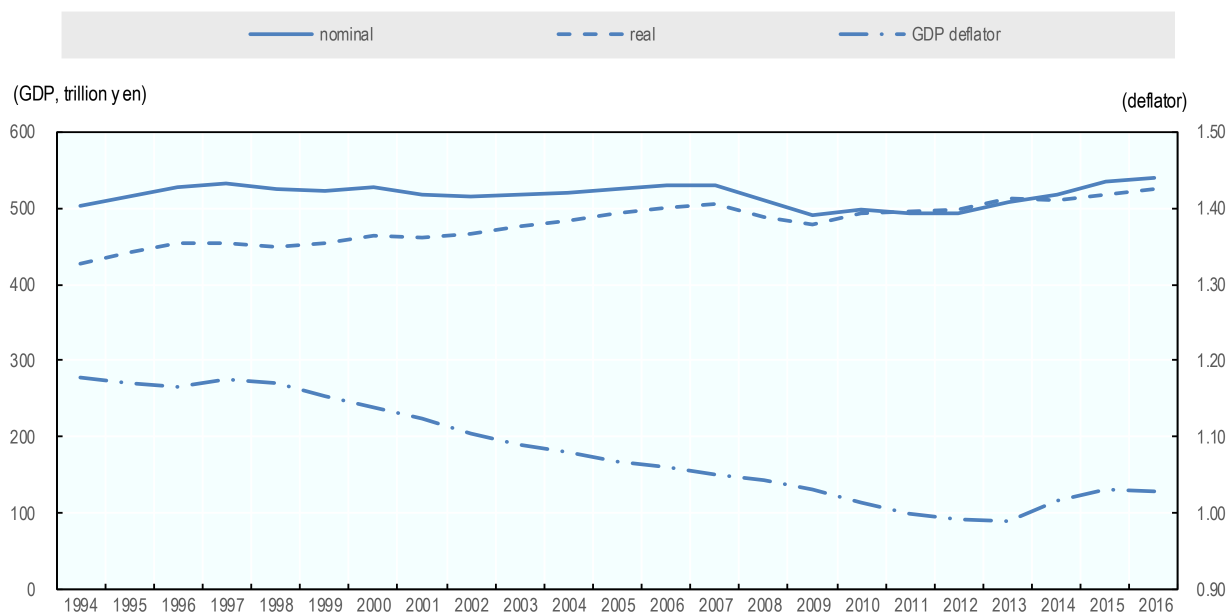
This chapter examines the current state and challenges related to inclusive growth and fiscal decentralisation in Japan. After reviewing the literature, it discusses the Japanese system of local public finance, with a description of recent reforms that have contributed to its fiscal decentralisation. The discussion highlights the integral role of local governments in the Japanese system of social protection, and it considers how and to what extent fiscal decentralisation could play a role in inclusive growth in the Japanese context. The rapid pace of ageing and population decrease in the country indeed poses serious challenges for inclusive growth and local public finances, which make it important to consider the roles of agglomeration and intergovernmental transfers.

5.1. Introduction

Japan has suffered from a stagnant economy for the last quarter of a century. Figure 5.1 shows its annual gross domestic product (GDP) (fiscal year) since 1994 in both current and constant prices, along with the GDP deflator. In current value, it had virtually no growth between 1994 and 2016, with small ups and downs during the period along with a large dip in 2008. The average annual growth rate during the period was as small as 0.33%. In constant prices, however, steady growth can be observed, with small dips in 1998, 2001, and 2014 and a relatively large dip in 2007–08. The average rate was below 1% (0.95%), however.

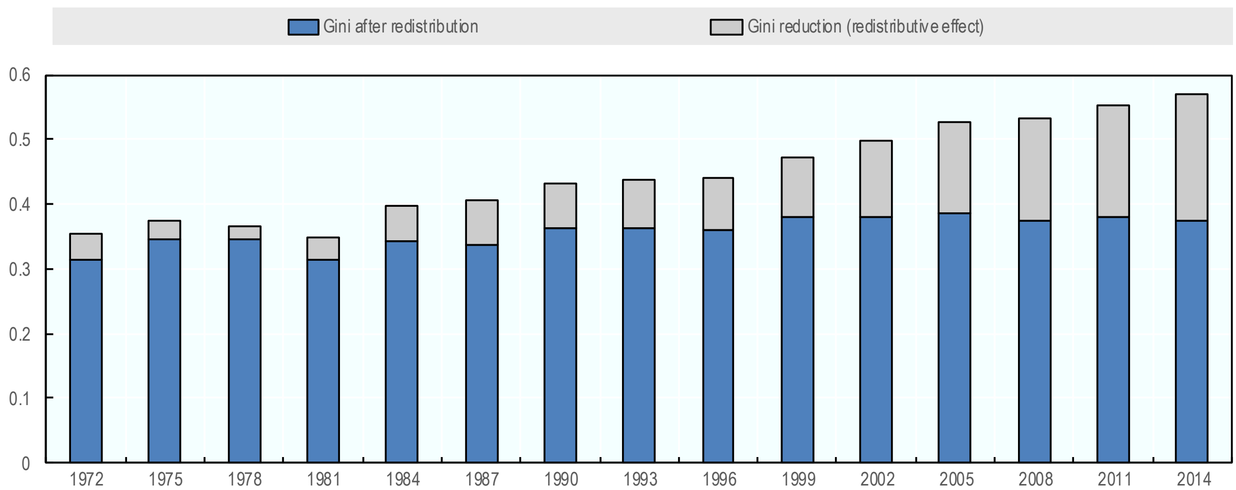
Figure 5.1. Trends in Japan's GDP (nominal and real) and GDP deflator, 1994-2016



Source: Cabinet Office (2017), *National Economic Accounts FY 2015*.

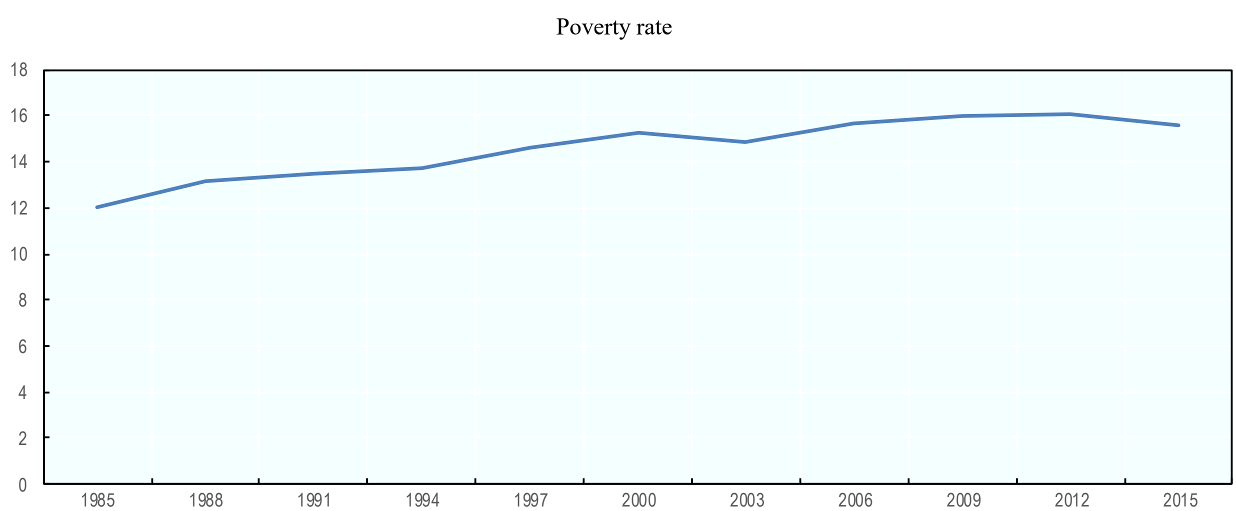
Japan has also suffered from increases in market inequality (Gini coefficient before redistribution), especially after the late 1990s, as Figure 5.2 shows. While a large part of the increasing inequality was attributable to Japan's ageing population (Ohtake, 2005), the increase in recent years is conspicuous even after controlling for the ageing effect (Shikata and Tanaka, 2017). While redistribution measures seem to be effective, with stable values of after-redistribution Gini coefficients after the 1990s, the Gini indices in recent years are almost equal to those before redistribution in the 1970s and 1980s. In addition, redistribution may not have been sufficient to reduce "poverty". Figure 5.3 shows a steady increase in poverty rates based on income after redistribution in cash. Since this poverty rate refers to the ratio of households whose equivalent incomes are smaller than half of the median, it implies that the lower tail of the income distribution is gradually thickening.

Figure 5.2. Japan's Gini coefficient, before and after redistribution, 1972-2014



Source: (Ministry of Health, Labour and Welfare), *Survey on the Redistribution of Income*.

Figure 5.3. Poverty rate in Japan, 1985-2015



Source: Ministry of Health, Labour and Welfare, *Survey on the Redistribution of Income.*

Inclusive growth is therefore an important policy issue for Japan, as it needs to target economic growth and inequality reduction at the same time. It is interesting that during the same quarter of a century, Japan has also implemented a series of fiscal decentralisation reforms. Starting with the Decentralization Promotion Act in 1995, Japan revised 475 national pieces of legislation that had tightly controlled sub-national government policies in 2000. Afterwards, it reduced the number of categorical grants and compensated for the reduction with an increase in local taxes in the mid-2000s. In a series of reforms, furthermore, it has also relaxed its regulations on local governments when they adopt new taxes, change local tax rates and bases, and issue public bonds. Furthermore, the central government tried to increase the administrative capacity of municipalities through municipal mergers and promoted the devolution of prefectural functions to municipalities.

Local governments are an integral part of the social protection system in Japan (Hayashi, 2006, 2007, 2010). As such, it is worth considering how and to what extent fiscal decentralisation could play a role in inclusive growth in the Japanese context. Furthermore, there are pressing challenges caused by the rapid pace of ageing and gradual population decrease in Japan, challenges that are indeed related to inclusive growth. With this as background, this chapter discusses the current state and challenges facing inclusive growth and fiscal decentralisation in Japan. The structure of the chapter is as follows. The next section reviews the theoretical and empirical literature on the effects of fiscal decentralisation on economic growth and income inequality. While the exact definition of inclusive growth may be elusive, we regard "inclusive growth" as economic growth accompanied by a reduction in inequality and/or poverty. The third section introduces the current Japanese system of local public finance, with a series of reforms that contributed to its fiscal decentralisation. This section also discusses the role of local governments in social protection and inclusive policy. The fourth section delineates the challenges facing inclusive growth in Japan, which highlights the important roles of agglomeration and intergovernmental transfers in this economy with an ageing, decreasing population. The final section offers conclusions.

5.2. Economic growth, income inequality, and fiscal decentralisation

When we consider inclusive growth and fiscal decentralisation, it is useful to examine how economic growth and income inequality interact, and then see how fiscal decentralisation is related in such an interaction. The empirical literature, with recent data from OECD countries, implies that economic growth may aggravate income inequality, e.g. (Chambers, 2010; Piketty, 2006), while income inequality promotes economic growth (Neves, Afonso and Sliva, 2016). These two causations together imply a self-defeating loop: growth exacerbates inequality, which then hinders growth, making growth unsustainable. An obvious solution to break this cycle is to make growth "inclusive". There may be two routes to do so. The first is through market arrangements, which is indirect in the sense that government aims to change the parameters that shape markets to increase wages (before redistribution) for low-income households. The other is through redistributive measures, which is direct in the sense that government redistributes the fruits of growth by taxing those who benefit more from growth and by transferring the proceeds to those who do not.

The literature shows that fiscal decentralisation affects both growth and inequality in some way. In what follows, we summarise the literature on the effect of decentralisation on growth and inequality. The purpose is to examine if fiscal decentralisation promotes growth and decreases inequality, thereby breaking the loop, such that fiscal decentralisation could make growth both "inclusive" and "sustainable".

5.2.1. The effect of decentralisation on economic growth

There is indeed a large body of studies, both theoretical and empirical, that examine the effect of fiscal decentralisation on economic growth. If fiscal decentralisation only promotes growth and does not affect inequality, it indirectly aggravates inequality, provided that growth aggravates inequality as the discussion above implies. In this case, we could conceptualise decentralisation as a governance structure that affects market arrangements before redistributive measures are taken. There are indeed theoretical studies that explicitly relate decentralisation to growth. For example, Feld, Schnellenbach and Baskaran (2012) imply that a decentralised system effectively manages the Schumpeterian processes of creative destruction, leading to higher productivity. Brueckner (1999) and

(2006) presents overlapping generation models where decentralisation would lead to more savings for young individuals and higher growth. An agglomeration model (Xie, Zou and Davoodi, 1999) also shows that a change from a unitary system to a decentralised system may be associated with permanently higher growth. Finally, Edwards (2005) constructs a model of time inconsistency where human capital investment drives growth. A unitary government cannot credibly commit to low tax rates, yielding high taxes, low human capital, and low growth. Meanwhile, the exit option in a decentralised system helps solve time inconsistency, inducing an equilibrium with low taxes, high investment, and high growth rates.

There is an even larger body of literature that relates decentralisation with the more general concept of efficiency. First, since local governments are "closer to the people", they are better informed of the preferences of their residents, cost functions, and other local conditions than a central government (Oates, 2005; Seabright, 1996). In contrast, it may be difficult for a central authority to grasp the preferences of residents and local conditions in the myriad localities that make up a whole country. Second, to the extent that there are different local programmes, there would be more opportunities for local governments to adopt effective programmes (Oates, 1999). Policy experimentation results in trial and error that leads to both successes and failures. Failures at the local level are less costly than those at the national level. Meanwhile, a success in a locality can easily be mimicked by other localities to yield a nation-wide impact. Decentralisation, therefore, constitutes a "laboratory" with smaller costs and larger benefits. Lastly, related to the propagation of small success, decentralisation allows residents to assess their local government by comparing its performance with that of other jurisdictions (Salmon, 1987; Besley and Case, 1995). In other words, they may be better able to hold their government to account and to pressure it to adopt better policy, using policy outcomes in neighbouring jurisdictions as a yardstick. If these features of decentralisation enhance the efficiency of an economy, we naturally expect it to lead to economic growth.

However, these advantages are not always guaranteed. The theoretical proposition of decentralisation fostering growth is model-dependent and does not generally hold. Furthermore, the more general discussions on the efficiency effects of decentralisation have their counter-arguments as well. First, the advantage of "being close" is endogenous, and does not necessarily yield better results. If the central government is more technically able than local government (Smith, 1985), there is no reason why a central authority could not make use of a variety of channels to assemble the necessary information on local conditions (Cremer, Estache and Seabright, 1995). There are also cases where local residents lack the ability to raise their voices, or without central supervision, local elites can capture rents by allocating public resources according to their preferences (Bardhan and Mookherjee, 2000). Second, innovations may be underprovided. Since information on innovation spills over local boundaries, its acquisition is free. Since innovation is costly if it is made through its own effort, a local government will want to "free ride" on innovation made by others, thereby under-providing innovation (Rose-Ackerman, 1980). Third, fiscal competition may not necessarily result in efficiency gains. Independent social spending at the local level may cause externalities through movements of tax bases and recipients, leading to suboptimal resource allocation. For example, local government could set tax rates too low so that local public goods are underprovided when tax bases are mobile among jurisdictions (Wilson, 1999). In addition, the free mobility of residents may lead to an inefficient allocation of the regional population (Flatters, Henderson and Mieszkowski, 1974; Boadway and Flatters, 1982).

It is thus difficult to derive clear-cut predictions regarding the growth effects of fiscal decentralisation, and it is therefore of interest to see how empirical literature answers this question. There is indeed a very large body of literature on the effect of decentralisation on growth, with diverging results. In their meta-regression analysis, Baskaran, Feld and Schnellenbach (2016) construct a histogram on the t-statistics for the coefficient on the decentralisation measure from 376 growth regression estimates, and they show that its distribution is centred around zero. They then regress the t-statistics on variables that describe the setup of the 376 models and show that the individual characteristics of the models and the type of sample affect the results significantly. For example, single-country studies tend to yield a positive effect. They argued that this might be because single-country studies analyse the impact within a common institution, whereas cross-country ones may have difficulties in isolating the effect of institutions other than decentralisation. Furthermore, the sign and significance of the *t*-statistics vary depending on the choice of controls variables. In addition, the choice of the measure for decentralisation has a large effect on the t-statistic. Therefore, they call for additional effort to establish more appropriate theoretical specifications for the choice of controls and a consensus as to how to measure decentralisation in the first place.

5.2.2. The effect of decentralisation on income inequality

When we examine the effect of fiscal decentralisation on income inequality, it is important to distinguish between the distribution of income before redistribution (market income) and that of income after redistribution (disposable income). There are only a few studies that examine the effect on market-income distribution, perhaps because it is difficult to theoretically associate fiscal decentralisation with market-income inequality. As an exception, Sacchi and Salotti (2014) estimate the impact of fiscal decentralisation on the Gini indices of market income with a panel of OECD countries. Using various decentralisation measures, they find that revenue decentralisation increases market-income inequality, while expenditure decentralisation yields no significant effects.

Meanwhile, if we are interested in the distribution of disposable income, the question concerns the effectiveness of decentralised redistribution. There are arguments for decentralised redistribution that are analogous to those for the efficiency of decentralisation described above (Banting and Boadway, 2004). First, local governments, being “closer to the people”, are better informed of the needs of their residents, which is essential for redistributive programmes. Local policy makers with an information advantage may be better able to tailor spending policies to reduce income inequality. They could also reduce income inequality by improving tax collection, taking advantage of local information. If decentralisation increases the share of tax revenues that stay within the locality, there might be stronger incentives for residents to fully declare their income and for local government to exercise their tax authority (Güth, Levatti and Sausgruber, 2005). In terms of implementing redistributive programmes, local governments would be more efficient at administering such programmes, since such programmes are usually delivered by local institutions like welfare agencies and hospitals. In addition, the logic of policy experimentation also applies to redistributive programmes, along with the yardstick-competition argument that holds local governments accountable.

However, also being analogous to the efficiency of decentralisation, these arguments are not always warranted. First, local governments may not exercise their advantages even when better informed. In contrast, decentralisation may bring officials into close contact with local interests, providing opportunities for these local interests to influence policy in their favour, and thereby breed corruption and favouritism. This tendency might even be stronger for redistributive programmes by local governments that fail to attract qualified employees (Prud'homme, 1995). A similar argument may apply to the relationship between local governments and welfare agents. Second, governments could free ride on innovations made by others in redistributive policy, leading to the suboptimal provision of social policy innovation. Third, high-income households could move to jurisdictions where the taxation level is lower, while low-income households could move to jurisdictions where the benefit level is higher, thereby restraining the degree of local redistribution. If potential recipients of and contributors to a redistributive programme are mobile, social spending at the local level may cause externalities, resulting in too low a level of redistribution (Brueckner, 2000).

It is therefore theoretically unclear whether decentralisation leads to effective redistribution that reduces inequality. We thus look at empirical studies, starting with those that utilise the Gini index of disposable income. Neyapti (2006) shows that revenue decentralisation needs good governance to reduce inequality. In contrast, Sepulveda and Martinez-Vazquez (2011) and Goerl and Seiferling (2014) indicate that expenditure decentralisation reduces inequality in countries with a smaller government size. Meanwhile, other studies indicate that both revenue and expenditure decentralisation reduce income inequality generally (Stossberg and Blöchliger, 2017), or only in rich regions (Cavusoglu and Dincer, 2015). A disaggregated analysis, however, indicates inequality-increasing effects in some spending and tax categories, although the effects are small (Stossberg and Blöchliger, 2017).

Other studies use indices that measure the lower tail of income distribution or poverty. For example, Sepulveda and Martinez-Vazquez (2011) measure poverty by the head-count ratio and the poverty gap, both defined with a poverty line of USD 1.25 (in purchasing power parity). Using a panel of developing countries, they show that fiscal decentralisation aggravates poverty, which remains robust after controlling for potential endogeneity. Meanwhile, Stossberg and Blöchliger (2017) utilise percentile ratios against the median, employing a panel of OECD countries. They show that, while fiscal decentralisation tends to reduce the gap against the median for the upper parts of the income distribution, it tends to increase the gap for the lower parts of the distribution.

The above discussion thus implies that fiscal decentralisation may reduce the spread of income distribution (Gini index) but increase the lower tail of the distribution (poverty ratio). As poverty is not reduced, the benefits of decentralisation are not reaching the poor, a result consistent with the findings of Galani, Gertler and Schargrodsky (2008) for school decentralisation.

5.2.3. The effects of decentralisation and country-specific factors

We are interested in examining whether decentralisation affects growth and inequality in such a way as to make growth inclusive and sustainable. While the literature on the decentralisation effect on growth is large enough to conduct a meta-analysis, it indicates that the effect is unclear and depends on the specifics of the study. In contrast, the literature on the decentralisation effect on inequality tends to indicate that decentralisation reduces the spread of disposable income distribution, and also makes its lower tail thick (i.e. aggravates poverty). However, too little research has been conducted to make a definitive conclusion. Furthermore, if decentralisation affects growth, it has an indirect effect on inequality through its effect on growth. From the literature review, therefore, it is hard to characterise the direction of the decentralisation effect on inequality. In addition, we should not expect too much from these empirical studies in the first place, since these empirical models are at best able to show the "average" picture from a panel of different countries. Not surprisingly, it may not help us examine a specific country since the effects are plausibly contingent on the existing structure of government, the existing distributions of income and wealth, and perhaps the existing structure of demography. Furthermore, fiscal decentralisation itself has many dimensions that may not be appropriately characterised by a small number of indicators. Therefore, it is instructive to depart from the "averages" among countries and to look at a single country – Japan, in this case.

5.3. Fiscal decentralisation in Japan

5.3.1. The Japanese system of local public finance

The system of local government in Japan consists of municipalities as the first tier and prefectures as the second tier. The total of 1 741 municipalities is comprised of 791 cities, 744 towns, 183 villages, and 23 Tokyo metropolitan special wards, as of 1 April 2017. Japan's cities are categorised into 20 designated cities, 48 core cities, 36 special cities (which is now in a transitory stage to being abolished), and 687 ordinary cities. Their expenditure functions vary among the types of municipalities. First, towns and villages do not implement some social programmes that are performed by ordinary cities. Second, the special wards do not have a few of the standard municipal functions (firefighting, water supply and sewage disposal), which the Tokyo metropolitan government provides instead. Third, prefectures devolve parts of their expenditure functions into three types of cities, with the largest degree of devolution to designated cities, followed by core and then special cities.

Prefectures, as the second tier, spatially cover municipalities and consist of 47 units (one *to*, one *do*, two *fu*, and 43 *ken*), including the Tokyo metropolitan government (*Tokyo-to*). They are supposed to provide services whose benefits spill over municipal boundaries and require uniform standards across municipalities within their jurisdictions. They also conduct infrastructure projects that are too large to be undertaken by municipalities and provide technical assistance to municipalities when required. In addition, prefectures function as a liaison between municipalities and the central government.

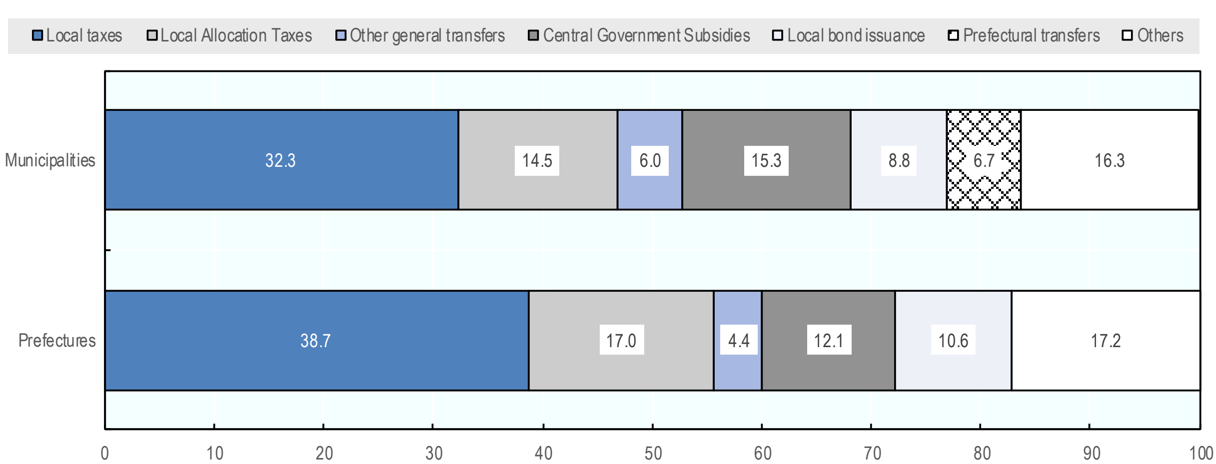
The organisational structure is uniform within a given class of local government. First, relevant national laws specify the structure of the organisation of local governments and assign the same functions (both expenditure and tax-related) to the same class of localities (e.g. prefectures, designated cities, core cities, special cities, ordinary cities, towns, and villages). Second, they are all democratic bodies. The executive and legislative branches are separated. Mayors (for municipalities) and governors (for prefectures) are directly elected for four-year terms through popular voting. Members of municipal councils and prefectural assemblies are also directly elected for four-year terms through popular voting. The executive branch makes and proposes a budget, and the legislative branch approves it.

This organisational uniformity does not imply that fiscal instruments are entirely centralised. While the central government assigns functions and sets national standards for many categories of services, local functions are *not* restricted to the list of items enumerated by the centre. Since local governments are independent authorities, the centre cannot abolish and create local governments without the consent of their local assemblies. Since they are also comprehensive authorities, they can exercise their powers to perform various activities that they find necessary through setting their bylaws (national legislation supersedes local bylaws when they are in conflict). For example, local governments can provide more than the national standards. Such additional services and/or benefits are called *Uwanose* (topping up). In addition, they can also provide services and benefits in areas "adjacent" to those the central assignment originally targets. Such an extension is called *Yokodashi* (widening out). Furthermore, the centre often assigns specific functions *without* specifying any standards local governments are supposed to satisfy. In such cases, local governments are free to choose their level of relevant services. The share of such "discretionary spending" in a given municipality is not small, with the average of 26.9% along with the minimum of 5.0% and the maximum of 72.4% for FY2013 (Hayashi, 2016).

Local spending is financed through local taxes, fees and charges, bond issuance, and transfers (grants) from the upper levels of government.[2] The national law (Local Tax Law, LTL) sets the framework for local taxation by specifying the standard tax bases and rates. As Figure 5.4 shows, major taxes for municipalities include, among others, the inhabitant tax (on personal and co-operative income), the fixed asset tax (on land, structures, and depreciable assets), and the city planning tax (on land, structures, and depreciable assets). Meanwhile, major taxes for prefectures include, among others, the inhabitant tax, the enterprise tax (on corporate income and value added) and the local consumption tax.

Note that local governments can increase the tax rate to a higher level than the standard tax rate set out in the LTL. Municipalities can impose higher tax rates than the standard rate, without upper limits, for the inhabitant tax on personal income and the fixed property tax. There is even no standard tax rate set for the city planning tax, albeit with a ceiling rate. Meanwhile, while there are ceilings for business-related taxes (i.e. the inhabitant tax on corporate income and the enterprise tax), they can, and some do, impose higher tax rates than the standard rate on those items. Since localities are endowed with these large tax bases (personal income, corporate income, production value added, and consumption), an increase in the tax rate would yield a substantial amount of tax revenue. In addition, local governments can also create their own taxes independent from those listed in the LTL, although they must consult with the central government beforehand. Note, however, that the central government *must* agree to the creation of a new local tax unless the new tax 1) imposes an excessive burden on the existing tax bases (national or local); 2) hinders commercial transactions beyond local borders; or 3) undermines national economic policy.

Figure 5.4. Local tax composition in Japan: Municipalities and prefectures (FY2015)



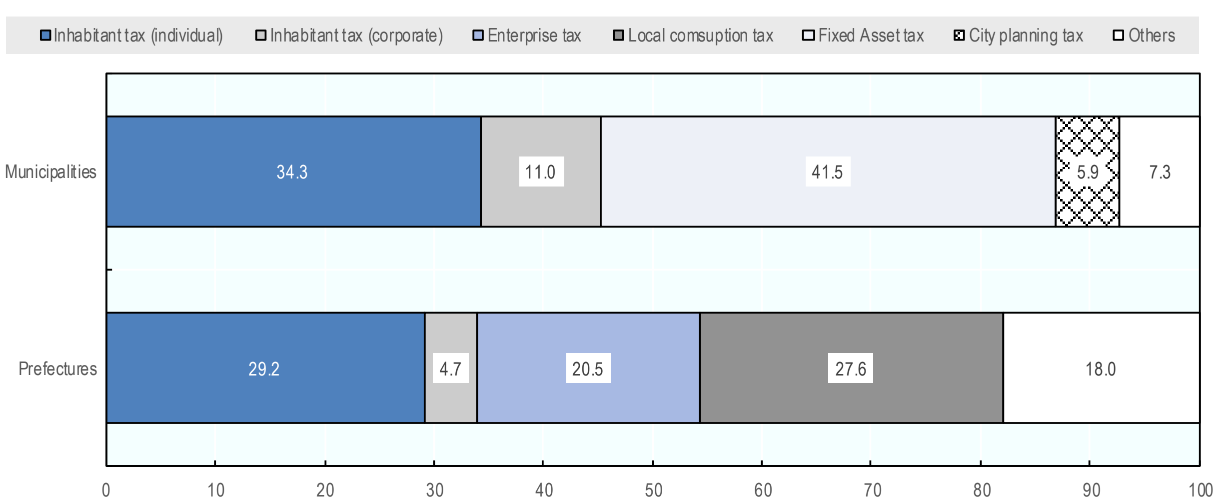
Source: Ministry of Internal Affairs and Communications (2017), *White Paper on Local Public Finance, FY2015*.

As the aggregate composition of municipal and prefectural revenues in Figure 5.5 shows, however, local taxes are not large enough to finance all local spending in every locality. To fill the gap, the centre provides grants to local governments. Among various types of central grants, the following two are the most important. First, there is a general-purpose grant, called the local allocation tax (LAT), which aims to adjust imbalances in tax revenue among localities (fiscal equalisation) and guarantee the revenues necessary to provide the functions and services assigned by the centre (fiscal guarantee). A substantial part of the LAT is financed by fixed proportions of five national taxes.[3] Additionally, 94% of the LAT is allocated among localities according to a gap-filling formula. The amount a locality obtains is given as the non-negative difference between the standardised estimates of local spending (the standard fiscal demand, SFD) and that of local tax revenues (the standard fiscal revenue, SFR).

Secondly, the central government also disburses a variety of central government subsidies (CGS).[4] The CGS, being categorical and typically matching, help localities maintain uniform services or encourage spending in a specific category. Since it is matching, localities share the costs of spending in a category at which the CGS is targeted. For some CGS-targeted categories, the SFD includes such a local burden so that the LAT and CGS together cover all "standard" level local spending in that category.

The central regulation of local borrowing is virtually non-existent when the borrowing localities are fiscally sound. Local governments are only expected to notify the upper level of government (prefecture for municipalities, central government for prefectures) before they issue local bonds if they want their debt service to be treated favourably in central grants. They do not even have to pre-notify the upper level if they can finance themselves from the bond market without favourable treatment by the centre. Local governments are only regulated in issuing local bonds if they are found fiscally unhealthy based on their public liability indicators. In that case, relevant national law requires them to consult, or obtain permission from the upper level of government.

Figure 5.5. Revenue composition in Japan: Municipalities and prefectures (FY2015)



Source: Ministry of Internal Affairs and Communications (2017), *White Paper on Local Public Finance, FY2015*.

5.3.2. Decentralisation reforms since 2000

The above descriptions of the Japanese system of local public finance indicate that local governments in Japan are practically decentralised at the margin, both on the expenditure and revenue sides. While the central government requires local governments to attain minimum levels in certain areas by assigning the core of expenditure functions and tax bases, local governments can extend, albeit not curtail, the boundaries or margins of such fiscal activities in most cases. This type of decentralisation, particularly those characterised as *Uwanose* and *Yokodashi*, had been in existence before 2000. However, the degree of fiscal decentralisation has substantially progressed through a series of reforms in the 2000s as follows.

In 1995, an expert committee, the Decentralization Promotion Commission was established. The committee issued four sets of recommendations between 1996 and 1998, which led to the enactment of the Omnibus Decentralization Promotion Bill. In 2000, this legislation revised 475 national laws. Particularly, it abolished the system of agency-delegated functions, where the central government treats a mayor or governor as its subordinate agent when it implements specific programmes. Due to this abolition, when the central government intends to make local governments implement a programme, the national Diet is now required to enact a specific piece of legislation for that specific purpose.

During 2004–06, the central government implemented a three-component package that arguably contributed to fiscal decentralisation. First, it reduced the amount of categorical grants (central government subsidies) by JPY 4.7 trillion and partially compensated for the reduction with JPY 3-trillion increases in local taxes. Second, such increases in local taxes were made through tax point transfers between national and local taxes (income tax and inhabitant tax) on personal income. Third, it reformed the system of general grants (LAT) by simplifying its formula on investment expenditures and suppressing the SFD, which yielded a total reduction of JPY 5.1 trillion in the general grants. This then resulted in a net reduction in local revenue by JPY 6.9 trillion.

In the meantime, deregulation of local taxation also progressed. First, the centre relaxed its control over the creation of new taxes by local governments. In 2000, local governments began to be allowed to set up new taxes of their own for general tax revenue. Before then when they intended to create a new tax, they had to earmark its revenue for specific spending. In addition, the central involvement was made minimal. The centre now must allow local governments to create new taxes unless specific conditions are violated. Second, the central government also relaxed the regulations on local tax rates and bases. It abolished the ceilings on the rates for the inhabitant tax on personal income for municipalities in 1998 and for the fixed property tax for municipalities in 2004. Meanwhile, the centre increased the ceiling on the tax rate for the enterprise tax of prefectures from 110% of the standard rate to 120%, and that for automobile taxes from 120% to 150%. Furthermore, starting in 2012, local government can adjust their tax bases by making their own tax exemptions and deductions, over and above those set by the national laws. Third, the centre itself created new local taxes and expanded them to increase the share of local taxes in local revenues. In 1997, the local consumption tax was introduced as a surtax on the national VAT (consumption tax) with a 1% tax rate on value added. In 2014, the rate was raised to 1.70% and is planned to increase again to 1.76% on unprocessed foods and 2.20% on other goods in 2019. Furthermore, a business VAT was introduced in 2004 as a component of the enterprise tax for prefectures.

The central government has also relaxed its regulation on local bond issuance. Local governments needed permission from the upper level of government (prefecture for municipalities, central government for prefectures) to issue local bonds before 2006 when it transformed the permission system into a consultation system. In the new system, local governments only had to "consult" the upper level of government to issue bonds. If the upper level of government agreed with the issuance, the central government treated it favourably by arranging funds to finance the issuance or funding of its debt service through the general grant (LAT). Even if the upper level did not agree, local governments could still issue bonds if they did not care about receiving this favourable treatment. In 2012, the centre changed the system again, from the consultation system to the current pre-notifying system, where local governments only have to notify their upper level of government before issuing their bonds. In this system, they do not even have to pre-notify the upper level, if they can finance the issuance from the bond market.[5] Note, however, that the permission system is still retained for localities whose fiscal status is below the standards of fiscal indicators. In other words, local governments are only regulated when they are found fiscally unhealthy.

The central government also implemented measures to enhance the administrative capacity of municipalities. First, it encouraged municipal mergers using "carrot and stick" measures. The carrots included generous provisions for favourable treatment of local bond issuance and temporal increases of the LAT grants for the merged municipalities, while the sticks included net decreases in local revenues in the 2004–07 three-component package. The merger policy was successful, reducing the number of municipalities from 3 229 on 1 April 2000 to 1 727 on 1 April 2010. Second, the central government encouraged the transfer of functions from prefectures to cities. In addition to designated cities, which cities with a population of more than 1 million are qualified to be, the central government created core cities in 1996 and special cities in 2000. Cities with a population of more than 300 000 were classified as core cities, whereas those with more than 200 000 were classified as special cities.[6] Analogous to the designated cities, prefectures are required to devolve parts of their functions to core and special cities, with a greater degree of devolution to the former. In addition, prefectures devolved some of their functions to cities in general. By April 2010, as many as 229 prefectural functions had been devolved to municipalities in at least one of the 47 prefectures (Ito, 2011).

5.3.3. The role of Japan's local governments in social protection

Local governments are an integral part of almost all redistribution programmes in Japan (Hayashi, 2006, 2007, 2010). Japanese social protection programmes can be classified into: 1) public pension; 2) work-related social insurance; 3) public health insurance; 4) long-term care insurance; 5) social assistance; and 6) social benefits and services for persons with disability (PWDs). Table 5.1 substantiates the local role in social spending. While localities share 55% of the total expenditures, their shares in social spending are even higher. Although the local share for social security benefits in cash (pension benefits) is small, its shares of social transfers in kind and social assistance are respectively 79.8% and 85.6%. Indeed, local governments in Japan are more responsible for social expenditures than those in other countries. Japan's shares are one of the highest, only after Denmark and even higher than the combined shares of state/province and local expenditures in the federal countries.

Table 5.1. Social protection expenses by government sector in Japan (2015, in JPY trillion)

	Central	Local	Social security funds		Total	Local share
				Local		
Social assistance (public assistance and other discretionary benefits)	0.5	6.6	0.0	0.0	7.1	94%
Social transfers in kind (health, long-term care, etc.)	0.1	3.1	43.4	33.3	46.6	78%
Social security benefits in cash (pensions, child allowances, etc.)	0.0	0.0	57.2	2.3	57.2	4%

Source: Cabinet Office, *National Economic Accounts*.

While the Ministry of Health, Labour, and Welfare (MHLW) at the centre designs and oversees social policies, local governments implement almost all social protection programmes, except public pension and work-related social insurance. Historically, public pension and public health insurance were built around full-time employees of established businesses. While employment-based associations still manage programmes for public pension and public health insurance, those excluded from these mainstream sources are taken care of by residual social insurance programmes, the National Pension (NP) and National Health Insurance (NHI). While the NP is managed at the national level, the NHI is managed at the local level. In particular, municipalities managed their NHI programmes separately until 2017. Starting in 2018, however, the NHI is now jointly managed by prefectures and municipalities. While municipalities continue to collect premiums according to their own schedules, prefectures receive the proceeds to manage the finances of NHI benefits at the prefectural level. In addition, municipalities manage Long-term Care Insurance (LTCI); they collect the LTCI premiums according to their own schedules and conduct eligibility assessments for the LTCI benefits. In addition to these two systems of regional insurance, prefectures and municipalities are required to plan and implement health promotion programmes. Furthermore, prefectures conduct regional medical planning where they forecast and control the supply and demand for healthcare services in their regions.

These social insurance programmes are premium-financed and may be regarded as the “mainstream” programmes in the Japanese system of social protection. The other residual programmes are tax-financed and are all implemented by local governments. First, local governments implement public assistance (PA), which is the last safety net in Japan. Cities and prefectures are required to implement PA, while towns and villages are not. Prefectures provide assistance to residents in towns and villages that do not implement PA. Second, local governments also provide a variety of personal services and benefits for PWDs, including institutionalised care, in-home support and day-care. In addition, they are also required to set an action plan for a disability policy. Third, in addition to services and benefits to PWDs, local governments implement a variety of social programmes, whose targets include low-income households, children, single mothers and widows, and the elderly.

Local governments often have discretion in implementing these social programmes. First, while in some areas, as is the case for PA, the central government assigns specific functions to local governments and sets out strict national rules, there are also cases where it simply mandates that localities conduct a given specific programme without specifying benefit levels and/or eligibility criteria. Localities then have full discretion when implementing such programmes. An example is school expense assistance (SEA), which financially helps children in low-income households attend primary and junior high school. While the centre mandates that municipalities implement SEA programmes, municipalities have full discretion over eligibility criteria and benefit levels for families with children that marginally fail to qualify for PA benefits (Hayashi and Kobayashi, 2011). As such, the SEA programmes differ greatly among municipalities.

Second, localities often provide additional benefits over and above what the central government mandates them to provide. For example, there is a variety of income supports for the PWDs at the local level, in addition to the uniform national system of PWD benefits. Hayashi (2010) provides an example, using the 2008 benefits in Tokyo. The Tokyo metropolitan government provides monthly benefits of JPY 15 500 to the severely handicapped over and above the national benefits. On top of these, the special district of Ohta in Tokyo adds JPY 2 000. Furthermore, all municipalities in Tokyo also provide benefits to the less severely handicapped, whose monthly amounts vary from JPY 4 000 in Showa city to JPY 13 500 in Bunkyo special district.

Third, local governments also provide services and benefits of their choice. Even in the 1960s, some local governments in wealthy urban areas introduced their own social welfare programmes, without subsidies from the central government. Typical programmes at that time were children's benefits and free medical care for the elderly, which were later adopted as national programmes by the central government in the early 1970s. Estéves-Abe (2008) calls this national adoption of local programmes the "trickling up" effect. An example in recent years includes medical care benefits for children. The public health insurance in Japan requires 20–30% co-payments when children receive medical treatments. To reduce such costs, many municipalities and prefectures subsidise the co-payments so that children can receive medical treatment at reduced costs, although the degree of cost reduction and the age of eligibility differ among localities.

5.3.4. Financing decentralised social expenditures

Municipalities and prefectures vary in size in terms of both population and economic development. Such disparities make it difficult for most local governments to finance social spending out of their own, locally financed revenues. We have explained above the two major routes to finance such spending: CGS and LAT, which is of course also important for local social spending. When the central government sets the framework for a majority of nation-wide social programmes, it typically assigns a given set of functions to a given class of local governments and partially funds them with CGS to implement the programmes. In addition, the local burden of such matching expenses in fiscally weak localities is taken care of by the LAT.

Let us consider the cases with CGS. We mentioned that CGS help local governments maintain the standards required by national laws. For example, the central government bears 75% of PA benefits and 33% of disbursements for child and child rearing allowances. It also provides 50% of capital and current expenditures for designated facility services for the PWDs. These cost-share ratios are all prescribed in related national laws. In addition, the CGS is disbursed to the special accounts of local governments. Municipalities, acting as insurers, set up separate special accounts to manage the NHI and LTCI. The central government subsidises 17% of NHI payments and 24% of LTCI payments through the CGS system. We also mentioned that the CGS serves as an incentive for local governments to adopt specific projects that contribute to national policy objectives. While many such projects are related to infrastructure, social policy is also supported in this way. For example, in-home services for PWDs are subsidised by this type of CGS with a maximum matching rate of 50%.

Since the CGS is matching grants, its funding is partial, and the uncovered cost is borne by local governments. The LAT effectively takes care of this remaining part for localities with insufficient revenue capacities. Recall that the amount of the LAT a locality receives is the nonnegative difference between the SFD and the SFR. What is important here is the fact that the SFD includes the costs that local governments are supposed to share with the CGS, especially when the subsidies assume the first function of CGS described above. For example, the SFD includes the local share (25%) of PA benefits as well as the standardised costs of caseworkers for the implementation of PA programmes. The NHI and LTCI are also supported through the LAT. Both prefectures and municipalities are required by law to make transfers from their general accounts to the NHI and LTCI special accounts. Designated parts of such transfers are included in the SFD. In other words, localities receiving LAT obtain additional financial support through the LAT system for expenditures subsidised through the CGS system.

