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Abstract
In South and East Asian countries a highly centralized government prevails, although recently some trends are moving toward a greater degree of decentralization. Also the two giants China and India, which cannot rely on a merely centralized Government, have experienced a greater or lesser degree of fiscal unionism. As to China the local government system provides four levels: provincial level; city level; county level; township level. Intergovernmental fiscal relations were revamped by the 1994 reform that established a new tax sharing system and gave local governments more control over the administration of local taxes but no significant degree of tax autonomy and no substantial expenditure assignments. The local financial revenue mainly derives from local taxes, shared taxes, and non-tax revenue. As to India, the federal system is quite complex. The center-states relations are envisaged in the Constitution also for the financial aspects: two constitutional amendments adopted in 1992 made India one of the most politically decentralized countries among developing ones. However, the implementation of the decentralization program is still lagging: till now India seems to have considered decentralization mainly in terms of the local election system, without the transfer of all functions provided for devolution to local bodies. Only India set up a different system of local bodies in rural and urban areas with different expenditure responsibilities and financing powers. On the contrary, China has a unitary fiscal system. In India it is necessary to redesign the transfer system to improve accountability, incentives and equity, whereas in China, the fiscal revenue sharing schemes limit intergovernmental budget transfers. Finally, the rule of hard budget constraint in China is faced by all levels of government, while in India sub-national governments face soft budget constraint.

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1. Introduction

China and India are the two biggest developing countries in South-East Asia. Although different as to their historical, institutional and cultural developments, these enormous countries cannot rely on a merely centralized Government, due to the extension and the striking existing differences among their regions, more than once populated by some hundred million people. Therefore, both the countries share a greater or lesser degree of fiscal federalism or, better, of fiscal unionism. We compare the different institutional arrangements of fiscal decentralization in China and in India, focusing on the financing (own resources, share to central taxes, grants, equalization systems) of sub-national layers. The two countries have different typology of decentralization. As to China the local government system provides four levels: provincial level, which is the highest local level and includes provincial, autonomous regions and municipal governments; city level, which includes cities under the jurisdiction of the provinces, autonomous prefectures and districts under the jurisdiction of municipal governments; county level, which includes autonomous counties, counties and towns; township level, which is the lowest level and includes towns and villages. Intergovernmental fiscal relations were revamped by the 1994 reform that established a new tax sharing system that fundamentally changed the apportionment of tax revenue between the central and provincial governments. The local financial revenue mainly derives from local taxes (such as business tax, personal income tax, tax on the use of urban land, tax on real estates, tax on agriculture and special agriculture products, etc.), shared taxes (value added tax, stamp tax and tax on resources other than the ocean petroleum resources) and non-tax revenue (fees, penalties, subsidies, other income, etc.). Notwithstanding the reforms, the fiscal system is still unitary. Nevertheless, local government is increasingly playing a part in local economic development and some local governments are beginning to exercise influence on central government. As to India, the federal system is quite complex, as a consequence of regional disparities and of both vertical and horizontal fiscal imbalances. The center-states relations are envisaged in the Constitution also for the financial aspects and the assignment of tax power is based on the principle of separation. Local governments have different institutional arrangements in rural and urban area, in accordance with the two 1992 constitutional amendments that made India one of the most politically decentralized countries among developing ones. However, in practice the implementation of the decentralization program is still lagging, especially in rural areas. Major taxes levied by urban local bodies, which have greater tax power than the rural ones, are tax on property including service levy for water supply, conservancy, drainage, lighting and garbage disposal; tax on entry of goods into a local area for consumption use of sale therein, known as octroi; tax on professions; tax on vehicles (other than motor vehicles).

Finally, in the last section we conclude by comparing fiscal federalism arrangements prevailing in these so big and still developing countries with the rules that should be followed to implement fiscal decentralization.

2. A short synopsis of administrative divisions and taxes by level of government

Shortly speaking, **t**he governmental systems that characterize the two countries are quite different: China is a communist state that is increasingly opening to areas of free-market, India is a federal democratic republic. Nevertheless, the countries have different levels of government and administrative divisions, as shown in Table 1.