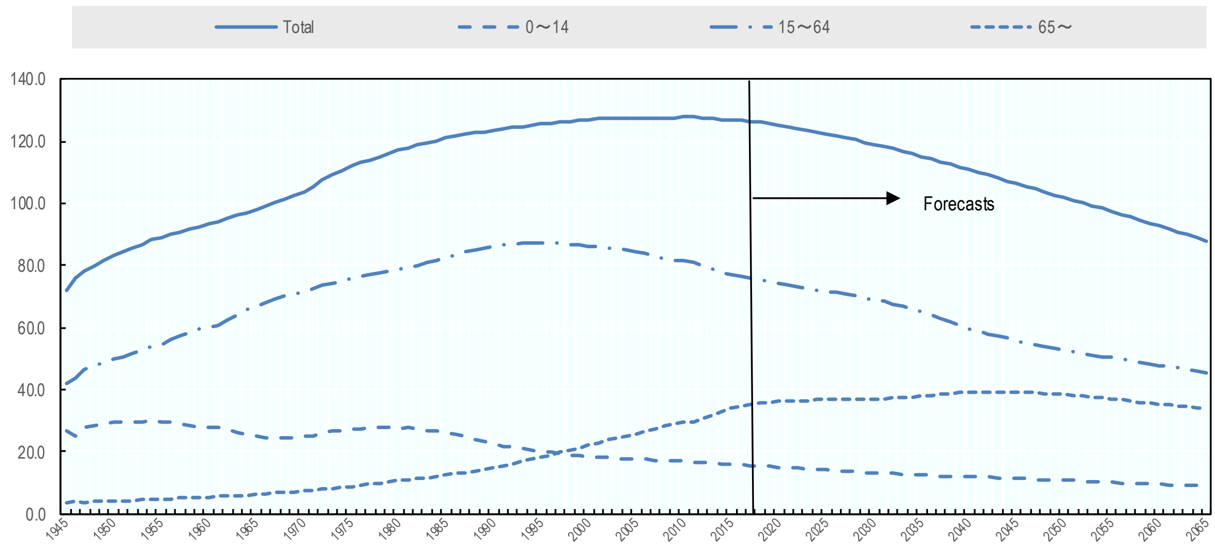
5.4. Challenges: Constraints on inclusion and growth in Japan

Given the description of the Japanese system of local public finance above, we could argue that its system of social protection is "properly" decentralised. The centre assigns specific functions a given class of local governments are supposed to perform, often with specific rules for benefit levels and eligibility criteria. These national standards work as floors where the "race to the bottom" stops since local governments can provide higher levels of services and benefits than those required by the central government if their local needs necessitate them to do so. In addition, the central government guarantees revenue sources for localities to maintain the standard levels of benefits and services through a set of CGS and LAT grants. If local governments intend to increase such benefits and services more than the standard, they can finance the funds by increasing their tax rates or creating new taxes, although the latter choice requires consultation with the central government. In other words, Japan's local public finance is fairly decentralised at the margin. Of course, it is up to local politics if they can effectively develop their own social protection or inclusive policy by utilising institutional tools assigned by the central government. However, it is beyond the scope of this chapter to discuss the political institutions and environment that contribute to effective inclusive policy at the local level.

5.4.1. Japan's ageing population, and rising regional disparities

The issue of fiscal decentralisation, therefore, does not seem to be a major problem in Japan, except perhaps in small specifics. The more serious issue is to find funding sources for inclusion policy both at the national and local levels. Figure 5.6 shows demographic changes from 1945 to 2015, along with the latest forecasts using a medium fertility rate scenario for the following 50 years, up to 2065, by the National Institute of Population and Social Security Research (2017). The forecasts predict that Japan's total population will decrease by 31.3% to 88 million in 2065 from its peak in 2010 (128 million). Its working-age population (ages 15–64) will be reduced more severely. It will decrease by almost half (48%) from its peak in 1995 (87 million) to 44 million in 2065, and by 41% from the latest figure in 2015 (77 million). Meanwhile, the elderly population (65+) is forecasted to steadily increase until around 2045. This is, of course, a rapid pace of ageing, and the dependency ratio is predicted to increase to above 0.9 by 2030. This implies that the demand for social protection spending will increase substantially, which will necessitate that Japan secures more revenue sources for local governments for their inclusion/redistribution programmes.

Figure 5.6. Population changes and forecasts in Japan (in million persons)



Source: National Institute of Population and Social Security Research (2017), *Population Projection for Japan: 2016-2065*, www.ipss.go.jp/pp-zenkoku/e/zenkoku_e2017/pp_zenkoku2017e.asp.

Evidently, such demographic change differs across regions. The forecasts by the Long-term Outlook Committee of the National Land Council (2011) show that less populated areas tend to suffer from larger population decreases. For example, municipalities with populations of fewer than 10 000 will have their population almost halved by 2050. Population disparity among regions will increase, which also implies that fiscal disparity will increase. Therefore, the demand for social protection will differ substantially, which makes the role of intergovernmental transfers even more important.

Therefore, the central government is conducting a series of tax reforms to increase tax revenues. In addition, it is also changing the formula for the allocation of fiscal transfers and shared taxes such that it can extract more out of urban areas (typically, Tokyo) to redistribute to nonurban areas. However, plagued with a historically high debt-GDP ratio, growth may be more important than increasing taxes and regional redistribution as these revenue sources would be limited without economic growth. Growth provides job opportunities and increases household income (albeit not for all households). Although it may increase income inequality, it obviously increases tax revenues without raising tax rates, from which more effective inclusion and redistribution programmes will be developed.

However, ageing also puts constraints on economic growth. Assume a production function $Y = (L, K, G)$ where Y, L, K, and G respectively refer to output, labour, private capital, and public capital (Mera, 1973; Aschauer, 1989). An ageing and decreasing population implies that L is decreasing quite fast, leading to a decrease in Y. An increase in K may offset such an adverse effect of L. However, if K is a substitute for L, like automation, an increase in K may reduce wages and labour share of income. An increase in G may also offset the effect of a decrease in L. In addition, rents generated from an increase in G may be distributed to L, thereby increasing labour wages.

Note that public capital or infrastructure (G) is ageing quite rapidly in Japan. Since most of its infrastructure was built in the 1960s and 1970s, they are reaching the end of their standard design lifetimes, 50 years. Furthermore, the amount of annual public investment has been decreasing since it hit a record high in 1995. Accordingly, public capital accumulation slowed in the 2000s; an estimation shows that its stock has indeed been decreasing in recent years (Cabinet Office, 2017). US evidence shows that ageing infrastructure in the 1970s and 1980s slowed economic growth (Aschauer, 1989). The same may apply to Japan. However, Japan will not be able to increase *G* as it used to due to 1) increasing demand for social expenses; and 2) huge public debt and its (potentially) increasing debt services.

5.4.2. Growth through agglomeration and compactisation

Japan has typically emphasised a policy of "balanced development of national land" and developed a series of infrastructure programmes that aim to counteract population inflow into large cities, including Tokyo. Population in non-urban areas is expected to decrease quite quickly. Nonetheless, the inhabited space may not shrink as fast as its population, keeping the size of inhabited areas almost intact. Infrastructure expenses per population will rise rapidly. In this ageing and depopulating economy, plagued with fiscal difficulties, a policy of "balanced development" is not only unsustainable but also will not contribute to economic growth.

The key to promoting economic growth in this population-decreasing and ageing economy is an "agglomeration economy". The concentration of population and firms in a given area may induce more efficient production. In such areas, it is not difficult to find necessary production inputs (including labour) without costing much time, since there is a variety of resources available. In addition, frequent face-to-face communication among people with different backgrounds contributes to producing new ideas and technology. Public infrastructure plays an important role in the realisation of agglomeration economies (Eberts and McMillen, 1999). For example, without an efficient highway system and adequate water and sewer capacity, the gains obtained from the proximity of people and businesses would be offset by the gridlock of the movement of people and goods, and the inability to meet the basic needs of densely populated areas. In the presence of agglomeration economies, the policy of "balanced development" does not help promote economic growth. Japan may then concentrate its resources on several urban areas (regional centres) to attract more households and firms. Improving infrastructure in urban areas helps advance agglomeration economies, thereby contributing to enhancing the productivity of the national economy and producing fiscal revenues for the increasing social expense demands.

What should Japan do with non-urban/de-populated areas? Depopulated areas may need "compactisation", i.e. the relocation of residences and facilities to more compact areas. The Long-term Outlook Committee (2011) also forecasts population in 2050 using a 1 km^2 grid, and it shows that more than 60% of the grids in residential areas will suffer from more than 50% population decreases, while only 2% of them will have a population increase. The grid forecast also indicates that population decreases will be larger to the extent that the area is located far from the centres of municipalities. This also means that residents in non-urban areas will be sparsely located. The forecast also shows that they will age quite quickly (even more so with the agglomeration policy). Once handicapped, it will become difficult for residents to obtain necessary services and benefits. It will also be costly for local authorities to reach out to them to provide the necessary benefits and public services. Compactisation should alleviate these difficulties and provide new places for them.

Lastly, what about inclusion? Growth through agglomeration raises two concerns. First, it would obviously aggravate regional disparities between urban and rural areas. Second, even within urban areas, the benefits of growth may not fully reach the lower tail of the income distribution. For these concerns, reforms are underway. While Japan has traditionally had a strong system for inter-regional transfers to counteract regional disparities, the central government is making it more effective by introducing new revenue sharing rules through the changes in the local consumption tax and local taxes on business income. It is also making its national income tax more redistributive, and it is developing programmes that contribute to inclusion and redistribution. Meanwhile, the local governments are considerably decentralised at the margin and are equipped with fiscal instruments to deal with specifics that the central government cannot easily handle. It is therefore up to local politics to develop an effective inclusive policy, over and above the national programmes in place.

5.5. Conclusion

In this chapter, we have considered the role of fiscal decentralisation for inclusive growth in the Japanese context. Given the pressing challenges caused by the rapid pace of ageing and gradual population decrease, inclusive growth is indeed an important policy issue for Japan, as it fosters economic growth and inequality reduction at the same time. In this chapter, we emphasised economic growth through agglomeration, which should be effective in this economy with an ageing and decreasing population. It is the central government that should assume a primary role in this "growth" policy since it will be difficult to effectively plan and implement it at the local level. Meanwhile, from our arguments in this chapter, we see that local governments are supposed to implement and develop an "inclusive" policy. First, we have argued that a key to easing the adverse effects of agglomeration is compactisation, which involves city and rural planning by municipalities. Second, we have explained that local governments are expected to provide standard levels of benefits and services, whose funds are guaranteed by the system of fiscal transfers. Lastly, we have pointed out that, being decentralised at the margins, local governments are fully equipped with fiscal instruments that allow them to provide additional social benefits and services above the national standards. Therefore, the issue of effective inclusive growth hinges on political will, not fiscal instruments, both at the central and local levels.

Notes

1. This study was financially supported by JSPS Grants-in-Aid for Scientific Research, Grant Number 15H01950.

2. There are also fiscal transfers from prefectural governments to municipal governments.

3. As of 1 April 1 2017, they are 33.1% of income tax and corporate income tax, 50% of alcohol tax, 22.3% of consumption tax, and 100% of local corporate tax.

4. The Japanese term for "central government subsidy" is *kokko shishutsukin*, which literally means "disbursements (*shisyutukin*) from the national treasury (*kokko*)". This chapter

borrowed this translation from an official publication by the Ministry of Finance (2004[210]). Meanwhile, many Japanese scholars use different English translations, including "national disbursements", "national treasury disbursements", and "national government disbursements".

5. A smaller municipality usually cannot finance itself in bond markets due to its small bond issuance need. To accommodate such small municipalities, the Japan Finance Organization for Municipalities (JFM) was established in 2008. Smaller municipalities borrow from the JFM, which bundles together small borrowing needs and issues JFM bonds in financial markets.

6. Note that the central government abolished the system of special cities and reduced the population threshold for core cities to 200 000 in 2015. The system itself is continuing as a transitory measure, and the *de facto* special cities are expected to become either core cities or ordinary cities by 2020.

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6. Inclusive growth and decentralisation in Korea

by

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One of the key connectors between inclusive growth and education seems to be fiscal decentralisation. Education equity has long been a significant policy concern, not only in developed but also in developing countries. This chapter points out how the equal distribution of educational opportunities through fiscal decentralisation affects inclusive growth. The empirical findings in this chapter pose some policy-related questions. First, the linkage between income disparities and education inequalities with the definition of student resiliency has been shown. Second, this study suggests that the mitigation of regional disparities may improve income equality. From this point of view, the regional imbalance of demographic and economic infrastructures may worsen income inequality in the highly congested capital cities in many Asian countries. Finally, this empirical study adds to the evidence concerning the relationship between two kinds of redistributive policies for many Asian countries and OECD countries.

6.1. Introduction

Wealth and income inequality have been increasing in many countries. Widening income disparities among individuals and regions may hurt the driving forces of inclusive growth. Many countries are trying to institutionalise pro-equity policies in order to minimise this. Regarding income inequality, the literature has mainly focused on two dimensions. Some have analysed the status quo regarding income inequality in countries. Others have tried to examine how to overcome it by expanding education opportunities. This chapter is in line with this second approach, and it raises the issue of the linkage between fiscal decentralisation and education opportunity.

From an economic perspective, the level of education and its distribution play a crucial role for income distribution and consequently for economic growth. One of the key connectors between inclusive growth and education seems to be fiscal decentralisation. Education equity has long been a significant policy concern, not only in developed but also in developing countries. This chapter points out how the equal distribution of educational opportunities through fiscal decentralisation affects inclusive growth.

Fiscal decentralisation may influence education expenditure, which will affect human capital and therefore economic growth (Kim, 2018; Fredriksen, 2013). While there are various attempts to assess the relationship between fiscal decentralisation and education empirically, the studies that consider the linkage between fiscal decentralisation and education equity are rare. This chapter tries to connect equal access to educational opportunities with the reduction of income inequality as well as fiscal decentralisation.

For the sustainability of inclusive growth, this chapter also touches on regional income distribution. One of the major themes of this chapter is the effect of the "regional" economy and demographic disparities on "individual" income distribution within a country. Regional disparities have been a significant political issue in Korea because half of Korea's total population lives in the capital area, which is only 12% of the total national area. Many Asian countries are now struggling with the problem of concentration in capital areas, such as Bangkok, Jakarta and Manila (Koyanagi and Venzon, 2017). Regional inequalities have been worsening in OECD countries as well. A recent report emphasises that understanding regional variations is important given that local and regional governments carry out around 40% of public spending and 60% of public investment in OECD countries (OECD, 2016). Regional disparities between countries are also a critical feature of the EU economy. In terms of fiscal arrangements within a country and between countries, regional disparities may be mutually related to individual income distribution through demographic changes. This trend would inevitably distort the distribution of the intergovernmental transfer and organic growth of sectoral economies. Even though not all countries in the OECD area and Asia are facing regional disparities, the regional imbalances seem to be tightly linked to individual income distributions (Sacchi and Salotti, 2011; The Economist, 2011). This chapter aims to present evidence of the relationship between regional disparities and the individual income distribution based on recently compiled data.

6.2. Literature review

As in other chapters of this volume, this chapter looks at the empirical association between fiscal decentralisation and inclusive growth. By way of example, this chapter attributes the expansion of education equality to inclusive growth. The direct link between "fiscal decentralisation" and "education equality" has rarely been studied. It is challenging to define the various factors that determine the two broad concepts of fiscal decentralisation and education equality. However, indirectly and independently, fiscal decentralisation and education equality are major topics explored by researchers.

For education equality, most recently, OECD (2017) reports that a significant portion of children with low socio-economic backgrounds demonstrate high educational outcomes in some countries. The latest OECD Programme for International Student Assessment (PISA) results show that 29.2% of disadvantaged students overcome their socio-economic challenges and score in the top quarter of all students in participating countries, after accounting for socio-economic status. The report provides evidence for forward-looking policies and as well as the data for researchers.

Coady and Dizioli (2017) examine the relationship between income distribution and education equality, summarising the main approaches to, and the importance of, inclusive growth: "not only is education expansion viewed as being important for promoting economic growth (Barro, 2013; Hanushek, 2013), but it can also help break the intergenerational transmission of poverty and reduce inequality of opportunity (Corak, 2013), which in turn reduces income inequality." The chapter provides a better understanding of income inequality (captured by Gini coefficient) and education expansion (defined by "average years of schooling"). Its policy simulations show the relationship between reducing inequalities and improving the quality of education. But the approach takes a macroeconomic perspective, and does not look at fiscal decentralisation and its related effects, like regional imbalances within a country and so on.

Thomas, Wang and Fan (2000) also find that the countries with a higher education attainment level are most likely to achieve better education equality than those with lower attainment levels, based on the data of 85 countries from 1960 to 1990. The chapter contributes to the measure of educational inequality by using the concept of an education Gini index along with school attainment data rather than the extent of fiscal decentralisation and regional variances.

Regarding the concept of fiscal decentralisation and inequalities, various findings have been discussed. As is well known, the relationship between fiscal decentralisation and inequalities is not conclusive in the literature. Goerl and Seiferling (2014) might be one of the most comprehensive studies on decentralisation and inequalities that uses cross-country data. The findings of this chapter suggest that the decentralisation of government expenditure can help achieve an equal distribution of income when a few conditions are fulfilled a sufficiently large government and comprehensive revenue decentralisation rather expenditure decentralisation.

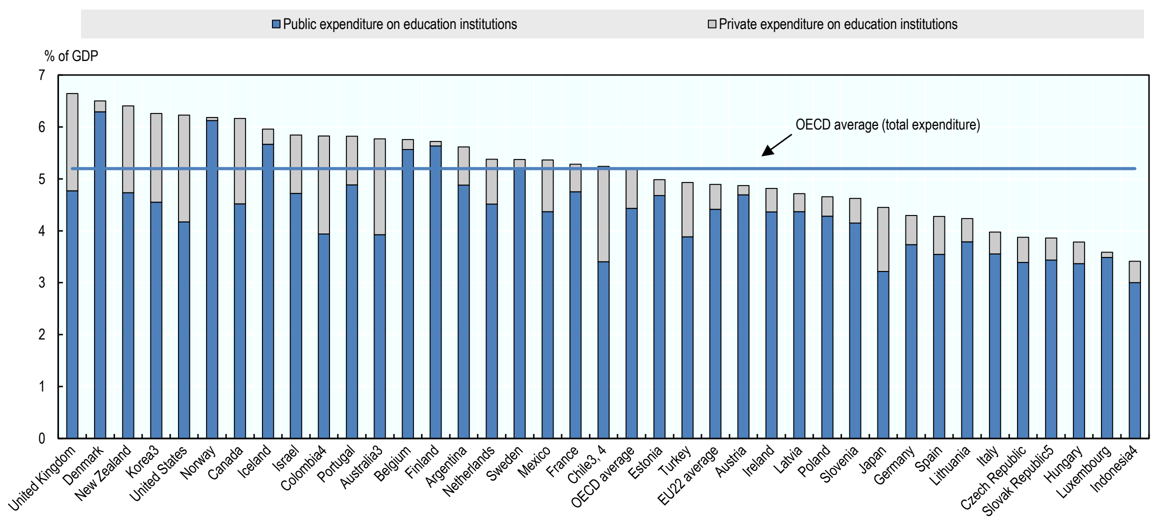
This chapter will extend the hypothesis concerning the relationship between fiscal decentralisation and inclusive growth by using the concept of education inequalities. In addition, the empirical study in this chapter will include the notion of regional disparities on income inequalities.

6.3. Education finance, performance and inequality in OECD and Asian countries

Korea's education expenditure has been consistently stable in recent decades and represents a significant percentage of governmental expenditure. Korea belongs to the top-tier group that invests significantly in education. The average share of public education in OECD countries ranges from around 3-7% of gross domestic product (GDP). In 2014, education expenditure was above 6% of GDP in Korea, which is much higher than the OECD average

(Figure 6.1). With Korea's high policy prioritisation on education, its education performance has been strong, according to PISA results from 2006 to 2015. Furthermore, a cross-country comparison of the data shows that Korea's education inequality does not seem to be high based on its PISA scores.

Figure 6.1. Expenditure on educational institutions as a percentage of GDP (2014)



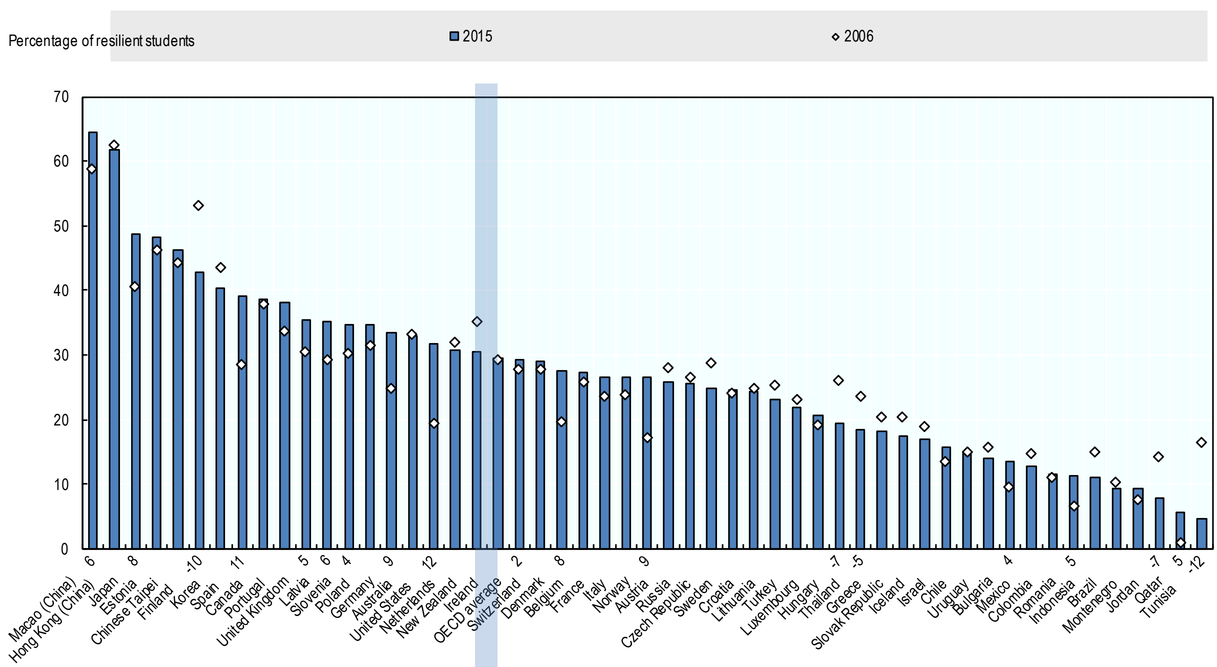
1. Including public subsidies to households attributable for educational institutions, and direct expenditure on educational institutions from international sources.
2. Net of public subsidies attributable for educational institutions.
3. Public does not include international sources.
4. Year of reference 2015.
5. Expenditure on public institutions for bachelor's, master's and doctoral degrees.
Countries are ranked in descending order of expenditure from both public and private sources on educational institutions.
Source: OECD (2017), *Education at a Glance 2017: OECD Indicators*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eag-2017-en, p.180, Figure B2.1.

However, economic growth has stagnated and slowed since 2011. According to OECD data, Korea's income inequality according to the Gini coefficient has not declined since 2011. Dabla-Norris et al. (2015) find that widening income inequality has increased not only in most advanced and emerging markets but also in most developing countries. Like other countries, the Korean government has tried to reform the inclusiveness of education policy for a long time in order to reduce income inequality. Its policy actions have focused on the expansion of research and development (R&D) investment, years of education and expansion of cash transfers to poor households. Unfortunately, in spite of these quantitative efforts, Korea has yet to achieve its goal. For example, income inequality of Korea is worse than average: in 32nd place of The Global Competitiveness Index by the World Economic Forum (WEF), 33rd place in the World Competitiveness Ranking by the Institute for Management Development, and in 15th place in the OECD PIAAC (Programme for the International Assessment of Adult Competencies) test. Furthermore, the use of information and communication technology (ICT) in OECD countries (Dabla-Norris et al., 2015) shows that Korea ranks in the lowest group.

Even though the average performance of 15-year-old students is quite impressive on PISA, the college enrolment rate of low income households' students is significantly lower than that of high income households. This tendency might have detrimental effect on social integration. Moreover, one of the main drawbacks regarding the linkage between inequality and economic growth is that the college enrolment rate of low-income household students is significantly lower than that of high-income households. This tendency may have a detrimental effect on social integration.

Recently, OECD updated the measurement of education accessibility for students. OECD (2017) explores the concept of "resilient students"; a student is classified as resilient if he or she is in the bottom quarter of the PISA index of economic, social and cultural status in the country/economy of assessment and yet performs in the top quarter of students among all countries, after taking their socio-economic status into account. The OECD definition of resilient students implies that the country with a higher ratio of resilient students might provide more equal access to education. This analysis postulates that student resiliency might be one of the critical indicators to measure with regard to education equality.

Figure 6.2. Change in student resiliency between 2006 and 2015



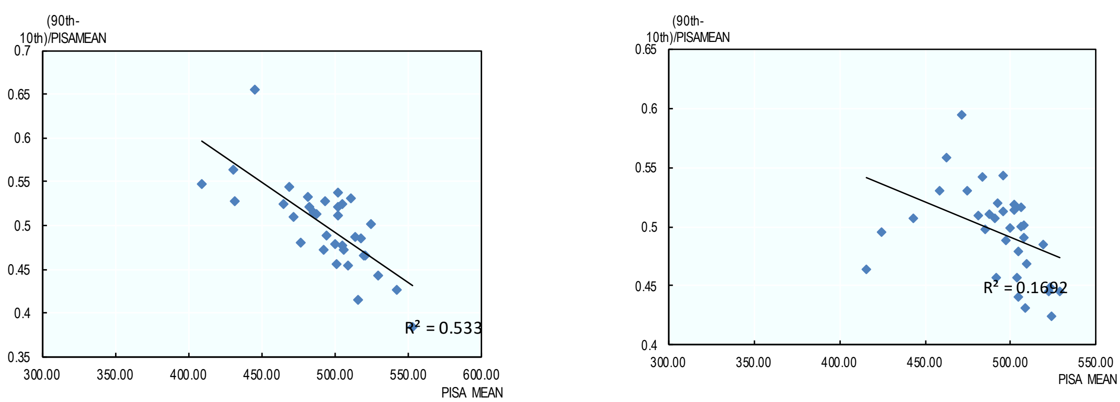
Note: A student is classified as resilient if he or she is in the bottom quarter of the PISA index of economic, social and cultural status (ESCS) in the country and economy of assessment and performs in the top quarter of students among all countries/economies, after accounting for socio-economic status.
The percentage-point difference between 2006 and 2015 in the share of resilient students is shown next to the country/economy name. Only statistically significant differences are shown.
Countries and economies are ranked in descending order of the percentage of resilient students in 2015.
Source: OECD (2016), *PISA 2015 Results (Volume I): Excellence and Equity in Education*, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264266490-en, Chapter 6, Figure I.6.8; OECD (2016), *OECD, PISA 2015 Database*, OECD Publishing, Paris, https://www.oecd.org/pisa/data/2015database/, Table I.6.7.

The year-over-year trend concerning student resiliency as measured by PISA has varied by country (Figure 6.2). The share of resilient students in Finland, Japan and Korea is above 40%, which is higher than in other OECD countries in the last decade. Germany, Spain, the United Kingdom and the United States may have undergone improvement in education equity in association with the increase of student resiliency. Exceptionally, student resiliency in Japan is still growing, at around 50%. Almost one out of every two students may achieve outstanding academic performance despite socio-economic disadvantage. On the contrary, high student resiliency has been decreasing since 2007 in some countries, including Finland and Korea. In this regard, OECD (2013) posited that the ongoing economic crisis had increased the urgency of investing in the acquisition and the development of citizens' skills both through the education system and training in the workplace.

This chapter aims to find another measurement for education accessibility. The idea comes from the inverse relationship between education inequality and the mean value, using PISA test scores (Figure 6.3). Freeman, Machin and Viarengo (2011) found that average test scores are higher in countries with lower inequality scores. These findings imply that the reduction of education inequality may yield a positive effect on general education performance. Intuitively, the larger education inequality, the more education equity worsens. From a policy perspective, access to education for low-scoring students would improve academic performance and grant them access to better quality jobs in the future.

Figure 6.3. The relationship between the mean and the discrepancy of high and low in PISA scores

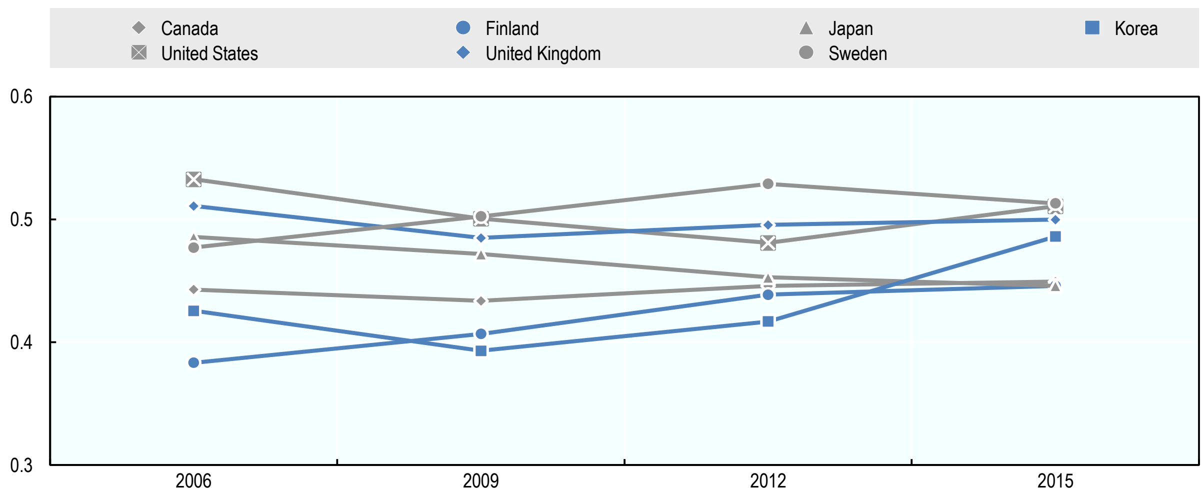
2006 2015



Source: Author's calculation, based on OECD (2019), "Science performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/91952204-en; OECD (2019), "Reading performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/79913c69-en and OECD (2019), "Mathematics performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/04711c74-en.

The performance gap indicator is calculated by normalising the mean scores by the discrepancy defined by deducting the low mean score from the high mean score [= (90th percentile PISA score - 10th percentile PISA score)/PISA mean) in each country from 2006 to 2015. The performance gap has been widening following the economic crisis in Korea as the share of resilient students has been declining. In 2006, Japan's performance gap was larger than that of Finland, Canada and Korea. However, this recent trend has changed. The data show that the discrepancy between high and low-scoring students in Japan has continuously narrowed in comparison with other OECD countries. Also, this trend is in line with the observation concerning OECD countries' student resiliency.

Figure 6.4. PISA performance gap between high and low scores in OECD countries

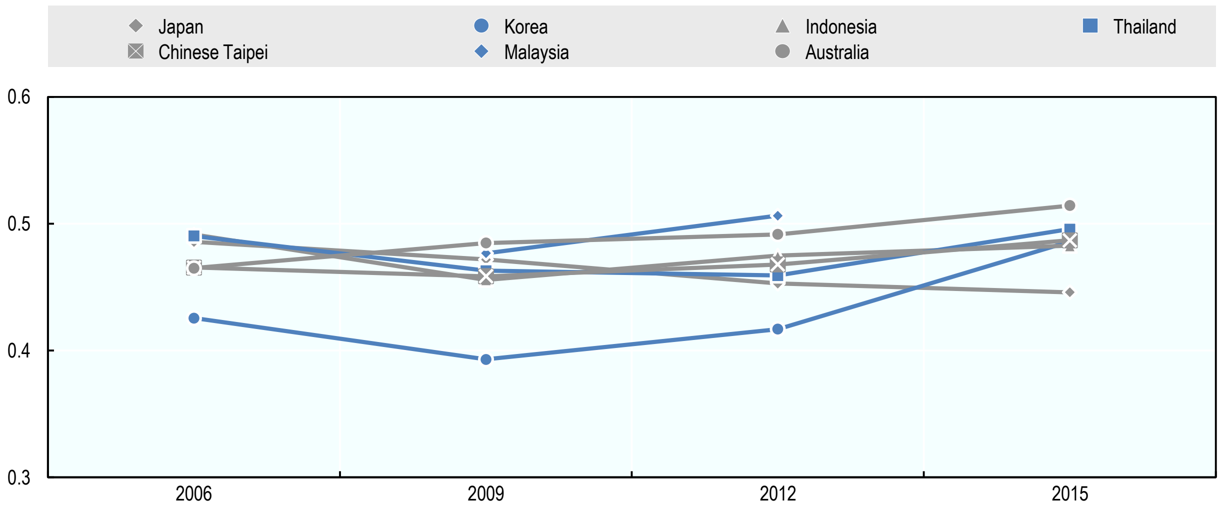


Note: Performance gap index = (90th-10th)/mean by PISA score
Source: Author's calculation, based on OECD (2019), "Science performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/91952204-en; OECD (2019), "Reading performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/79913c69-en and OECD (2019), "Mathematics performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/04711c74-en.

Among Asian countries, Indonesia, Malaysia, Chinese Taipei and Thailand are considered in this chapter. The academic performance gap has been widening since 2010 in the above four countries (Figure 6.5). In Thailand, the gap had narrowed between 2006 and 2012, but recently widened again in 2015. The widened gap of academic performance among students in Asian countries may reveal a negative situation in educational institutions within a country, reflecting high income inequality, limited educational accessibility and social instability.

This chapter approaches the issue of education inequality by using two measurements: student resiliency in OECD countries and the academic performance gap between high and low scores (using PISA scores). From the perspective of education equity, recent changes from 2012 to 2015 in both indices challenge the issue of achieving social goals. Both lower levels of resilience and widening variation of test scores between countries suggest policy-related questions: Do relatively high-performing countries have lower variations of high and low scores? What needs to be done to improve education inequality for education equity with the reduction of income inequality?

Figure 6.5. The PISA performance gap between high and low scores in Asian countries



Note: Performance gap index = (90th - 10th) / mean of PISA score
Source: Author's calculation, based on OECD (2019), "Science performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/91952204-en; OECD (2019), "Reading performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/79913c69-en and OECD (2019), "Mathematics performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/04711c74-en.

Fiscal decentralisation and education equality in OECD countries

Data and hypotheses

The analysis in this chapter examines whether fiscal decentralisation may affect education inequality. Three hypotheses are suggested, and the empirical model and data are modified from Kim (2018), inspired by Busemeyer (2008) and Fredriksen (2013). The hypotheses are tested with the standard model of pooled OLS estimation as follows.

Hypothesis 1: Income inequality may decrease with the share of resilient students.

Hypothesis 2: Fiscal decentralisation may increase with the share of resilient students.

Hypothesis 3: Regional disparities may affect education performance through the change in income inequality and education expenditure.

$$RS_{jt} = f\left(X_{jt}, S_{jt}, FD_{jt}, R_{jt}\right) \Rightarrow RS_{X,S,D} > 0$$

$$I_{jt} = f\left(X_{jt}, FD_{jt}, R_{jt}\right) \Rightarrow I_{X,D} > 0, \quad I_R \lesssim 0$$

$$RS_{jt} = \beta_0 + \beta_1 X_{jt} + \beta_2 S_{jt} + \beta_3 FD_{jt} + \beta_4 R_{jt} + \mu_j + \lambda_t + \nu_{jt}$$

$$I_{jt} = \beta_0 + \beta_1 X_{jt} + \beta_2 FD_{jt} + \beta_3 R_{jt} + \mu_j + \lambda_t + \nu_{jt}$$

The data from 2005 to 2015 OECD countries are based mainly on OECD datasets. The dependent variables are the share of resilient students and the Gini coefficient in OECD countries. The variables for resilient students come from the OECD *PISA 2015 Database* for 2006 and 2015 and *OECD Education at a Glance 2011* for 2009 (OECD, 2011). As mentioned in Kim (2018), Gini indices (I_{jt}) are disposable income as calculated on post-tax and transfer basis. The data are aggregated according to the new OECD terms of reference. Compared to the previous terms of reference, they include a more detailed breakdown of current transfers received and paid by households as well as revised definitions of household income, including the value of goods produced for their own consumption as an element of self-employed income. The concept of poverty is introduced in the model by using the *OECD poverty rate.*

For the education performance (E_{jt}) variables, this test uses PISA results, which consist of three mean scores; for the total sample, 90th percentile and 10th percentile by academic subjects (OECD, 2016). The average national PISA mean attempts to measure student achievement (average mean score = 1/3 score in mathematics + 1/3 score in science + 1/3 score in reading). The PISA scores by each subject are based on OECD (2019).

The model covers the factors, $\underline{X_{jt}}$, inducing education environments to affect education performance and students resiliency. X_{jt} consists of macroeconomic variables and categories of education expenditures. Variables for the level of GDP per capita and real GDP growth rate are based on *World Bank Open Data*. In addition, other control variables are found in the OECD data: average wage (OECD, 2019), unemployment rate (OECD, 2019), tax ratio to GDP (OECD, 2019) and public expenditure variables on education from the *OECD National Accounts dataset*. Education expenditures are examined with the variables not only for education expenditure to GDP (*OECD National Accounts*) but also for tertiary education and compulsory education (UNESCO, 2017).

The model considers some important factors to capture education performance, indicated as quality of education (S_{jt}) such as the number of students per class and teachers' salary at the beginning career year and 15th career year in 2015 as the independent variables (OECD, 2019).

The appropriate representation of fiscal decentralisation has been heavily debated (Kim, Lotz and Blöchliger, 2013). Over the last decade, different variables have been defined and used in the literature (Vo, 2008). The dominant indicators for fiscal decentralisation are the revenue and expenditure share of sub-national governments to total government. In this chapter, the variables for fiscal decentralisation (FD_{jt}) are based on the *OECD Fiscal Decentralisation database* (OECD, 2017). The variables for revenue and expenditure decentralisation indicate the share of sub-national revenue and expenditure total government revenue and expenditure. R_{jt} indicates gap variables such as the level of income inequality and regional disparities from *OECD Regions at a Glance*. Subscript *j* and *t* denote country and year respectively.

Table 6.1. Empirical data from 2005 to 2015

	Category	Variables
RS_{jt}	Share of resilient students	
I_{jt}	Income inequality	Gini coefficient, Poverty rate
E_{jt}	Education performance	PISA mean, 90thpercentile or above and 10th percentile mean
X_{jt}	Level of education environment Public expenditure on education	Per capita GDP, Real GDP growth rate Average wage, Unemployment rate, Tax ratio to GDP Education expenditure to GDP Education expenditure to total expenditure Tertiary and compulsory education expenditure
S_{jt}	Quality of education	Number of students per class Salary of teachers at the beginning career year Salary of teachers at the 15th career year

	Category	Variables
FD_{jt}	Fiscal decentralisation	Share of sub-national expenditure Share of sub-national revenue
R_{jt}	Regional gap Regional disparity	Coefficient of variation of GRDP on “T2 level” from *OECD Regions at a Glance*

Source: Author.

The effect of fiscal decentralisation on resilient students in OECD countries

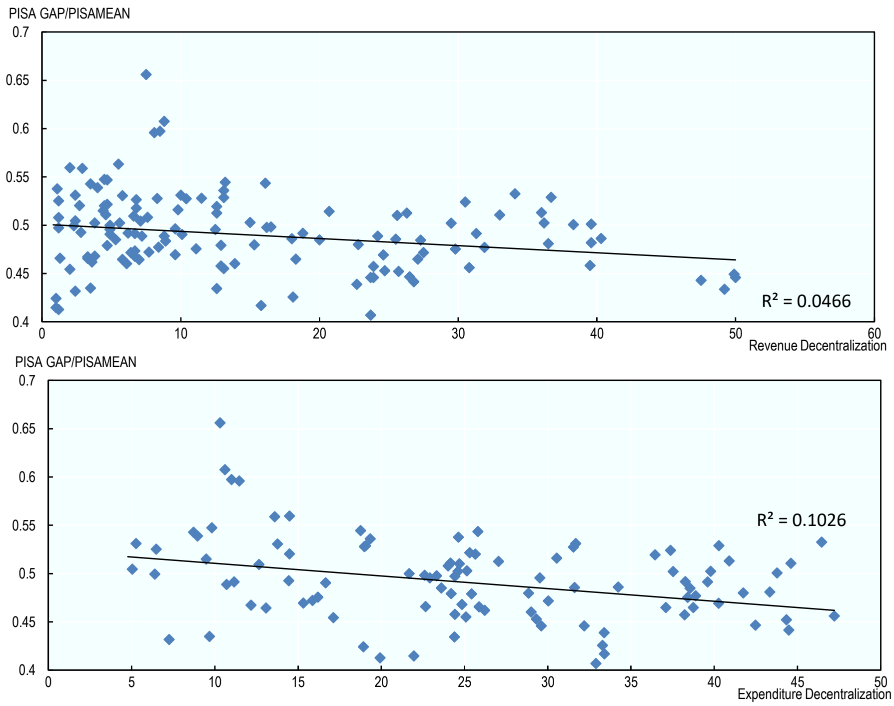
The empirical results are shown in Figure 6.6 (also Table 6.2 and Table 6.3). The first hypothesis is supported by significant coefficients of Gini indices. When an OECD country has a relatively equal income distribution, then the share of resilient students is higher. The results imply that students from unfavourable circumstances, be they economic, socio or cultural environments, may perform better only with the equal distribution of income levels in a country. Among all the other variables, the income distribution variable is the most dominant factor affecting education equality by using the concept of student resiliency in this work. The empirical results in this chapter are consistent with earlier literature that finds that income inequality may be detrimental to education inequality.

This empirical approach is different from existing literature in the way it uses this quality-based measurement of education equality. In most papers, like Coady and Dizioli (2017), the variables of education expansion (i.e. “average number of years of school attainment”) have been used as an indicator of the education equality. In addition, the inequality of education in a country was considered as the Gini coefficient of years of education for a given year (Barro and Lee, 2013).

The empirical results for the second hypothesis are not obvious. Only model (1) supports the assumption that fiscal decentralisation may increase student resiliency. The rationale behind it has been captured by the direct relationship between education expenditure and fiscal decentralisation (Kim, 2018; Fredriksen, 2013); if students can receive more financial benefits from sub-national governments, they can have better access opportunities to education and higher test results. A simple relationship between the education performance gap and fiscal decentralisation shows an inverse tendency in the following figures.

Indirectly, the hypothesis relying on Goerl and Seiferling (2014) suggests that fiscal decentralisation of the government expenditure can help achieve more equal income distribution with the fulfilment of critical conditions: 1) the government sector should be sufficiently large; 2) decentralisation should be comprehensive, including redistributive government spending; 3) the revenue side should be accompanied with adequate decentralisation, such as an own-revenue source.

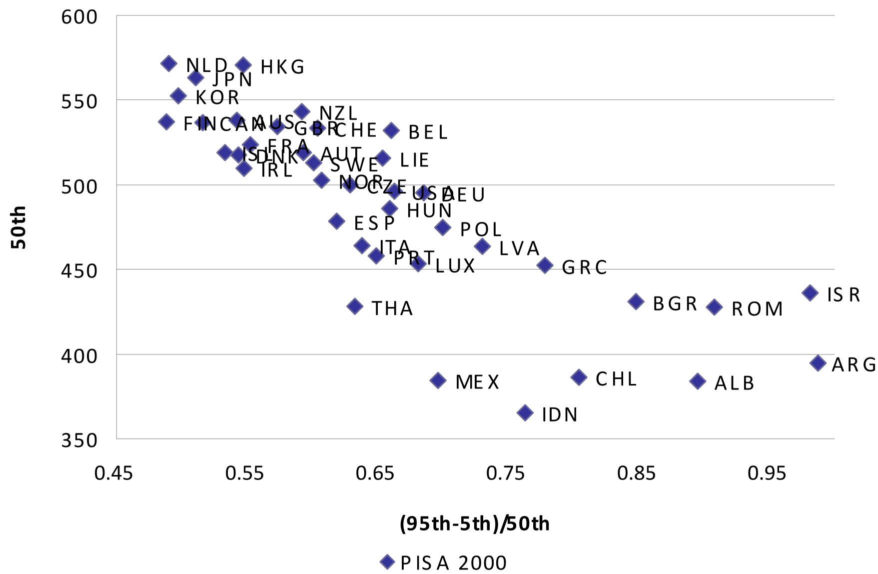
Figure 6.6. Revenue and expenditure decentralisation and the discrepancy of high and low PISA scores



Source: OECD (2017), *OECD Fiscal Decentralisation Database*, www.oecd.org/tax/federalism/fiscal-decentralisation-database.htm; Author's calculations, based on OECD (2019), "Science performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/91952204-en; OECD (OECD, 2019), "Reading performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/79913c69-en and OECD (OECD, 2019), "Mathematics performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/04711c74-en.