3. China and India: a comparison

China and India are the world's two largest nations[1] and, from an historical point of view, there are a number of similarities between the two countries: ancient civilizations that were, at one time, the richest in the world, declining in the second half of the second millennium and starting their way to modernity in the middle of the last century. Moreover, many general similarities existed between the economies of China and India at the time the Communists assumed power in China in 1949 and India achieved its independence in 1947. Until the 1980s of the last century the economic performance of China and India was not much different (also per capita GDP was similar) and both the countries experienced economic reforms that led to a growth's acceleration. In particular, during the period 1952-80 the two countries grew at about the same GDP rate because the slow growth of the Chinese agriculture and service sectors smoothed its fast growing industrial sector.

Under the leadership of Deng Xiaoping, in 1980 China initiated economic reforms, a decade earlier than India, and as a consequence its economy grew at double the rate of growth of India during the 1980s and the early 1990s. Thus since few years there is a growing gap between the performance of the two giant countries and in 2003 the per capita GDP[2] was estimated to be $ 5,000 in China and $ 2,900 in India (see CIA, The World Factbook). This result is not only imputable to a

[1] According to the estimated data of The World Factbook, on July 2004 the population of China was around 1,299 million and that of India was around 1,065 million.
[2] GDP on a purchasing power parity basis divided by population as of 1 July for the same year.

faster GDP growth, but also to a lower population increase, thanks to the one-child policy implemented in China. For a short comparison of selected items see Table 2.

Moreover, the two countries have a different government type though both have a multi-level government. China is a “socialist state under the people's democratic dictatorship led by the working class and based on the alliance of workers and peasants” (art. 1 of the Chinese Constitution). According to article 30 of the Chinese Constitution, the administrative division of the People's Republic of China is as follows: a) the country is divided into provinces, autonomous regions, and municipalities directly under the central government (these latter and other large cities are divided into districts and counties); b) provinces and autonomous regions are divided into autonomous prefectures,[3] counties, autonomous counties and cities; c) counties and autonomous counties are divided into townships, nationality townships, and towns. The state may establish special administrative regions when necessary. As shown in Table 1, currently China has 23 provinces (considering Taiwan the 23rd), five autonomous regions and four municipalities, while Macau and Hong Kong are special administrative regions.[4] Then the modern Chinese system[5] includes a share of authority between the central and local governments, providing a partial basis for a special kind of federalism called “market-preserving federalism”[6] (Weingast 1995).

As regards India, we have already noted that it is a federal republic and its government consists of a central (union) government, 28 state governments and 7 union territories. Many states have autonomous regions with regional councils and in different states there are three tiers of local bodies. There also are 602 districts administered by their respective state/UT government.

In the following sub-sections we briefly outline the main features of intergovernmental fiscal relations in both the countries.

[3] Autonomous prefectures are divided into counties, autonomous counties, and cities

[4] The special administrative region is the product of the conception of “one country, two systems,” which means that the Mainland of China carries out a socialist system and Hong Kong, Macao and Taiwan a capitalist system. But in international affairs, the People’s Republic of China is the only country representing China.

[5] Currently the government structure in China is the following: the People’s Congress is the supreme organ of state power and its permanent organization is the Standing Committee that exercises legislative power. The local People’s Congresses at different levels are the state power organs at local level. The State Council is the supreme administrative organ of the state and the executive organ of the supreme organ of state power. People’s Courts at different levels are the judicial organs. The People’s Courts at local levels, Special People’s Courts and Supreme People’s Courts exercise judicial authority. The Supreme, Local and Special People’s Protectorates at local levels are the organs of law supervision of the state. Local governments are the administrative organs of state under leadership the State Council and are divided in autonomous governments of nationality regions and governments of special administrative regions. The organizational system of local government is divided into provincial, city, county and village level (Unescap b, n.d.).

[6] It has been noticed that, to the extent that federalism has played a helpful role in promoting China’s economic growth, the competitive benefits of “market-preserving federalism” depends very much on political centralization (Blanchard and Shleifer 2000).

3.1 Intergovernmental fiscal relations in China

China has a five-tiered administrative structure: apart from the central government, there are 31 provincial level units (22 provinces, 5 autonomous regions and 4 municipalities directly under the central government); 331 prefectures and municipalities at the prefectural level; 2,109 counties, autonomous counties and cities at the county level; 44,741 townships, towns and city districts.

Intergovernmental fiscal relations have undergone substantial changes in the last twenty-five years (Bahl and Wallich 1992; Arora and Norregaard 1997; World Bank 2002). Until the beginning of the reform era and as a consequence of central planning (extending approximately from 1957 to 1979) public finances in China were rather centralized in that all taxes and profits accrued to the central government, which then transferred to local governments the funds they needed to meet the spending priorities set by the central government itself. Local governments were responsible for collecting all taxes - acting simply as agents of the center - and their spending autonomy was restricted to minor amounts covered with extra-budgetary funds. A revenue sharing mechanism was introduced in 1980, partly with a view to providing local governments with incentives to improve tax collection. To this end revenues from each tax were classified as "central fixed revenue", "local fixed revenue" or "shared revenue" (the shares were determined through negotiations between the central and provincial governments). It should be noted that this arrangement only involved the center and the provinces, which were left free to decide on revenue assignments at lower levels as they pleased, in line with the nature of the system as a "nested hierarchy". To enable poorer provinces to cope with their expenditure needs, the system was revised in 1985 so that provinces where local fixed revenue exceeded local expenditures were required to remit part of that revenue to the center, while provinces where local expenditures could not be covered by local fixed revenue were granted a higher proportion of shared revenue or, in the event that even all of it was insufficient to break even, were given a transfer from the central government. A final change before the 1994 reform was made in 1988 with the establishment of the so-called "fiscal contracting system" (also known as the "fiscal responsibility system"), under which provincial governments agreed to transfer a fixed tax quota (i.e. a lump-sum remittance or subsidy, to increase annually at a single-digit rate) to the central government, while retaining every revenue in excess of it. The different terms of the revenue-sharing contracts negotiated by each province resulted in growing disparities among provinces and increased the elements of bargaining present in intergovernmental relations. In the words of Ahmad, Li and Richardson (2002) "*the new system also created a strong incentive for local governments to conceal information about local revenue from the center, else they would face a "ratchet effect," as this information would be valuable at the time the fiscal contracts were renegotiated. Furthermore, many of the new enterprises in the rapidly expanding* *township and village enterprise sector were joint ventures with local government ownership. With retained profits accruing to the benefit of "local shareholders", there was a continued incentive to shift deficits to the center and hide profits from taxation."*

One of the main objectives of the 1994 reform was therefore to revamp intergovernmental fiscal relations. Consequently a new tax sharing system (TSS) was established which fundamentally changed the apportionment of tax revenue between the central and provincial governments. Taxes were classified into three categories: central fixed taxes, local fixed taxes and shared taxes. Tax revenues assigned to the central government included mainly those from: customs duties, VAT and excise taxes on imports; consumption tax; income tax on all centrally owned state enterprises; taxes collected from the Ministry of Railroads and from the headquarters of banks and insurance companies; income tax, turnover taxes and resource tax from offshore oil activities; enterprise income tax collected from banks and other financial institutions. Local governments were assigned revenues from: personal income tax; income tax on locally owned state enterprises, collectives and private firms; urban and rural land use tax; farmland occupation tax; land appreciation tax; house property tax; urban real estate tax; vehicle and vessel use tax; deed tax; agricultural and animal husbandry taxes; slaughter tax; entertainment and banquet taxes. Shared taxes included: VAT (75 percent central, 25 percent provincial); the securities exchange tax (88 percent of the revenues from stock transactions to the central government; all the rest to provincial governments); the natural resource tax (almost entirely local). To implement the new revenue assignment the tax administration was split: the bureaus of the State Administration of Taxation were charged with collecting all central and shared taxes, while local taxes were left to the responsibility of local tax bureaus. Despite the introduction of the TSS provincial governments were not given any significant degree of tax autonomy, since they can only set the rates of a few minor taxes, while every other revenue decision is to be taken at Beijing.