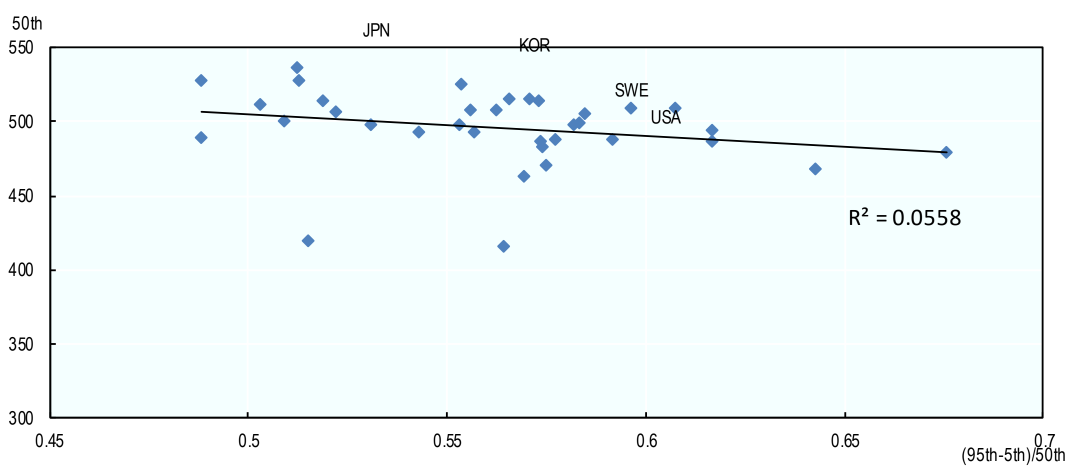
However, according to the empirical findings in this chapter, the academic performance with the concept of student resiliency is not fully matched with the average level of education expenditure. Even though the positive relationship between education expenditure and the academic "average" PISA score has been clear from the early PISA results (Freeman, Machin and Viarengo, 2011) (Figure 6.7), the degree of the increase of education expenditure to local governments may have become less sensitive to student resiliency, based on the 2015 data (Figure 6.8).

Figure 6.7. PISA median and the performance gap (2000)



Source: Freeman, R. B., Machin, S.J. and Viarengo, G. M. (2011), "Inequality of education outcomes: International evidence from PISA", *Regional and Sectoral Economic Studies*, Vol. 11-3, p. 9.

Figure 6.8. PISA median and the performance gap (2015)



Source: OECD (2016), *PISA 2015 Database*, www.oecd.org/pisa/data/2015database/.

This finding has an important implication on the future policy of education financing and performance distribution. For inclusive growth, with the expansion of educational opportunity, the proportional increase of education expenditure to local governments and the distribution of education financing, along with income levels, are important for students from lower-income households. As a result, fiscal decentralisation does not always seem to be linked with education equality. This inconclusiveness is consistent with the results of Sepulveda and Martinez-Vazquez (2011) and Lessman (2012).

The third assumption about the influence of regional discrepancies within a country on education equality does not hold in this analysis (see columns 2 to 4 of Table 6.2). Because regional imbalances may distort the priorities of expenditure, education expenditure from local governments might not be sufficient to support the education sector. This idea has not been borne out by OECD data in this attempt.

Instead, the results show that the macro variables such as Gini coefficient and GDP per capita are more influential on education equality. Thomas, Wang and Fan (2000) already proposed that education inequality is negatively associated with GDP per capita based on the data from 1960 to 1990. Now, OECD data confirm that GDP per capita may be positively related with student resiliency (see columns 2 and 4 of Table 6.2). Socio-economically, GDP per capita represents a country's comprehensive capability, including the maturity level of "all kinds of institutions". When a country may hold the effectiveness of institutions (such as politics, administrative governance, stable legitimacy, etc.), the economic growth measured by GDP per capita may grow and be sustained. This may allow policies for education equality to be implemented well.

Table 6.2. The effect of fiscal decentralisation and inequality on resilient students

Dependent variable: The ratio of resilient students	(1)	(2)	(3)	(4)
PISA mean score	14.25** (3.57)	-	-	-
Gini coefficient	-	-17.30** (7.89)	-14.70* (8.38)	-13.18* (7.70)
Average class size	1.13 (1.91)	3.54 (2.65)	4.22 (2.82)	3.02 (2.57)
Teacher starting salary	-5.26** (2.32)	-8.17*** (2.30)	-7.87*** (2.19)	-7.83*** (2.23)
Salary of teachers in 15th year	4.54** (2.15)	11.35*** (2.43)	10.89*** (2.34)	11.09*** (2.34)
Education expenditure to GDP	0.21 (0.24)	0.34 (1.34)	0.36 (0.27)	0.26 (0.24)
Expenditure decentralisation	3.87** (1.91)	-	0.33 (2.83)	2.18 (1.93)
Real GDP growth rate	0.003 (0.05)	-0.10 (0.05)	-0.10 (0.06)	-0.10 (0.05)
Regional disparity	-	0.64 (0.63)	0.45 (0.67)	0.66 (0.61)
GDP per capita	-	-2.31*** (0.81)	-	-2.54*** (0.79)
Constants	-81.60* (24.28)	-17.55*** (7.42)	-17.45*** (0.67)	-11.17 (8.17)
No. of observation	62	58	58	57
R-squared	0.43	0.50	0.49	0.57

Note: Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1.
Source: Author's calculations.

The effect of regional disparities on the Gini coefficient in OECD countries

In order to examine the third hypothesis thoroughly, this analysis investigates the relationship between the Gini coefficient and regional disparities, which is measured by the indices of the coefficient of variations from T2 levels. Empirical results confirm this conjecture as well as previous literature (Sacchi and Salotti, 2011). When regional disparities within a country are wider, the Gini coefficient rises in OECD countries (Table 6.3). This implies that regional disparities may exacerbate income inequalities.

Although the implications seem obvious, the link to policy is not straightforward. Thorough studies of regional disparities and income inequality have been carried out. Given extensive debate about the relationship between fiscal decentralisation and income inequality (Goerl and Seiferling, 2014), the argument of the effect of regional disparities on the income distribution needs further study with more comprehensive data and rigorous methodology. This chapter cannot provide the evidence of how each affects the other at this stage, but can illustrate the correlation between regional disparities and individual income inequalities through the data-based evidence in OECD countries.

Table 6.3. The effect of regional disparities on the Gini coefficient in OECD countries

Dependent variable: Gini coefficient	(1)	(2)	(3)
Poverty rate	0.08*** (0.01)	-	-
Average wage	-0.002 (0.01)	-	-0.02*** (0.01)
Unemployment rate	-0.009 (0.005)	-0.014 (0.012)	-0.015** (0.006)
GDP per capita	-	-0.007 (0.012)	-
Tax ratio to GDP	-0.002** (0.0008)	-0.001 (0.001)	-0.002** (0.0006)
Real GDP growth rate	0.0002 (0.0007)	0.0008 (0.001)	-
PISA mean score	-	-0.18** (0.07)	-
Tertiary share of education expenditure	0.0002 (0.0004)	-0.0009 (0.0007)	0.0001 (0.004)
Compulsory education share of education expenditure	0.01*** (0.002)	0.01*** (0.004)	0.015*** (0.002)
Regional disparity	0.02** (0.006)	0.05*** (0.012)	0.056*** (0.006)
Constants	0.41** (0.16)	1.41*** (0.45)	0.45 (0.10)
No. of observation	114	56	161
R-squared	0.77	0.65	0.60

Note: Standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1.
Source: Author's calculations.

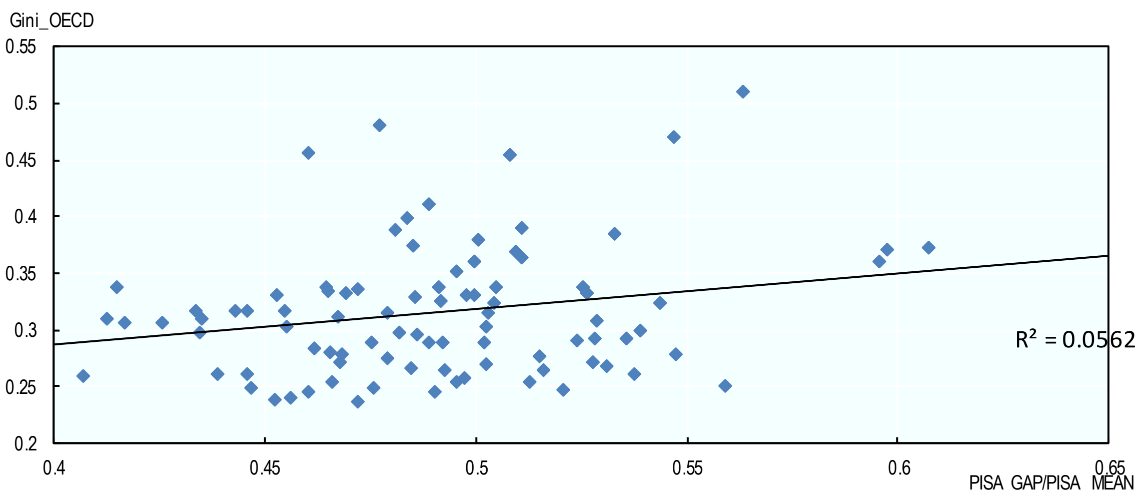
This study also raises interesting and ongoing arguments. By controlling for macroeconomic variables and other factors, mean PISA test scores seem to be negatively related with Gini coefficients (Kim, 2018). Similarly, van Damme (2014) clearly shows the negative relationship between mean numeracy score by the PIAAC test and the Gini coefficient.

Without controlling for other factors, Figure 6.9 and Figure 6.10 show the linear relationship between the Gini coefficient and the PISA mean score (and the discrepancy between high and low PISA mean scores). Both the empirical results and the simple graph show that the income distribution is related to education performance using PISA scores.

Especially in Figure 6.9, the proportional increase of education performance discrepancy with the increase of the Gini coefficient poses fundamental policy questions:

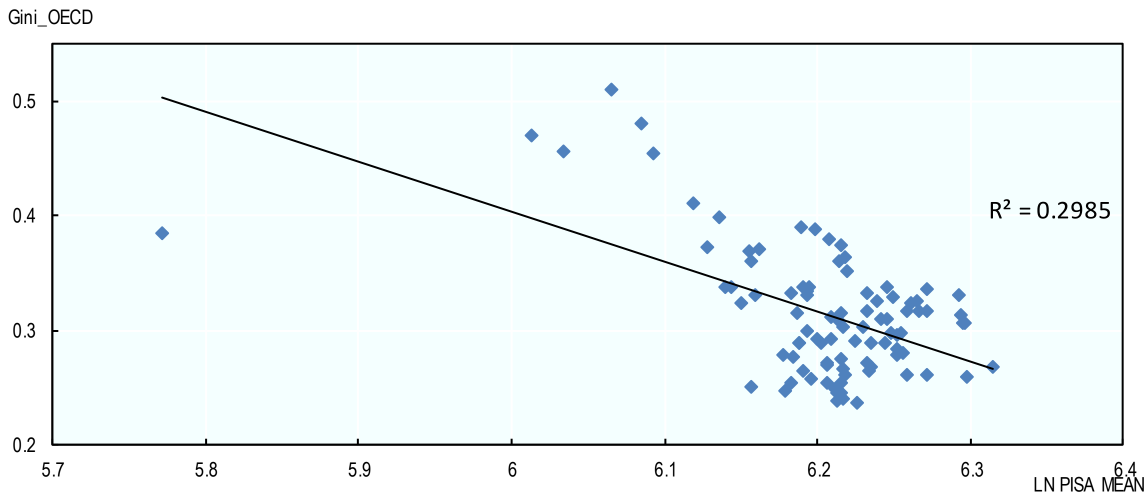
- Which one would affect the other more?
- Which one would be reduced more significantly for inclusive growth?
- Which levels of government can make policies more relevant and implement them more efficiently?

Figure 6.9. Gini coefficients and the PISA mean score



Source: OECD (2019), *OECD Income Distribution Database (IDD)*, www.oecd.org/social/income-distribution-database.htm; author's calculations based on OECD (2019), "Science performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/91952204-en; OECD (2019), "Reading performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/79913c69-en and OECD (2019), "Mathematics performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/04711c74-en.

Figure 6.10. Gini coefficients and the discrepancy between high and low PISA scores



Source: OECD (2019), *OECD Income Distribution Database (IDD)*, http://www.oecd.org/social/income-distribution-database.htm; author's calculations based on OECD (2019), "Science performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/91952204-en; OECD (2019), "Reading performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/79913c69-en and OECD (2019), "Mathematics performance (PISA)", PISA indicator, https://dx.doi.org/10.1787/04711c74-en.

In addition, the coefficients of compulsory education show a positive relation with the Gini coefficient. This implies that higher income inequality is associated with higher spending on compulsory education in OECD countries. So, when a country has a more equal income distribution, the country tends to have more balanced investment among all education levels, be it primary, upper secondary, tertiary or early education. This finding suggests that countries with higher income inequality may have focused on investment in primary education in order to prepare their students for higher education. The policy direction seems to be intuitively obvious, so it seems worth developing policies in this way for countries with higher income inequality. Thomas, Wang and Fan (2000) found that Korea was the country to expand its education coverage at the fastest pace in the world, so accordingly, the education Gini coefficient from 1960 to 1990 showed the fastest decline. Actually, the income Gini coefficient was quite stable during that period. As a result, the finding suggests that lower income inequalities may be compatible with higher performance in compulsory education based on PISA scores.

Policy suggestions for inclusive growth through fiscal decentralisation

Discussion and policy suggestions

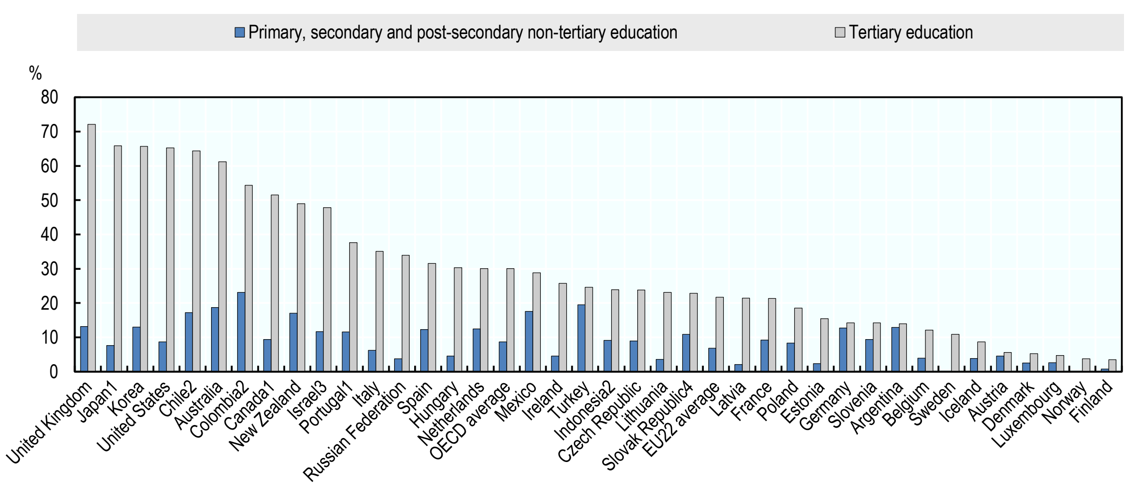
The empirical findings in this chapter pose some policy-related questions. First, the linkage between income disparities and education inequalities with the definition of student resiliency has been shown. Reducing income inequalities is likely to enhance education investment and education equality more effectively. Among OECD countries, income inequality is one of the main determinants of education equality.

Furthermore, the results show that the macro variables such as Gini coefficient and GDP per capita are more influential on education equality. The effect of fiscal decentralisation on student resiliency is not conclusive in this chapter. For the ladder-climbing effect through education, income inequalities seem to be more effective than the effect of fiscal decentralisation in this phase. The empirical study provides the evidence only for hypothesis (1), intending to explain the effect of income inequality. Moreover, increasing education budgets does not necessarily mean a better distribution in education performance. The indirect and comprehensive influence of fiscal decentralisation on education inequalities should be examined with more stringent elaboration in a future study.

For inclusive growth with increased educational opportunities, policies for more targeted and focused groups need to be expedited and developed to narrow the gaps among income levels. For example, the countries with a high dependency on private education expenditure have to monitor the performance results of student resiliency and help promising students from lower income levels (Figure 6.11).

Second, this study suggests that the mitigation of regional disparities may improve income equalities. By using the definition of coefficient of variation in the gross regional domestic product (GRDP) among T2 levels in each country, the Gini coefficients have maintained a significant positive relationship within the wider economic gaps between regions (Figure 6.12). OECD (2016) shows that regional disparities in housing, safety and air quality inside countries are widening in many cases. From this point of view, the regional imbalance of demographic and economic infrastructures may worsen income inequalities in the highly congested capital cities in many Asian countries.

Figure 6.11. The share of private expenditure on education institutions (2014)

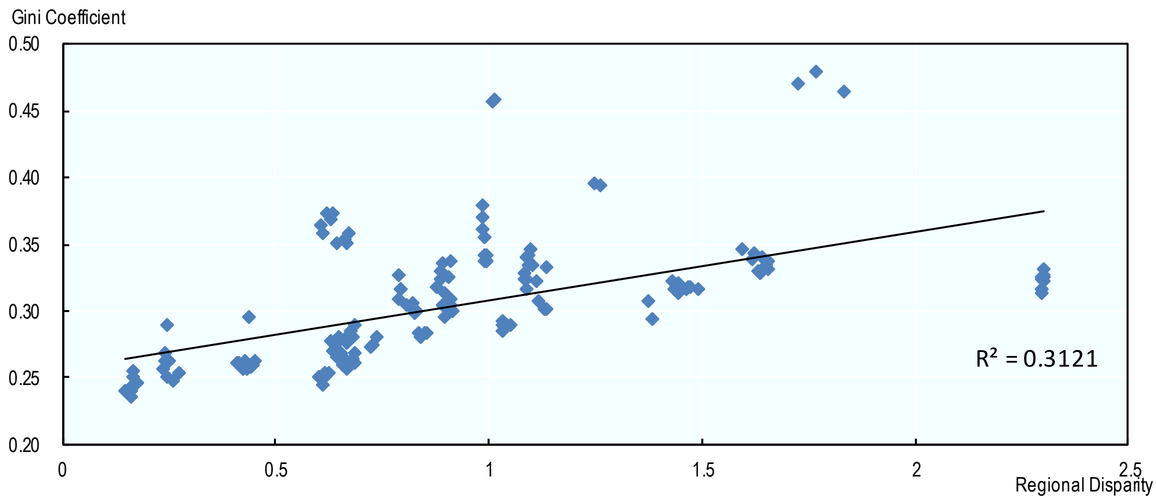


Note: The figure shows private spending on educational institutions as a percentage of total spending on educational institutions. This includes all money transferred to educational institutions from private sources, including public funding via subsidies to households, private fees for educational services or other private spending (e.g. on accommodation) which goes through institutions.

1. Some levels of education are included with others. Refer to "x" code in Table B1.1 in (OECD, 2017) for details.
2. Year of reference 2015.
3. Private expenditure on government-dependent private institutions is included under public institutions.
4. Expenditure on public institutions for bachelor's, master's and doctoral degrees.

Source: OECD (2017), *Education at a Glance 2017: OECD Indicators*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eag-2017-en, p. 190, Figure B3.1.

Figure 6.12. Gini coefficient and regional disparities in OECD countries



Source: OECD (2019), *OECD Income Distribution Database (IDD)*, www.oecd.org/social/income-distribution-database.htm; OECD (2016), *OECD Regions at a Glance 2016*, OECD Publishing, Paris, https://dx.doi.org/10.1787/reg_glance-2016-en.

Finally, this empirical study may add to the evidence concerning the plausible relationship between two kinds of redistributive policies. The arrangement of redistributive budgets between the individual and regional level might be the most challenging political agenda in most countries. For example, especially for many Asian countries, reducing the income gaps among individuals rather than economic gaps among regions might be a higher prioritised policy for social cohesion and inclusive growth, through education equality. In OECD countries, the policy remedy for the mitigation of regional income disparities could involve transfers to local governments.

Limitations and further study

This chapter does not report all the causal analyses of specific policy determinants of educational inequality. The dynamics between individual income inequality and regional inequalities were not fully examined. The interpretation of the relationship between PISA scores and Gini coefficients in this chapter also needs more careful attention. Further study would be recommended to consider unobserved variables for institutions. In general, there have been mixed results about the relationship between cognitive skills and economic outcomes using cross-country data (Broeke, Quintini and Vandeweyer, 2016). As Pena (2015) pointed out by using PIAAC, the understanding of dynamics between skills and economic inequality has evolved in different ways within and across countries.

Finally, the scope of analysis included in this chapter should be extended to other Asian countries. With regard to a policy suggestion, the key features of fiscal decentralisation and education inequalities in Asia would be critical to understanding the dynamics of the inclusive growth mechanism. For further study, information gathering and data expansion in Asian countries should be available so as to enable more in-depth research and development of more relevant policies.

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7. Decentralisation to promote regional development in Indonesia

by
Petar Vujanovic

Indonesia embarked on an ambitious course of decentralisation in 1998. Over a period of a few years, facilitated by financial transfers from the central government, responsibility for many public services and administrative tasks were devolved to local authorities. This process is continuing. Regional development is now very much in the hands of the four sub-national tiers of government. However, the speed of the devolution means that much is being done without the required accompanying skills, technical capacities, resources and oversight. As a result, while good progress has been made nationally along a number dimensions, outcomes in health, education, infrastructure, corruption and the provision of other social services have not improved as quickly as was hoped, and the variance in results across the regions has been considerable. Rather than simply devolving more and more responsibilities to sub-national authorities, the central government could take a more strategic view of regional economic development, monitoring the performance of sub-national governments, providing them with technical assistance where needed, encouraging them to emulate best performers and making use of direct grants. In the longer term the objective should be tax autonomy and transfers based primarily on block grants, although this should be conditional on adequate oversight and sufficient local capacity.

7.1. Introduction

Indonesia is a vast and diverse country. An almost 2 million square kilometre archipelago spanning three time zones, it is made up of around 17 500 islands, of which around 1 000 are inhabited. Its population of 260 million people makes it the fourth most populous country in the world, and it has over 300 distinct ethnic groups. Moreover, the population is distributed very unevenly, with approximately 55% on the central island of Java, only 7% of the nation's land mass. While Bahasa Indonesia is the national language and lingua franca, there are around 34 other languages spoken by at least half a million people and 726 spoken languages in total. Cultural and religious diversity is also striking. While Islam is the majority religion (87%), significant populations of Christians (10%), Hindus (2%) and Buddhists (0.7%) are spread across the country. On top of this, Indonesia has been undergoing an impressively smooth political transition to democracy over the past two decades.

This democratic transition has gone hand in hand with a policy of decentralisation. This process accelerated rapidly in response to the Asian economic crisis. The "big bang" decentralisations in 2001 and 2005 handed greater political autonomy to the regions and devolved substantial responsibilities for administration and public services provision from the centre to sub-national governments.

While Indonesia's national motto, 'Unity in Diversity', binds the country together, the diversity and complexity of the country makes governing especially challenging. This is true not only in a political sense, but also in formulating economic and social policies that promote the well-being of all Indonesians. Since decentralisation, the nation's diversity takes the political form of 34 provinces and 514 regencies/cities, each having its own government and legislative body (Table 7.1). A further level is 7 160 districts. Since 2005, four out of the five administrative levels of government have had directly elected leaders, the exception being districts, whose heads are appointed by the regencies/cities, one level above. The diversity across these sub-national entities is large. For instance, provincial populations range from 43 million in West Java to 525 000 in North Kalimantan – a ratio of 81:1. The variance in population across the regencies/cities is even greater, with the smallest (Tambrauw in West Papua) having just 6 144 residents, compared to the largest (Bogor in West Java) with 4.8 million. The variance in the size of villages is even greater (see below).

Table 7.1. The levels of government in Indonesia, as of end-2015

Type	Type (Indonesian)	Head of administration (English)	Head of administration (Indonesian)	Number
Central	Central	President (elected)	Presiden	1
Province	Provinsi	Governor (elected)	Gubernur	34
Regency & City	Kabupaten & Kota	Regent & Mayor (elected)	Bupati & Wali kota	416 & 98
District	Kecamatan	Head of district (appointed)	Camat	7 160
Village	Desa & Kelurahan	Chief (elected for village, appointed for Kelurahan)	Kepala desa / Lurah	83 184

Source: Statistics Indonesia (based on Ministry of Home Affairs, Regulation no.56/ 2015).

The objective of regional development is to improve the well-being of all – to promote national development by assisting lagging regions to catch up with those at the frontier – not only in terms of just economic growth, but also education, health and environmental outcomes. Indeed, these are all co-requisites for sustainable and inclusive development – especially for a developing country like Indonesia (OECD, 2012d). In the Indonesian context this means not only giving sub-national governments the resources required to make the investments needed to enhance the competitiveness of their jurisdictions, but also the necessary resources to improve the provision of basic services and the capacity to put in place appropriate social, structural and regulatory policies.

With decentralisation, the goal of regional economic development is now very much in the hands of sub-national entities who are responsible for the delivery of public services, the rationale being better accountability and service delivery through increased responsiveness to local needs (Faguet, 2014), often called "subsidiarity". Indeed, the politics of decentralisation in Indonesia has meant that regencies/cities and districts have been favoured over provinces in terms of receiving downward devolved responsibilities (Malley, 2009). Decentralisation can improve performance by promoting competition between regions in the efficient provision of services and attracting businesses. Regions can also draw lessons from each other and benefit from best practice (OECD/KIPF, 2016).

In Indonesia regional autonomy has not delivered the improvements that were expected when launched in 2001, in terms of the provision of public services or in the management of natural resources (Resosudarmo et al., 2014; Buehler, 2010; Moeliono et al., 2009; World Bank, 2009). This is despite a steady increase in transfers from the central to sub-national governments – these now make up about half of the central government budget (net of subsidies and interest payments; about 6% of GDP), and in 2015 over 65% of this amount accrued to the regencies/cities (*kabupaten/kota*). Furthermore, despite some evidence of convergence across the regions, the variance in social-economic outcomes remains large. This includes fundamentals such as education, health, infrastructure, the rule of law (including corruption), the quality of business regulation and the capacity of sub-national governments to administer the provision of public services competently and efficiently. Indeed, research finds that fiscal decentralisation tends to increase regional disparities in poorer countries, while it is either neutral or tends to reduce disparities in richer countries (Rodríguez-Pose and Ezcurra, 2011; Lessmann, 2012). Institutional quality is an important factor: decentralisation seems to foster convergence when institutional quality is high, while it tends to exacerbate disparities in a low-quality environment, fuelling local capture (Kyriacou et al., 2015; Bartolini et al., 2016). This is first and foremost where policymakers' efforts need to focus. Without these fundamentals in place, the blossoming of economic activity in the regions will be constrained, and they will become increasingly dependent on central government funding.

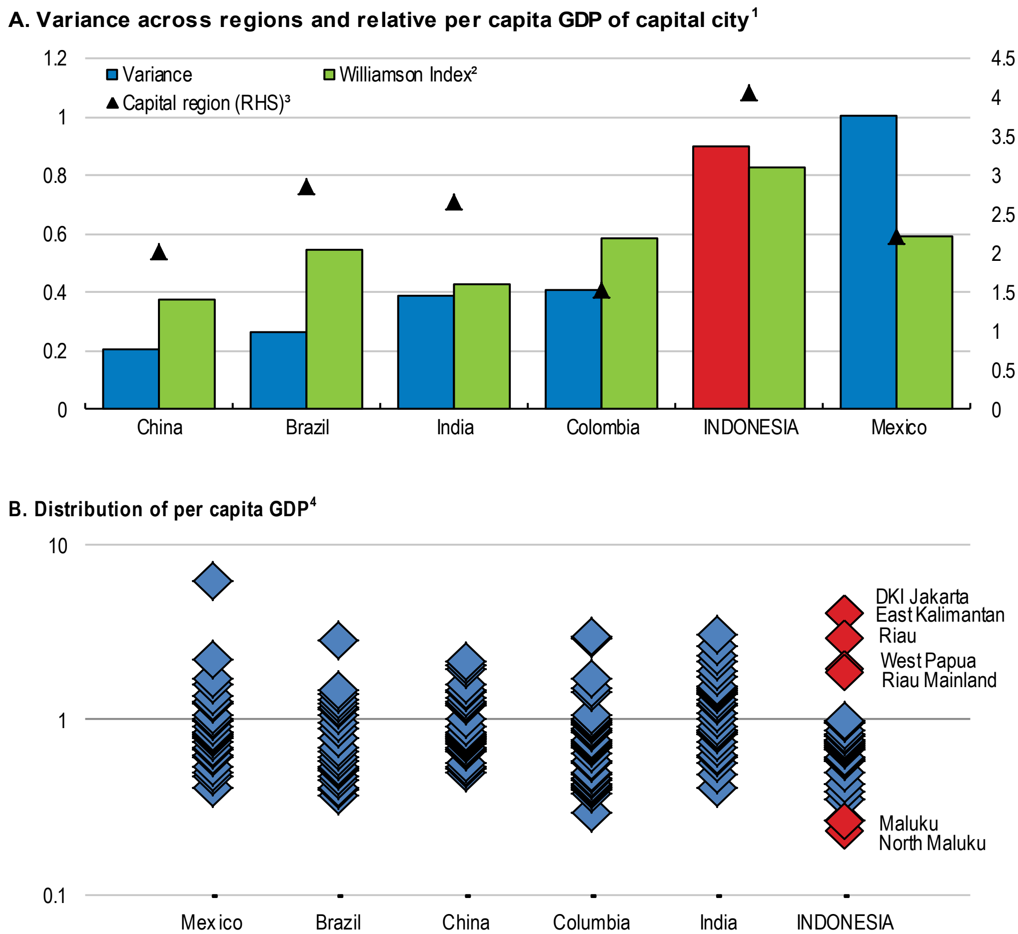
This chapter looks at the challenges Indonesia faces in regional development from the perspective of decentralisation. Even though impressive progress has been made in improving the well-being of its citizens, advances have not been even across the archipelago, with a variance in outcomes considerably greater than in other countries at similar levels of development. The chapter will examine why regional development is particularly challenging, given Indonesia's geographical, historical and political context. The process of democratisation and decentralisation has happened very quickly; yet there is a sense that it is incomplete. Jurisdictions often remain ill-defined or overlap, and local legislation and regulations are frequently at odds with national policies. And because it has happened so quickly, the checks and balances needed for good governance have had very little time to evolve organically. Indeed, the capacity of the sub-national governments – from the 34 provinces to the 83 000 villages – to deliver high-quality public services is often lacking, and so are the frameworks that monitor the proper and efficient use of public resources. Corruption is also a huge issue at the regional level, which, given the lack of efficient legal and administrative means, is the way business is conducted. It nevertheless entrenches privilege and impedes equal opportunity for all. Finally, the programmes currently in place to promote business development in the regions have been ineffective. These programmes have focused excessively on attracting investment though fiscal incentives, rather than improving the business climate and assisting regional firms to become nationally and internationally competitive.

7.2. Progress in regional development has been mixed

Indonesia has made great strides in improving the quality of life of its people. In the years since independence, social and economic outcomes have improved steadily, including in the realms of health, poverty and literacy. For instance, between 1960 and 2015 life expectancy at birth increased from around 49 to 69 years, and infant mortality (per 1 000 births) fell from 148 to 23. Likewise, the $1.90 (2011 PPP) per day poverty rate has dropped from 72% in 1984 to 16% in 2010. The female literacy rate increased from 57% in 1980 to 90% in 2011. Nevertheless, as in many other developing countries, these national averages mask large within-country variances. Moreover, on some metrics, these variances across regions are particularly pronounced in Indonesia.

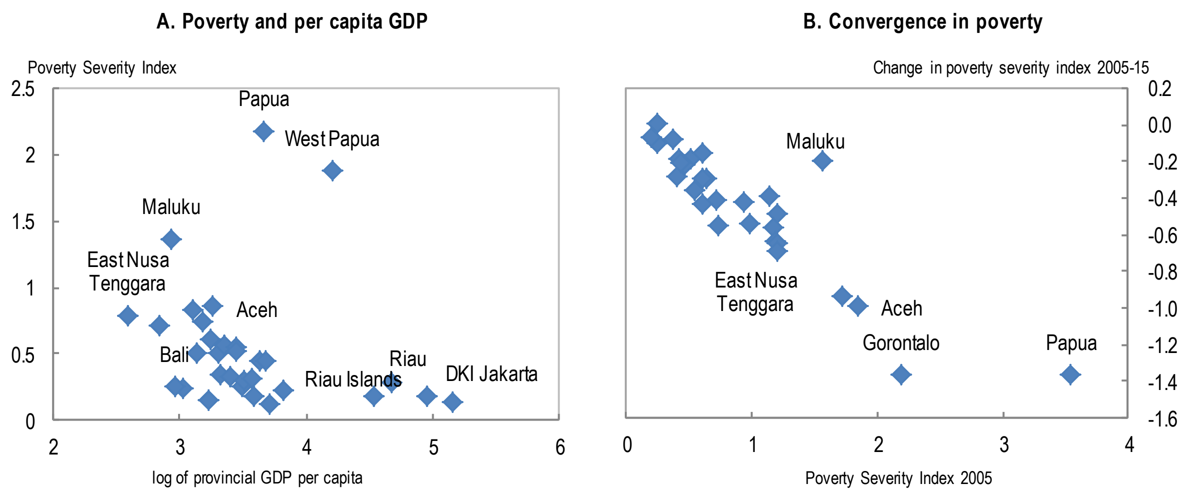
Looking at real GDP per capita, the variance across the Indonesian provinces in 2013 was high compared to a range of other developing countries (Figure 7.1, Panel A). The difference in per capita GDP in the national capital compared to the national average was particularly pronounced –Jakarta's per capita GDP is over four times the national average. Besides the imbalance due to the capital city region, Panel B of Figure 7.1 points to other reasons for the high variance in provincial incomes in Indonesia. The richer regions are those that are resource rich, like East Kalimantan (oil), Papua (copper and gold), Riau and Raiu Island (oil, gas and palm oil). At the other end of the scale, the poorest regions tend to be remote islands that largely lack natural resources like Maluku. It is these outliers at both ends of the range that account for a large part of the high level of inter-regional variance in incomes. Yet, per capita GDP is not the best measure of the standard of living, in particular in these resource-rich provinces, where a significant proportion of the income from the extraction of commodities is likely to flow outside the province. This is confirmed when looking at the distribution of real consumption expenditures across provinces. For instance, West Papua’s ranking drops from being the fourth richest province in real GDP per capita to sixteenth in real consumption per household. West Papua’s low ranking by spending, despite its resource revenues, is corroborated when looking at poverty (Figure 7.2).

Figure 7.1. Per capita GDP of regions in selected countries, 2013



Notes:
1. Variance of the ratio of regional GDP per capita in current local currency to national average. Sample restricted to those countries with around thirty TL2-size regions. 2012 data for Brazil and Indonesia.
2. The Williamson Index is a measure of variance that weights regions by their share of the national population.
3. Ratio of capital city region GDP per capita to national average.
4. Log of ratio of regional GDP per capita (current local currency) to national average.
Source: OECD Regional Database.

Figure 7.2. Poverty severity and convergence in poverty across Indonesian provinces*



Note: * The province of West Papua did not exist in 2005 and is included as part of Papua in Panel B.
Source: Statistics Indonesia.

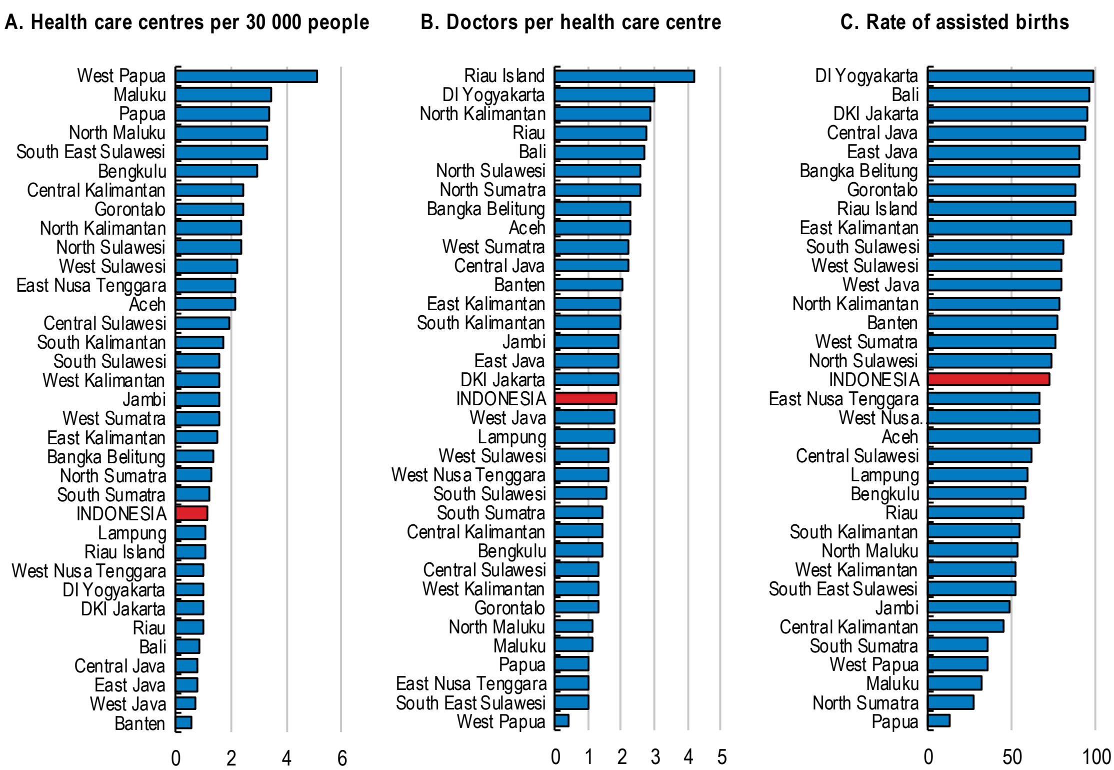
Inequality is higher within urban areas when compared to rural areas, but the prevalence of poverty is greater in rural areas. The strong trend to urbanisation over recent decades is therefore working to reduce aggregate poverty but is increasing income inequality.

Measures to address poverty operate at all levels of government. The fiscal equalisation formula used to calculate the level of transfers from the central to regional governments includes the prevalence of poverty as a parameter (see below for further details). The minimum wage is also a poverty reduction strategy, although an imperfect one because those subject to it may come from affluent households, it may prevent jobs from being created, and it applies only to those employed in the formal sector. Additionally, there are various government measures that address poverty directly, including targeted conditional (Programme Keluarga Harapan or PKH) and unconditional cash transfers and the RASKIN rice programme. Nevertheless, regarding reducing poverty in the regions that most need assistance, it is the targeting of these programmes that is critical World Bank (2012d). This was discussed at some length in the 2015 Economic Survey of Indonesia (OECD, 2015a). In particular, work on increasing the coverage and improving the accuracy of the PPLS14 database of the 40% poorest Indonesians should continue. At the regional level poverty-alleviation programmes still focus on meeting the basic needs of the poor, rather than addressing the underlying causes of poverty or providing long-term growth and employment opportunities. Most programmes are driven by national mandates and agency priorities, rather than by locally perceived needs. Unconditional transfers to sub-national entities, such as provided for by the 2014 Village Law (see below), are mostly politically motivated and are unlikely to be helpful (Andrianto, 2006).

7.2.1. Health

Like poverty, health outcomes have improved markedly over the past few decades. There have been impressive increases in life expectancy and large reductions in infant mortality, for example. Moreover, the provision of health care services and related infrastructure has improved markedly. While this does not necessarily indicate anything about the quality of available health care, the target of having an accessible health care centre (*puskesmas*) for every 30 000 people has been achieved in all but a few of the most densely populated provinces (Figure 7.3, Panel A). However, the number of doctors working in these centres varies greatly (Panel B). The low rate of assisted births in some provinces bears testament to the low numbers of health professionals working in health care centres in these same provinces (Panel C).

Figure 7.3. Provincial health care indicators, 2014.



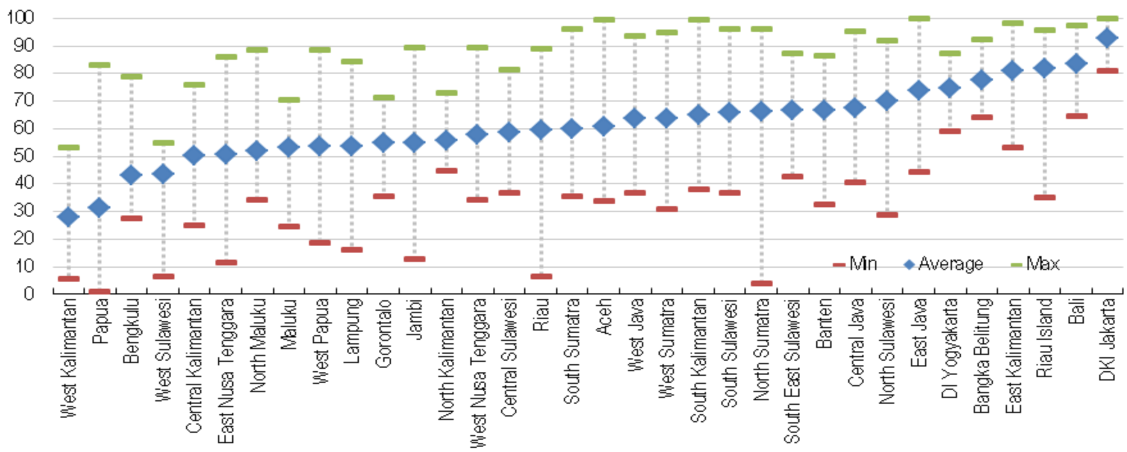
Source: Ministry of Health.

While good progress has been made in the provision of health infrastructure, the focus needs to be on improving the quality of care across the country. This includes staffing health care centres adequately. As in many other countries, attracting qualified and competent professionals to small health care centres in remote regions is challenging. A number of districts have programmes that sponsor medical students through their studies, provided that after graduating they repay this by working for a time in medical centres in the sponsoring district. This practice could be adopted more widely, and indeed the central government could earmark funding for such programmes. Moreover, the low effective density of doctors could also be due to stringent rules that regulate entry into the medical profession, including by foreign medical professionals (OECD, 2012a).

Also from the standpoint of health, particularly children's health, households' access to safe water varies greatly, even across the regencies/cities within individual provinces (Figure 7.4). Indeed, not just in the poorer eastern provinces, but in almost half of all Indonesian provinces there are regencies/cities where less than a third of households have access to safe drinking water.

Figure 7.4. Variation in household access to safe water, 2013

% of households, provincial averages and within-province ranges*



Note: * Within-province ranges are at the regency/city level.
Source: Statistics Indonesia, National Social Economic Survey (SUSENAS).

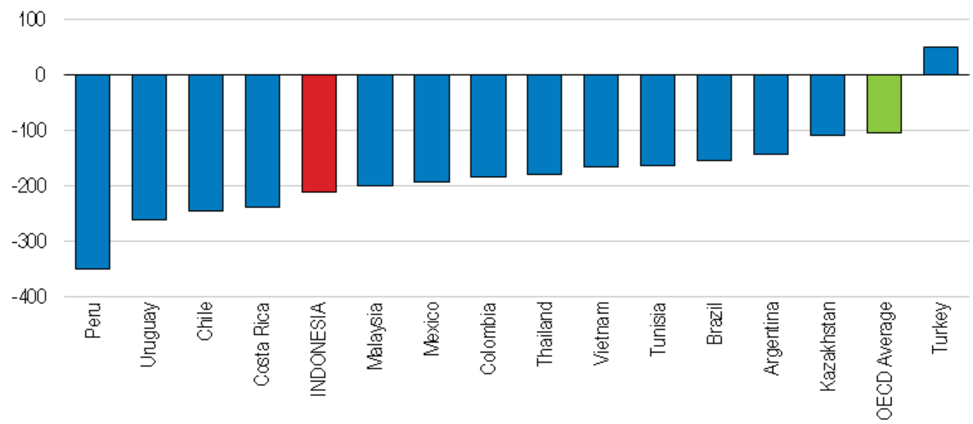
7.2.2. Education

Much headway has been made in ensuring greater access to education over the past few decades. Successive governments' focus on basic education has paid dividends, with improved attendance at all levels across the archipelago. Nevertheless, there is some way to go to achieve universal primary and lower secondary enrolment, the government's stated objective. For instance, in 2012 9% of regencies/cities had primary school enrolment rates of less than 90%. While this is down from 29% in 1996, it still amounts to 1.3 million children who did not go to primary school (UNESCO, 2015). Enrolment at higher levels is even more heterogeneous across the country and socio-economic groups. For instance, recently only 55% of children from low-income families were enrolled in lower secondary schools (World Bank, 2012c).

Indonesia's average PISA score is close to other countries' at a similar level of development. While a regional breakdown of Indonesia's PISA performance is unavailable, there is a breakdown based on town size. The difference in PISA performance between big cities and villages is comparatively large among developing countries (Figure 7.5). This might be caused by a number of factors, including accessibility and the quality of teachers (Hayashi et al., 2014).

Figure 7.5. Rural-urban student performance differentials, selected countries

Difference in PISA scores between villages and large cities*



Note: * Sum of PISA reading, science and mathematics scores.
Source: OECD 2012 PISA database.

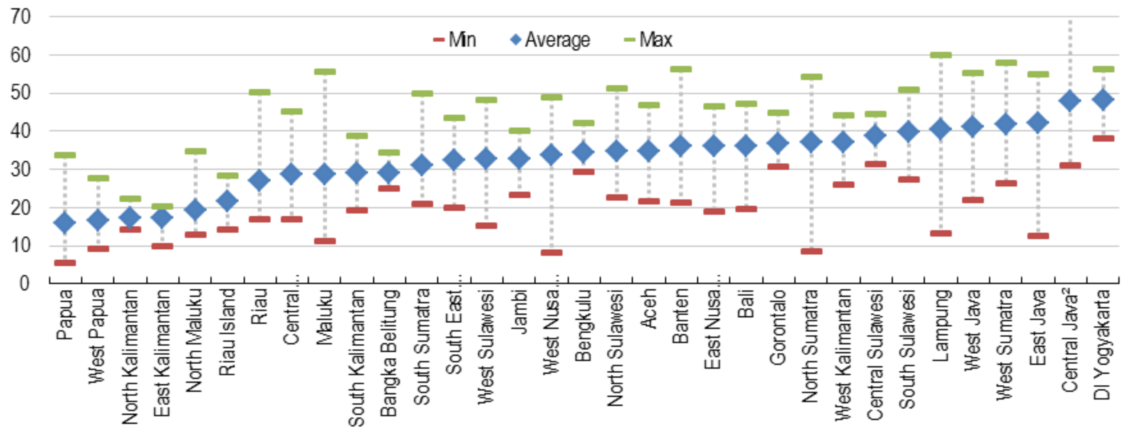
The supply of teachers and quality of teaching may help to explain variations in student performance across the country. Because of a general oversupply of teachers, Indonesia has one of the lowest pupil-teacher ratios worldwide, and teacher recruitment continues to outpace student enrolment at all levels. Over the past decade the number of teachers in all except Islamic schools rose by 51%, and the national pupil/teacher ratio declined from 20:1 to 15.4:1 (Suharti, 2013). Many rural districts have low pupil-teacher ratios because they have many small schools, but despite this, the rule is that each primary school should have a minimum of nine teachers. Moreover, teachers are attracted to remote locations by allowances that can triple their salaries. So, while it means that rural schools are not generally understaffed, staffing classes of 10 pupils or fewer with a qualified teacher is inefficient (OECD, 2015b).

Larger numbers of teachers and increased salaries have accounted for a growing share of education budgets (World Bank 2013a; Kristiansen and Pratikno, 2006). With decentralisation, the number of teachers is set by the central government based on the number of students and schools. Recruitment and salaries are effectively set by the local governments who are fully compensated by central government transfers (see below). This creates a perverse incentive for the regions to increase teacher numbers regardless of needs or competencies. More should be done to assist sub-national governments to fully and efficiently allocate their education spending. This includes rewarding teachers for performance and not just academic qualifications and seniority.

Whereas education policy and standards have remained the responsibility of the central government since 2001, the delivery of basic education has been that of the regency/city governments. This has provided more opportunities for parental participation, including greater flexibility and improved access to educational services in certain areas. Since 2005, the constitution has required that all levels of government dedicate 20% of government spending to education. In 2012, 13% of all regencies/cities spent under 20% of their budget on education, while many spend a great deal more (Figure 7.6).

Figure 7.6. Variation in expenditure on education across and within provinces, 2012

Education expenditure as a percentage of total revenue, provincial averages and within-province ranges[1]

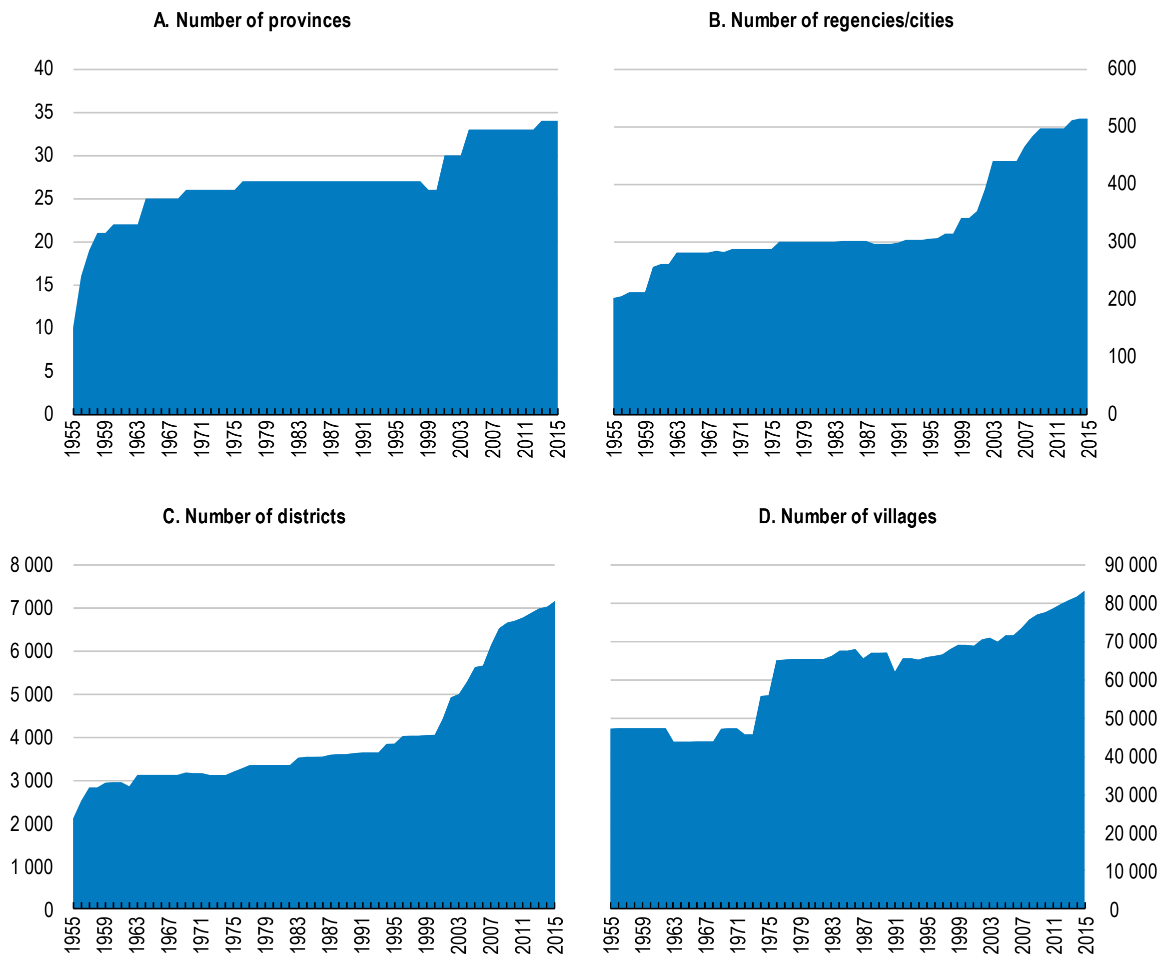


Notes: 1. Within-province ranges are at the regency/city level; 2. Within-province maximum for Central Java is 97.3%.
Source: Statistics Indonesia, National Social Economic Survey (SUSENAS); INDO-DAPOER database.

7.3. Regional administrative fragmentation continues apace

One of the most striking aspects of decentralisation in Indonesia has been the proliferation and continuing subdivision of political and administrative units. This process, which has been named *pemekaran* (blossoming), has occurred at all sub-national levels of government. (Kimura, 2013). Between 1999 and 2015 the number of provinces increased from 26 to 34, the number of regencies/cities increased by 55%, districts by 77% and villages by 20% to over 83 000 (Figure 7.7).

Figure 7.7. Number of sub-national administrative units in Indonesia since 1955



Source: Statistics Indonesia.

The subdivision of a country into small political regions is desirable from a number of perspectives. It brings the provision of public services closer to the people, thereby better meeting needs. A large number of smaller sub-national units also makes it easier for residents to vote with their feet and move to a jurisdiction offering a mix of services and taxes that better match their preferences (Tiebout, 1956). It also provides greater scope for civil participation and political accountability. However, the optimal granularity is very much open to debate, both in terms of size (topographical and demographic) as well as the range of services provided. There is a trade-off between catering for local preferences and the efficiency (the ability to exploit economies of scale, for example) and the technical capacity of small government units.

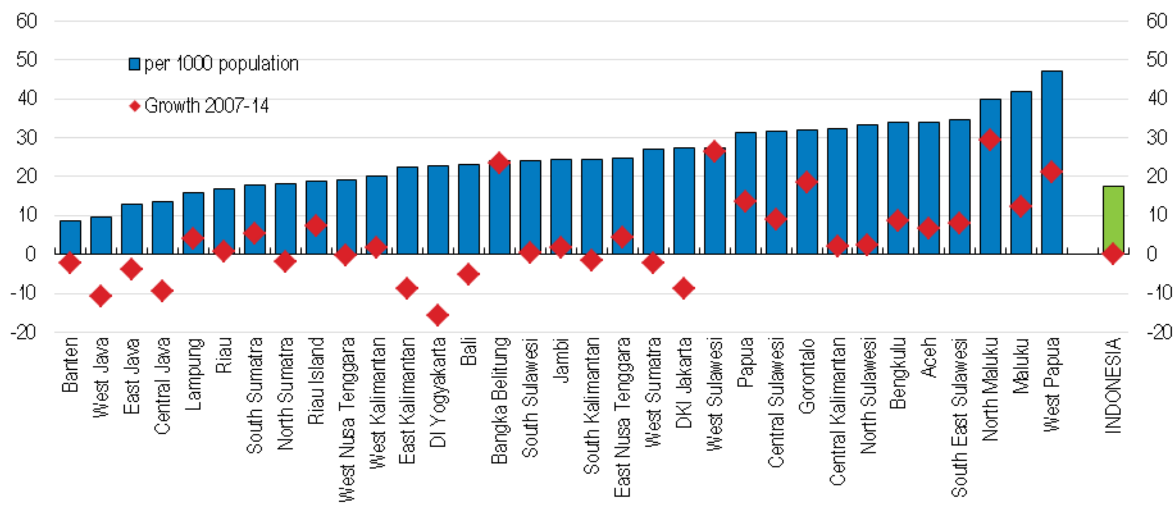
Sub-national politics is undergoing a process of atomisation that is allowing local elites to subdivide power. This process has been tolerated by the central government because it acts as a political pressure valve (Nolan et al., 2013). Kimura (2007) argues that fragmentation since the transition to democracy has largely been in response to vertical coalitions composed of politicians at the national, regional and local levels. Gone are the days when military men or national-level bureaucrats were parachuted in to implement central government policies. In 2005, the direct election of governors, district heads and mayors was introduced, and so political power is now contested by locals with local interests (Buehler, 2013). Burgess et al. (2012) document the pernicious impact that the multiplication of jurisdictions has had on the management of forests in Kalimantan.

The blossoming in the number of political entities at the sub-national level has been mirrored by a boom in the number of public-service jobs. At around 17.5 public servants per 1 000 population, Indonesia has a very high share of government employees compared to peer countries. Lewis (2015) concludes that Indonesian sub-national governments spend too much on administration and personnel and not enough on actual service delivery: indeed, district administrative expenditures are extremely high in international comparison. On average, districts spend around a third of their entire budget on general administration cost, such as wages, and not on public service delivery. Corresponding figures are 3% for US counties and UK districts, 8% for Norway and 13% for Tanzania (Suharnoko Sjahrir et al., 2014). In Indonesia, around 73% of government employees are at the regency/city level, and this is where the highest growth rates have been. This of course reflects the increase in service delivery responsibilities at this level of government, but those provinces with the highest civil-servant densities in 2007 were also those with the strongest growth in the number of civil servants over the subsequent seven years. Moreover, the variance across Indonesia's provinces in public servant density is enormous, ranging from around 10 per 1 000 population in Banten and West Java, to over four times that in Maluku and West Papua (Figure 7.8). Lewis and Oosterman (2011) argue that while the sub-national governments account for a significant proportion of public investment spending, a large share of this goes to towards relatively unproductive assets such as office buildings. All these indicators suggest that sub-national governments are, in this respect at least, not converging on best practice.

An important factor that has driven the rapid blossoming of new villages in Indonesia over recent years is the system that allocates funds on a per-village basis, largely without regard to population size or the individual needs of each village. This means that subdividing a village into two effectively almost doubles the per capita allocation from the central government. This applies to some degree to all levels of sub-national government; Fitrani et al. (2005) show that the lump-sum nature of Indonesia’s general allocation grant (see below) means that “two new districts get effectively twice as much as the larger older district” from which they were formed.

The rise in the number of administrative units has also had broader economic consequences. For instance, the subdividing is frequently done in such a haphazard manner that the geographical boundaries of newly formed administrative units are often left undefined, making spatial planning and land-use zoning problematic, especially from the perspective of businesses wanting to build and invest. Since 1994 there has been a project led by Statistics Indonesia to produce digitised maps of regency/city, district and village-level boundaries. For a country like Indonesia with upwards of 83 000 villages, often in remote and hard-to-access locations, mapping is a massive task, not least because of the constantly changing administrative boundaries, but this project should be prioritised and properly funded.

Figure 7.8. Number of public servants by province, 2014

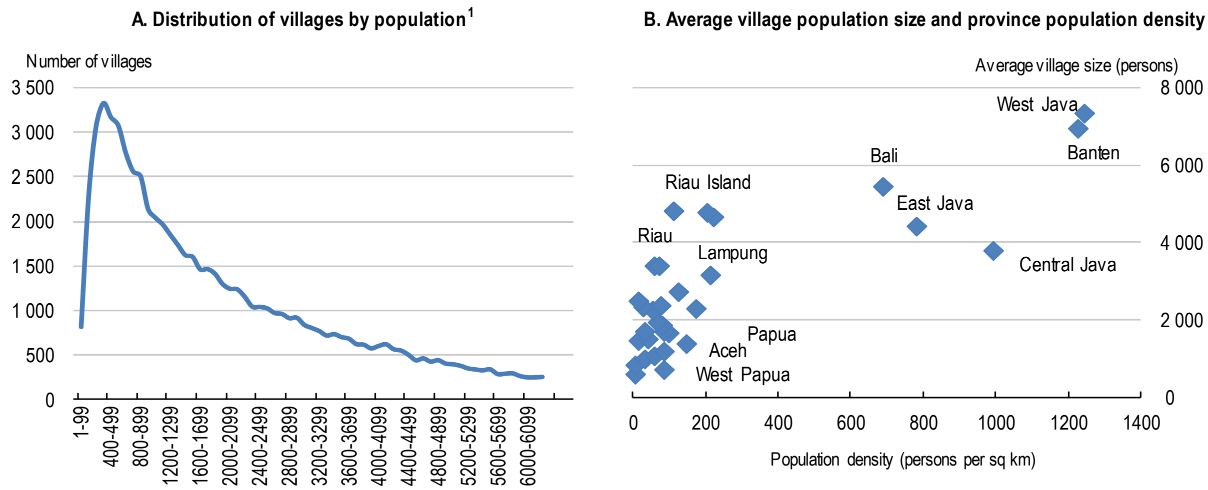


Source: Statistics Indonesia; INDO-DAPOER; OECD estimates.

As in many other countries, including OECD countries such as France, the Czech Republic, Finland and Denmark, very small political units can be costly from a public administration perspective. As mentioned earlier, fragmentation into small administrative units can improve outcomes as local governments closer to the people can implement policies that better match their needs, thus providing goods and services in a more efficient way. However, small operational unit sizes can conversely result in diseconomies of scale and policy and legal fragmentation that impedes firms from operating efficiently across jurisdictions (Bartolini, 2015). Moreover, the small talent pool might mean that the technical capacity of public-sector workers can be a problem. With decentralisation, the district level of administration in Indonesia has been tasked with a broad array of public service delivery responsibilities ranging from education to health. There are around 6 500 districts with a mean size of around 38 000 people and a median of just 24 000. Indeed, there are districts in Indonesia with as few as 200-odd residents (the Syujak district in Tambrauw regency in West Papua). Likewise, with the new 2014 Village Law, greater resourcing (to reach 10% of total intergovernmental transfers by 2017) and social service delivery responsibilities are being given to villages. However, while as yet the legal and regulatory framework provides only a general indication of village service responsibilities, with over 200 villages comprising less than 50 people (and indeed 13 with less than 10 people; Figure 7.9; Panel A), the technical capacity to administer these funds and deliver these services, let alone supervise their expenditure, is stretched. The issue of fiscal transfers and village-level governance is discussed in more detail below.

Measures have been taken to put a brake on the fragmentation of sub-national political entities. In 2008 a moratorium was imposed on the formation of new provinces, but then in 2013 the country's 34th province, North Kalimantan, with only 525 000 inhabitants, was sliced out of East Kalimantan province. The Village Law 2014, Article 8 (3.b) specifies the minimum population required for new village formation (for example, in Java 6 000 persons or 1 200 households, and in Papua and West Papua 500 persons or 100 households).

Figure 7.9. Village population size, 2010

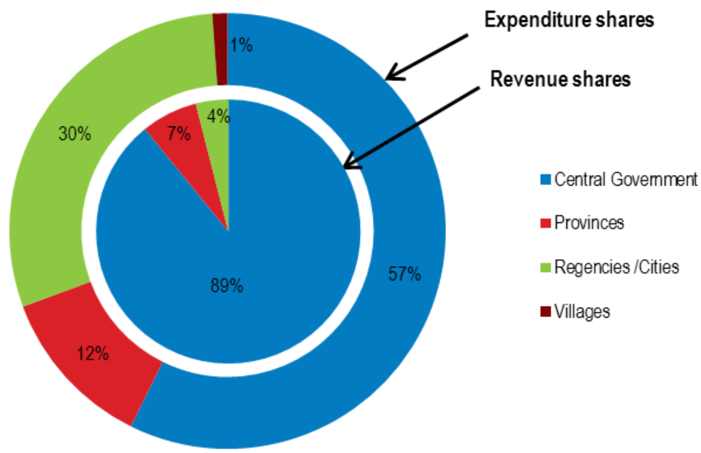


Note: 1. There are 8 498 (11% of total) villages with a population of greater than 6 300, although the frequency continues to decrease monotonically with size.
Source: Statistics Indonesia, Census 2010.

7.4. Some fiscal aspects of decentralisation could be improved

Over the past decade and a half, Indonesia has gone from being one of the most centralised countries in the world in administrative, fiscal and political terms, characterised by a dominant and authoritarian central government, to one of the most decentralised. Starting in 2001, as devolution of responsibilities for the provision of public services began, the provincial governments, which had previously shouldered a lot of these responsibilities, were leap-frogged in favour of having service delivery responsibilities at lower levels of government. Given that the sub-national governments have very limited revenue-raising capacity, the majority of the funding for these services continues to come via central government transfers. Indeed, in 2015, 89% of all government revenue collected was by the central government, while only 47% of expenditure was incurred by central government (Figure 7.10).

Figure 7.10. Revenue and expenditure shares by level of government, 2015

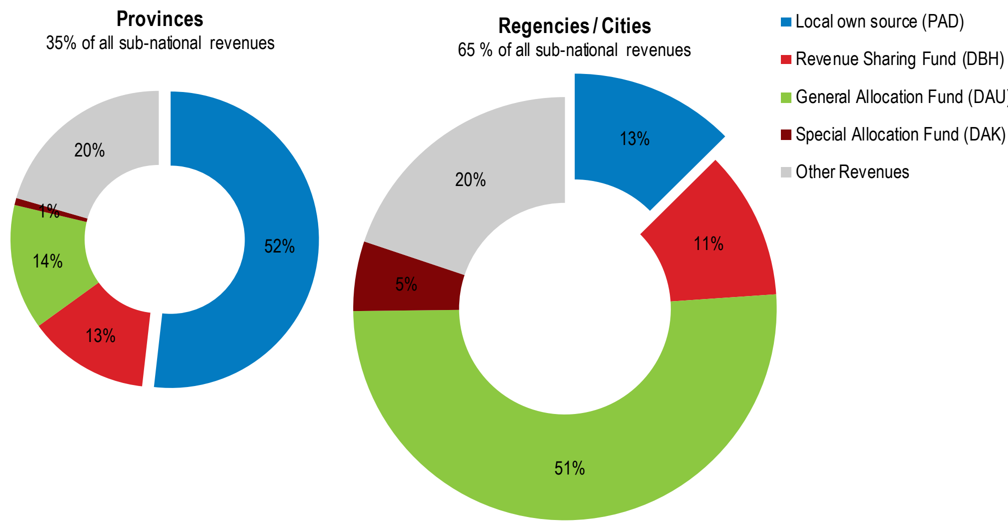


Note: 1. The 2015 figure for village expenditure is an OECD estimate. Given the ramping up of the 2014 Village Law, the estimated 2015 village expenditure share is likely to be an underestimate.
Source: Ministry of Finance, Statistics Indonesia; OECD estimates.

Funds from the central government are allocated directly to three sub-national levels of government: namely the provinces, the regencies/cities and villages. Districts are funded and administered by the regencies/cities. In broad terms there are three categories of transfers: (i) equalisation funds; (ii) autonomy funds; and (iii) village funds. Equalisation funds have a number of subcategories. The General Allocation Fund (DAU) is a large block grant, half of which is earmarked for wages and salaries, with the rest unconstrained. The Special Allocation Fund (DAK) is an targeted block grant. The Revenue-Sharing Fund (DBH) redistributes revenues earned from natural resources (forestry, mineral mining, fishery, oil, natural gas and geothermal), and non-natural resources (land and building tax, property tax and income tax). Autonomy funds provide a few resource-rich provinces with a larger share of resource royalties. Village funds are grants directly to villages. The details of each of these transfers, including the formulae used to calculate the distribution among sub-national governments, are discussed in detail below. Finally, there are also de-concentration funds which provide "off-budget" grants directly from central government line ministries to sub-national governments to fund specific national programmes.

In 2015 the regencies/cities accounted for around two-thirds of all revenues at the sub-national level (5.4% of GDP), while provincial revenues accounted for the remaining one-third (2.3% of GDP). By far the largest transfer is the General Allocation Fund (Dana Alokasi Umum; DAU) transfer to the regencies/cities, which accounts for around half of all central government transfers to these two sub-national levels. In addition to revenues from central government transfers, provinces and regencies/cities also raise their own revenues, but they account for only 52% and 13% of total revenues for provinces and regencies/cities, respectively (Figure 7.11).

Figure 7.11. Sub-national government revenues by source, 2015



Note: 1. Excludes transfers to villages. Other Revenues include Autonomous Regions Funds to Aceh, Papua and West Papua.
Source: Ministry of Finance.

7.4.1. The General Allocation Fund

The largest central government transfer to the regions is the DAU, accounting for 56% of total central transfers and financing 46% of sub-national expenditures. DAU is a block grant paid to the provinces and regencies/cities with a fixed 10/90 split between the two. The formulation that determines its distribution across regional government is heavily weighted towards a basic allocation for public service wages and salaries; this component is around half. Box 7.1 gives further details of the formula used to calculate the remainder, based on a fiscal gap.

Box 7.1. Formula for the distribution of the General Allocation Fund (DAU)

The total national DAU pool is calculated annually by the Ministry of Finance based on the total central government budget. This has typically been around one quarter of total domestic revenue in the national budget. The DAU pool is divided into two parts: (i) the basic allocation and (ii) the fiscal gap.

The basic allocation is intended to cover personnel costs for sub-national civil servants (including teachers and medical staff, etc). This usually amounts to around half of the total DAU pool.

The remainder of the pool is divided among the provinces and the regencies/cities. The split is set by agreement between the government and parliament and is currently 10%-90%. The fiscal gap formula is used to decide how these shares are divided among the provinces and among the regencies/cities. The fiscal gap is the fiscal needs *less* fiscal capacity. The fiscal needs of a region are local expenditures adjusted by population, land area, construction prices and poverty. Fiscal capacity is local revenue adjusted by estimated revenue potential. This is represented by the sum of an industry index, a natural resources index and a human resources index. Local revenue is local own revenue plus any tax-sharing revenues received.

By comparison to other federal countries, the formulation of this transfer is both complex and results in undesirable incentives. For instance, the blanket coverage for public service wages and salaries strongly encourages a large public payroll. The central government imposes some controls over local recruitment and staffing in order to mitigate this perverse incentive. However, at the regency/city level where the DAU represents over half of all revenues (compared to just 14% for provinces), the public payroll is much larger than at the provincial level and also compared to other local governments with similar service delivery responsibilities in peer countries (World Bank, 2005). Indeed, personnel accounted for 47% of all regency/city expenditure in 2014, up from 31% in 2009. This is in contrast to the provincial level where it accounted for just 16% of expenditure in 2014, down from 20% in 2009.

If direct compensation for the local level public payroll is to remain, for the sake of transparency the basic allocation should be separated from the fiscal gap allocation. Furthermore, payroll compensation should not cover 100% of the payroll: the salary of each additional public employee should be compensated at a fixed marginal rate of less than one, with the remainder coming from other non-compensated transfer streams or, even better, from local own-source revenues (see below for recommendations on increasing the share of own-source revenues in regional budgets) so as to encourage regional governments to economise on public-sector hiring.

The formula for the fiscal gap transfer also needs to be reconsidered. Indeed, in many developing countries (such as Brazil, India and Thailand, and in the United Kingdom) very simple per-capita revenue- sharing frameworks are used and explicit grants target social inequality, infrastructure exigencies and other regional inequality issues (Shah et al., 2012). While moving to such a system is very unlikely in Indonesia due to the political economy of decentralisation, reforms are needed that focus on simplicity, transparency and certainty, while enhancing efficiency and citizen-based accountability. Incentivising improvements in outcomes, such as achieving a target poverty rate or reducing road disrepair, should also be designed into the framework; that is not to say that being at or above a target should result in higher payments, but that improvements towards a target should be rewarded. Finally, as mentioned above, the formulation of the DAU perversely rewards regional fragmentation with higher per capita transfers after a province or regency/city is subdivided (Harjowiryono, 2011) and needs to be changed.

7.4.2. The Specific Allocation Fund

The Special Allocation Fund (Dana Alokasi Khusus; DAK) is a grant targeted at spending on areas of national priority. However, in reality the DAK has proven to be not much more specific than the DAU. Furthermore, the effectiveness of the DAK allocation mechanism in poverty alleviation, boosting economic growth, cutting unemployment and other specific dimensions has been disappointing (Wibowo et al., 2011). This might reflect the small size of the programme, which accounts for just 6% of central government transfers and finances just 5% of sub-national expenditures.

There are also Special Incentives Grants (Dana Insentif Daerah; DID) and Hibah, which used to be earmarked but since 2015 locals government have been free to use them according to local needs. DID is a small grant programme (accounting for less than 1% of total transfers) to better performing provinces and cities based on the quality of public financial management, level of tax effort, progress in improving the Human Development Index, economic growth, reductions in poverty, unemployment and inflation. Hibah transfers are intended to finance sub-national infrastructure and social development expenditures (Qibthiyyah, 2011).

Shah et al. (1994) suggest an alternative to DAK grants could be conditional open-ended matching grants, along with intensive ongoing evaluation and monitoring to align the allocation of funds to regions with regional development targets. The World Bank is currently funding a project allocates the DAK grants in a similar way to Output-Based Approach (OBA) subsidies, which reimburse service providers for independently verified, pre-agreed measurable physical outputs. Both of these approaches have merit and should be tested. More generally, a greater share of transfers should be in the form of earmarked special-purpose grants.

7.4.3. Autonomy transfers

The central government has entered into special arrangements with Aceh, Papua and West Papua to allocate a greater share of resource revenues to them through the tax sharing system. However the DAU offsets a large part of those gains by including 95% of tax sharing transfers as increases in fiscal capacity for the provinces and 63% for regencies/cities. Nevertheless, the total transfers to these three provinces in per capita terms are the highest of any. The use of the autonomy funds goes largely unsupervised by central government and is therefore extremely prone to fraudulent practices by officials from both central and local governments (Jakarta Post, 2011). The Supreme Audit Agency (BPK) found indications that between 2001 and 2010 around 20% of the IDR 19 trillion in special autonomy funds for Papua and West Papua may have been misused or embezzled (Jakarta Post, 2011).

7.4.4. The Revenue Sharing Fund

Dana Bagi Hasil (DBH) are revenue-sharing transfers. The central government collects taxes on personal income, property, and renewable and non-renewable natural resources and returns a pre-defined share of the revenues to the originating jurisdiction. The sharing formula is set out in Law (33/2004). In 2015 DBH accounted for 13% of all provincial revenues and 11% of regency/city revenues.

7.4.5. Village-level transfers

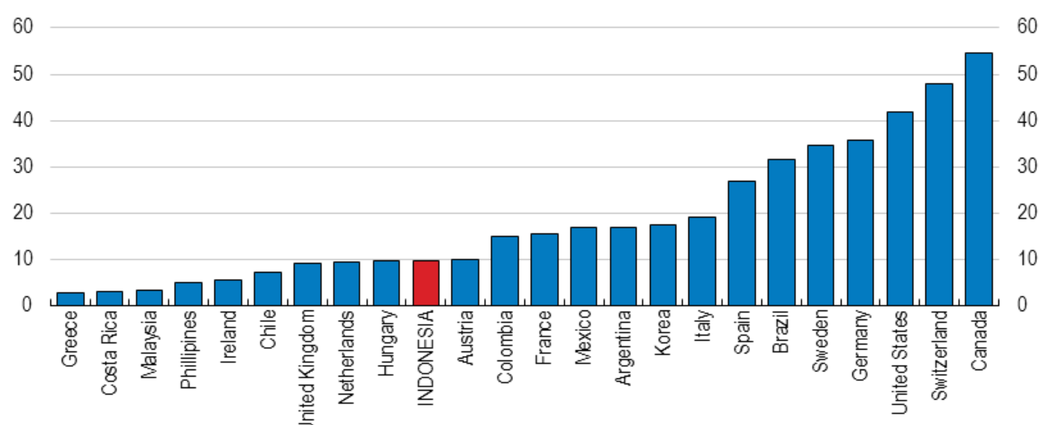
The 2014 Village Law instituted a new system of transfers directly to villages both from the central and regency/city governments (*Dana Desa*); it is to be phased in over a three-year period. In 2015, villages received over IDR 20 trillion (approximately USD 1.5 billion) in *Dana Desa*, which amounts to about 3% of total central-to-sub-national transfers. In addition, regencies/cities will be required to contribute 10% of their own-source revenues (PAD), revenue sharing grants (DBH) and general purpose transfers (DAK) – an estimated IDR 40 trillion (USD 3 billion) – to village budgets. Taken together, these funds made up about 3% of all government spending in 2015, and this is set to increase as the scheme is implemented. The majority of the funds (90%) are to be distributed as equal allocations per village, with the remainder based on a "needs" formulation. Indeed, a popular refrain used by both candidates in the 2014 presidential election was '*satu desa, satu milyar*' ('one village, one billion rupiah'). The basic per-village allocation means a median-sized village will receive IDR 325 600 (USD 23) per capita. This uniform per-village allocation runs counter to the very large heterogeneity among villages, including in terms of population, land area and poverty – indeed there are 2 436 villages with one tenth the median population that are set to receive 10 times the median per capita allocation. This brings into question the scheme's equity. The allocation formula needs to be reassessed and an alternative scheme adopted that uses a simple formulation that accounts for population size and poverty prevalence. Also greater use should be made of earmarked grants for village capital needs.

Beside the equity issue, the other major problem with the 2014 Village Law is that villages' service responsibilities are not clearly defined. The legal and regulatory framework provides only a general indication of these responsibilities. Central, provincial and regency/city governments will be responsible for detailing the actual tasks that villages will perform at a later date. Despite claims that 'money follows function' – best practice in fiscal decentralisation – in this case the opposite is true. Furthermore, as yet, no provisions have been made for external audits of village-executed budgets.

7.5. Strengthening revenue raising in the regions

On the back of falling resource revenues and rising expenditure demands, including for infrastructure and social spending, the national government is seeking to increase tax revenues. However, while around half of all public spending is at sub-national level, only about a quarter of the revenue is raised locally. Or, put another way, only around 10% of total government revenue is raised at the sub-national level, which is low by international comparison, especially in contrast to other federal countries like Brazil, Canada, Germany, Switzerland and the United States (Figure 7.12).

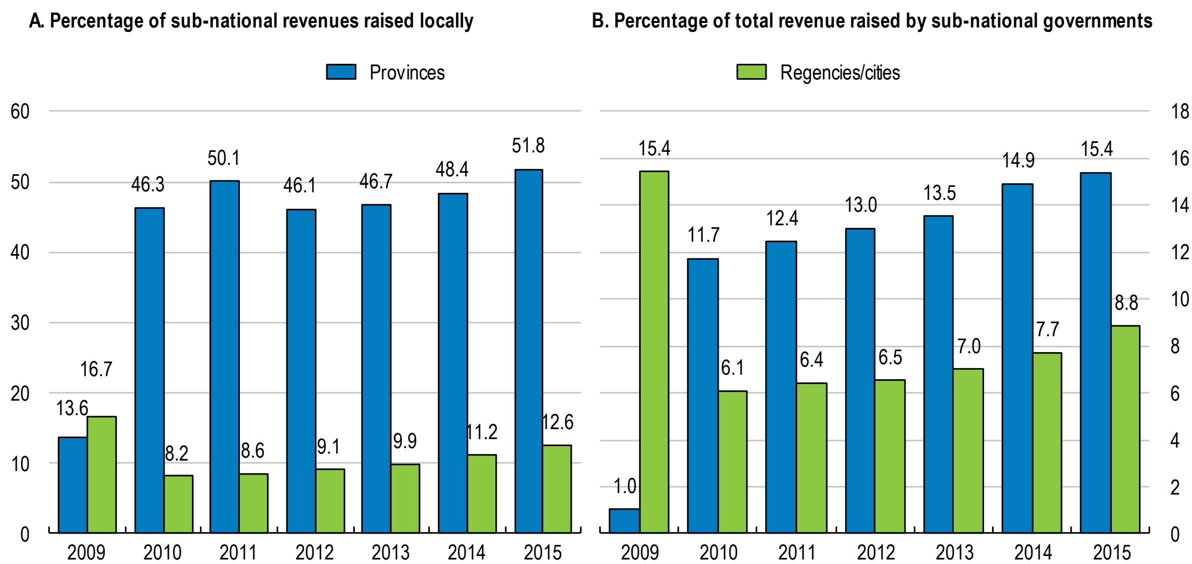
Figure 7.12. Sub-national own-revenue as a share of total government revenue, 2014[1]



Note: 1. 2013 for Indonesia, Philippines, Malaysia, Brazil, Argentina, Colombia, and Costa Rica.
Source: OECD Fiscal Decentralisation Database; OECD (2015), *Revenue Statistics in Asian Countries 2015: Trends in Indonesia, Malaysia and the Philippines*, OECD Publishing; OECD (2016), *Revenue Statistics in Latin America and the Caribbean 2016*, OECD Publishing.

Attempts have been made to promote revenue raising at the sub-national level. Law 34/2000 aimed to promote taxation at the regional level. However, while what constitutes an allowable regional tax under the law adheres to solid taxation principles, the criteria for what is allowed are couched in vague and imprecise terms (for example "not damaging to the economy"). As a consequence, a large proportion of the taxes and user charges that have proliferated are ill-advised and act to inhibit business development and investment (Butt and Parsons, 2012). Law 28/2009 on Regional Taxes and User Charges was intended to address concerns that regional governments were harming the investment climate, particularly by enacting ‘problematic’ taxation and regulations. Additionally, the law transferred a number of taxes from regencies/cities to provinces, and since then total revenue raised at the sub-national level has increased appreciably, from 16.4% to 24.2% (Figure 7.13, Panel B). However, the problem with both Laws 34/2 000 and 28/2009, and the reason that local governments have resorted to what are often nuisance levies and user charges, is that these statutes do not provide for any major tax instrument, such as personal or business tax, to be collected by sub-national governments.

Figure 7.13. Sub-national government own-source revenues (PAD), 2009 to 2015



Source: Ministry of Finance.

Greater efforts should be made to encourage the regional governments to raise revenue locally. Revenues raised at the local level are desirable on a number of grounds. Local taxation provides a strong incentive to grow the local economy, because that will expand the tax base. Better matching local revenue to local spending strengthens local responsibility and accountability. If the taxes are borne by local (voting) residents, it promotes local civic participation – local residents feel less ownership of transfers from central governments and are therefore less likely to hold local politicians and bureaucrats accountable for how these revenues are used or misused. Of course to the extent local accountability is lacking, there is a risk that the use of revenues raised locally is not scrutinised to the same extent as spending out of central transfers. Moreover, in the Indonesian context, the feasibility of local governments raising appreciable revenues through taxes and charges is in question – local capacity is often lacking, and revenue raising can encourage corruption and rent-seeking. Moreover, there is the fundamental question of which taxes, fees and charges should be allocated to sub-national jurisdictions.

In the Indonesian context, the principles of good regional taxation may mitigate against a local VAT because, while it could piggy-back on the national VAT or even simply be imposed as a surcharge on the national VAT, the tax credit mechanism and export redemption would make it difficult to administer, particularly given the still low administrative capacity of many local governments. A local turnover tax would interfere with the national VAT. A local retail sales tax might be easier but would also impose a significant administrative burden. Despite their pro-cyclicality, more promising would be local personal income and local business taxes, which are not currently allowed to be levied by non-central governments. The former could take the form of a surcharge or piggy-back tax on the national income tax for reasons of administrative simplicity. Yet, under the conditions prevailing in Indonesia, where personal income tax collection at the national level is still very low, a local income tax would probably raise little revenue. A local business tax would be, however, feasible in the short run if care is taken to keep the base simple. While a local property tax would be the ideal local tax in theory, the existing property taxes levied at the regional level, raise little revenue in practice. Aside from the administrative complexities in determining the base, the reasons for its poor performance in most countries are the political impediments at play at the local level. Another option for motivating local revenue raising is to offer matching grants as Mexico has done since the 1970s (Campbell, 2003; OECD, 2015c).

7.6. Imprecise division of responsibilities across levels of government

As argued above, there is broad agreement that many public services should be provided at lower levels of government in order to enhance the efficiency of the public sector and to increase its responsiveness to voters' preferences and demands for collective services. The theory of optimal fiscal federalism posits that the services provided at lower levels should be based on three factors. The first is that local government should provide services that most people benefit from – where the tax-benefit linkage is strong. Roads are an example where everyone benefits, and therefore everyone is willing to pay. The second factor is a lack of externalities. If the local public good has positive spill-overs to other communities, it will be under-provided. In this case higher levels of government have a role in promoting its provision. The third factor that determines the optimal level of decentralisation is economies of scale in production. Goods with large economies of scale, like power generation, are not efficiently provided by multiple competing local jurisdictions. This framework therefore predicts that local spending should focus on broad-based programmes with few externalities and few economies of scale.

A decade and a half after the big bang decentralisation in Indonesia, there still remain unclear lines of responsibility for the delivery of public services across levels of government. While Law 23/2014 goes some way to providing broad guidelines, it relies largely on regulation to articulate functional responsibilities. The central government should be more explicit in setting norms, standards, procedures and criteria for local government service delivery responsibilities and provide guidance and supervision. Likewise minimum service standards should be better monitored and enforced.

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8. Strengthening the internal revenue allotment system towards greater equity in the Philippines

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The internal revenue allotment, or IRA, is a major aspect of intergovernmental relations in the Philippine government. The IRA brings alive many local government units (LGUs) that depend on the transfer up to 98% of their budget. The importance of the IRA is highlighted by the fact that it is the largest source of funding for many LGUs. At the same time, the central government has required certain mandatory expenditures to be funded out of the IRA. On the premise that the central government knows better where the IRA must be spent, the mandatory expenditures must contribute to the collective and overall societal growth of the country. Data show that economic growth has not happened where it was intended. Among provinces, IRA dependence remains significant. Poverty incidence is similar in provinces that have high IRA dependence. Thus, while the Philippines has achieved economic growth in general, growth has not spread in areas as desired. Provincial governments continue to generally have insufficient resources due in part to their own limited administrative capacities or limited resources, and the limited resources afforded them or the over-assigned expenditure responsibilities they must undertake.

8.1. Introduction

8.1.1. Overview

The current decentralisation policy of the Philippines is embodied in Republic Act (RA) No. 7160, also known as the 1991 Local Government Code. RA 7160 introduced significant policy changes that generally expanded the scope of powers and functions of local government units (LGUs). After 27 years of decentralisation experience, many local governments have proven themselves capable of self-government by achieving a much-improved quality of life for their constituents. Nevertheless, statistics on poverty at the provincial level show the still significant level of poverty that the government, national and local, has to address to achieve a better quality of life for all Filipinos. The latest official data on poverty incidence among families (as of 30 June 2015) stood at 16.5%.

The devolution of power and responsibilities to local governments has been assessed to not be supported by an adequate amount of taxing powers and financial resources (DILG, 2015; Llanto, 2012; Manasan, 2005; Cuaresma and Ilago, 1997). For one, the taxing powers of local governments have been found insufficient, and the devolved local taxes have only small tax bases. Second, the internal revenue allotment (IRA) from the national government remains the largest income source of most local governments, except in some highly urbanised cities, particularly in Metro Manila. It goes without saying that many local governments are still highly dependent on the national government for their finances.

Intergovernmental transfers are of two kinds: general purpose (unconditional), and specific-purpose (conditional) (Shah, 2007). Transfers in the form of grants, subsidies and allotments are meant to ensure that devolved functions in a decentralised set-up, as well as national priority programmes, are properly undertaken at the local level. Conceptually, allotments and transfers perform a variety of roles (Boadway and Shah, 2007; Diana, 2008): 1) to fill in the fiscal gap or the gap between devolved functions and locally available resources; 2) to equalise resources between poor and rich local governments; and 3) to enable the central government to ensure the implementation of national programmes at the local level.