The reform of intergovernmental relations was completed by redesigning the system of transfers, with a view to introducing a more rule-based mechanism. Now there are four types of grants in China: the "fixed subsidies under the old system" serve to provide local governments with the same (nominal) level of revenue as in 1993;[7] the "revenue returned" is intended to allow provinces to share in the increase in the revenue from VAT and consumption tax; the "specific-purpose grants" (or earmarked transfers) are administered by individual ministries and have a regulatory function, forcing local governments (which are also required to match the grants received with local funds) to comply with policy priorities set by the center; finally, the "transitional transfers", introduced on a pilot basis in 1995, are designed to equalize fiscal resources across

[7] It should be added that "fixed subsidies under the old system" include also transfers from local governments to the center.

provinces. In view of the unique redistributive purpose of the latter, we look at them in more detail. The formula for computing the amount to be transferred to each province is made out of three components: the first one, objective in nature, is intended to measure the gap between "standard expenditures" and local fiscal capacity; the second one has policy motivations, tending to favor regions with large ethnic minority population; and the third one, added in 1996, should reward provincial tax effort (World Bank 2002).

The respective weights of each of these types of transfers in the five-year period 1997–2001 are shown in Table 3.

Fixed subsidies are a minor component of total transfers and their share halved from almost 4 percent in 1997 to 2 percent in 2001. Earmarked transfers amounted to more than one third of total transfers in 2001 and they have nearly doubled in relative terms during the period involved; their increasing importance is the result of the proactive regional policy of the central government in recent years and of the necessity to respond to particular emergencies (the Asian financial crisis, the inadequacy of resources for local spending on social protection, the rise in pension benefits), however, in the absence of effective monitoring mechanisms to control how these funds are really used, they may be diverted by local governments to their own priorities. Transfers based on the "revenue returned" mechanism, though continuously declining, still represented almost 40 percent of total transfers in 2001 and, in view of the regressive nature of the formula for determining their amount (which favors the wealthier coastal provinces), their predominance is an enduring obstacle to the equalization of fiscal resources. Finally, general-purpose grants (a composite item including the transitional period transfers) more than tripled their share in total transfers (from 7.5 percent in 1997 to 24.5 percent in 2001). However, during the transitional period, transfers are still a minor component, by accounting for around one tenth of the total in 2000.

An insight into the equalization properties of the actual transfer system in China is given by the simulations presented in Ahmad, Singh and Fortuna (2004). First of all, the authors calculate expenditure needs for each province based on 2000 data: they group expenditures into seven categories, determine the share of each in total expenditure and apply specific weights for each category that should reflect factors likely to affect public services' costs in each province (total population, degree of urbanization, presence of ethnic minorities, age structure of population). They construct then an indirect measure of each province's "revenue capacity": to this end they use each province's GDP as a proxy of the tax base of the province and multiply it by a coefficient obtained by regressing provinces' own revenue (*i.e.* revenue before transfers) against their GDP[8]. The next step is subtracting the standard expenditure needs of each province from its revenue capacity to get

[8] As for expenditures, data refer to year 2000.

the shortfall or excess of resources of each province. Finally, the authors consider three scenarios: in the first one, the amount of total transfers from the central government to provinces in 2000 is used for equalization purposes (provinces with a positive balance get nothing, while provinces with a "deficit" receive a grant proportional to their shortfall) and every other type of transfer is cancelled; in the other two scenarios, equalization is carried out only partially (absorbing respectively only 20 percent and 60 percent of total transfers), while the remaining amount is attributed to provinces according to the transfer pattern in 2000. By regressing per capita transfers against per capita GDP in each province, the authors find that the actual system has no equalizing effect, which is absent or insignificant also in the two hypotheses of partial equalization, while a positive and significant equalizing effect is present only in the first scenario.