8.1.2. Framing the discussion

The internal revenue allotment is a major aspect of intergovernmental relations in the Philippine government. The IRA is the share of local governments from the internal revenue collected by the Bureau of Internal Revenue. As an instrument of devolution, the IRA has substantially funded the operations of LGUs, without which poor LGUs would not be able to operate. The IRA is a general-purpose allotment equivalent to 40% of internal revenue collections of the Bureau of Internal Revenue on the third preceding year. At the LGU level, the total share is first divided by LGU level, i.e. provinces, cities, municipalities and barangays, after which the share of each LGU is calculated based on the recognition of three criteria: population, land area and equal sharing.

This chapter revisits the IRA and discusses the extent to which it has been an instrument of inclusive growth. The IRA is a major component of the fiscal character of local governments and is a defining element of LGU financial performance. The chapter seeks to add to the lively discourse on allotments and transfers and the assessment of the fiscal performance of LGUs. It takes a fresh look at the IRA and its contribution to the achievement of inclusive growth.

8.1.3. The income and poverty status of Philippine local governments

As of 31 December 2017, the Philippines has 81 provinces, 145 cities, 1 489 municipalities and 42 036 barangays (DILG, 2018). Based on the most recent national census data on poverty, 44 (or over half of the provinces in the country) are classified as first income class provinces, having earned at least an average annual income of PHP 450 million (Table 8.1) (Philippine Statistics Authority, 2016). Paradoxically, poverty afflicts rich and poor local governments. The high level of inequality is not necessarily reduced in areas with high growth rates.

Table 8.1. Income classes of Philippine provinces (as of 30 June 2016)

Class	Average annual income (in PHP millions)	Number
First	450 or more	44
Second	360 or more but less than 450	16
Third	270 or more but less than 360	12
Fourth	180 or more but less than 270	4
Fifth	90 or more but less than 180	3
Sixth	Below 90	0
	Not indicated/no data	2
	Total number of provinces	81

Source: Philippine Statistics Authority (2016), *Statistics*, http://www.psa.gov.ph/; http://www.nscb.gov.ph/activestats/psgc/articles/con_income.asp, based on Department of Finance Department Order No. 23-08 effective 29 July 2008.

The national poverty incidence among the population remains high at 21.6% in 2015 (Philippine Statistics Authority, 2016). Eight provinces have a population poverty incidence ranging from 50% to 75%. Twelve provinces have a poverty incidence of 40-49.9%, which is still considered very high. Eighteen provinces have a poverty incidence lower than 15%, of which 14 are located in Luzon. The provinces with the highest poverty incidence are found in Mindanao (six) and Visayas (two) (Table 8.2).

Table 8.2. Number of Philippine provinces and the poverty incidence of populations, by major group of islands (2015)

	50-75%	40-49.9%	30-39.9%	16-30%	Up to 15%	% to total
Luzon	--	4	7	14	14	39
Visayas	2	3	2	6	3	16
Mindanao	6	5	8	7	1	27
Total	8	12	17	27	18	82

Source: Philippine Statistics Authority (2016), *Official Poverty Statistics of the Philippines: First Semester 2015*, https://psa.gov.ph/sites/default/files/1st%20Sem%202015%20Poverty_Publication_0.pdf.

Excluding the national capital region (NCR), the top 20 provinces with the highest poverty incidence in 2015 are led by Lanao del Sur (Table 8.3). Their poverty incidence ranged from 39% to 72% of their population. By broad geographic region, the 11 poorest provinces are found in Mindanao (Regions IX, X, XII, CARAGA and ARMM), 5 are found in the Visayas (Regions VI, VII and VIII), and 4 in Luzon (CAR and Region V). Of the 20 provinces with the highest incidence of poverty, 16 belong to the 1st income class category, demonstrating that people in high-income LGUs can also suffer the same poverty levels as those in low-income LGUs. This suggests that high incomes and increasing growth do not necessarily alleviate poverty.

Table 8.3. Top 20 Philippine provinces with the highest poverty incidence (2015)

Region	Province	Income class	Population poverty incidence, %, 2015	No. of poor population, 2015
ARMM	1. Lanao del Sur	1st	71.9	725 262
ARMM	2. Maguindanao	1st	57.2	551 681
VIII	3. Northern Samar	2nd	56.2	337 064
XII	4. Saranggani	2nd	55.2	233 164
ARMM	5. Sulu	2nd	54.9	577 987
X	6. Bukidnon	1st	53.6	732 027
VII	7. Siquijor	5th	52.9	78 433
IX	8. Zamboanga del Norte	1st	51.6	588 451
XII	9. Sultan Kudarat	1st	48.0	393 833
CARAGA	10. Agusan del Sur	1st	47.3	318 638
VIII	11. Western Samar	1st	46.9	348 948
VIII	12. Eastern Samar	1st	46.3	226 309
V	13. Masbate	1st	45.4	424 568
VII	14. Negros Oriental	1st	45.0	694 293
X	15. Lanao del Norte	1st	44.3	415 967
V	16. Catanduanes	1st	43.4	129 486
XII	17. North Cotabato	1st	41.4	615 923
V	18. Sorsogon	1st	41.3	375 178
CARAGA	19. Surigao Del Sur	1st	40.1	248 345
CAR	20. Mt. Province	1st	39.0	63 332

Source: Philippine Statistics Authority (2016), *Statistics*, http://www.psa.gov.ph/.

In terms of the number of poor population in 2015, provinces with a lower poverty incidence tend to rank high. Among the 81 provinces (except the NCR), the Cebu Province has the highest number of poor individuals, although Cebu is a highly urbanised, first income class province. Other provinces with relatively lower poverty incidence have a significant number of poor persons, such as Negros Occidental, Camarines Sur, Leyte, Nueva Ecija, Iloilo, among others (see Table 8.4). This proves that poverty afflicts both low-income and high-income provinces and suggests that economic growth does not necessarily uplift the welfare of individuals in high-income growth areas.

Table 8.4. Top 20 Philippine provinces with the highest number of poor populations (2015)

Region	Province	Income class	Population poverty incidence, %, 2015	No. of poor population, 2015
VII	1. Cebu	1st	21.4	986 557
VI	2. Negros Occidental	1st	29.0	867 141
X	3. Bukidnon	1st	53.6	732 027
ARMM	4. Lanao del Sur	1st	71.9	725 262
VII	5. Negros Oriental	1st	45.0	694 293
V	6. Camarines Sur	1st	35.2	665 165
VIII	7. Leyte	1st	31.0	652 690
XII	8. North Cotabato	1st	41.4	615 923
IX	9. Zamboanga del Norte	1st	51.6	588 451
ARMM	10. Sulu	2nd	54.9	577 987
ARMM	11. Maguindanao	1st	57.2	551 681
III	12. Nueva Ecija	1st	22.6	547 711
VI	13. Iloilo	1st	20.0	540 001
IV	14. Quezon	1st	22.7	482 295
IX	15. Zamboanga del Sur	1st	24.8	476 765
XI	16. Davao del Sur	1st	15.6	450 012
I	17. Pangasinan	1st	15.3	439 709
V	18. Masbate	1st	45.4	424 568
X	19. Lanao del Norte	1st	44.3	415 967
XII	20. South Cotabato	1st	24.6	411 404

Source: Philippine Statistics Authority (2016), *Statistics*, www.psa.gov.ph/.

8.2. Inclusive growth

Inclusive growth has been interchangeably used with the terms "broad-based growth", "shared growth", and "pro-poor growth", although these are distinct concepts (Lanchovichina and Lundstrom, 2009). Inclusive growth itself distinctly focuses on the pace and pattern of growth, which suggests a rapid, sustained and broad-based character of economic growth, where people should have contributed as well as benefited (ibid). Where there is inclusive growth, there should be a reduction in poverty, and equality of opportunity in the access to productive employment, markets and resources. Conversely, growth is not inclusive where:

- Growth has been slow.
- Benefits are not broadly shared.
- Massive corruption and political legitimacy undermined achievements.
- The majority of the poor are not able to improve their economic lot.
- Poverty is not significantly reduced.

The Preamble of the 2030 Agenda for Sustainable Development sums up the meaning and intent of inclusive growth. Briefly, inclusive growth means freeing people from poverty and sustaining the health of the environment and doing or achieving these with no one being left behind. Inclusive growth (IG), applied at the local government level, means that everyone, particularly those at the lower rungs of local society should experience a good or acceptable quality of life by national or international standards. In more concrete terms, those who are poor must have a job and/or livelihood that generates income sufficient to sustain an acceptable quality of life. The IG indicators are no different from the sustainable development goals indicators. One can only say that growth is inclusive if and when each member of the population lives a decent life.

Over the long term, inclusive growth implies rapid and sustained poverty reduction and productive employment while at the same time ensuring the sustained health of the environment. It is characterised by declining inequality, achievable where the poor's income rises to a level that enables them to increasingly pay for their socio-economic needs and depend less and less on government transfers. This implies a rising level of decision making by the poor induced by sustained productivity and the rising value of their labour and products. Growth can only be inclusive if the economic lot of the poor is raised to a level that enables them to meet daily basic needs at a sustained level and maintain a better quality of life. Over the medium to long term, the poor should graduate to the low or middle-income categories.

Inclusive growth requires a mix of policy that is country-specific. One of those policies is the provision of fiscal transfers substantial enough to engender long-term and sustained growth. This goes to say that fiscal transfers must be accompanied by equally important policy strategies to achieve poverty alleviation on a wider scale (UNDP, 2017; World Economic Forum, 2017). That is transfers must be accompanied by technical support and capacity building in the areas of development planning, policy formulation, programme implementation, and even performance assessment. Lack of technical capacity has been cited as evidence in the inability of LGUs to formulate or develop local development plans and to accomplish efficient delivery of projects. Not only do LGUs lack technical capacity, but they also lack the finances to conduct day-to-day activities. Scholars (Llanto, 2012; McLure and Martinez-Vazquez, 2011) assert that LGUs were clothed with sufficient taxing, spending and borrowing powers and a clear assignment of responsibilities at the provincial, city, municipal and barangay levels, but their lack of capacities in various areas of governance contribute to poor performance.

8.3. Internal revenue allotment

Lanchovichina and Lundstrom (2009) suggest that some policies may induce growth but may otherwise worsen inequality. The IRA as a policy of fiscal decentralisation cannot on its own be expected to reduce poverty and inequality significantly. Theoretically, the IRA is a major financial instrument for achieving local economic growth and development (Cuaresma and Ilago, 1997). This statement is based on the fact that it can comprise up to 98% of a provincial government's total income (refer to *Iskor ng Yong Bayan* data on IRA dependence in iskor.blgf.gov.ph). Likewise, the various directives of the national government on the utilisation of the IRA suggest that it is difficult to spend it (IRA) for other purposes since the total IRA is almost totally earmarked. Let us look at the nature and scope of IRA.

The internal revenue allotment refers to the share of sub-national governments or local government units in the national internal tax revenue collections of the Bureau of Internal Revenue (BIR). By design, the IRA is an unconditional block grant intended to address the vertical fiscal gap (Llanto, 2012) between the central government and the LGUs. Starting in 2006, the IRA was automatically appropriated, as mandated in Section 4 of RA 9358 (approved on 17 October 2006). As to the release of the IRA, Section 286 of RA 7160 of

1991 had already provided for its automatic release to LGUs without any precondition. As practised, the Department of Budget and Management (DBM) releases the IRA comprehensively. The DBM releases the notice of cash allocation (NCA) monthly to the DBM-Regional Office (RO), which in turn issues checks for deposit in LGU bank accounts (Table 8.5).

Table 8.5. Determination of the Philippine internal revenue allotment, RA 7160

Sec. 284, RA 7160	Sec. 286	In practice	Sec 4 RA 9358 SA 2006
40% share in national internal revenue taxes on 3rd fiscal year back	Shares shall be released without need of any further action	IRA allotment is released comprehensively; NCA is released monthly to DBM-RO; ROs issue checks for deposit in LGU bank accounts	Henceforth, IRA shall be appropriated automatically

Source: Author.

Section 21 of the National Internal Revenue Code (NIRC, as amended by RA 10653) identifies the national internal revenue taxes to include the taxes, fees and charges whose net total amount for the 3rd preceding year is the basis for calculating the 40% IRA share, to wit:

- income tax
- estate and donor's taxes
- value-added tax
- other percentage taxes
- excise taxes
- documentary stamp taxes
- such other taxes that may be imposed by the national government and collected by the BIR.

Once the 40% IRA share is determined, the gross amount is divided first among provinces, cities, municipalities and barangays. Once the total share of the category of LGUs is determined, the share of each LGU within each category is calculated on the basis of population, land area and an equal share (Table 8.6).

Table 8.6. The formula for determining the IRA share of LGUs (RA 7160)

Level of LGU	Number of LGUs	IRA share, in %
A. Determination of share of each LGU category		
Provinces	81	23%
Cities	145	23%
Municipalities	1 489	34%
Barangays	42 036	20%
B. Determination of share of each LGU in each category, criteria for sharing		
Provinces Cities Municipalities	Population – 50% Land area – 25% Equal sharing – 25%	
Barangays	Initial deduction: PHP 80 000 per barangay with a population of <100 persons Allocation of the balance: • 60%, based on population • 40%, equally shared by all barangays	

Source: Author.

For fiscal year (FY) 2018, the total IRA share amounted to PHP 522.748 billion (2018 General Appropriations Act [GAA]) (see Table 8.7). The amount is 7.37% higher, or PHP 35.83 billion, more than the 2017 IRA share. The 2018 IRA allocation is guided by LBM Circular No. 75, issued on 1 June 2017. The 2018 IRA calculation utilised the following factors:

- FY 2015 Census of Population as approved through Proclamation No. 1269[1] dated 19 May 2016
- FY 2001 Master List of Land Area certified by the Department of Environment and Natural Resources (DENR) Land Management Bureau pursuant to Oversight Committee on Devolution Resolution No. 1, s. 2005 dated 12 September 2005.
- BIR certification of 2015 actual revenue collection.

Table 8.7. Philippine IRA shares, 2018 GAA

LGU level	No. of LGUs	Share equivalent to the cost of devolved functions/city-funded hospitals, as of 31 December 1992	Share determined on the basis of Section 285, RA 7160	Total IRA shares
Provinces	82	2 845 490 826	118 742 506 152	121 587 996 978
Cities	145	1 031 550 030	118 742 506 152	119 774 056 182
Municipalities	1 478	2 599 358 264	175 532 400 400	178 131 758 664
Barangays	41 889	--	103 254 353 176	103 254 353 176
Total	43 594	6 476 399 120	516 271 765 880	522 748 165 000

Source: Department of Budget and Management (2018), "Local Budget Memorandum No. 75", Republic of the Philippines, www.dbm.gov.ph/wp-content/uploads/Issuances/2017/Local%20Budget%20Memorandum/LOCAL%20BUDGET%20MEMORANDUM%20NO.%2075.pdf.

The 2018 IRA share for 21 provinces is shown in Table 8.8. The total IRA received by each province (including the IRA of the province, cities, municipalities and barangays) is weakly related to the provincial poverty incidence. As Table 8.8 shows, the provinces with relatively lower poverty incidence received a larger amount of IRA. This is expected considering the criteria applied in the determination of the IRA share for each LGU; the criteria lean in favour of more population and more urbanised localities and has little to do with the rate of poverty. Poverty incidence and IRA share (total for provinces, cities and municipalities) are found to have a weak negative correlation (Pearson = -0.1698) (Figure 8.1).

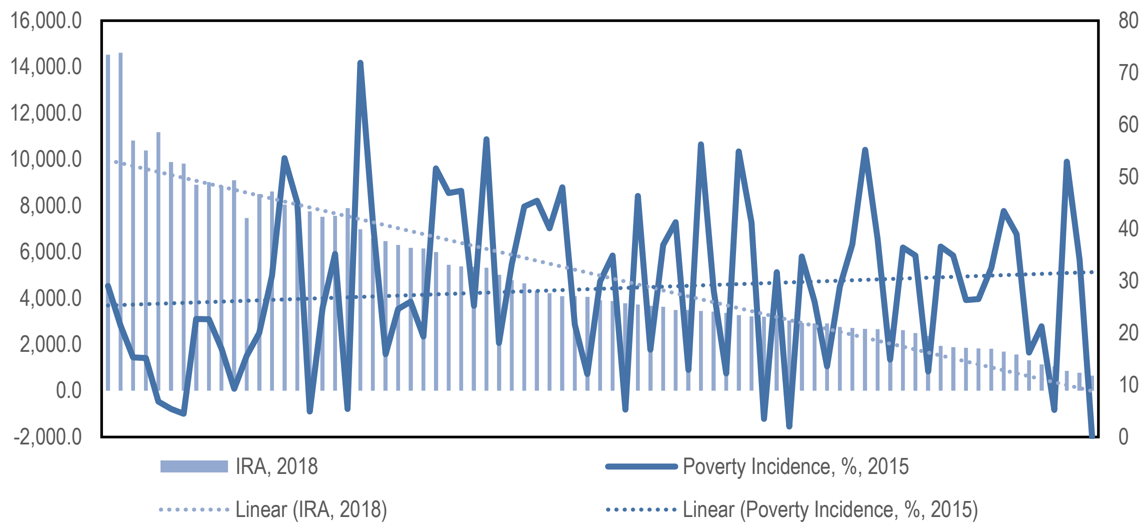
Table 8.8. Top 21 Philippine provinces with the highest total IRA received compared to the provincial population poverty incidence (2018)

Ranked by total IRA

Region	Province	Population poverty incidence, %, 2015	IRA, 2018 (total for all LGUs) (Ranked from highest to lowest)
VII	1. Cebu	21.4	14 606.8
VI	2. Negros Occidental	29.0	14 531.8
IV-A	3. Cavite	6.8	11 174.9
I	4. Pangasinan	15.3	10 818.1
II	5. Isabela	15.2	10 385.6
IV-A	6. Laguna	5.4	9 894.6
III	7. Bulacan	4.5	9 826.4
IV-A	8. Batangas	9.3	9 098.5
III	9. Nueva Ecija	22.6	9 012.5
IV-A	10. Quezon	22.7	8 901.5
IV-B	11. Palawan	17.0	8 868.1
VIII	12. Leyte	31.0	8 619.2
VI	13. Iloilo	20.0	8 510.8
X	14. Bukidnon	53.6	8 048.1
IV-A	15. Rizal	5.4	7 892.2
III	16. Pampanga	4.9	7 755.8
VII	17. Negros Oriental	45.0	7 719.4
V	18. Camarines Sur	35.2	7 562.7
IX	19. Zamboanga del Sur	24.8	7 526.1
XI	20. Davao del Sur	15.6	7 470.3
ARMM	21. Lanao del Sur	71.9	6 977.4

Note: The data exclude the NCR and Davao Occidental and Dinagat Islands due to incomplete data.
Source: Philippine Statistics Authority (2018), *Statistics*, www.psa.gov.ph.

Figure 8.1. Comparison of IRA (PHP millions) and poverty incidence of 79 provinces (%)



Source: Philippine Statistics Authority (2018), *Statistics*, www.psa.gov.ph.

8.4. IRA mandatory allocations: Do they promote inclusive growth?

As mentioned above, the IRA is received by every LGU without any precondition. The spending, however, is restricted by national government-imposed rules on local budgeting, which requires LGUs to fully provide for statutory and contractual obligations, including the following:

- LGUs shall set aside 20% of its annual IRA for development projects as mandated under Section 287 of RA 7160. The same shall be utilised in accordance with DILG-DBM Joint Memorandum Circular (JMC) No. 2017-1 dated 22 February 2017.
- The debt service shall not exceed 20% of the regular income of the LGU.
- Provinces, cities and municipalities shall allocate at least PHP 1 000 as aid to barangays.
- The LGU shall allocate not less than 5% of the estimated revenue from regular sources as the Local Disaster Risk Reduction and Management Fund (LDRRMF) in accordance with Section 21 of RA No. 10121 and Rule 18 of its Implementing Rules and Regulations (IRR).
- LGUs are also obliged to comply with RA 9165 or the Comprehensive Dangerous Drugs Act of 2002, and the DBM Local Budget Memorandum No. 74-A, dated 9 September 2016. Under this memorandum, LGUs shall appropriate a substantial portion of the local budget on preventive or educational programmes on drug abuse prevention and control, and the rehabilitation and treatment of drug dependents. The suggested specific activities that LGUs should fund are:

  - conduct barangay clearing operations, including rehabilitation and after care of drug users in co-ordination with the Department of Health (DoH) and the Department of Social Welfare and Development (DSWD)
  - establish special drug education centres
  - strengthen the barangay *Katarungang Pambarangay* or the village justice system.
- Personal Services appropriations shall not exceed 45% in the case of 1st to 3rd income class LGUs, and 55% in 4th to 6th income class LGUs of the total annual income from regular sources generated in the preceding year.
- There shall be no cash overdraft in any local fund at the end of the year.

Let's take the IRA of Lanao del Sur as an example. The provincial 2018 IRA of PHP 2.528 billion for Lanao del Sur Province is equivalent to 97.8% of its total income. Its total income is about PHP 2.575 billion. After deducting all nationally mandated expenditure allocation, a province like Lanao del Sur can only decide on the utilisation of only about 28% of its total budget (Table 8.9).

Table 8.9. Example of Lanao del Sur provincial government budget allocation (2018)

Mandatory expenditures	In PHP millions	In USD millions	Percent
Total provincial budget	2 575	50.49	100.0
Less mandatory expenditures required in various laws			
20% Development Fund	515	10.1	20.0
PHP 1 000 aid to 1 159 Barangays	1.159	0.023	0.04
5% Calamity Fund	128.75	2.52	5.0
45% PS Allocation	1 158.75	22.72	45.0
1% Debt Service (assumption)	25.75	0.50	1.0
1% Rehabilitation of Drug Dependents (assumption)	25.75	0.50	1.0
Total mandatory expenditure allocation	1 855.159	36.363	72.04
Remaining balance to be allocated at the discretion of the provincial government	719.841	14.127	27.96

Note: Exchange rate: USD 1 = PHP 51.00. Remarks: Low assumption for Debt Service and Drug Dependents Rehabilitation is adopted. The Debt Service shall not exceed 20% of the total regular income.
Source: Author's calculations.

In addition to the above mandatory expenditure allocations, the LGUs are mandated to:

- Cover the cost of basic services and facilities enumerated in Section 17(b) of RA 7160, particularly those devolved by DoH, DSWD, Department of Agriculture (DA), DENR, and other devolved functions.
- LGUs are required to harmonise local budget plans and goals with the Philippine Development Plan and Public Investment Programme for 2017-22, and should align LGU programmes, projects and activities (PPAs) with AMBISYON 2040, the 2030 Agenda for Sustainable Development, which is anchored on a set of Sustainable Development Goals (SDGs), and the President's 0+10-Point Socio-Economic Agenda.
- LGUs shall also prioritise in the local budget PPAs on or related to:
  - climate change pursuant to RA 9729 or the Climate Change Act

- gender and development pursuant to RA 7192 (Women in Development and Nation Building Act), RA 9710 (The Magna Carta for Women), and Philippine Commission on Women-DILG-DBM National Economic and Development Authority JMC No. 2016-01 dated 12 January 2016
- peace and order and protection of children, under RA 9344 or the Juvenile Justice and Welfare Act of 2006
- senior citizens and persons with disabilities, pursuant to RA 9994 or the Expanded Senior Citizens Act of 2010, amending RA 7432, and RA 9442, amending RA 7277
- combatting Acquired Immune Deficiency Syndrome (AIDS) under RA 8504 or the Philippine AIDS Prevention and Control Act of 1998.

8.5. Summary of findings and conclusion

The internal revenue allotment makes up a significant portion of LGU finances, particularly in provinces. Low-income provinces depend on the IRA, up to 98% of their budget. This dependence has been interpreted to mean a lack of political will on the part of LGUs to exercise their taxing powers and generate resources from all possible means including a partnership with the private sector and local borrowing to undertake development projects. The IRA, together with other regular income of LGUs, has been subjected to mandatory expenditures that can take up a minimum of 72% of an LGU's regular budget, leaving only about 28% for all other LGU-determined expenditures. Otherwise, the IRA is just sufficient to fund mandatory expenditures. It is thus important for LGUs to be creative in generating income and/or in identifying ways to create new resources that can be earmarked for projects intended for poor sectors of the local community. Where benefits of services extend beyond the geographic area of the LGUs, they are encouraged to co-operate in programmes and projects that may be beneficial to LGUs (Manasan, 2005, p. 37). Crane (2017) cites the presence of a well-developed framework on intergovernmental sharing of powers and functions, yet this framework is weak or fails to consider practical environmental issues and citizen participation.

There is room for improvement with regard to LGU finances. LGUs could choose to update the schedule of fair market values (SFMV) of real property for purposes of taxation (see Table 8.10), for example. Some provincial governments have not done updated their SFMV for more than 11 to 28 years. Updating the SFMV could offer opportunities for provincial governments to expand the tax base and raise potential local revenue. Inferring from the high dependence on the IRA and the implication of the low level of local tax collection, 19 provincial governments are unable to allocate at least 20% of their budgets for development projects. This could be a symptom of what Bahl (2008, p. 9) refers to as over-assigned expenditure responsibilities relative to available resources - such that some services are not delivered at all.

Proposals have been put forward to raise the IRA share to 50% (House Bill 2613, 8 August 2016) to 60% (Hutchcroft, 2012, p. 118[146]; ULAP, 2017[147]), and to amend the IRA formula to include performance criteria such as tax collection efficiency. In view of the limited resources of poverty-stricken provinces, requiring high tax collection efficiency or some other performance measure will further fail to secure a higher amount of resources for LGUs, simply because of their low tax base and limited capacity to administer tax related functions (of assessment and collection).[2]

Table 8.10. Performance of 40 Philippine provinces (randomly selected) based on three criteria from Iskor ng Yong Bayan (2012)

Region	Province	How high/low is the IRA dependence? (%)	Is the SFMV up to date? (as of 2012)	Did the LGU allocate 20% of IRA for development projects?
CAR	Apayao	Very high (VH), 96%	Yes, SFMV was 2 years old in 2012	Yes, 23.3%
CAR	Benguet	Low, 69%	15 years old	No, 10.7%
I	Ilocos Norte	Low, 62%	Yes, 3 years old	No, 18%
I	La Union	Low, 58%	Yes, 3 years old	Yes, 2.7%
I	Pangasinan	Fair, 82%	Yes, 1 year old	No data
II	Batanes	No data	Yes, 3 years old	No data
II	Cagayan	High, 87%	No, 9 years old	Yes, 20.2%
III	Nueva Ecija	High, 88%	Yes, updated in 2012	No, 11.6%
III	Pampanga	Low, 71%	18 years old	No, 15.8%
III	Bulacan	Low, 75%	7 years old	No, 13.3%
III	Bataan	Low, 71%	11 years old	No, 0.6%
IVA	Batangas	Low, 75%	Yes, 2 years old	No data
IVA	Cavite	Low 71%	Yes, I year old	Yes, 20.3%
IVA	Laguna	No data	Yes, updated in 2012	No data
IVA	Rizal	No data	Yes, 1 year old	No data
IV-B	Marinduque	No data	19 years old	No data
IV-B	Mindoro Oriental	VH, 90%	Yes, updated in 2012	No, 14.8%
IV-B	Palawan	High, 89%	7 years old	No, 14.2%
V	Albay	High, 79.9%	11 years old	No, 15.7%
V	Masbate	VH, 94%	Yes, 3 years old	No, 9.4%
V	Camarines Sur	VH, 91.3%	15 years old	No, 9.3%
VI	Negros Occidental	VH, 93.9%	Yes, I year old	Yes, 21%
VI	Guimaras	High, 88%	13 years old	No, 13.1%
VII	Siquijor	VH, 92%	Yes, updated in 2012	No, 17.1%
VII	Negros Oriental	VH, 84.2%	15 years old	No, 9.4%
VII	Cebu	Fair, 85%	Yes, update took effect in 2013	Yes, 30.8%
VIII	Northern Samar	VH, 91%	Yes, update took effect in 2013	No, 6.6%
VIII	Western Samar	VH, 99%	7 years old	No data
VIII	Leyte	High, 75.5%	5 years old	No, 7.5%
IX	Zamboanga del Norte	VH, 82.8%	5 years old	No, 9.5%
X	Bukidnon	High, 76.6%	11 years old	No, 3.9%
X	Camiguin	VH, 91%	Yes, 2 years old	No, 17.4%
XI	Davao Oriental	Fair, 84%	Yes, updated in 2010	Yes, 25.4%
XI	Davao del Sur	VH, 91%	Yes, update took effect in 2013	Yes, 21.4%
XII	Saranggani	VH, 97%	4 years old	No, 5.3%
XII	Sultan Kudarat	VH, 97%	Yes, 3 years old	No, 6.6%
XII	North Cotabato	VH, 83.1%	Yes, 1 year old	Yes, 29.5%
ARMM	Lanao del Sur	VH at 97.8%	11 years old	Yes, 23.3%
ARMM	Maguindanao	VH, 96.0%	28 years old	Almost complied at 19.4%
ARMM	Sulu	VH, 98%	7 years old	Yes, 23.6%

Note: The SFMV should be updated every three years.
Source: DOF (2018), "Bureau of Local Government Finance", website, http://blgf.gov.ph/. See also Cuaresma (2017), "Poverty and Climate Change: An Assessment of the Administrative Responses of 10 Poor Provinces in the Philippines", Eastern Regional Organization of Public Administration International Conference, Seoul, Korea.

The IRA performs the roles of balancing the vertical gap in financial resources between the central government and LGUs, and the horizontal distribution between and among each group of LGUs. In large part, the IRA share is determined by the size of the population of an LGU. It is the case that the highly populated LGUs are more urbanised than the less populated ones. But it is also the case that poverty afflicts both high-income and low-income LGUs. The task of directly trying to achieve inclusive growth, i.e. lowering poverty and raising access to services, may not be assigned to the IRA as it is already burdened by nationally mandated expenditures and LGU maintenance expenses. If the central government truly wants to achieve inclusive growth, it must allocate more money to transfers that expand the discretion of LGUs to spend, other than the IRA.

Notes

1. Declaring as official the 2015 population of the Philippines by province, city/municipality, and barangay based on the 2015 Census of Population conducted by the Philippine Statistics Authority.

2. The Philippine Supreme Court affirmed on April 10, 2019 its July 2018 decision that the base for the computation of the IRA shall not only include the revenue collections of the Bureau of Internal Revenue but also the collections of the Bureau of Customs from tariffs and duties (Philippine News Agency, April 11, 2019).

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9. Fiscal federalism in the Russian Federation and its Asian regions

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The Asian regions of the Russian federation play a disproportionately important role in the economy of the country. While only about one-quarter of Russia's population lives in Asia, they produce almost 30% of the country's gross domestic product (GDP). This chapter describes the intergovernmental fiscal framework in Russia and examines its effects on regional fiscal incentives, economic growth, and inequality, focusing on the Asian regions. The analysis suggests that fiscal incentives, both in the Asian regions and the rest of Russia, generated by the tax assignment policy and transfers from the federal budget are relatively weak. However, explicit fiscal rules aimed mostly at fiscally weak regions enhance fiscal incentives. Although federal transfers do not seem to impede economic growth of the Asian regions, overall transfer dependence and particularly balancing transfers are associated with lower regional growth in the European part of Russia. Transfers do reduce inter-regional inequality with respect to budgetary revenues and expenditures, but the effect is smaller for equalization transfers. The balancing transfers reduce inequality the least and sometimes even increase it. This is true both for the Asian regions and for the country as a whole. Overall inter-regional revenue inequality with and without transfers decreased in 2005-2007, stabilized in 2007-2013, and increased significantly through 2015.

9.1. Introduction

Since the Russian Federation (hereafter, "Russia") is the largest country in the world by territory, it is natural that its regional and municipal authorities play an important role in the economy. Even with the trend towards greater political and economic centralisation taking place in Russia since the early 2000s, sub-national budgetary expenditures account for about half of all government spending outside of retirement pensions, national defence and national security. Also, although the Russian fiscal constitution is formally highly centralised (Blöchliger and Kantorowicz, 2015), the implementation of economic policies often depends on the actions of sub-national governments (Yakovlev and Zhuravskaya, 2013).

The Asian regions of the country play a disproportionately important role in its economy. While only about one-quarter of Russia's population lives in Asia, they produce almost 30% of the country's gross domestic product (GDP). And even these numbers understate the contribution of the Asian regions to Russia's economy because gross regional products (GRP) are calculated in current domestic prices while most of Russia's energy exports come from the Asian regions and are sold at much higher world market prices.[1]

The large role of sub-national governments in providing essential services for their citizens and facilitating the functioning of the economy, and the economic significance of the Asian part of Russia make it important to study the fiscal relationships between the regional governments east of the Urals on the one hand and the federal government in Moscow on the other. This role also makes it important to study the intra-regional fiscal arrangements, i.e. fiscal relations between regional governments and municipal authorities.

In this chapter, we examine the current design and consequences of Russia's fiscal federalism with a special focus on the Asian regions. The emphasis is on the impact of inter-budgetary fiscal relations on regional economic growth and inter-regional inequality. Since this chapter does not describe the historical developments and even the current fiscal arrangements in detail, the reader is referred to an excellent, albeit somewhat outdated, survey of fiscal federalism in Russia provided in De Silva el at. (2009). More recent although less detailed descriptions and analysis can be found in Zhuravskaya (2010), Alexeev and Weber (2013), Yushkov, Savulkin and Oding (2017) and Di Bella, Dynnikova and Grigoli (2017). Martinez-Vazquez, Lago-Penas and Sacchi (2017) present a rather brief but still comprehensive survey of the recent literature on the economic and political impact of fiscal decentralisation.

This chapter is organised as follows. The next section describes the essential administrative features of fiscal federalism in Russia and provides the main economic and fiscal descriptive statistics for Russia's regions. The third section examines the effects of fiscal federalism on the incentives of regional governments and regional economic growth. The fourth section evaluates the impact of transfers on inequality between the regions. Brief conclusions are presented in the final section. Some more technical material is relegated to the Annex.

9.2. Basic features of Russian fiscal federalism

Russia has a complicated, multi-tiered administrative structure. The country is divided into 85 so-called "subjects of the federation" (hereafter, regions), including two located on the Crimean peninsula, which Russia annexed from Ukraine in 2014.[2] According to the Russian Constitution, all regions have their own legislation and possess equal rights in relation to the federal government. The regions are further divided typically into two tiers of more than 20 000 municipalities. In addition, there are several federal districts, each of which contains several regions. These districts were created as an administrative mechanism for federal co-ordination, monitoring, and control of the regions. Some of the peculiarities of Russia's administrative structure include the federal cities such as Moscow and St. Petersburg and the existence of regions (autonomous *okrugs*) located within other regions with somewhat unclear fiscal relationships between the respective regions. Peculiarities also include the so-called closed territorial entities, which are municipalities with special status and special relationships with the federal government due to their importance for national security.

Some of the non-fiscal features of Russia's regions that presumably contribute to the characteristics of Russia's fiscal federalism include the relatively small population of most regions as well as a currently high degree of political and economic centralisation of the country, at least compared to other large federations such as Brazil, India, Mexico and the United States. For example, the 2015 median population of Russia's regions was only slightly higher than 1.2 million, compared to more than 4.4 million people in the US states.[3]

The Asian part of Russia is comprised of 27 regions, including two autonomous *okrugs* (territory) that are contained inside Tiumen' oblast' (province) and the only stand-alone autonomous *okrug* in the country (Chukotskii okrug, hereafter, "Chukotka"). These regions are aggregated into three federal districts: the Urals, Siberian, and Far Eastern. Asian regions have on average smaller populations and larger land areas than the regions in European Russia. Asian regions also have a considerably higher average per capita GRP and personal incomes and somewhat younger populations than Russia's European regions (Table 9.1).

Table 9.1. Non-fiscal characteristics of the European and Asian regions of Russia (2015)

	European regions			Asian regions		
	Median	Min	Max	Median	Min	Max
Population	1 233 345	43 606	12 263 861	1 075 608	50 348	4 328 739
Land area (1000s sq. km)	44.95	1.439	587.4	316.9	36	3 103.2
Per capita GRP (current RR)	307 092	116 008	4 990 318	371 099	150 258	3 376 616
Share of mining in GRP	0.6	0	67.5	11.1	0.5	67.8
Investment climate	0.264	0.150	0.528	0.276	0.202	0.558
Urban population (%)	70.65	34.8	100	72.4	29.2	95.5
People under working age (%)	16.55	13.7	34.7	18.9	16.7	33.5
People over working age (%)	25.8	9.2	29.5	21.6	9.3	27.3

Note:
1. All share values are in per cent. "Working age" is 16-59 for men and 16-54 for women.
2. Investment climate index is from the website of Expert RA (www.raexpert.ru/ratings/regions/). Higher values of the index represent greater investment risk.

Source: Unless stated otherwise, the non-fiscal regional data for Russia are from the website of the Russian statistical agency Rosstat (www.gks.ru), including the statistical yearbook, *Regiony Rossii*, for various years.

9.2.1. Revenue side of Russia's fiscal federalism

Although constitutionally the regions have significant autonomy, their fiscal independence is limited by the "general principles" of taxation established by the federal government in the tax code. Moreover, all taxes are collected by the federal tax service, and inter-budgetary relations, as well as budget governance of all levels, are defined in the federal budget code.

Taxes in Russia are classified as federal, regional and local. Regional and local authorities have some flexibility with respect to the bases and rates of "their" taxes within the constraints imposed by the "general principles". Federal taxes account for the lion's share of tax revenue. However, the revenue from two major federal taxes – corporate income tax (CIT) and personal income tax (PIT) – is assigned almost exclusively to the regional governments and constitutes their largest sources of revenue. Although CIT is a federal tax, the regions are allowed to reduce the regional portion of its rate to some extent. The main taxes, revenue assignments, and 2015 shares in total tax and non-tax revenues are shown in Table 9.2.[4] In addition, the federal budget receives significant revenue from federal properties, out of central bank profits, and from government services. Notably, oil and gas production are taxed by the federation, and tax proceeds accrue entirely to the federal level. Regional budgets receive considerable revenues from regional companies and other properties (almost 5% of their total own revenue) and from the sales of properties such as apartments. The regions also obtain a share of the taxes on natural resources.

Table 9.2. Russia's main federal, regional, and local taxes and revenue assignments (2015)

Tax or fee	Type	Revenue assignment			Share in federal revenue (%)	Share in own consolidated regional revenue (%)
		Federal	Region	Local		
VAT; domestic	Federal	100			18.27	
VAT; imports					13.73	
CIT	Federal	10	90		3.67	27.64
PIT	Federal		85	15		36.82
MET 1	Federal	100			20.18	
MET 2	Federal	100			2.59	
MET 3	Federal	40	60		<1.00	
MET 4	Federal		100			<1.00
MET 5	Federal		100			<1.00
Water tax	Federal	100			<1.00	
Excise taxes	Federal	Typically 50 or 100	Typically 50 or 100		3.94	6.38
Customs fees	Federal	100			24.59	
State stamp fee	Federal	100			<1.00	
Simplified taxation regime	Special	100			<1.00	3.33
Agricultural tax	Special			100		<1.00
Imputed tax	Special			100		1.03
Patents for individual entrepreneurs	Special			100		<1.00
Corporate property tax	Regional		100			9.35
Gambling tax	Regional		100			<1.00
Transport tax	Regional		100			1.84
Land tax	Local			100		2.43
Personal property tax	Local			100		<1.00

Note:
1. VAT – value added tax; MET – mineral extraction tax; MET 1 – crude oil; MET 2 – natural gas; MET 3 – other subsoil resources, excluding diamonds and "commonly occurring" resources; MET 4 – diamonds; MET 5 – commonly occurring subsoil resources.
2. Federal and consolidated regional tax amounted to RUB 13 659.2 billion (16.1% of GDP), and non-tax revenues amounted to RUB 7 691.4 billion (9.2% of GDP). These revenues do not include various transfers such as transfers between budgets of different levels and transfers from extra-budgetary funds.
3. Russia's 2015 GDP in current RUB was 83 233 billion.
Source: Unless stated otherwise, the Russian budgetary data in this table and elsewhere are either directly from or are calculated based on the information on the Russian Treasury website (www.roskazna.ru).

Note that the data in Table 9.2 exclude the so-called extra-budgetary funds, such as the pension fund and health insurance funds. Although these funds are important parts of Russia's budgetary system at both federal and regional levels, we will not include transfers from them in most calculations unless stated otherwise. This is because most transfers from extra-budgetary funds are targeted at individuals and do not provide for any discretion by regional officials. We will, however, account for the transfers from the regional budgets to their health insurance funds as these expenditures constitute a large part of regional spending on healthcare and represent an additional burden on regional budgets.

As indicated in Note 2 for Table 9.2, federal revenues are almost twice as large as own regional revenues, resulting in revenue decentralisation of only about 36%.[5] Meanwhile, regional expenditure responsibilities are quite substantial, implying a significant vertical fiscal imbalance and requiring large transfers from the federal to sub-national budgets. These transfers amounted to RUB 1 616.7 billion or 21% of own revenues of consolidated regional budgets and 1.94% of the country's GDP. The transfers to Asian regions totalled RUB 487.8 billion or 21.6% of own revenues of these regions. The median transfer dependence of Asian regions was 21.9%.[6]

9.2.2. Federal transfers

There are four main types of transfers from the federal centre to sub-national budgets: equalisation grants, balancing grants, subsidies and subventions. In addition, there is the "other" category that includes a sundry list of transfers, sometimes only to a specific region, with the two largest items being grants for improving the supply of medicines and for the maintenance and development of transportation infrastructure. The goals and rules for determining the amounts for the main types of transfers are described below.

Equalisation grants comprise the Fund for Financial Support of Regions (FFSR) and are determined based on the so-called imputed budget sufficiency index (IBS), which is defined as the ratio of the index of potential tax revenue (ITR) in the region and the index of budget expenditures (IBE). The goal of equalisation grants is to bring all regions to the level of IBS that equals the average pre-equalisation IBS for all regions when the ten richest and ten poorest regions are excluded from calculations. The methodology for calculating ITR is outlined in Annex 10A. The regional IBE measures the cost of local public goods provision relative to the average such cost for the country, which is set to unity. It takes into account the regional differences in wages, cost of living, cost of housing and utility services, demographic structure, degree of urbanisation, road density, and the remoteness of regional settlements and the region itself. The total size of FFSR for a given year must be at least as large as the previous year's FFSR in nominal terms (grandfather entitlements).

Balancing grants are determined in a discretionary manner. In principle, these grants aim to support the regions that for some reason did not receive adequate resources through equalisation grants. For example, the regions might have had lower than expected tax collections or higher than expected budgetary expenditures, particularly if the extra expenditures are caused by federal mandates or other developments exogenous to the region. More than half of the amounts of balancing grants are determined by the federal budget law, and the remainder is set by government decrees.

Unlike the aforementioned grants that are not earmarked, subsidies serve as a co-financing mechanism for specific expenditure categories that either are under the exclusive responsibility of the regional and local authorities or are shared between the federal and regional governments (see below for more detail on expenditure responsibilities). The amounts of most subsidies for each recipient entity are determined by the federal budget law and by government decrees. Subsidies that come from the presidential reserve fund and the government reserve fund are determined by, respectively, presidential and government decrees.

Subventions are the most restricted type of transfers. The goal of subventions is to pay for mandatory expenditures that a higher level of government imposes on the lower level. Most subventions pay for social services or income support for particular categories of individuals. For example, there are subventions to pay for housing and utilities for World War II veterans, subventions for welfare payments to the unemployed, and subventions for one-time payments to foster families for taking in orphans. Typical subsidies are different from subventions mainly in that the latter are more specifically earmarked and do not presuppose any matching payments by sub-national governments, although some "subsidies" and "other" transfers might not involve matching either. However, subventions are not always fully funded, and some of them leave significant room for discretion by sub-national governments.[7]

Table 9.3 presents some descriptive statistics for the shares of different types of transfers in total transfers and in regional own revenues. As mentioned earlier, transfer dependence of Asian regions is slightly higher than for Russia as a whole. The share of equalisation transfers in total federal transfers to Asian regions is also relatively high despite Asian regions having higher per capita GRP. This is because the Asian regions on average have much higher IBEs with a mean of 2.17 due to their inhospitable climate, low road density, and remoteness from the main population centres of the country. Therefore, many of them become eligible for equalisation grants even though their nominal budgetary revenues are relatively high. In fact, while without adjustment for IBE most Asian regions have higher per capita transfer-inclusive budget revenues than the Russian median, only a handful exceed this median when IBE is taken into account (Figure 9.1 and Figure 9.2).

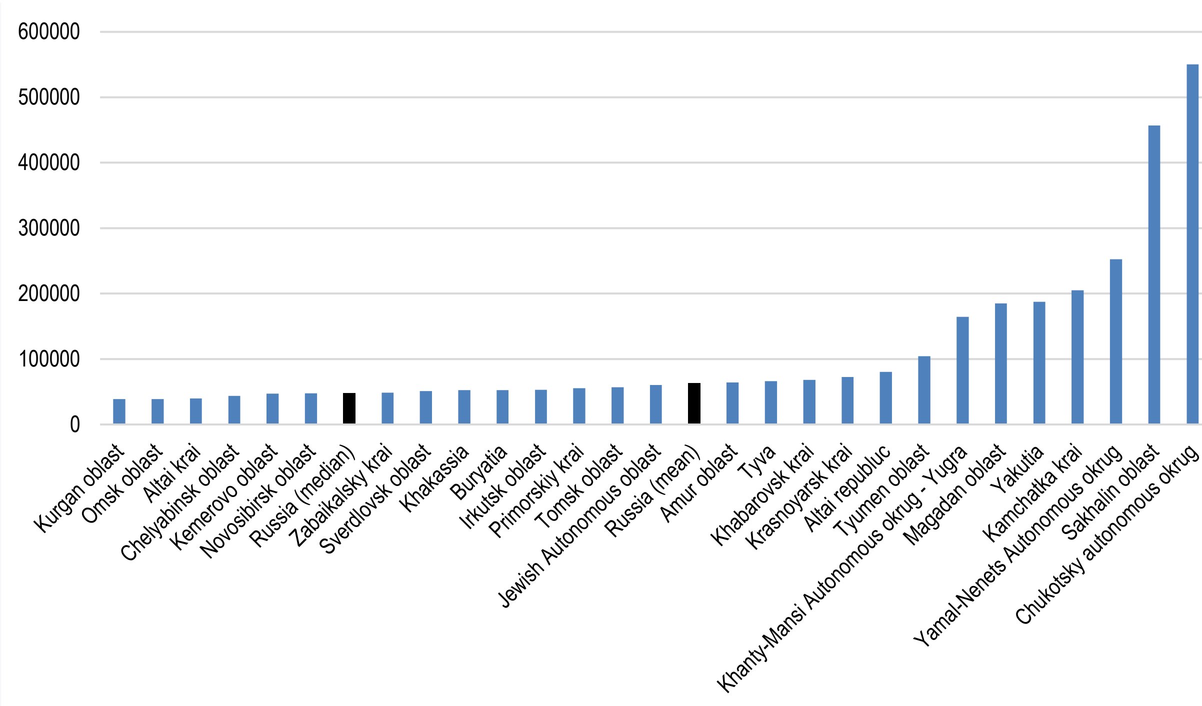
Table 9.3. Federal transfers to Asian regions, types of transfers (2015)

Percentage

	Russia			Asian regions		
	Share in total transfers	Median share in transfers	Median share in own revenues	Share in total transfers	Median share in transfers	Median share in own revenues
Equalisation grants	29.97	26.15	6.75	41.80	26.56	6.55
Balancing grants	8.5	7.35	2.56	7.51	7.75	3.06
Subsidies	24.79	24.64	7.19	17.78	18.26	7.12
Subventions	21.66	23.36	6.19	18.78	20.80	4.94
Other	15.08	12.65	3.42	14.12	14.97	3.65

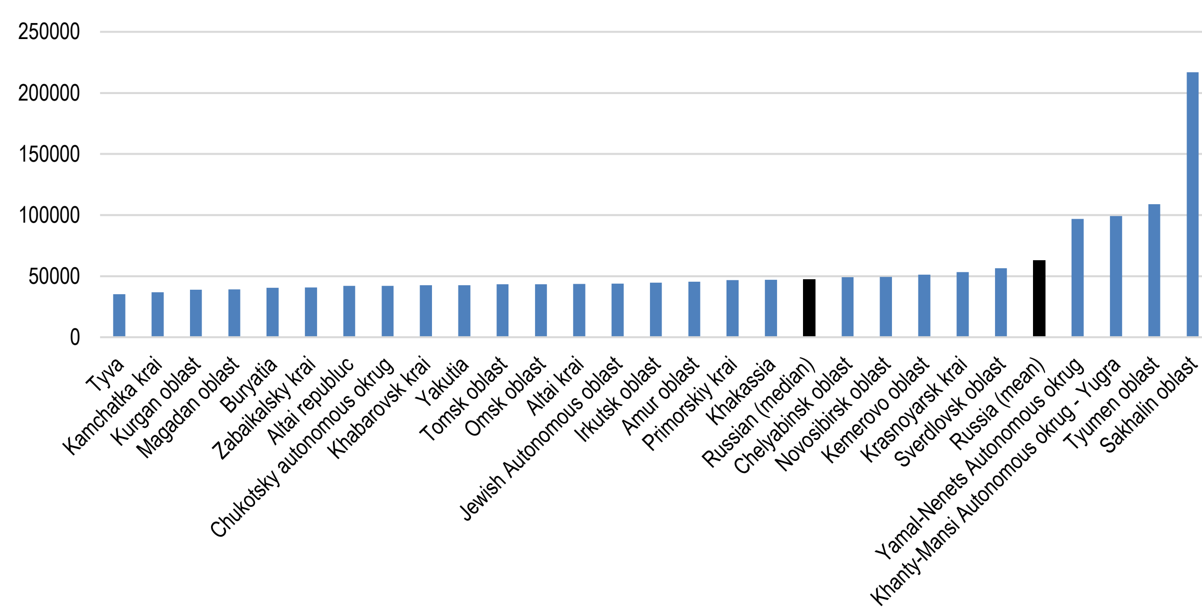
Source: Russian Treasury (www.roskazna.ru).

Figure 9.1. Distribution of per capita budget revenues, including transfers, for Asian regions (2015) (not adjusted for IBEs)



Note: The mean values for Russia are calculated as the totals for all regions divided by the country's population.
Source: Russian Treasury (www.roskazna.ru).

Figure 9.2. Distribution of IBE-adjusted per capita budget revenues, including transfers, for Asian regions (2015)



Note: The mean values for Russia are calculated as the totals for all regions divided by the country's population.
Source: Russian Treasury (www.roskazna.ru).

9.2.3. Intra-regional fiscal relations

In addition to the system of transfers from the federal centre to the regions and municipalities, there is a similar system of transfers from the regional budgets to municipalities. These are governed by the regional laws within the general framework established by the Budget Code and other federal laws. There is a great variety of intra-regional fiscal arrangements that is sometimes confusing. For example, a regional government can assign parts of the revenue from regional taxes to municipalities. Moreover, these tax assignments could change from one municipality to another, making it difficult to distinguish between tax assignments and inter-budgetary transfers.[8] For this reason, tax revenue decentralisation might not be a highly meaningful indicator of intra-regional fiscal decentralisation, at least for Russia.[9] Overall, the Asian regions of Russia are slightly more decentralised in terms of expenditures but somewhat more centralised with respect to revenue, although these differences are not large. As a result, municipalities in the Asian regions exhibit significantly greater transfer dependence, particularly if we exclude subventions, than municipalities in Russia as a whole (Table 9.4).[10, 11]

Table 9.4. Intra-regional fiscal decentralisation in Russia and Asian regions (2015)

Sub-national in percent of general government

	Russia			Asian regions		
	Median	Minimum	Maximum	Median	Minimum	Maximum
Tax decentralisation	20.61	8.01	40.18	18.87	8.01	40.18
Own revenue decentralisation	24.19	7.73	41.09	23.10	7.73	41.09
Expenditure decentralisation	42.50	9.76	66.54	43.26	32.98	66.54
Transfer dependence	62.54	22.84	84.66	67.18	45.71	84.66
Transfer dependence excluding subventions	38.69	10.19	81.04	49.23	18.81	81.04

Note: Tax decentralisation=(Tax revenue of municipalities)/(Consolidated regional tax revenue); Own revenue decentralisation=(Own revenue of municipalities)/(Consolidated regional tax revenue); Expenditure decentralisation=(Expenditures by municipalities)/(Consolidated regional expenditures); Transfer dependence=(Transfers from regional to municipal budgets)/(Revenue of municipalities, including transfers).
Source: Russian Treasury (www.roskazna.ru).

The incentives of regional authorities in Russia are not always aligned with the interests of their local constituents. This is in part due to the high degree of political centralisation, which makes regional governors often more beholden to the federal government than to local citizens or local elites. As a consequence, many of the conventional factors, such as regional size, that determine the degree of intra-regional fiscal decentralisation in other federal countries do not seem to operate in Russia. Alexeev and Mamedov (2017) show that the abundance of natural resource rents is the only factor positively associated with greater expenditure centralisation in Russia's regions while such characteristics as land area and population size have no discernible effect. This is apparently a relatively recent development. For example, using 1996-2001 data Freinkman and Plekhanov (Freinkman and Plekhanov, 2009) found that expenditure decentralisation was positively associated with the size of the region.

9.2.4. The spending side of Russia's fiscal federalism

The Russian constitution stipulates expenditure responsibilities of different government levels in broad terms and classifies them into exclusively federal and shared between federal and regional, and also stated that municipal residents decide local issues by themselves. The exclusive federal responsibilities include national defence and defence-related industry, management of federal property, various federal development programmes, federal energy systems, nuclear power, federal-level transportation, space exploration, international relations and federal law enforcement.[12] Shared expenditure responsibilities are listed in detail in the federal laws and include, among others, regional administration, public safety, housing and utilities, environmental protection, education,[13] support of cultural activities and sports, public health, emergencies and natural disasters, and social security. All expenditure responsibilities that are neither exclusively federal nor shared are under the purview of regional governments. The federal centre also delegates some of its expenditure responsibilities to the regional governments and typically, albeit not always, provides funds (subventions) to cover these expenditures. For example, federal subventions cover various subsidies to veterans and the disabled, unemployment benefits, maternity benefits, certain categories of expenditures on education, etc.

Overall expenditure decentralisation between the federal government and the regions in Russia is about 41.6%.[14] However, the sharing rates for the expenditures under the joint federal and regional jurisdiction vary greatly from one category to another. Consolidated regional budgets play a major role in spending on primary and secondary education, housing and utilities, healthcare, and the "support of the economy", which includes expenditures on regional infrastructure and subsidies to industrial enterprises and agriculture (Table 9.5). In other words, regional spending is quite important for the functioning of the economy and for the provision of basic services to the population.

Table 9.5. Russia's consolidated total and regional spending by type (2015)

In RUB billions

Expenditure category	Consolidated total	Consolidated regional	Regional/total (%)
Expenditures, total	29 741.5	9 479.8	31.87
General government expenditures	1 848.2	603.2	32.64
National defence	3 182.7	3.8	0.12
National security and law enforcement	2 072.2	107.6	5.19
Support for national economy	3,774.4	1 866.0	49.44
Housing and utilities	979.9	854.9	87.24
Environmental protection	71.7	22.1	30.88
Education	3 034.6	2 472.5	81.48
Culture and cinematography	395.6	310.6	78.50
Healthcare	2 861.0	1 355.8	47.39
Social policy/welfare transfers	10 479.7	1 497.1	14.29
Physical education and sport	254.9	193.1	75.77
Mass media	125.7	43.6	34.68
Servicing government and municipal debt	661.0	149	22.54

Note: Consolidated total expenditures include expenditures of extra-budgetary funds, which constitute a significant share of expenditures on healthcare and on social policy/welfare. Russia's 2015 GDP: RUB 83 233 billion.
Source: Russian Treasury (www.roskazna.ru).

9.2.5. Sub-national fiscal rules

The Budget Code imposes various fiscal restrictions and requirements on sub-national authorities. Violations of these rules can entail reductions in transfers (except for subventions) to the region or municipality. Currently, the regions are not allowed to run budget deficits (not counting transfers) above 15% of their own revenue. The regions whose federal transfer dependence exceeded 10% of their own revenues in two of the previous three years are not allowed to engage in any spending outside of that which is explicitly assigned to regional governments by the constitution and federal laws. These regions are also limited in terms of their expenditures on government employees and administration. Additional constraints are imposed on the regions with transfer dependence exceeding 40%.

Domestic borrowing is permitted, albeit only to cover the current year's deficits, but there are also limits on foreign borrowing. Currently, only the regions that do not receive federal equalisation transfers and have no debt arrears are allowed to borrow from foreign sources. However, the existing foreign loans can be refinanced even by the recipients of equalisation grants as long as the region does not have debt arrears. In general, regional debt is not allowed to exceed annual own revenues of a region, and debt service cannot exceed 15% of total expenditures excluding subventions.[15] Similar, although not identical, fiscal rules are applied to municipal budgets. Note, however, that the overall debt burden of Russia's regions is relatively low. It amounted to only about 36% of annual own regional revenues as of the end of 2015.

9.3. Russian fiscal federalism and its impact on growth and inequality

9.3.1. Growth is uneven across Russian regions

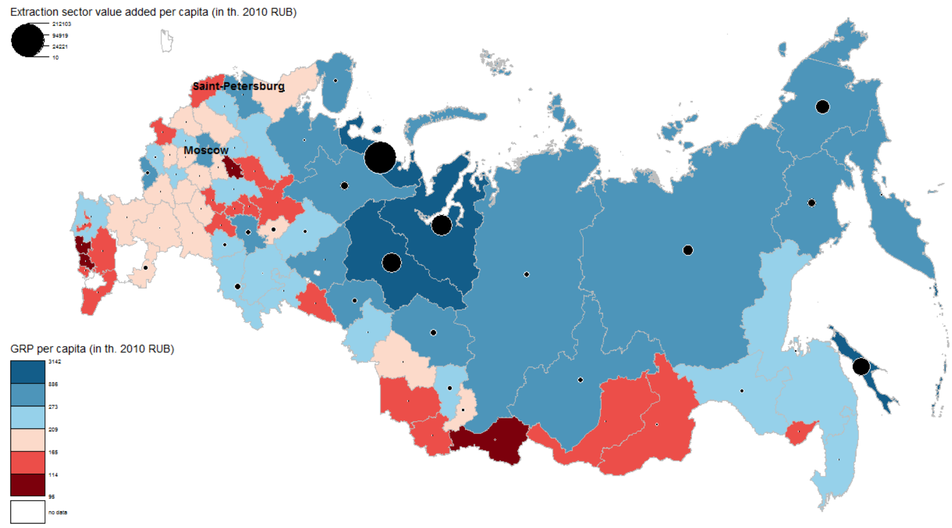
GDP is geographically concentrated in Russia. GDP per capita is highest in the metropolitan areas of Moscow and St. Petersburg and in a few remote economies in the north and east of the country relying on natural resources (Durand-Lasserve and Blöchliger, 2018). Natural resources define economic wealth in Asian regions: while some resource-rich regions in northern Siberia and close to the Urals boast some of Russia's highest regional GDP per capita, some resource-poor south Siberian regions close to China, Kazakhstan and Mongolia have among the lowest GDP per capita. Growth is also uneven: some Asian regions benefitted more from the natural resource boom during 2005-15 than others, suggesting that regional convergence, but also factors other than resource wealth, play a role in explaining the growth of Russia's Asian regions (Figure 9.3).

9.3.2. Transfers and sub-national governments' economic and fiscal incentives

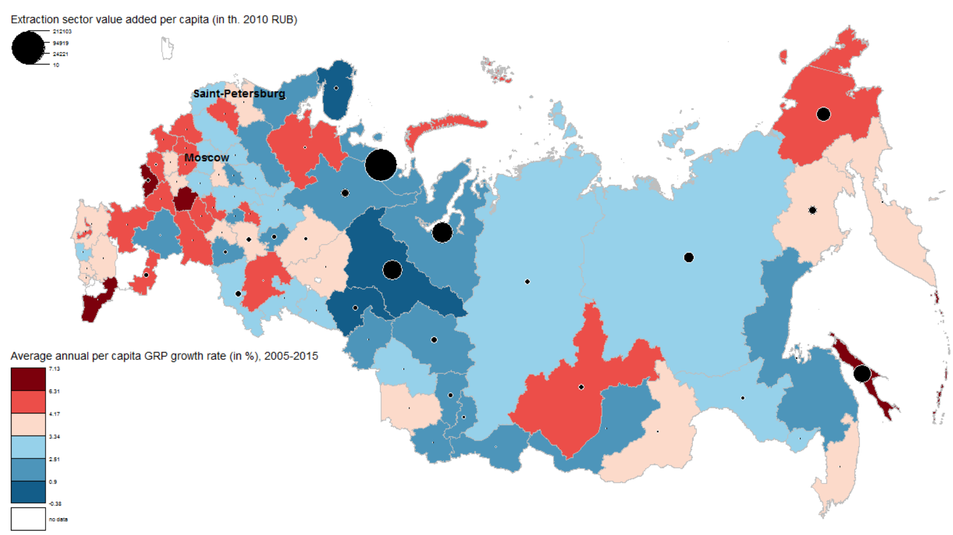
The way transfers are allocated can have a significant impact on the incentives of sub-national governments to foster growth and provide local public goods. These incentives seem to have increased over the last two decades. According to Zhuravskaya (2000), transfers tended to offset changes in own revenues of municipalities one-for-one, resulting in extremely weak fiscal incentives for municipal authorities. Zhuravskaya's conclusions were largely confirmed by Alexeev and Kurlyandskaya (2003). Using a different approach, Plekhanov (2004) found that the fiscal incentives of Russia's regions were only slightly stronger, with a short-run elasticity of regional budget expenditures with respect to GRP at around 0.2. Similar estimates were obtained by Alexeev and Weber (2013).

Figure 9.3. Economic wealth is unevenly distributed across Russian regions

Regional GDP per capita



Growth of regional GDP per capita



Source: Durand-Lasserve and Blöchliger (2018)

The time period is important because of significant changes to Russia's intergovernmental fiscal relations implemented in 2005-09. The first three studies relied on 1990s data while the latter used data for 2001-09. Using the most recent data (2005-14) and both Zhuravskaya's and Plekhanov's approaches, Alexeev (2016) finds dramatically stronger fiscal incentives for both regional governments and municipalities, similar to those in the United States and China. Transfers offset only about 11% of changes in own regional revenues, and the short-run elasticity of regional expenditures with respect to GRP is about 0.53. Using a limited set of Russia's regions, Alexeev and Chernyavskiy (2018) show that federal transfers to regions were particularly responsive to changes in own budget revenues during the 2009 crisis and became virtually independent of the changes in own revenues in 2014-15. If all regions are included, changes in transfers offset about 40% of changes in revenues and the elasticity of regional expenditures with respect to GRP falls to slightly under 0.5 (Table 9.6). Incentives seem to be stronger in the Asian part of Russia but the differences are not statistically significant. The precise specifications for all regressions are shown in the Annex.

Table 9.6. Fiscal incentives in Russia and its Asian regions

Dependent variable / Independent variables	ΔFederal transfers	ΔFederal transfers	Ln(Consolidated regional expenditures)			
	Russia	Asian regions	Russia	Asian regions	Russia	Asian regions
	(1)	(2)	(3)	(4)	(5)	(6)
ΔConsolidated own revenue	-0.405***	-0.309**				
	(0.027)	(0.126)				
Ln(Consolidated own revenue)			0.548***	0.604***		
			(0.042)	(0.060)		
Ln(GRP)					0.482***	0.507
					(0.093)	(0.345)
Observations	830	270	913	297	913	297
R-squared	0.343	0.438	0.757	0.754	0.570	0.337
Number of regions	83	27	83	27	83	27

Note: All regressions contain year fixed effects; robust standard errors clustered by region in parentheses; *** p<0.01, ** p<0.05, * p<0.1; Δ denotes annual change.
Source: Author's calculations, cross-sectional analysis.

9.3.3. Transfers and economic growth

The impact of transfers on economic growth is difficult to estimate due to potentially serious endogeneity, including the possibility of reverse causality. This is particularly true for the types of transfers that are determined in a discretionary manner, such as balancing grants. Freinkman, Kholodilin and Thieβen (2009) found no evidence that federal transfers impeded economic growth in the early 2000s. Deriugin et al. (2017) for 2005-14 find that the share of balancing grants in total transfers as well as the share of transfers in regional own revenue have a large and statistically significant negative effect on economic growth. However, the impact of balancing transfers becomes insignificant in system-GMM regression when the effect of the 2009 crisis is taken into account. Moreover, Deriugin et al. (2017) excluded the same set of regions as did Alexeev (2016). Adding the Tiumen region and its *okrugs* (which is rich in oil and receives relatively small amounts of transfers) further undermines the results.

Most recently, Di Bella, Dynnikova and Grigoli (2017) find no significant correlations between most types of transfers and economic growth. The only exception is a weakly significant positive correlation between subventions and growth. Given the nature of subventions, it is hard to see how they can affect economic growth. Indeed, the authors recommend treating this result with caution.

The following cross-sectional analysis reveals a potentially negative impact of transfers on growth (Table 9.7). As in the case of fiscal incentives, the Asian regions of Russia do not differ significantly from the rest of the country with respect to the degree of β-convergence and the association between transfers and economic growth and is within the range of estimates from the studies summarised in Guriev and Vakulenko (2012). Limiting the regression to Asian regions, this elasticity is a positive 0.0005 although the difference is not statistically significant. The shares of equalisation grants and balancing grants are negatively and significantly associated with regional growth in Russia as a whole, although not for the two groups of regions. Most importantly, the Gini coefficient has a relatively strong positive association with economic growth, implying that higher income inequality is associated with higher growth (Columns 4-6 of Table 9.7).

Table 9.7. Cross-sectional GRP growth regressions

	Ln(Annual GRP growth during 2005-15)					
	Russia	European regions	Asian regions	Russia	European regions	Asian regions
Variables	(1)	(2)	(3)	(4)	(5)	(6)
Ln(2005 per capita GRP)	-0.005**	-0.007*	0.0005	-0.011***	-0.014**	-0.006
	(0.002)	(0.003)	(0.003)	(0.003)	(0.006)	(0.004)
Average transfer				0.024	0.030	-0.016
dependence				(0.018)	(0.025)	(0.022)
Average equalisation				-0.028*	-0.034	0.002
grants/total transfers				(0.015)	(0.024)	(0.017)
Average balancing				-0.037*	-0.096	-0.001
grants/total transfers				(0.020)	(0.065)	(0.016)
Average Gini coefficient				0.243**	0.242**	0.205*
				(0.094)	(0.112)	(0.117)
Constant	0.088***	0.109***	0.021	0.069**	0.104	0.020
	(0.025)	(0.039)	(0.030)	(0.034)	(0.075)	(0.047)
Observations	82	55	27	82	55	27
R-squared	0.052	0.064	0.001	0.217	0.275	0.170

Note: Robust standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1.
Source: Author's calculations, OLS 2005-15.

Panel regressions largely confirm these findings, except that overall transfer dependence and the share of balancing grants in transfers have a negative influence on the growth of the European regions while not affecting the growth of the Asian regions (see Annex Table 9.A.1. and Annex Table 9.A.2. in the Annex). Moreover, the association between growth and inequality (Gini coefficient) is insignificant.

One possible reason for the negative effect of transfers on regional growth is that transfers could weaken regional governments' incentives to improve the investment climate. However, the data show no evidence of this. In a fixed effects regression with the investment climate index from Expert RA as a dependent variable and the lagged share of transfers in own regional revenue, share of balancing grants in transfers, and share of equalisation grants in transfers as main independent variables, none of the relevant coefficients is statistically significant.[16]

9.3.4. Decentralisation to the local level

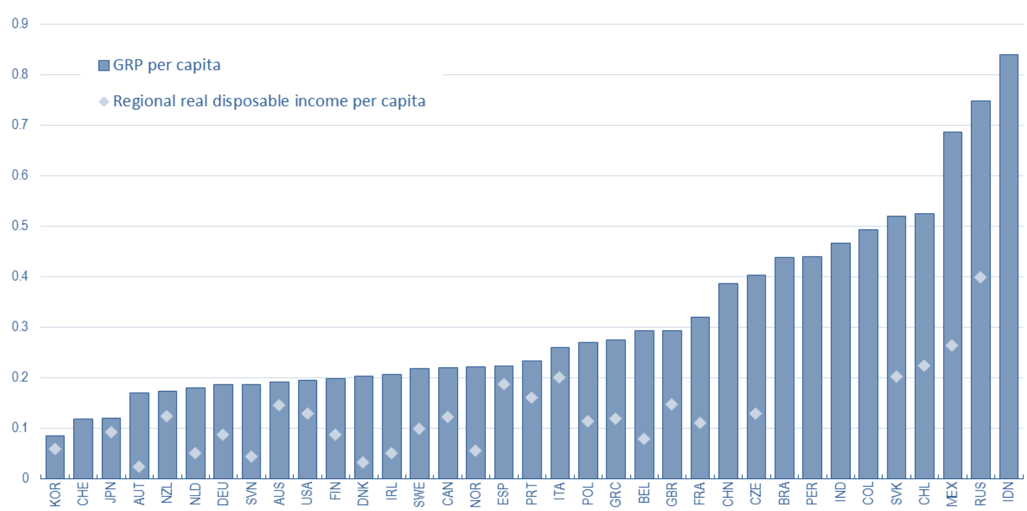
Although most of the empirical literature on the growth implications of fiscal federalism focuses on the fiscal relationships between the federal centre and the regions, there are also some papers that analyse the effect of *local* fiscal decentralisation on regional economic growth. Using cross-sectional data for the United States, Xie, Zoo and Davoodi (1999) did not find any effect of within-state fiscal decentralisation on economic growth, while Akai and Sakata (2002) found some evidence of a positive impact. Using both cross-sectional and panel data, Alexeev (2016) did not find any statistically significant effects of intra-state fiscal decentralisation in the United States but obtained statistically significant coefficients of intra-region expenditure decentralisation for Russia. Deriugin et al. (2017) obtain similar results with a larger set of controls but only in OLS FE regressions. As noted earlier, both of the two latter papers excluded several regions from their data. When all regions (except Moscow and St. Petersburg) are included, the effect of intra-regional expenditure decentralisation on regional economic growth disappears.

9.4. The effects of Russian fiscal federalism on regional inequality

9.4.1. Inter-regional disparities are no longer declining

Russia is characterised by rather high inter-regional inequality with respect to various economic indicators, including per capita GRP, wages, and per capita own revenue and expenditures of regional budgets. For example, the 2015 Gini coefficient for per capita GRP for the Russian regions was 0.75, which is significantly larger than the 0.20 Gini coefficient for the United States. This is partly due to the relatively small average size of Russia's regions and low inter-regional mobility of the factors of production (Figure 9.4).

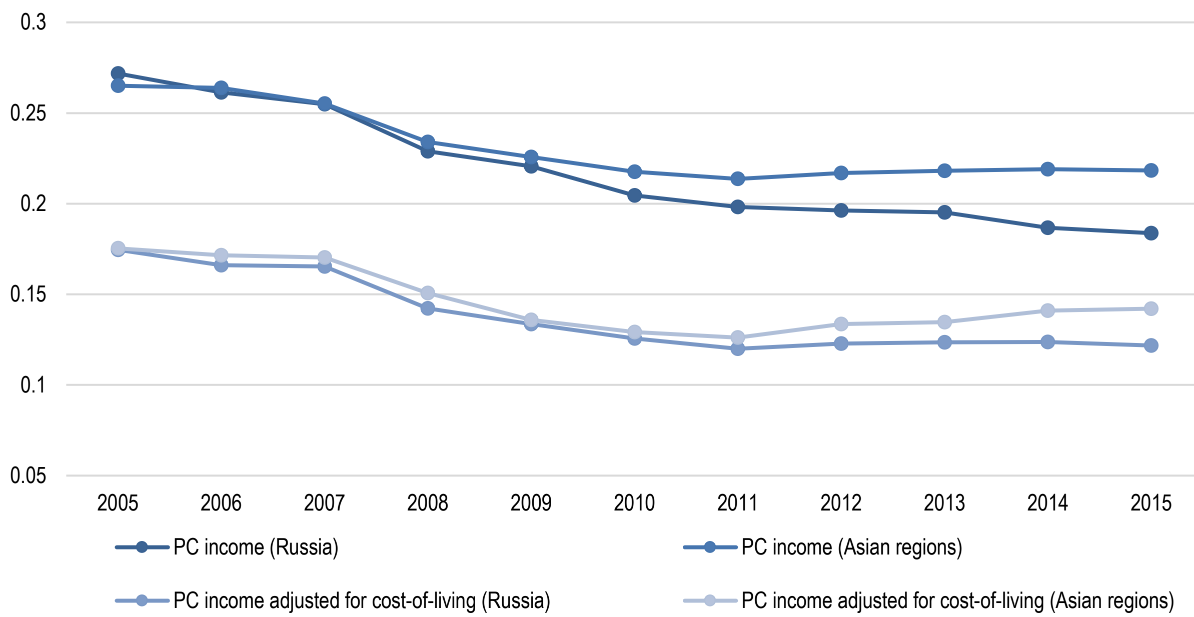
Figure 9.4. Regional disparities are high in Russia



Note: Calculation based on TL2 regions; coefficients of variation are weighted by population.
Source: OECD ((n.d.)), *OECD Regional Statistics* (database), OECD Publishing, Paris; Rosstat Central Database (for regional real disposable income per capita in Russia).

Large inter-regional disparities in the cost of living and in the cost of provision of public goods constitute perhaps an even more important reason for high inter-regional inequality, although this consideration is less relevant for per capita GRP. In order to account for these factors, personal incomes and budgetary data are adjusted by the regional cost-of-living index and the index of budgetary expenditures (IBE), respectively.[17] Overall, inter-regional disparities as measured by the Gini coefficient declined until around 2010, from which date on regions no longer seem to have converged (Figure 9.5). Differences between the Asian regions have even increased. The picture does not change fundamentally whether regional GDP is adjusted for cost of living, or whether the IBE correction factor is applied (Annex Figure 9.A.1.).

Figure 9.5. Gini coefficients for per capita personal incomes with and without adjustment for cost of living in Russia and Asian regions (2005-15)



Source: Authors' calculations

Still, the adjusted inequality measures are significantly lower than the unadjusted ones, particularly starting in 2013. Whether the appropriate measures of inter-regional inequality should or should not include adjustments for IBEs is unclear and presumably depends on the issue at hand. The IBE coefficients are far from perfect and, as noted earlier, depend both on the costs per unit of public good provision (e.g. they depend on salaries of government employees and costs of providing public housing services) and on the demographic structure and other characteristics of the region. In the literature on income inequality, the adjustments for these characteristics typically are not made.

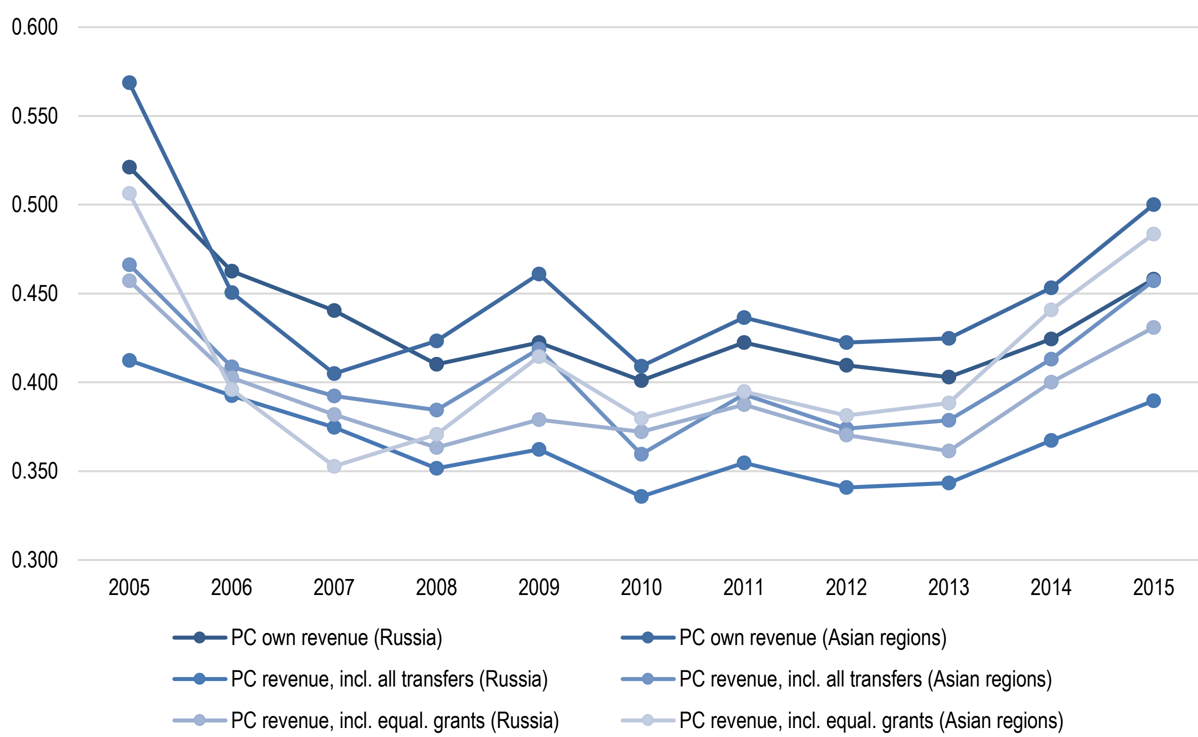
9.4.2. Transfers have an equalising effect

A major goal of inter-budgetary transfers is to reduce inter-regional inequality with respect to the regions' ability to provide public goods, implying that transfers aim to reduce inequality of budgetary revenues. In order to evaluate the degree to which federal transfers achieve this goal, we calculate how the Gini coefficients of per capita revenues of consolidated regional budgets change as we add in different types of transfers.[18] The results of this exercise can be summarised as follows (see also Figure 9.6 and Figure 9.7):[19]

1. Per capita budgetary revenues are more unequal among Asian regions than for the country as a whole.
2. The greatest reductions in revenue inequality are achieved by total transfers. Equalisation transfers alone do not perform quite as well, except for 2006-08 in the Asian regions.

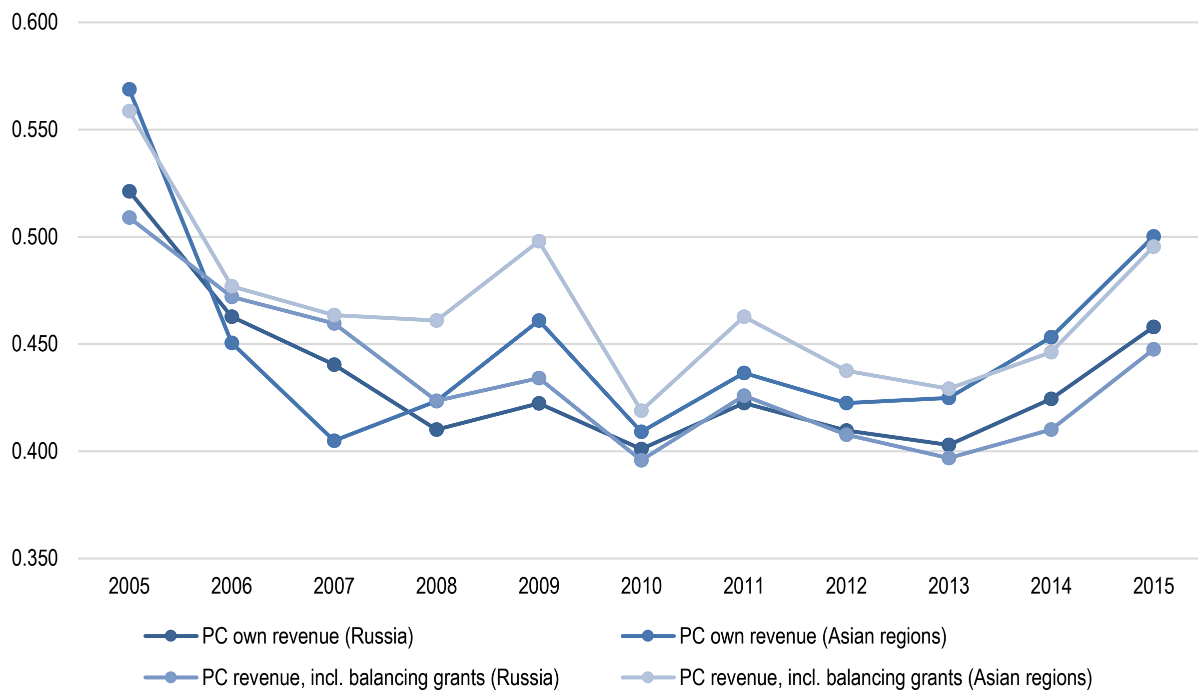
3. The discretionary budget balancing transfers equalise revenues the least. In fact, taken alone, balancing transfers increased revenue inequality in several years, particularly in the Asian part of the country.
4. Overall inter-regional inequality decreased substantially between 2005 and 2007, then remained stable in 2007-13, and rose substantially in 2014 and 2015.
5. Although transfers do reduce regional per capita budget revenue inequality, they do not significantly affect the dynamics of this inequality over the years. Thus, the lines for the Gini coefficients for per capita own revenue and per capita revenue including all transfers for Russia as a whole are almost exactly parallel to each other. Interestingly, the dynamics of IBE-adjusted and unadjusted Gini coefficients are quite different, reflecting changes in the IBE (Annex Figure 9.A.2. through Annex Figure 9.A.4.).

Figure 9.6. The effect of all transfers and equalisation grants on regional revenue inequality in Russia and Asian regions (2005-15)



Source: Authors' calculations.

Figure 9.7. The effect of balancing grants on regional revenue inequality in Russia and Asian regions (2005-15)



Source: Authors' calculations.

9.5. Conclusion

This chapter described the main administrative features of fiscal federalism in Russia and assessed its effects on regional fiscal incentives, economic growth, and inequality, focusing on the Asian regions and comparing them with the rest of the country. Russia is a rather fiscally centralised country relative to most other federations. This is true both with respect to the revenue autonomy of its sub-national governments and with respect to conventional measures of revenue and expenditure decentralisation. Econometric analysis suggests that fiscal incentives generated by the tax assignment policy and transfers from the federal budget are relatively weak, although this result depends on the particular sample of regions included. If some arguably unusual regions are excluded from the calculations, fiscal incentives appear to be quite strong. The Asian regions and the rest of Russia have similar fiscal incentives according to conventional measures.

In addition to fiscal incentives implied by the econometric results, there are also explicit fiscal rules that aimed at strengthening regional fiscal incentives. These rules were enhanced in late 2017 by the government decree that stipulated requirements imposed on all regions receiving equalisation transfers.[20] For example, these regions are now required to raise their own revenues in 2018 relative to 2017, increase private investments and the share of employment at small and medium-sized enterprises, and reduce registered unemployment.

Although there is no evidence that federal transfers policy has impeded the economic growth of the Asian regions, overall transfer dependence and particularly balancing transfers are associated with lower GRP growth in the European part of Russia. At the same time, no such evidence is found with respect to the impact of transfers on per capita personal incomes in the regions.

Transfers do reduce inter-regional inequality with respect to budgetary revenues and, therefore, expenditures. Overall transfers appear to provide for the largest reduction in inequality with equalisation transfers producing a somewhat smaller effect. The balancing transfers reduce inequality the least and sometimes even increase it. This is true both for the Asian regions and for the country as a whole. Overall revenue inter-regional inequality with and without transfers decreased in 2005-07, stabilised in 2007-13, and increased significantly through 2015. Similar conclusions hold for cost-adjusted (IBE, index of budget expenditure) budgetary revenues with a notable exception of 2013 when inter-regional inequality suddenly dropped. This outcome highlights the important role of IBEs in evaluating regional inequality and perhaps raises questions about the validity of these adjustments.

Notes

1. Slightly more than 70% of Russia's oil is produced in Asia (*Regiony Rossii*, 2017). This crude oil alone would constitute almost 23% of Russia's nominal 2015 GDP expressed in USD if that oil was accounted for at world market prices. In addition, more than 90% of Russia's natural gas, coal, and most diamonds, aluminium and gold are also mined in the Asian regions. Assuming that natural gas rents are about equal in size to those of oil – see Gaddy and Ickes (2013) - one could easily argue that Asian regions account for over half of correctly calculated value added in the country.

2. Most countries do not recognise these two regions – the Republic of Crimea and the federal city Sebastopol – as parts of Russia. We will disregard them in this chapter, except when we use the aggregated data for the entire country.

3. Here and elsewhere, unless stated otherwise, the non-fiscal regional data for Russia are from the website of the Russian statistical agency Rosstat (www.gks.ru), including the statistical yearbook *Regiony Rossii* for various years. The US population data by state are from the US Census Bureau, Population Division.

4. Unless stated otherwise, the Russian budgetary data in this table and elsewhere are either directly from or are calculated based on the information on the website of the Russian Treasury (www.roskazna.ru).

5. This is largely because taxes and export fees on crude oil and natural gas, which accounted for more than 30% of all budgetary revenues in the country in 2015, accrue entirely to the federal government.

6. Transfer dependence on the order of 20% is not particularly large by world standards. According to Aldasoro and Seiferling (2014), the average vertical imbalance in their large sample of countries is about 40%. However, most countries in Aldasoro and Seiferling's sample are not federations and thus would have relatively centralised fiscal systems.

7. Yushkov, Oding and Savulkin (2016) argue that due to often changing rules for calculating some of the subventions or even the absence of such rules, subventions represent a flexible way of redistributing resources across regions but at the same time, they reduce accountability of sub-national governments for certain types of expenditures.

8. Since 2009, the regional governments are required to use uniform tax assignments for all tax revenues except for PIT. However, since PIT is the largest source of regional tax revenues, this constraint is presumably often not binding.

9. See Alexeev and Mamedov (2017) and Alexeev et al. (2015) for a more detailed discussion. Although genuine revenue autonomy may be important for sub-national fiscal incentives, expenditure decentralisation appears to be more relevant for intra-regional fiscal issues in Russia, in part due to the substitutability between tax assignments and transfers.

10. We exclude the federal cities of Moscow and St. Petersburg from the calculations of intra-regional decentralisation measures because these cities do not have conventional municipalities.

11. It might make sense to exclude subventions from the calculation of transfer dependence because municipal authorities have relatively little discretion in spending funds received via subventions. In effect, subventions can be viewed as regional government expenditures administered by municipalities. However, as mentioned earlier, some types of subventions do offer spending flexibility to lower levels of governments. For this reason, we will not subtract subventions in the variables used in our regressions and in most other calculations.

12. Despite the fact that these spending categories are formally the exclusive federal responsibility, regional budgets indicate some small amounts in the corresponding expenditure lines in the regional budgets.

13. Federal budget provides most of the support for state-run higher education while regional budgets pay for almost all primary and secondary education.

14. This number excludes spending by extra-budgetary funds. If these expenditures are included in the denominator, Russia's expenditure decentralisation would have been about 32% in 2015 (see Figure 9.5).

15. There are some exceptions, however. For example, the debt level can exceed annual own revenue by the amount of loans from the federal government.

16. These regressions are available upon request.

17. Some issues with adjustments for IBEs are discussed briefly in Annex 10.A.

18. The difference between regional revenues including all transfers and regional expenditures consists of borrowing, which is relatively small in most, albeit not all, regions.