3.2 Intergovernmental fiscal relations in India

As we have already noticed, India has a federal structure with peculiar features. The two essential features of Indian federalism are: a) federalism is not the result of an agreement by the units; b) the component units have no freedom to secede[9]. Historical factors, mainly the colonial system, have played a strong role in making the Indian federal system quite centralized. Indian Constitution makers divided the government functions in three lists: federal, state and concurrent. Under the Seventh Schedule of the Indian Constitution, the central government has exclusive powers on foreign policy, defence, communications, currency, taxation on corporations and non-agricultural income, and railroads; while state governments have the exclusive power to legislate on such subjects as law and order, public health and sanitation, local government, betting and gambling, and taxation on agricultural income, entertainment, and alcoholic beverages. On some issues both the central government and state governments may legislate, though a union law generally dominates states' ones. Among these areas are criminal law, marriage and divorce, contracts, economic and social planning, population control and family planning, trade unions, social security, and education. All residuary issues lie within the exclusive domain of the central government. An important power of the central government is that of creating new states, by combining states, changing their boundaries, and terminating a state's existence. The central government may also create and dissolve any of the union territories, which have more limited powers than those of the states. Although the states exercise either exclusive or joint control over a substantial range of issues, the Constitution establishes a more dominant role for the union government.

[9] For a brief description of the evolution of financial relations from 1858 up to the coming into force of the Constitution in 1950 see Vithal and Sastry, 2001.

The assignment of tax power is based on the principle of separation; most broad based taxes are assigned to the centre, whereas in practice the states have a narrower tax base[10] and the consequence is a vertical fiscal imbalance. In 2002-03 the states, on average, raised about 38 percent of central revenues, but incurred about 58 percent of expenditures. The capacity of the states to finance their current expenditures from their own sources of revenues has declined from 69 percent in 1955-56 to 52 percent in 2002-03. Transfers from the centre made up the balance (Singh 2004).

The inadequacy of the states to meet expenditures from their own resources is recognized by the Constitution of India (Articles 275 and 282) that provides principles for the sharing of resources between the centre and the states, without specifying the revenue shares but providing for a Finance Commission, which is appointed by the President of India every five years or earlier if needed.[11] In other words, the Finance Commission is the body provided by the Constitution to regulate the flow of transfers from the central government to the states and their allocation among different states.

Generally, the Finance Commission makes recommendations on the following matters:

i) the distribution between the union and the states of the net proceeds of taxes that are to be divided between them under Chapter I Part XII of the Constitution[12] and the allocation among the states of the respective shares of such proceeds;[13]

ii) the principles that should govern the grants-in-aid of the revenues of the states out of the consolidated Fund of India[14] and the sums to be paid to the states which are in need of assistance by way of grants-in-aid of their revenues under article 275 of the Constitution;[15]

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[10] See country chapter.

[11] The last Finance Commission appointed is the twelfth and its report must cover a period of five years commencing on the 1st April 2005.

[12] Before the Eightieth Amendment Act, 2000, the Constitution provided for sharing of two taxes, income tax and union excise duties, with the states. The relevant ratios determining the vertical allocation in tax devolution have remained for many years at 85 percent in the case of income tax and at 45 percent for union excise duties. The Tenth Finance Commission proposed a system of vertical resource sharing in which central taxes are pooled and a proportion of 29 percent of gross proceeds devolved to the states (26 percent to all states and three percent to those where sales tax on sugar, textiles and tobacco was not levied). That recommendation brought forth an amendment to the Constitution (Eightieth Amendment Act 2000). The Eleventh Finance Commission recommended the devolution of 29.5 percent (28 percent to all states and 1.5 percent to those which did not levy sales tax on sugar, textile and tobacco) of net proceeds of all shareable taxes. (Government of India 2000). About 20 per cent of the revenue collected by the union is transferred under tax sharing mechanism (Chaubey 2003).

[13] For example, the Eighth and Ninth Commissions determined the respective shares of states in the devolution of income tax and union excise duties on the basis of three allocating criteria: a) population; b) distance (measured by the term (y_n - y_i) where y_n is the highest per capita income among all the states); c) inverse of income.

[14] The consolidate Fund of India is a part of the government accounts in which are credited all revenues received by government by way of taxation and other receipts flowing to government in connection with the conduct of government business, like receipts from railways, posts, transport etc. (non-tax revenues). Similarly, all loans raised by government by issue of public notifications, internal and external debt and all moneys received by government in repayment of loans and interest thereon is also credited into this fund. All expenditure incurred by the government for the conduct of its business including repayment of internal and external debt and release of loans to states/union territory governments for various purposes is debited against this fund.

iii) the measures needed to augment the consolidated Fund of a state to supplement the resources of the *panchayats* and municipalities in the state on the basis of the recommendations made by the Finance Commission of the state.[16]

Moreover, the Commission reviews the financial situation of the union and the states and suggests a plan by which the governments, collectively and severally, may bring about a restructuring of the public finances to restore budgetary balance and to achieve macro-economic stability and debt reduction along with equitable growth.