19. Calculations similar to those in Figure 9.6 and Figure 9.7 are also performed by Tabata (2017).

20. Government Decree No. 1701, dated 30 December 2017.

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Annex 9.A. Technical annex

Calculation of the tax potential of a region

The index of potential tax revenue (ITR) of a region is used in determining the amount of equalisation grants. The ITR is the ratio of per capita tax potential of the region and the average per capita tax potential of all regions, where the tax potential of a region equals the sum of its tax potential for each tax assigned to the region. This tax-specific potential, R_i^j, is calculated as:[1]

$$R_i^j = F^j \times \left(0.3 \times \frac{Q_i^{j,t-2}}{\sum_k Q_k^{j,t-2}} + 0.35 \times \frac{Q_i^{j,t-1}}{\sum_k Q_k^{j,t-1}} + 0.35 \times \frac{Q_i^{j,t}}{\sum_k Q_k^{j,t}}\right)$$

where F^j is the forecast of total collections of the j-th tax for all regions and $Q_i^{j,t}$ is the base of tax j in region i in year t. For example, the tax base for corporate income tax (CIT) is taxable profit of enterprises, the tax base for personal income tax (PIT) is the sum of wages in the region, etc. In other words, the tax potential of a region is a product of the overall tax collections forecast and the three-year weighted average share of the region's tax base in the countrywide tax base for each tax.

Description of regression specifications

As mentioned in the main text, all the budgetary variables are either from or are calculated based on information available on the Russian Treasury website, www.roskazna.ru. The only exceptions are the data in Table 9.5 and the data on the index of budget expenditure (IBEs) that are from the Ministry of Finance website (www.minfin.ru). The non-budgetary data are from Rosstat's website (www.gks.ru).

The estimates presented in the first two columns of Table 9.6 are from the following OLS FE regression:

$$\Delta TRANSFERS_{j,t} = \beta_0 + \beta_1 \Delta OWN\ REVENUE_{j,t} + \gamma X_{j,t} + \varepsilon_{j,t}$$

where $TRANSFERS_{j,t}$ is the amount of all transfers from the federal government received by consolidated region j's budget in year t, $OWN\ REVENUE_{j,t}$ denotes own revenues of consolidated regional budget, Δ denotes change in the respective variable between years $t-1$ and t, $X_{j,t}$ is a vector of controls, and $\varepsilon_{j,t}$ is the error term. As stated in the main text, the estimates in Table 9.6 are from regressions that do not include any controls except region and year fixed effects, but the results with additional controls are qualitatively the same.

The last four columns of Table 9.6 show the results of estimating the elasticity of sub-national expenditures with respect to gross regional product or tax revenues using the following regression:

$$\log(EXP_{i,t}) = \alpha_0 + \alpha_1 \log(GRP_{i,t}) + \gamma X_{j,t} + \varepsilon_{j,t}$$

where $EXP_{i,t}$ stands for region i's expenditure in year t and α_1 represents the relevant elasticity. Again, the only controls included in the regressions shown in Table 9.5 are region and year fixed effects.

Table 9.7 presents the estimates of the following cross-sectional regression equation:

$$\frac{1}{11}\log\left(g_{i,2005} \times g_{i,2006} \times \ldots \times g_{i,2015}\right) = \beta_0 + \beta_1 \log\left(y_{i,2005}\right) + \gamma X_i + \varepsilon_i,$$

where $g_{i,t}$ is the growth rate of real GRP of region i in year t, $y_{i,2005}$ is 2005 per capita GRP in RR, X_i is a vector of other regressors, and ε_i is the error term. In the first two columns of the table, X_i is empty but in the last two columns it includes the region's transfer dependence (the share of transfers in regional revenue, including transfers), the share of equalisation transfers in all federal transfers, the share of balancing transfers in all transfers, and the regional Gini coefficient for per capita personal incomes, all averaged over 2005-15.

The regressions for the growth of personal incomes (available upon request) are similar to those in Table 9.7 except the dependent variable is the ratio of per capita personal incomes in 2015 and 2005 adjusted for the regional cost-of-living indices, i.e., $\frac{1}{10}\log\left({y_{2015}}/{y_{2005}}\right)$.

Panel data growth regressions

A set of panel regressions complement the cross-sectional regressions as follows:

$$\log g_{i,t} = \beta_0 + \beta_1 \log\left(y_{i,t-1}\right) + \gamma X_{i,t} + \varepsilon_{i,t}$$

whereas before, $g_{i,t}$ and $y_{i,t}$ are respectively, the growth rate of real GRP in region i and year t and the per capita GRP in constant 2005 RUB. $X_{i,t}$ is a vector of other regressors that includes the ratio or mining output to GRP, the growth rate of regional employment, the growth rate of investment, the Gini index, transfer dependence, share of equalisation transfers in all transfers, share of balancing transfers in all transfers, and regional and year fixed effects. The table separately shows the estimates based on the sample of all Russia's regions, European regions, and Asian regions.

The results of panel regressions for GRP growth are shown in Annex Table 9.A.1 and Annex Table 9.A.2 below. They are not all that different from cross-sectional estimates as shown in Table 9.7 in the main text. The main exception is that although transfer dependence does not appear to affect growth rates for the country as a whole, overall transfer dependence and the share of balancing grants in transfers have a negative influence on the growth of the European regions while not affecting the growth of the Asian regions in a statistically significant way. These results are confirmed by the system-GMM regression. The results with respect to GRP growth rates are however not robust to removing year 2009. Without that unusual in terms of transfers and growth rates year, neither the effects of transfers on GRP growth nor the difference between the European and Asian regions in this respect is statistically significant in system-GMM regressions. However, the OLS FE regressions continue to show the negative effects of balancing grants on GRP growth in the European Russia and statistically significant differences between the impact of transfers on growth in the European and Asian parts of the country. As expected, the coefficients of the share of mining in GRP, employment index, and investment index are all positive and mostly statistically significant in the panel growth regressions.

As in the cross-sectional regressions, panel estimates of the effects of transfers on the growth of regional personal incomes are mostly statistically insignificant (Annex Table 9.A.3). The only transfers-related statistically significant coefficient is for overall transfer dependence in the OLS FE regression for the Asian regions, and this result does not survive in the system-GMM specification (Column 4). Unlike in the GRP growth panel regressions, but similarly to the cross-sectional results, personal income growth is strongly positively associated with the Gini index.

Annex Table 9.A.1. GRP growth in the European and Asian parts of Russia (OLS FE; 2005-15)

Dependent variable: Ln(GRP index)

	Russia	Europe	Asia
	(1)	(2)	(3)
Ln(Per capita GRP(t-1))	-0.263***	-0.223***	-0.430***
	(0.036)	(0.042)	(0.071)
Mining/GRP	0.001**	0.001	0.003***
	(0.001)	(0.001)	(0.001)
Employment index	0.391***	0.834***	0.290***
	(0.084)	(0.191)	(0.053)
Investment index	0.005	0.008**	0.007
	(0.004)	(0.004)	(0.005)
Gini index	0.350	0.256	0.149
	(0.229)	(0.290)	(0.332)
Transfer dependence	0.010	-0.078*	0.074
	(0.061)	(0.044)	(0.113)
Equalisation grants/Total	-0.002	-0.034	0.040
transfers	(0.024)	(0.028)	(0.038)
Balancing grants/Total	-0.011	-0.081***	0.055
transfers	(0.034)	(0.024)	(0.042)
Observations	797	537	260
R-squared	0.616	0.716	0.570
Number of regions	83	56	27

Note: All regressions contain year fixed effects; Robust standard errors clustered by region in parentheses; *** p<0.01, ** p<0.05, * p<0.1.
Source: Author's calculations.

Annex Table 9.A.2. GRP growth in Russia with dummy variables for Asian regions (2005-15)

Dependent variable: ln (GRP index)

	OLS FE	System-GMM
	(1)	(2)
Ln(GRP index (t-1))		0.131**
		(0.054)
Ln(Per capita GRP(t-1))	-0.270***	-0.085**
	(0.039)	(0.034)
Mining/GRP	0.002***	0.003***
	(0.001)	(0.001)
Employment index	0.371***	0.388***
	(0.082)	(0.048)
Investment index	0.006*	0.007**
	(0.003)	(0.003)
Gini index	0.339	0.568*
	(0.214)	(0.310)
Transfer dependence	-0.104**	-0.101*
	(0.045)	(0.058)
Equalisation grants/Total	-0.049*	0.002
transfers	(0.025)	(0.060)
Balancing grants/Total	-0.079***	-0.128***
transfers	(0.025)	(0.046)
Asia×(Transfer dependence)	0.255***	0.149
	(0.085)	(0.099)
Asia×(Equalisation grants/Total	0.087**	0.014
transfers)	(0.039)	(0.085)
Asia×(Balancing grants/Total	0.109***	0.194**
transfers)	(0.039)	(0.083)
Asia		-0.068
		(0.042)
R-squared	0.641	
Hansen J-statistic (p-value)		0.443
AR(2) (p-value)		0.639
Observations	797	797
Number of regions	83	83
Number of instruments		36

Note: All regressions contain year fixed effects; Robust standard errors clustered by region in parentheses; *** p<0.01, ** p<0.05, * p<0.1.
Source: Author's calculations.

Annex Table 9.A.3. Per capita personal income growth (2005-15)

Dependent variable: ΔLn(per capita personal income adjusted for regional cost of living)

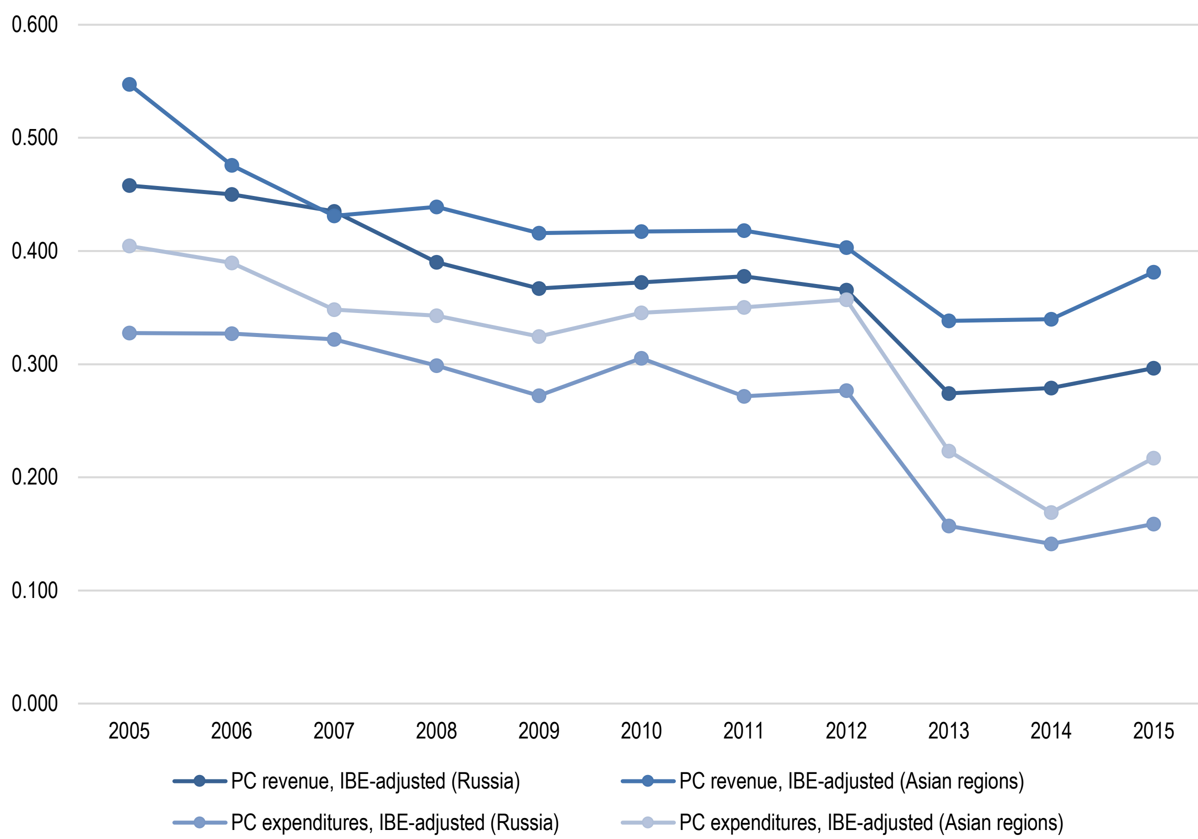
	OLS FE		OLS FE	System-GMM
	Europe	Asia	Russia	
	(1)	(2)	(3)	(4)
ΔLn(per capita adjusted				-0.007
personal income (t-1))				(0.069)
Ln(per capita adjusted	-0.467***	-0.526***	-0.490***	-0.654***
personal income (t-1))	(0.046)	(0.055)	(0.036)	(0.079)
Mining/GRP	0.001	0.000	0.000	0.002
	(0.001)	(0.001)	(0.001)	(0.002)
Employment index	0.149	-0.024	0.011	-0.119*
	(0.270)	(0.028)	(0.038)	(0.068)
Investment index	0.008**	0.004	0.003	-0.002
	(0.003)	(0.003)	(0.002)	(0.004)
Gini index	2.306***	3.725***	2.723***	4.420***
	(0.347)	(0.620)	(0.369)	(0.711)
Transfer dependence	-0.044	-0.133*	-0.033	0.109
	(0.052)	(0.072)	(0.049)	(0.181)
Equalisation grants/Total	-0.020	0.045	-0.009	0.093
transfers	(0.032)	(0.034)	(0.032)	(0.104)
Balancing grants/Total	-0.041	0.047	-0.035	0.047
transfers	(0.032)	(0.028)	(0.032)	(0.072)
Asia×(Transfer dependence)			-0.049	0.153
			(0.062)	(0.241)
Asia×(Equalisation grants/Total			0.026	0.026
transfers)			(0.043)	(0.150)
Asia×(Balancing grants/Total			0.042	-0.014
transfers)			(0.039)	(0.084)
Asia				-0.105
				(0.102)
R-squared	0.716	0.686	0.694	
Hansen J-statistic (p-value)				0.575
AR(2) (p-value)				0.928
Observations	537	260	797	719
Number of regions	56	27	83	83

Note: All regressions contain year fixed effects; Robust standard errors clustered by region in parentheses; *** p<0.01, ** p<0.05, * p<0.1.
Source: Author's calculations.

Adjustments for IBEs

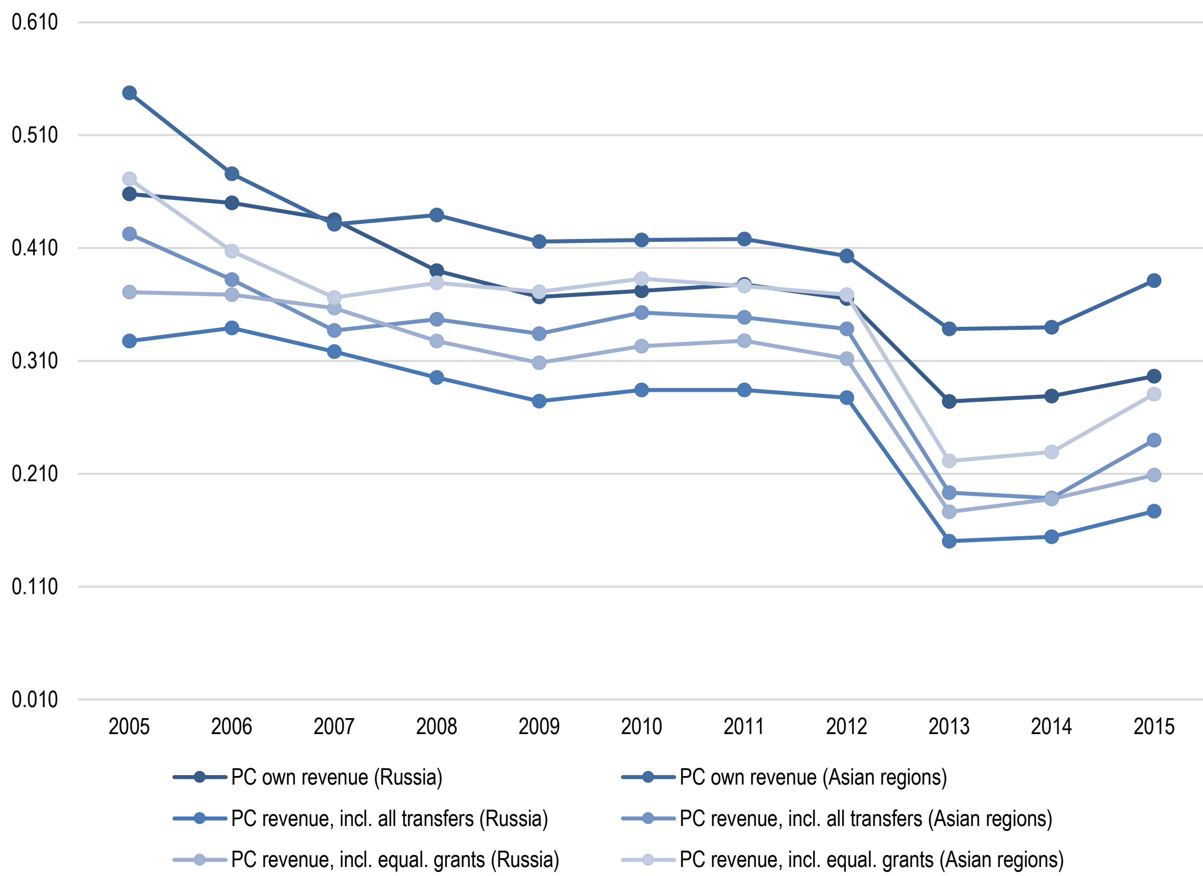
The pre-2013 publicly available IBE data are incomplete.[2] One might assume that IBEs do not change much from one year to another and so one can substitute 2013 values of IBE for the missing values in 2005 and 2010-12. Note, however, that this is not necessarily a valid assumption. For example, the average IBE for the Asian regions of Russia changed from 2.20 in 2010 to 1.87 in 2013 and then again to 2.17 in 2015. In part, this might be due to the change in the methodology of calculating the IBEs in late 2013.[3] Also, Zubarevich and Gorina (2015) note that the IBE for Chukotka changed from about 7 in 2012 to 13 in 2014 while for Magadan province, which is relatively similar to Chukotka in terms of the costs of providing services, the IBE was only about 4. These authors suggest that the IBEs are a subject of significant lobbying efforts by the regions. However, Chukotka is the only region with such a large change in IBE. It is also by far the smallest region by population size. Therefore, we choose to present the IBE-adjusted measures of inequality but take out Chukotka in these calculations.[4] The charts with Gini coefficients for IBE-adjusted own budget revenues, expenditures, and revenues including various types of transfers are shown in Annex Figure 9.A.1 through Annex Figure 9.A.4.

Annex Figure 9.A.1. Gini coefficients for per capita own budget revenues and expenditures adjusted for IBEs in Russia and Asian regions (2005-15)



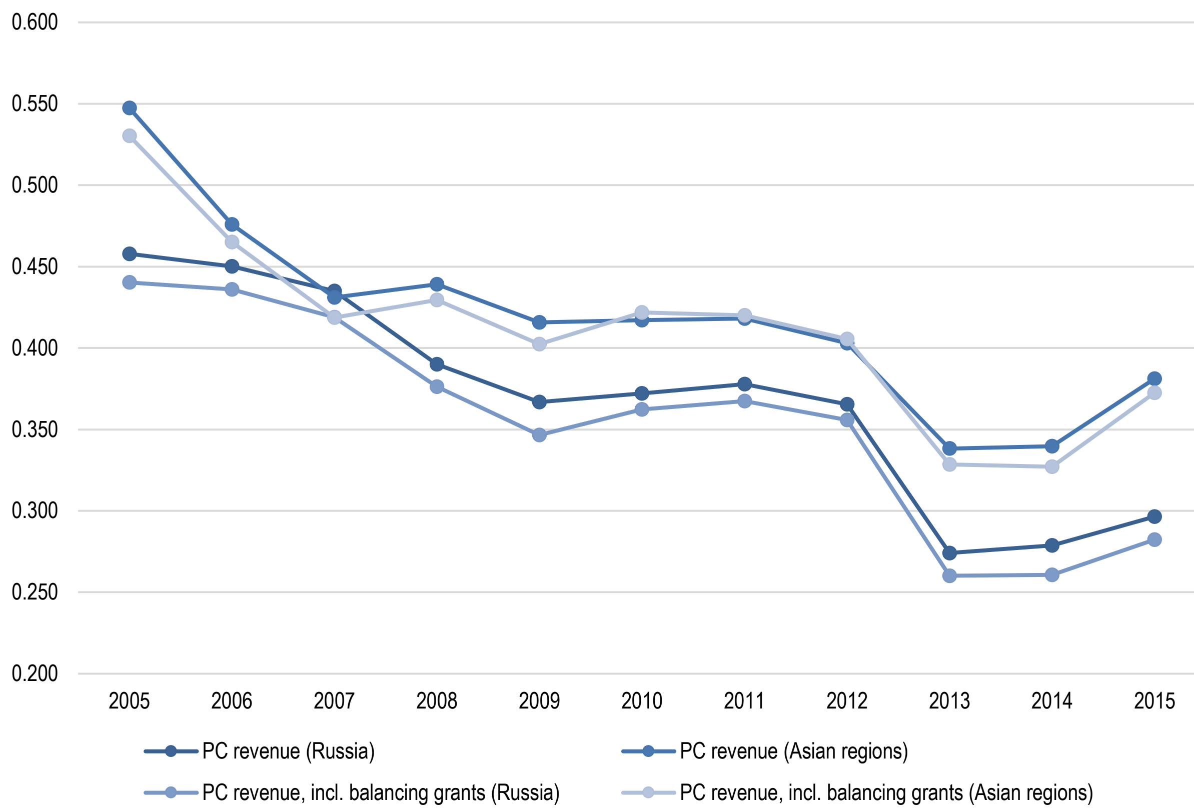
Source: Author's calculations.

Annex Figure 9.A.2. The effect of all transfers and equalisation grants on regional revenue inequality, Gini coefficients, IBE-adjusted, in Russia and Asian regions (2005-15)



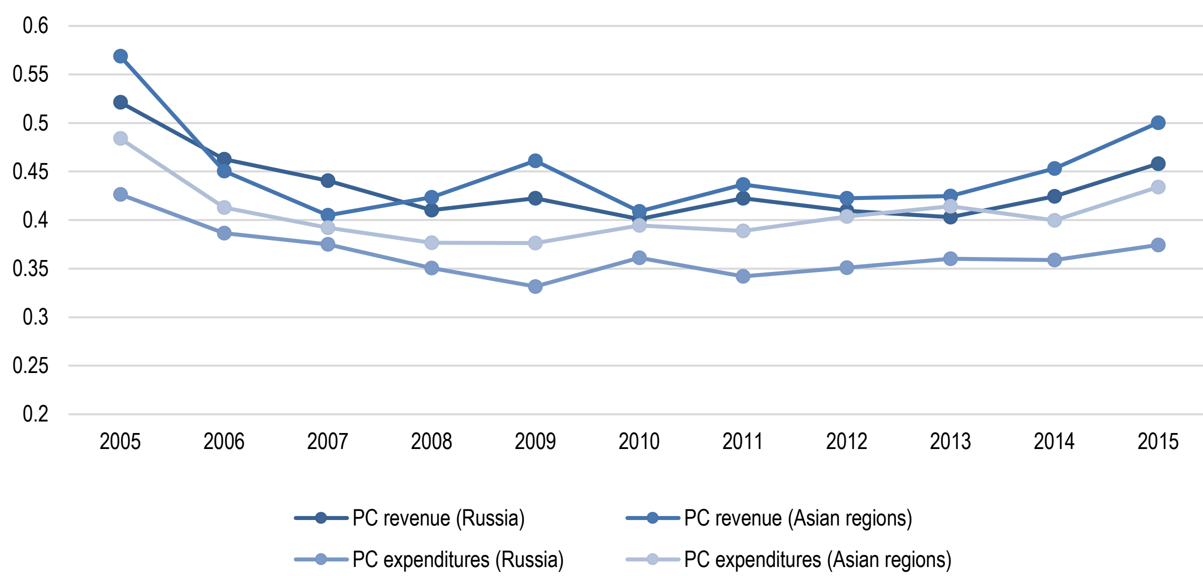
Source: Author's calculations.

Annex Figure 9.A.3. The effect of balancing grants on regional revenue inequality, Gini coefficients, IBE-adjusted, in Russia and Asian regions (2005-15)



Source: Author's calculations.

Annex Figure 9.A.4. Gini coefficients for per capita own budget revenues and expenditures without IBE adjustment in Russia and Asian regions (2005-15)



Source: Author's calculations.

Notes

1. The methodology for calculating IBE and ITR is described in the Russian government Decree No. 670 dated 22 November 2004, although the original methodology has been modified somewhat over the years by amendments to this decree.

2. The IBE data for 2015 are from the website of the Russian Ministry of Finance (www.Minfin.ru). The earlier data are also from the Ministry of Finance, but they are no longer posted on the website.

3. It appears that the change affected only two regions: Chukottskii and Yamalo-Nenetskii *okrugs* [see Deriugin, Arlashkin and Proka (2016)].

4. Whether the appropriate measures of inter-regional inequality should include adjustments for IBE is unclear and presumably depends on the issue at hand even if their values are not subject to lobbying efforts of regional administrations. Deriugin et al. (2016) discuss some problems with these indices and propose changes to the methodology of their calculation. Also, as noted earlier, these indices depend both on the costs per unit of public good provision (e.g. they depend on the salaries of government employees and costs of providing public housing services) and on the demographic structure and other characteristics of the region. One could argue that the demographic structure, for example, should not be included in the adjustments as it typically is not included in measures of inter-regional inequality.

10. Fiscal decentralisation and governance in Thailand

by

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This chapter studies expenditure assignment, revenue assignment and the debt of local governments in Thailand. The distribution of local expenditures and revenue among jurisdictions in 2017 are analysed by applying the Gini index and Lorenz curve. The study shows that the governmental functions that have the most unequal distribution of local expenditure per capita among local governments are agriculture, domestic peace maintenance and commerce. The least unequal distribution of local expenditure per capita is in general administration, central budget and education. Thai local governments collect a very small proportion of their budgets themselves, with around eight percent of their budgets coming from local sources of revenue. This study suggests that the shared revenue and grants are good instruments to reduce the disparity of local governments' revenue. Moreover, government functions should be defined more clearly, identifying which functions are solely provided by the central government and which functions should be jointly provided by the central government and local governments.

10.1. Fiscal Decentralisation and governance in Thailand

Thailand is a highly centralised unitary state, where traditionally, local autonomy has been extremely limited. The 1997 Thai Constitution mandated decentralisation, stating that Thailand needed to have a plan and process to decentralise power to local governments. The local governments would be granted independence in their policy determination, governing powers and administrative abilities. They would provide public goods and services to their own local people. The Constitution of 2007 reaffirmed the goals and commitments of the decentralisation process. A new Constitution, following the 2014 coup, was issued on 6 April 2017. It also has a section on local administration. Fiscal decentralisation is the key mechanism for advancing decentralisation in Thailand, which requires co-operation from both the central and local governments.

10.1.1. The administrative structure of Thai local governments and the context of fiscal relations

Thailand's administrative structure is organized into a dual system of local administration (de-concentration) and local autonomous self-government (decentralisation). The local administration consists of 76 provinces (*Changwat*), with a governor and head officials appointed directly by the Ministry of Interior. These provinces are divided into districts and subdivided into sub-districts.

The structure of local autonomous self-government is a two-tier system of units that are independent from each other. The Constitution required that local administrators and their councils be directly elected. However, they are still placed under the control and supervision of the provincial governors, district officers and ultimately the Minister of the Interior, who retains the authority to approve their annual budget plans and local regulations, dissolve local councils, and dismiss local councillors. There are 7 852 local governments (as of 1 December 2017), shown in Table 10.1. The upper layer of local administration are the Provincial Administrative Organizations (PAOs), which co-ordinates and assists other local governments within each province in delivering public services. Currently there are 76 PAOs. The lower level of local administrative bodies are municipalities and Sub-district/*Tambon* Administrative Organizations (SAOs/TAOs). Municipalities are located in urbanized areas of the province. There are 2 441 municipalities, classified into three categories, *Nakorn* municipalities (30 units), City municipalities (178 units) and Sub-district/*Tambon* municipalities (2 233 units). The rest of the local governments are the 5 333 Sub-district/*Tambon* Administrative Organisations. These are located in more rural and remote areas of the province. In addition, there are two special local units, the Bangkok Metropolitan Administration (BMA) and Pattaya City. Recently, there have been discussions about merging some municipalities and some TAOs together in order to reduce some administrative costs of each local unit and to improve efficiency of local goods and services provision.

Table 10.1. Number of local governments in Thailand

Types	Number
1. PAO	76
2. Municipality	2 441
Nakorn municipality	30
Town municipality	178
Sub-district municipality	2 233
3. TAO	5 333
4. Special local governments	2
(BMA and Pattaya city)	
Total	7 852

Source: Department of Local Administration, Ministry of Interior, 1 December 2017.

The National Decentralisation Committee (NDC)[1] formulates decentralisation policy, sets the guidelines for the devolution of functions and personnel to local governments, designs revenue assignment and intergovernmental transfer formulas, and monitors and evaluates the devolution process and its impacts on local people. The chairperson of the NDC is the Prime Minister or the Vice Prime Minister assigned by the Prime Minister, since a major responsibility of the committee is to reassign functions and revenue from the central government to local governments, which requires executive decision.

The local governments (except BMA and Pattaya city) do not receive their budget directly from the national budget, according to the Budget Procedures Act of 1959. They receive their budget through the Department of Local Administration (DOLA), part of the Ministry of Interior. DOLA is the unit that transfers the budget from the central government to each local government according to a formula provided by the NDC. Moreover, DOLA has duties to follow up with and give technical supports to local governments.

Ideally, the appropriate functions should be devolved from the central government to local governments, though the central government must make sure that local governments also have an appropriate budget to finance their functions. Both central and local governments should work together to respond to the equity, quality and standards of public goods and services which are provided in the area.

10.1.2. Expenditure assignment of Thai local governments

The central government is responsible for national policies, national public goods and services (such as defence, foreign affairs, justice, and police), and standards for devolved functions. Local governments are responsible for local public goods and services (such as education, public health, social security and welfare, infrastructure investment, urban planning, waterways and harbour maintenance, water sewage maintenance, maintaining local order, the stability of communities and society, planning and promoting local commerce and tourism, natural resources and environment management and protection, and promoting or preserving art, culture, and local wisdom).[2] The division of responsibilities between the central government and local governments in Thailand is shown in Table 10.2.

Table 10.2. Expenditure assignment in Thailand

	Central	PAOs	LGs*
Defense	X		
Foreign affairs	X		
Justice	X		
Police	X		
Fire fighting		X	X
Education			
- University	X		
- High school education	X	X	X
- Elementary and secondary education	X	X	X
- Kindergarten			X
Public health			
- Public health curative services	X	X	
- Public health promotion	X	X	X
Social welfare administration	X	X	X
Elderly care and child care Centres		X	X
Infrastructure investment	X	X	X
Urban planning		X	X
Waterways and harbour maintenance		X	X
Water sewage maintenance		X	X
Local order, stability of communities and society		X	X
Planning and promoting of local commerce and tourism		X	X
Natural resources and environment management and protection	X	X	X
Art, culture and local wisdom	X	X	X

Note: * Includes Municipalities, TAO, BMA, and Pattaya City.
Source: The Office of the National Decentralisation Committee, Prime Minister Office.

Devolving functions and public administrative autonomy has been an important issue under the decentralisation plan in Thailand, since public services can be tailored to local preferences. The NDC was charged with deciding which functions3 were to be devolved to local governments, and how much financial support would be allocated to them.

The central government has been mandated to devolve 359 functions[4] from 57 departments under 15 ministries to local governments which covered 6 functional areas:

1. Public infrastructure investment;
2. Improvement of Quality of Life;
3. Order, and Security of Communities and Societies;
4. Planning, Local Investment Promotion, Commerce and Tourism;
5. Conservation and Management of Natural Resources and Environment;
6. Local Culture, Tradition, and Local Wisdom.

At this point, not all functions have been transferred to local governments as mandated (262 functions have been transferred). The delay of the transferring functions is caused by many issues, most notably due to the lack of co-ordination between the related government agencies and local governments. Many local governments now bear the financial burden of paying for functions that have been transferred to local governments, without receiving enough in financial subsidies from the central government to fully fund the functions.

10.1.3. The analysis of local expenditure allocation in Thailand

In this section, the local expenditure allocation in Thailand will be analysed by using real local expenditure from 7 788 local governments (not including BMA) which the local governments reported to DOLA. The calculation in this section may be over or under-estimated due to the incomplete data but this is the only set of local expenditure in Thailand that we currently have.

Most local expenditures (more than 40%) are dedicated to general administration and the central budget. The other two large categories of local expenditures are education (19.6%) and housing and community amenities (18.23%) as shown in Table 10.3 and Figure 10.1. The functions which local governments spent less than one percent of their budget are agriculture, commerce and social work.

Table 10.3. Percentage distribution of total local expenditure by functions: 2017

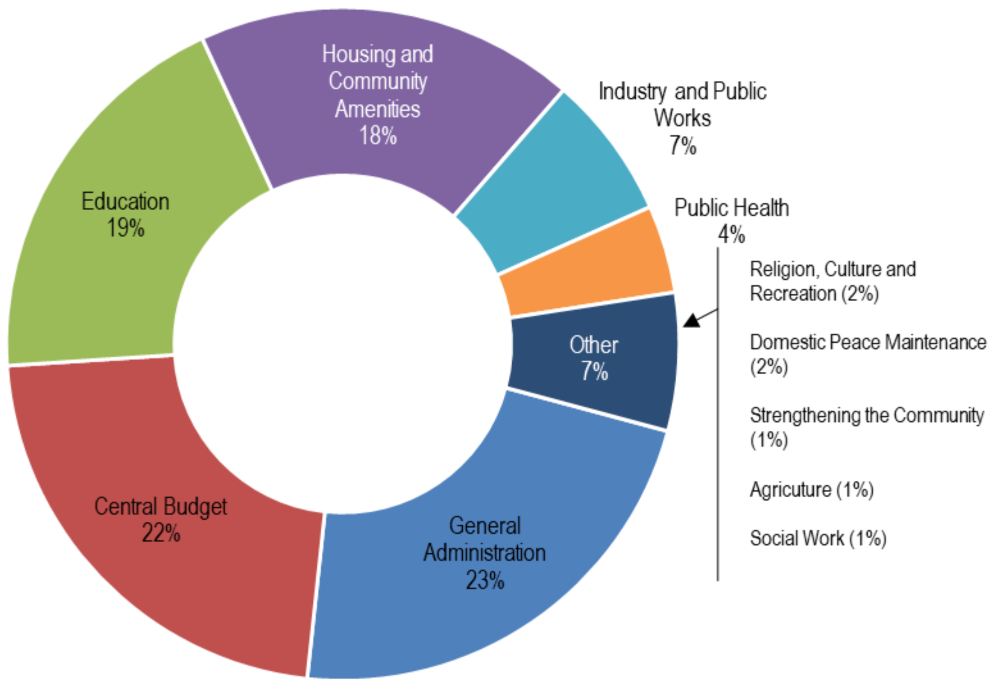
Functions	Percentage Share
1. General administration	22.65
2. Education	19.16
3. Public health	4.17
4. Agriculture	0.63
5. Industry and public works	6.79
6. Commerce	0.75
7. Strengthening the community	1.13
8. Housing and community amenities	18.23
9. Social work	0.84
10. Domestic peace maintenance	1.75
11. Religion, culture and recreation	1.53
12. Central budgeting	22.37
Total Local Expenditure	100.00

Note: Calculated for 7 788 local governments, BMA is not included.
Source: DOLA and calculations by the author.

For the country as a whole, the functions which comprise the most unequal distribution of expenditure per capita are agriculture, domestic peace maintaining, and commerce. The functions where there is the least unequal distribution of expenditure per capita are central budget, general administration, and education.

For PAOs, the functions with the most unequal distribution of expenditure per capita are social work, domestic peace maintenance, and agriculture. The functions with the least unequal distribution of expenditure per capita are general administration, central budget, and public health.

Figure 10.1. Percentage distribution of total local expenditure by functions (2017)



Source: DOLA and calculations by the author.

For municipalities, the functions with the most unequal distribution of expenditure per capita are agriculture, commerce, strengthening the community and social work. The functions with the least unequal distribution of expenditure per capita are central budget, general administration, and housing and community amenities.

For TAOs, the functions with the most unequal distribution of expenditure per capita are agriculture, public health, and domestic peace maintaining. The functions with the least unequal distribution of expenditure per capita are central budget, general administration, and education.

In summary, the functions which have the most unequal distribution of local expenditure per capita in common among local governments are agriculture, domestic peace maintenance and commerce. These may be a result from the different economic structure and social condition among jurisdictions so the local governments allocate their budget by different amount according to their structure and condition. The functions that have the least unequal distribution of local expenditure per capita in common among local governments are general administration, central budget and education. That means for these three functions, each jurisdiction does not allocate their budget that much different.

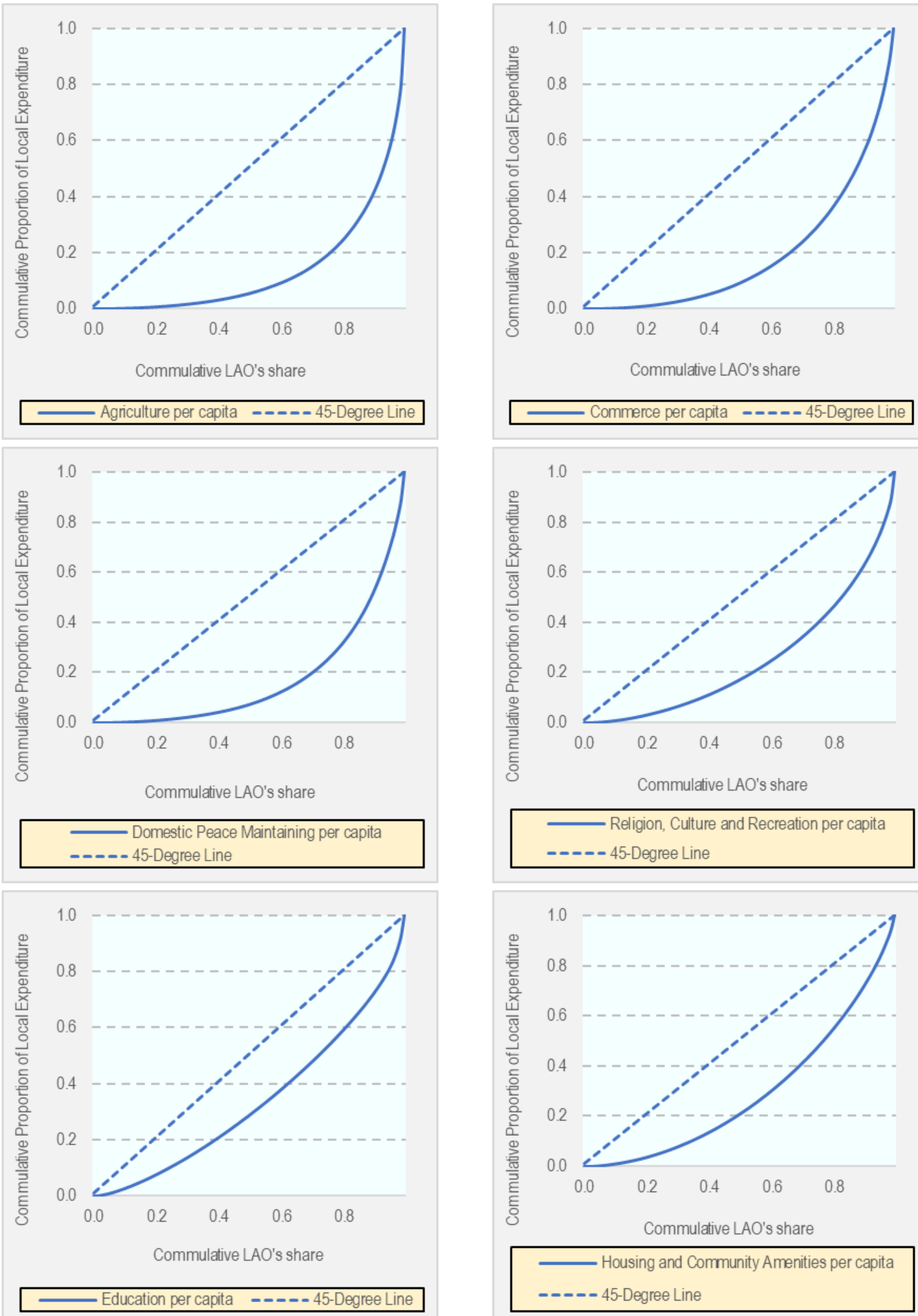
The Gini coefficient of per capita total local expenditure for the whole country is 0.21, which is not that much different from each type of local governments which are range between 0.16 and 0.23. It means that the distribution of per capita total local expenditure among jurisdictions are not particularly unequal. The Gini coefficients of local expenditure for each function are shown in Table 10.4 and the Lorenz curves of local expenditure for each function are shown in Figure 10.2.

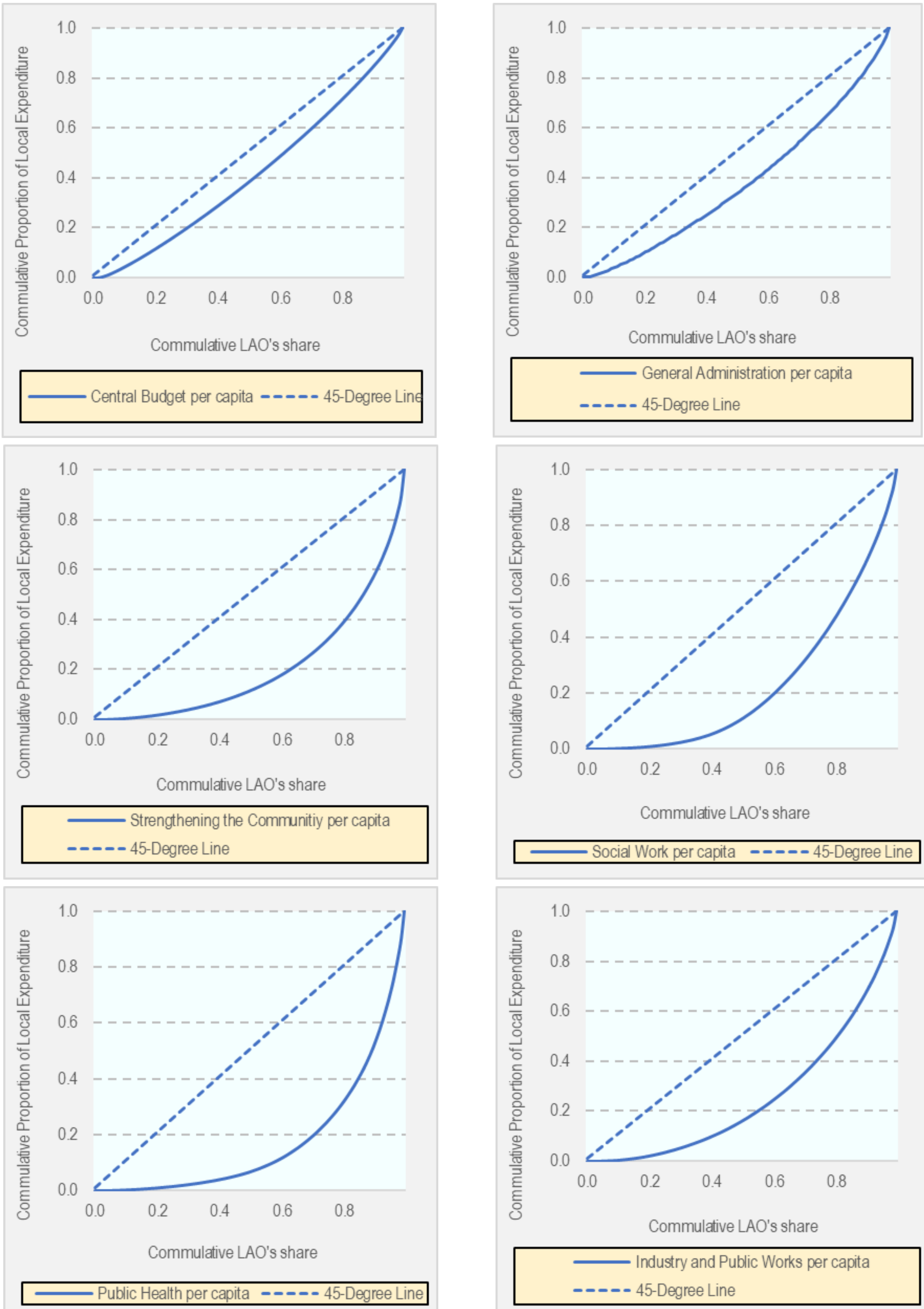
Table 10.4. Gini coefficients of local expenditure appropriation in Thailand classified by functions (2017)

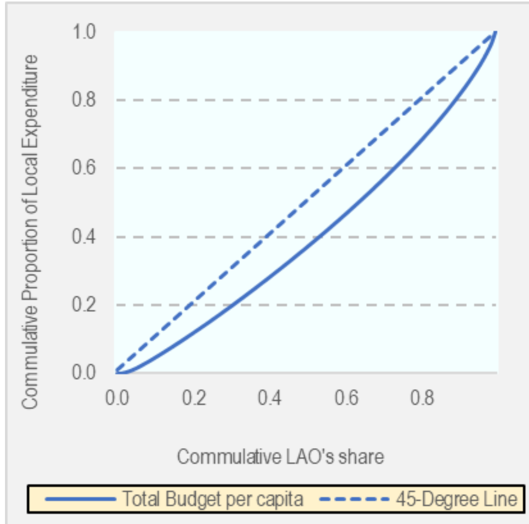
	Functions												
	Agriculture	Commerce	Domestic peace maintenance	Religion, culture and recreation	Education	Housing and community amenities	Central budget	General administration	Strengthening the community	Social work	Public health	Industry and public works	Total budget
Whole Kingdom													
Expenditure	0.80	0.63	0.74	0.73	0.58	0.57	0.38	0.29	0.77	0.65	0.84	0.66	0.43
Expenditure per capita	0.73	0.63	0.66	0.51	0.34	0.43	0.18	0.25	0.59	0.55	0.66	0.50	0.21
PAO													
Expenditure	0.68	0.49	0.74	0.56	0.68	0.65	0.52	0.32	0.67	0.81	0.48	0.49	0.36
Expenditure per capita	0.63	0.46	0.69	0.50	0.55	0.60	0.37	0.28	0.61	0.79	0.37	0.45	0.20
Municipality													
Expenditure	0.73	0.66	0.64	0.67	0.63	0.59	0.45	0.29	0.69	0.64	0.66	0.56	0.45
Expenditure per capita	0.70	0.66	0.54	0.53	0.41	0.39	0.18	0.28	0.57	0.57	0.53	0.51	0.23
TAO													
Expenditure	0.73	0.61	0.66	0.50	0.36	0.47	0.27	0.18	0.59	0.53	0.70	0.51	0.25
Expenditure per capita	0.73	0.60	0.62	0.48	0.24	0.44	0.16	0.22	0.57	0.53	0.63	0.48	0.16

Note: Gini coefficient calculation does not count the samples which have zero expenditure in each function.
Source: DOLA and calculations by the author.

Figure 10.2. Lorenz curves of local expenditure appropriation in Thailand classified by functions (2017)




Commulative Proportion of Local Expenditure
Commulative LAO's share
Central Budget per capita
45-Degree Line
General Administration per capita
45-Degree Line
Strengthening the Communitiy per capita
45-Degree Line
Social Work per capita
45-Degree Line
Public Health per capita
45-Degree Line
Industry and Public Works per capita
45-Degree Line
0.0
0.2
0.4
0.6
0.8
1.0



Source: DOLA and calculations by the author.

For the country as a whole, the three largest areas of average local expenditure per capita are allocated to general administration, central budget and housing and community amenities. The three smallest average local expenditure per capita are allocated to agriculture, social work, and strengthening the community.

- For PAOs, the largest average local expenditure per capita are allocated to general administration, industry and public works, and education. The smallest average local expenditure per capita are allocated to commerce, domestic peace maintaining, and agriculture.
- For Nakorn municipalities, the largest average local expenditure per capita are allocated to education, housing and community amenities, and central budget. The smallest average local expenditure per capita are allocated to agriculture, commerce, and social work.
- For City municipalities, the largest average local expenditure per capita are allocated to education, central budget, and housing and community amenities. The smallest average local expenditure per capita are allocated to agriculture, social work, and commerce.
- For sub-district municipalities, the largest average local expenditure per capita are allocated to general administration, central budget, and education. The smallest average local expenditure per capita are allocated to agriculture, social work, and commerce.
- For TAOs, the largest average local expenditure per capita are allocated to general administration, central budget, and housing and community amenities. The smallest average local expenditure per capita are allocated to strengthening the community, agriculture, and social work.

The result of this analysis shows that education is among the top three per capita expenditure for PAO and all types of municipality. The expenditure per capita is high in general administration and central budget while the expenditure per capita is low in agriculture, social work, commerce, strengthening the community.

Pattaya city has the highest total expenditure per capita, which is 26 139 THB. The average total expenditure per capita for City municipality, Nakorn municipality, sub-district municipality, TAO, and PAO are 9 574, 9 366, 7 553, 5 771, and 827 THB, respectively. The average local expenditure per capita in Thailand in 2017 are shown in Table 10.5.

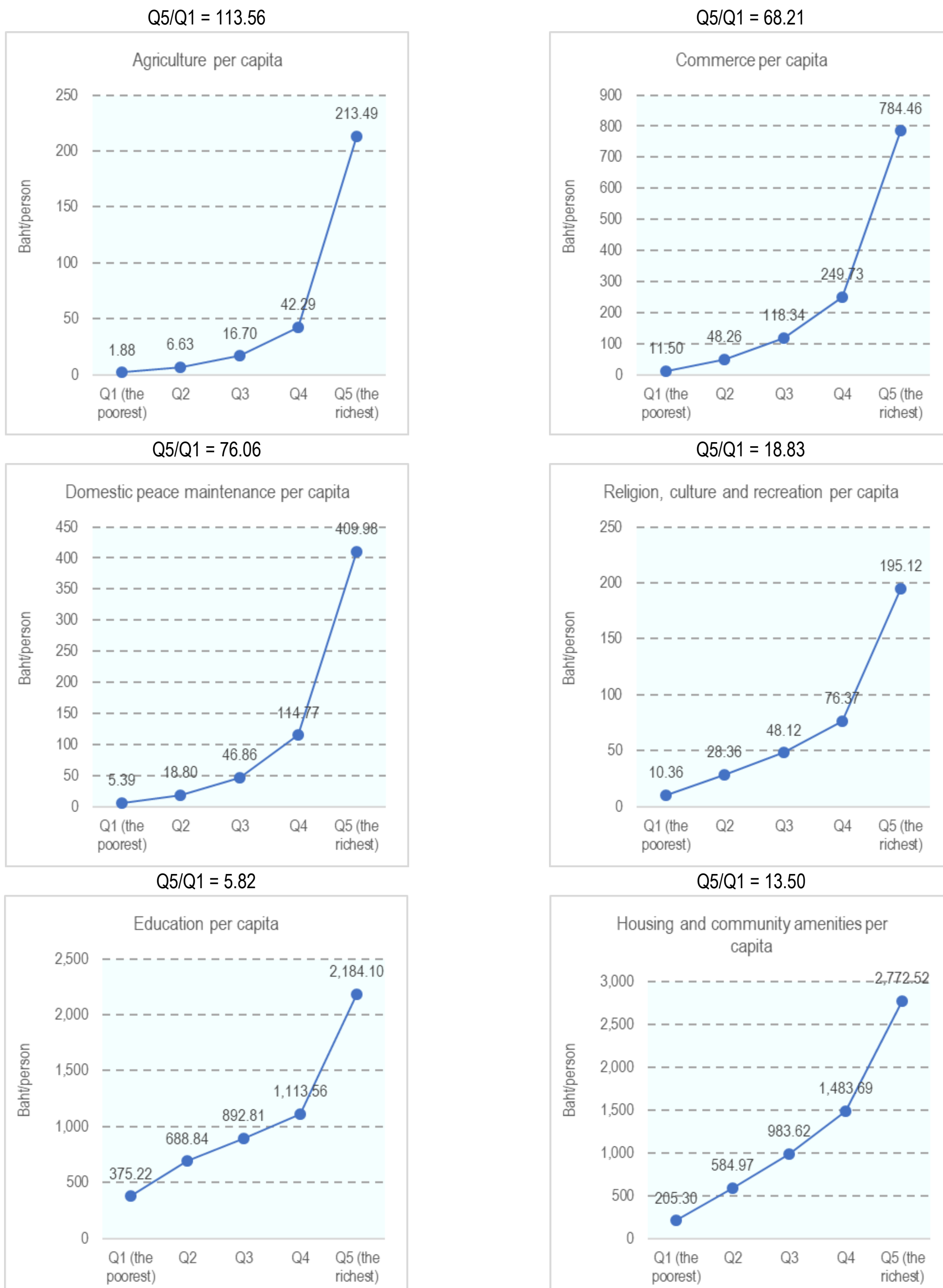
Figure 10.3 show that when the average local expenditure per capita for each function are ranked by quintiles, the top three highest differences between the 5th quintile (the highest expenditure) and the 1st quintile (the smallest expenditure) are agriculture, domestic peace maintenance, and public health, respectively. The least three smallest differences between the 5th quintile and the 1st quintile are central budget, general administration, and education, respectively. The difference between the 5th quintile and the 1st quintile of the total budget per capita are a ratio of 2.88, which is not significantly different.

Table 10.5. Average local expenditure per capita in Thailand classified by functions (2017)

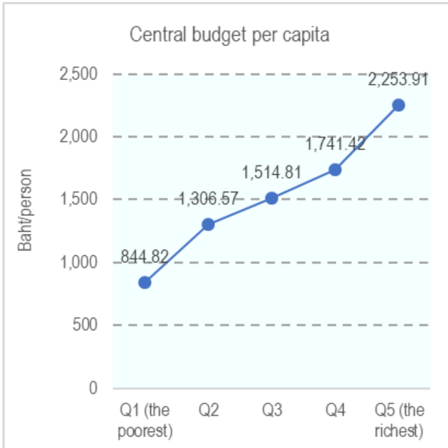
	Functions/Budget per capita												
	Agriculture	Commerce	Domestic peace maintenance	Religion, culture and recreation	Education	Housing and community amenities	Central budget	General administration	Strengthening the community	Social work	Public health	Industry and public works	**Total budget**
Provincial administrative organisation	12.65	0.10	3.21	35.85	134.90	119.01	62.42	157.33	24.38	10.54	110.16	156.94	**827.50**
Municipality	22.53	63.91	226.47	93.35	1 463.76	1 322.51	1 743.75	2 010.62	74.78	46.93	331.25	322.82	**7 722.69**
- Nakorn municipality	4.77	26.64	268.05	165.15	3 168.79	1 978.14	1 867.15	1 047.97	94.85	54.17	465.75	225.13	**9 366.56**
- City municipality	1.42	54.97	324.53	146.10	3 163.01	1 630.27	2 013.64	1 390.45	135.15	46.20	441.71	227.18	**9 574.64**
- Sub-district municipality	24.45	65.12	218.10	88.19	1 305.47	1 289.19	1 720.58	2 072.97	69.70	46.89	320.65	331.75	**7 553.06**
Tambon administrative organisation	43.89	65.10	55.29	56.73	852.40	1 120.15	1 430.16	1 617.14	40.64	49.20	72.04	368.30	**5 771.03**
Pattaya city	0.00	0.00	2 086.19	814.42	4 689.50	4 898.89	1 522.99	1 537.41	72.43	85.04	3 876.36	6 556.10	**26 139.32**
Total	36.94	64.09	108.28	68.01	1 036.08	1 173.87	1 514.46	1 725.38	51.10	48.13	153.51	352.90	**6 332.75**

Source: DOLA and calculations by the author.

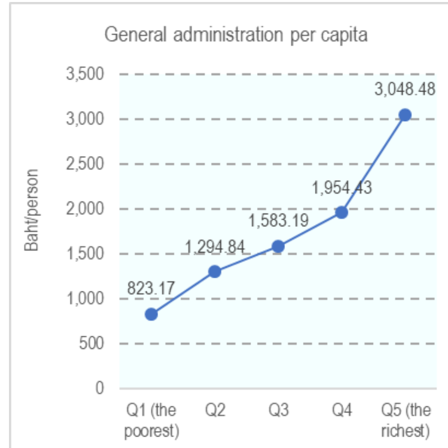
Figure 10.3. Average local expenditure per capita by quintiles in Thailand



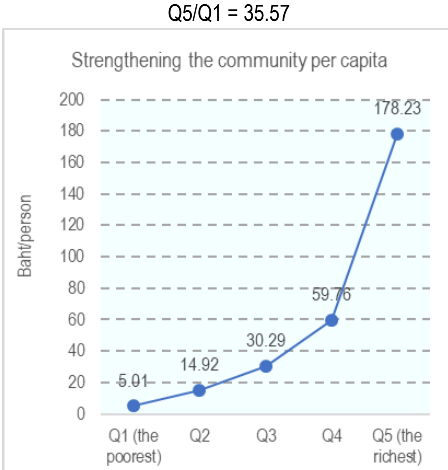
Q5/Q1 = 2.67



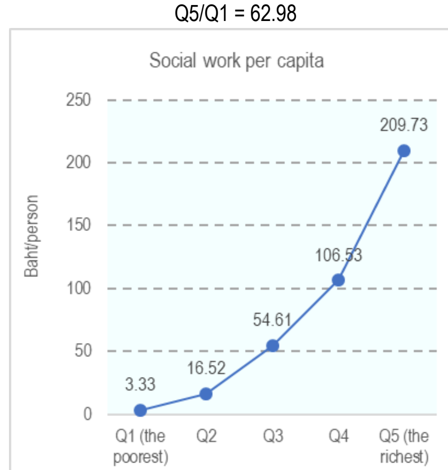
Q5/Q1 = 3.70



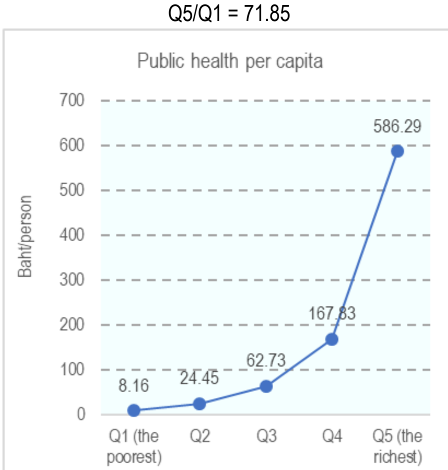
Q5/Q1 = 35.57



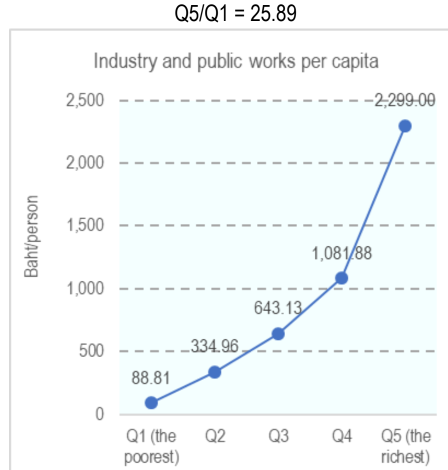
Q5/Q1 = 62.98



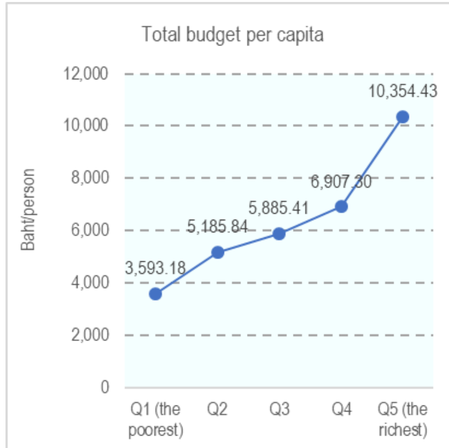
Q5/Q1 = 71.85



Q5/Q1 = 25.89



Q5/Q1 = 2.88



Source: DOLA and calculations by the author.

10.1.4. Revenue assignment of Thai local governments

Thailand applies a "revenue sharing approach" in reallocating revenue from the central government to local governments, which ensures continuity of revenue received by local governments. This helps balance local revenue and expenditure for functions of the local governments. How the revenue is allocated among the different jurisdictions is determined by a formula that captures the differences in economic conditions and fiscal needs of each jurisdiction. This will theoretically reduce the fiscal disparity among local governments and improve the quality of life in each jurisdiction.

The sources of local government revenue in Thailand can be specified into four main sources. First, locally levied revenue, which includes both taxes and non-taxes. Locally levied taxes include building and land taxes, local development taxes, signboard taxes, animal slaughter taxes, bird nest collection taxes, a retail tax on the sale of cigarettes, tobacco and gasoline[5] and hotel rental taxes[6]. Locally levied non-tax revenue includes fees, fines and permission charges, revenue from property, revenue from public utility provision and a few other small sources of revenue. The second major source of revenue is centrally levied revenue that is reallocated to local governments includes the value added tax (VAT)[7], specific business taxes, alcohol and beer taxes, excise taxes, motor vehicle taxes and fees, property registration fees, gambling fees, mineral fees, petroleum fees and miscellaneous revenue[8]. Third, a share of the tax, which is collected under the value added tax, as specified under the Decentralisation Plan and Process Act. Fourth and finally, there are general and specific grants made by the central government, for various purposes.

The Decentralisation Plan and Process Act of 1999 set up two main principles for allocating revenue to local governments. First, if local governments get insufficient funds for their functions, from their locally levied revenue and centrally levied revenue (which is reallocated to local governments), the share of VAT specified under Decentralisation Plan and Process Act and government grants will equalise the revenue of each local government. Secondly, allocating revenue would also be based on the sources of these revenues. However, in practice, due to lack of information, the best that we can do is to reallocate the revenue back to that province. Within the same province, the reallocation is based on the size of the population local government represents, not on where the revenue is actually created or collected.

Table 10.6 shows the structure of the revenue of the local governments. From 2009-2018, the share of locally levied tax revenue is quite low (around 10%). The share of centrally levied revenue, which is reallocated to local governments, and shared taxes, are around 50%. Local revenue relies on government grants for up to 40% of total local revenue. The proportion of local revenue to total government revenue has been increased from 25.8% in 2009 to 29.4% in 2018. The share of local revenue to gross domestic product is 4.6% and the share of locally levied revenue to gross domestic product is just 0.5% in 2017.

The central government assigns revenue to local government based on the Decentralisation Plan and Process Act of 1999 and the preceding laws. Each type of local government has different sources of revenue (Table 10.7) depending on the economic structures, the objectives of administration, the responsibility of public service provision and the political realities at both the central and local levels.

The local governments in Thailand have only limited power to raise their own tax revenues. Both central government and local governments are reluctant to impose politically unpopular new taxes. That is why Thailand does not have an actual property tax, even after it has been under discussion for more than 20 years, it is still in process in parliament today.

Table 10.6. Structure of the revenue of local governments, 2009-2018

Unit: Million THB

Type of revenue	Budget year				
	2009	2010	2011	2012	2013
1. Locally Levied Revenue	38,745.96	29,110.41	38,745.96	46,529.72	50,281.54
(%)	(9.35)	(8.54)	(8.99)	(8.78)	(8.78)
2. Centrally levied revenue that is reallocated to local governments	140,679.27	126,589.59	148,109.04	175,457.28	187,988.46
(%)	(33.95)	(37.12)	(34.34)	(33.10)	(32.83)
3. Shared tax	71,900.00	45,400.00	70,500.00	86,900.00	97,900.00
(%)	(17.35)	(13.31)	(16.35)	(16.40)	(17.10)
4. Grants	163,057.00	139,895.18	173,900.00	221,091.79	236,500.00
(%)	(39.35)	(41.03)	(40.32)	(41.72)	(41.30)
Total local revenue	**414,382.23**	**340,995.18**	**431,255.00**	**529,978.79**	**572,670.00**
(%)	**(100.00)**	**(100.00)**	**(100.00)**	**(100.00)**	**(100.00)**
Total government revenue	1,604,640.00	1,350,000.00	1,650,000.00	1,980,000.00	2,100,000.00
Proportion of local revenue to total government revenue	**25.82**	**25.26**	**26.14**	**26.77**	**27.27**

Type of revenue	Budget year				
	2014	2015	2016	2017	2018
1. Locally levied revenue	56 306.25	61 458.00	70 000.00	112 000.00*	112 000.00*
(%)	(9.04)	(9.51)	(10.67)	(16.28)	(15.54)
2. Centrally levied revenue that is reallocated to local governments	203 818.75	218 222.00	218 940.00	218 800.00	229 900.00
(%)	(32.74)	(33.76)	(33.36)	(31.81)	(31.89)
3. Shared tax	109 000.00	109 000.00	109 000.00	111 000.00	115 000.00
(%)	(17.51)	(16.86)	(16.61)	(16.14)	(15.95)
4. Grants	253 500.00	257 663.78	258 298.60	246 091.62	263 922.04
(%)	(40.71)	(39.86)	(39.36)	(35.77)	(36.61)
Total local revenue	**622 625.00**	**646 343.78**	**656 238.60**	**687 891.62**	**720 822.04**
(%)	**(100.00)**	**(100.00)**	**(100.00)**	**(100.00)**	**(100.00)**
Total government revenue	2 275 000.00	2 325 000.00	2 330 000.00	2 343 000.00	2 450 000.00
Proportion of local revenue to total government revenue	**27.37**	**27.80**	**28.16**	**28.99**	**29.42**

Note: * The new land and building tax bill has not yet been agreed on, so the government has to allocate more revenue to local governments in order to keep the same proportion of local revenue to total government revenue as approved by the cabinet.
The data in this table is estimated local revenue.
Source: The Office of the National Decentralisation Committee, Prime Minister Office

10.1.5. Analysis of local government revenue allocation in Thailand

In 2017, the local governments collected eight percent of the money they had in their budgets themselves, from local sources of revenue. Shared revenue (in this section, shared revenue also includes centrally levied revenue which is reallocated to the local governments) and grants, at 47% and 45% respectively, accounted for the vast majority of total local government revenue, as shown in Figure 10.4. The result shows that Thai local governments have low autonomy in collecting their own revenue.

Table 10.7. Structure of local government revenue in Thailand

Type of revenue	PAO	Municipality	TAO	BMA	Pattaya city
1. Locally levied revenue					
1.1 Locally levied tax					
Building and land tax		√	√	√	√
Local development tax		√	√	√	√
Signboard tax		√	√	√	√
Animal slaughter tax		√	√		
Bird nest collection tax		√	√		
Retail sale of cigarettes, tobacco, gasoline and hotel rental tax[1]	√			*	
1.2 Locally levied non-tax					
Fee, fine and permission charge	√	√	√	√	√
Revenue from property	√	√	√	√	√
Revenue from public utility	√	√	√	√	√
Miscellaneous revenue	√	√	√	√	√
2. Centrally levied revenue allocated to local governments					
Value added tax[2]		√	√	√	√
Specific business tax		√	√	√	√
Alcohol and beer tax		√	√	√	√

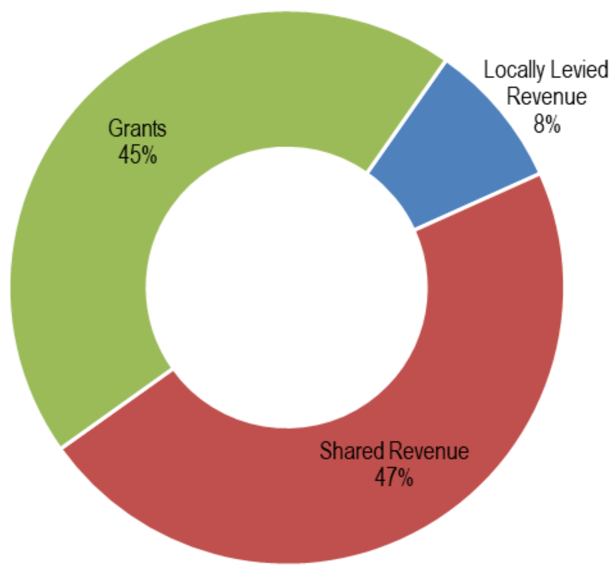
Type of revenue	PAO	Municipality	TAO	BMA	Pattaya city
Excise tax		√	√	√	√
Motor vehicle tax and fee	√			√	
Property registration fee		√	√	√	√
Gambling tax		√	√	√	√
Mineral fee	√	√	√	√	√
Petroleum fee	√	√	√	√	√
Miscellaneous[3]			√		
3. Shared Tax					
Value added tax under Decentralisation Plan and Process Act	√	√	√	√	√
4. Grants					
General grants	√	√	√	√	√
Specific grants	√	√	√	√	√

1. Only PAOs can receive these taxes, except hotel rental tax, which BMA can also levy.
2. The local government will get 1/9 of VAT that the government can collect according to the value added tax and specific tax allocation to local governments act, 1991, the Pattaya City Act and Provincial Administrative Organisation Act.
3. Including revenue from national park act, forestry fee, under-ground water fee and fishing fee.
Source: The Office of the National Decentralisation Committee, Prime Minister Office.

Table 10.8 and Figure 10.5 and Figure 10.6 show that locally levied revenue has the widest disparity of revenue among local governments because of a wide range of economic structures in each jurisdiction, which determine the ability to collect revenue from each jurisdiction. After allocated shared revenue, the disparity of revenue received at the local level is reduced. The disparity has been reduced even more after the local governments received grants from the central government. This analysis suggests that the shared revenue and grants are good instruments to reduce the disparity of local governments' revenue.

Pattaya city has the highest local revenue per capita (31 496 THB). The average local revenue per capita for Nakorn municipalities, City municipalities, sub-district municipalities, TAOs, and PAOs are 11 539, 11 496, 8 607, 6 511, and 1 137 THB, respectively. The average local expenditures per capita in Thailand in 2017 are shown in Table 10.9.

Figure 10.4. Proportion of each type of local revenue in Thailand (2017)



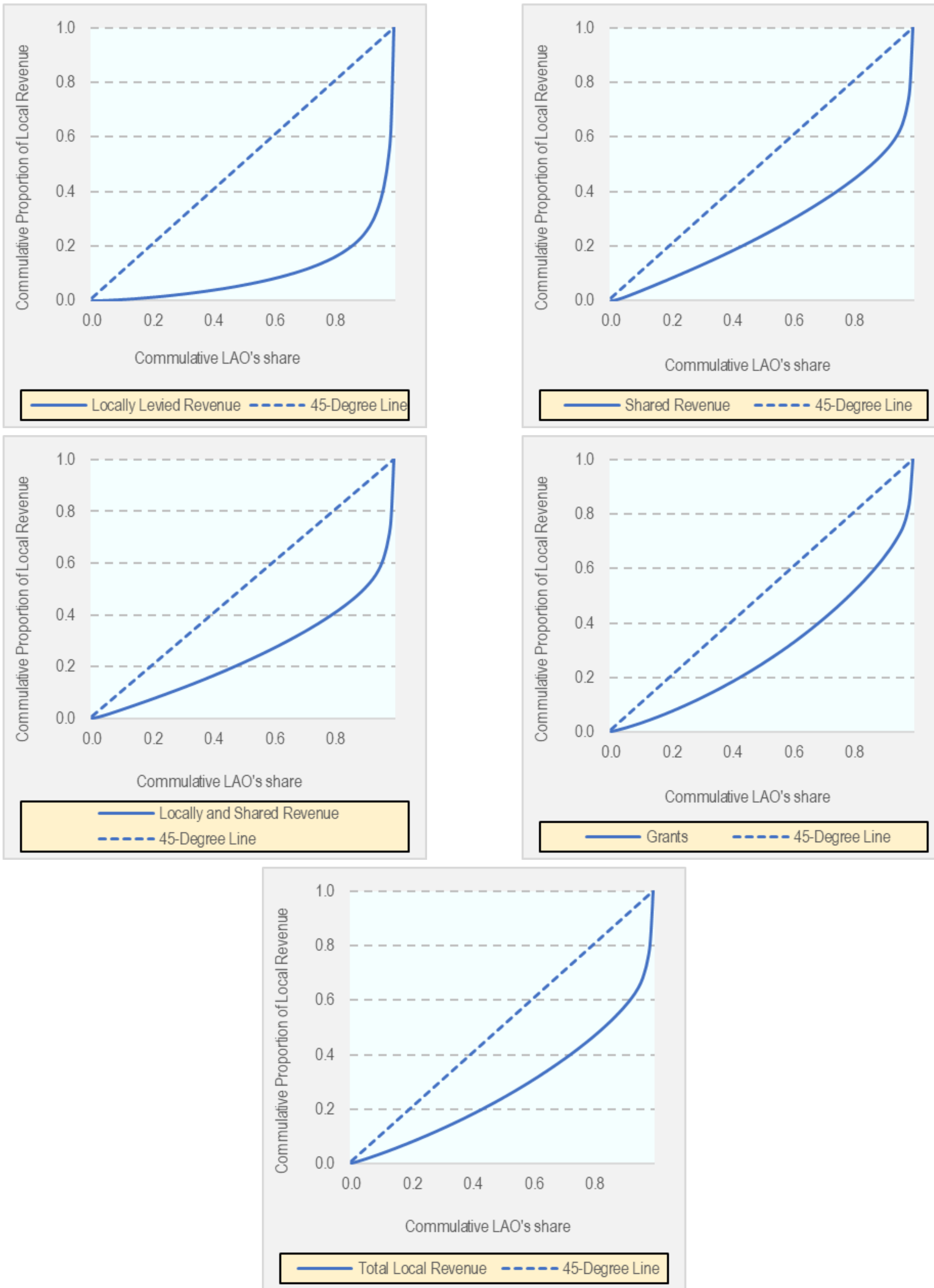
Source: DOLA and calculations by the author.

Table 10.8. Gini coefficients of local revenue allocation in Thailand classified by type of local revenue and local governments (2017)

	Types of revenue 2017				
	Locally levied revenue	Shared revenue	Locally levied revenue + shared revenue	Grants	Total revenue
Whole Kingdom					
Revenue	0.80	0.47	0.51	0.41	0.45
Revenue per capita	0.62	0.24	0.27	0.19	0.19
PAO					
Revenue	0.48	0.42	0.42	0.41	0.38
Revenue per capita	0.42	0.28	0.29	0.23	0.22
Municipality					
Revenue	0.78	0.48	0.53	0.45	0.48
Revenue per capita	0.56	0.26	0.28	0.23	0.23
TAO					
Revenue	0.66	0.22	0.26	0.27	0.24
Revenue per capita	0.60	0.20	0.22	0.14	0.14

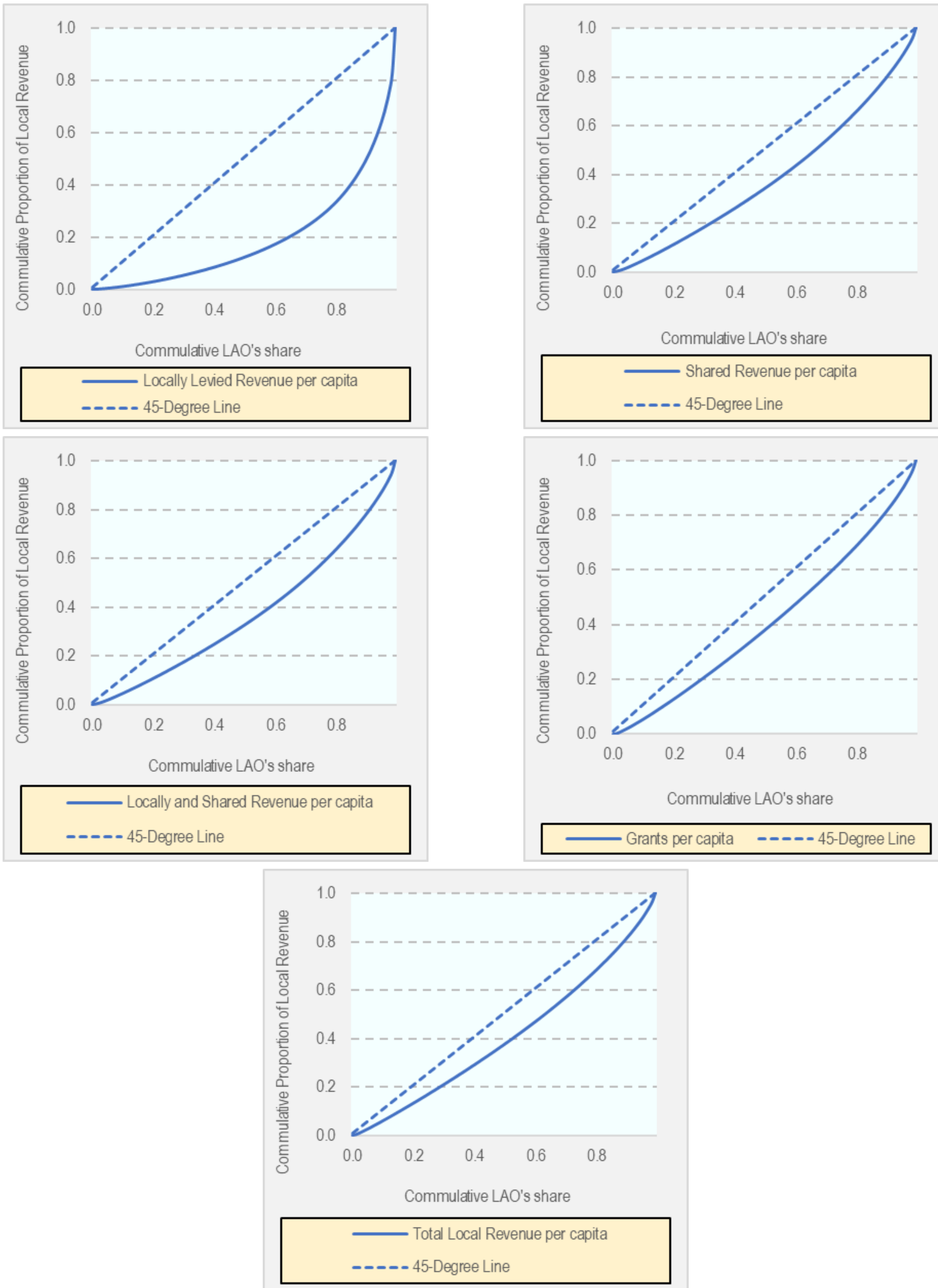
Source: DOLA and calculations by the author.

Figure 10.5. Lorenz curves of local revenue allocation in Thailand classified by type of local revenue (2017)



Source: DOLA and calculations by the author.

Figure 10.6. Lorenz curves of local revenue per capita in Thailand classified by type of local revenue (2017)



Source: DOLA and calculations by the author.

Table 10.9. Average local revenue per capita in Thailand classified by type of local revenue and local governments (2017)

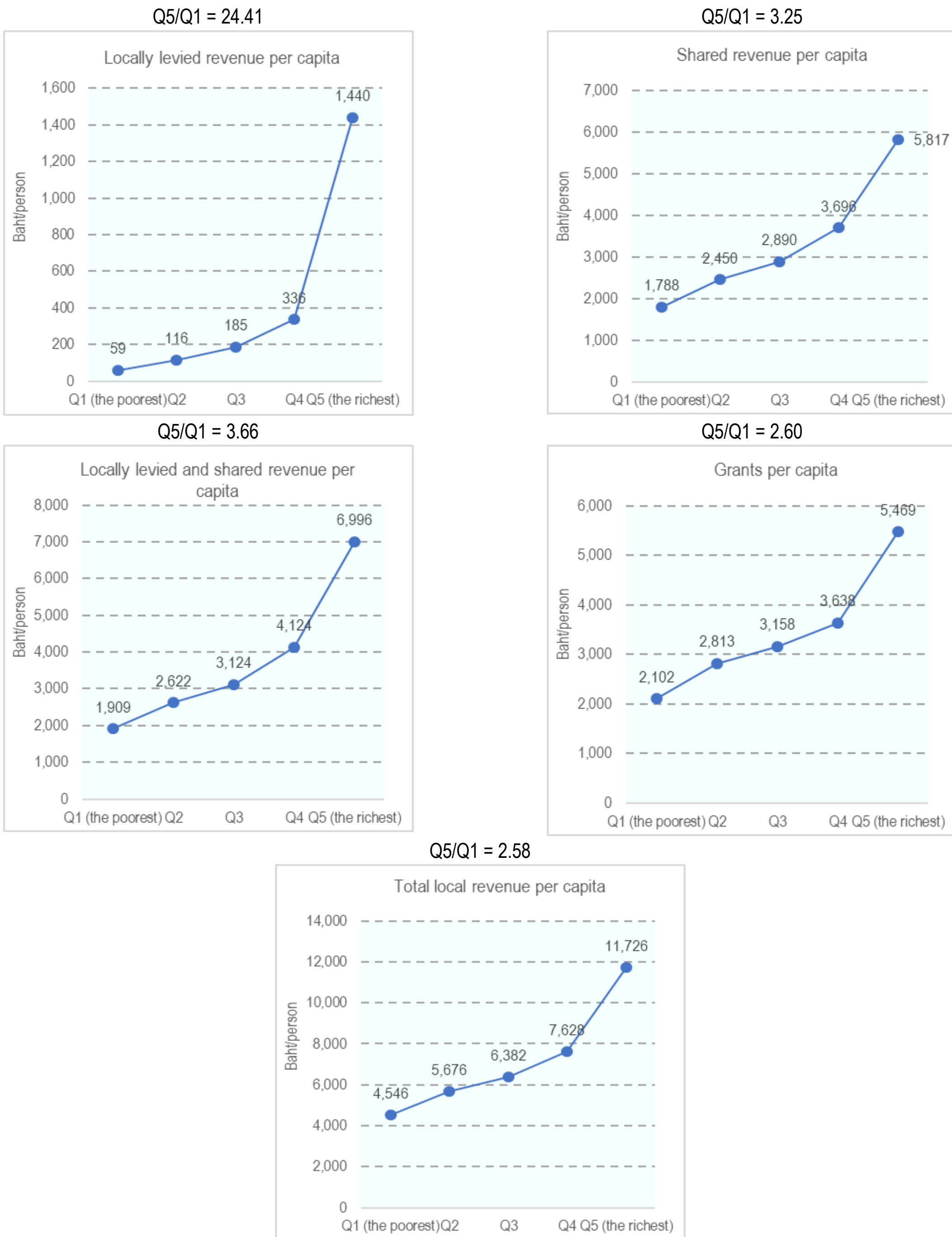
Unit: THB

Type of local governments	Locally levied revenue per capita	Shared revenue per capita	Locally and shared revenue per capita	Grants per capita	Total local revenue per capita
Provincial administrative organisation	109	695	804	333	1 137
Municipality	698	4 031	4 729	4 125	8 854
Nakorn municipality	2 212	4 724	6 935	4 604	11 539
City municipality	1 532	4 548	6 080	5 416	11 496
Sub-district municipality	611	3 980	4 591	4 016	8 607
Tambon administrative organisation	306	3 042	3 348	3 163	6 511
Pattaya city	6 195	13 147	19 342	12 154	31 496
Total	427	3 328	3 755	3 436	7 191

Source: DOLA and calculations by the author.

Figure 10.7 shows that the difference between the 5th quintile (the highest revenue) and the 1st quintile (the smallest revenue) of locally levied revenue varies by a factor of 24.4. After allocated shared revenue and grants to local governments, the difference between the 5th quintile and the 1st quintile of total local revenue has been reduced to 2.6 times. This also confirms that the shared revenue and grants are good instruments to reduce the disparity of local governments' revenue.

Figure 10.7. Average local revenue per capita by quintiles in Thailand



Source: DOLA and calculations by the author.

10.1.6. Local government debt in Thailand

The cabinet approved a new draft rule for local government borrowing from financial institutions in March 2018, it has been implemented since 19 April 2018.[9] The main idea is that the local governments may borrow money from financial institutions to spend for three main objectives: investment projects, debt restructuring, and revolving funds (allowed only for local governments' pawnshops). In general, the debt service ratio must be not exceeded 10% of local government revenue (calculated by using a three-year moving average of revenue data). The local governments that would like to borrow money must have financial plans, standard accounting system, internal monitoring system, and a financial management and repayment system.

The local government debt in Thailand has been decreasing since 2013. In 2017, Thailand has THB 31 421.39 million in local government debt, which accounted for 0.21% of gross domestic product (Table 10.10). The central government does not guarantee these loans so local governments have to take responsibility to their debt by themselves.

Table 10.10. Local government debt in Thailand: 2012-2017

Unit: Million THB

	2012	2013	2014	2015	2016	2017
Debt	35 626.42	39 254.64	37 577.25	34 650.88	33 208.33	31 421.39
Debt/GDP (%)	0.33	0.33	0.31	0.26	0.24	0.21

Source: The Public Debt Management Office

10.1.7. Fiscal decentralisation: challenges for inclusive growth

This study shows that the functions that have the most unequal distribution of local expenditure per capita among local governments are agriculture, domestic peace maintenance and commerce. The local governments allocate their budget differently because of the differences in their economic structure and social condition. General administration, central budget and education have the least unequal distribution of local expenditure per capita.

Education spending is among the top three per capita expenditure for PAOs and all types of municipalities. General administration and central budget functions also have high expenditure per capita, while agriculture, social work, commerce and strengthening the community have low expenditure per capita. The average local expenditure per capita for the whole country is 6 333 THB (not including BMA).

Thai local governments have low autonomy in collecting their own revenue, collecting only about eight percent of their budgets themselves. This study suggests that the shared revenue and grants are good instruments to reduce the disparity of local governments' revenue. The average local revenue per capita for the whole country is 7 191 THB (not including BMA).

Thailand should have clear criteria on the division of responsibilities between the national government and local governments, and among local governments. The functions should be defined clearly, clarifying which functions are solely provided by the central government and which functions should be jointly provided by the central government and local governments. For transferred functions, the new roles of government units at regional level should be assigned. The local governments should build partnership with central government units or the other local governments for large investment projects.

The current formula for allocating revenue to local government is primarily based on the population and area of jurisdiction, which does not capture all the fiscal needs in each jurisdiction. Thailand should redesign the revenue assignment system and formula to reflect the real costs of the functions of the local governments, and should include fiscal equalisation criteria in the inter-governmental transfer formula. This will reduce the fiscal gap of each local government and promote fiscal equity among local governments, ensuring both vertical and horizontal equity.

The proportion of locally levied revenue of local governments in Thailand is extremely low. Currently, Thailand is attempting to issue a new Land and Building Tax Bill to replace two old tax bills (the Local Development Tax Bill and the Building and Land Tax Bill). If this new Land and Building Tax Bill is designed properly, it will increase locally levied revenue and promote fiscal decentralisation. This new tax would be a good source of revenue for promoting growth and equity in each jurisdiction. Monitoring and evaluating the impact of decentralisation is also needed in order to know the impact on quality of the services and the accessibility to the services of people in the area.

Notes

1. The structure of the NDC is composed of central government's staffs from related ministries such as the Ministry of Interior, Ministry of Finance, Ministry of Education, etc. The others are representatives of local governments, and experts on decentralisation that are mostly from academic institutions.

2. Both central government and local governments are responsible for some of the functions (such as education, public health, social security and welfare, infrastructure investment, natural resources and environment management and protection, and art, culture and local wisdom).

3. The Decentralisation Plan and Process Act of 1999 and 2006 determined guidelines and details of the transferred functions.

4. 245 functions are under the first Decentralisation Action Plan, 2002, and the other 44 functions are under the second Decentralisation Action Plan, 2008.

5. The revenue sources for PAO only.

6. The revenue source for the PAO and the BMA.

7. The local government will get 1/9 of VAT that the government can collect according to the value added tax and specific tax allocation to local governments act, 1991, the Pattaya city act and provincial administrative organization act.

8. Including revenue from the national park act, forestry fee, under-ground water fee and fishing fee.

9. The State Financial and Fiscal Discipline Act, 2018.

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OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
ISBN 978-92-64-46995-2 – 2019

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