Over the last fifty years the Finance Commissions have elaborated a sophisticated methodology to deal with horizontal and vertical fiscal imbalances. To distribute horizontally the major taxes that are shared between the centre and the states[17] the Finance Commissions used a large number of criteria, among which: population, tax effort, collection assessment, income distance, income adjusted total population, indices of social and economic backwardness, territorial area, post-devolution deficits, poverty, revenue equalization, etc. (Singh 2003). The Eleventh Finance Commission (2000-2005) set a new benchmark in the centre-state fiscal relations: it reduced weight of population from 20-30 percent in the recent past to 10 percent, maintained weight of income distance criterion at 62.5 percent and chose to allocate the remaining percent of states' share of pooled proceeds according to area (7.5), infrastructure (7.5), tax effort (5.0) and fiscal discipline (7.5).

Besides the devolution of share in central taxes and duties, the central government gives the states grants-in-aid[18] to cover their revenue deficit[19]. In addition, specific grants to states are provided for their special problems and for upgrading administration's standards in a number of sectors.[20] Grants for local bodies are also provided.[21]

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[15] For example, the Eleventh Finance Commission suggested giving grants-in-aid to the states equal to the amount of the deficits as estimated for each of the years during 1995-96 to 1999-2000. Under this head only 3-4 percent of the total revenue receipts of the union are transferred (Chaubey 2003).

[16] For a brief description of the main recommendations with respect to local government see, for example, Rao and Sing, 2004.

[17] Under Article 270 of the Constitution, as amended by the Constitution (Eightieth Amendment) Act, 2000, a prescribed percentage of the net proceeds of all central taxes and duties (except union surcharge, cess levied for specific purposes and the duties and taxes referred to in article 268 and 269 – that is stamp duties, duties of excise on medicinal and toilet preparations, taxes on the sale or purchase of goods other than newspapers and taxes on the consignment of goods, where such sale, purchase or consignment take place in the course of inter-state trade or commerce) is to be assigned to the states within which that tax or duty can be levied in that year and distributed among those states in terms of the recommendations of the Finance Commission.. The 11th Finance Commission recommended that 29.5% of the net proceeds of central taxes/duties may be distributed amongst all such states where the central tax/duty can be levied.

[18] Grants-in-aid under Article 275 of the Constitution are need-based, on the recommendations of the Finance Commission, while grants under Article 282 are purpose-based, in the sense that the central government has the power to make discretionary grants to the states.

[19] For example, the 11th Finance Commission recommended grants-in-aid amounting to Rs.35359.07 crores to 15 states equal to the amount of deficits assessed for each year during the period 2000-05.

[20] For example, the 11th Finance Commission recommended grants for the period 2000-05 amounting to Rs.3843.63 crores to all the states for upgrading of standards of administration for the following sectors: district administration;

Moreover, the central government distributes substantial grants to the states through its development plans as elaborated by the Planning Commission[22]. While the Finance Commission decides on tax shares and makes grants-in-aid, the Planning Commission allocates resources in accordance with the foreseen priorities, making grants and loans to implement development plans. It is worth to notice the problem of coordination between the two independent commissions that arises. The loan-grant composition of the assistance given to special category states is 10:90 while that to other states is 70:30 (the amount allocated to any recipient state include grant and loan in the above proportion, and the state cannot accept the grant without accepting the loan). Before 1969, plan transfers were project-based; since then, the distribution has been done on the basis of a formula that takes into account population, per capita income, fiscal performance (tax effort, fiscal management, national objectives) and special problems (Singh, 2004 and Ma, 1997). Plan revenue grants make about 7-8 percent of the total revenue receipts of the union (Chaubey, 2003).

Summing up, the Indian intergovernmental transfer system consists of three elements: a) a general purpose grants mechanism, based on a revenue-sharing scheme (at present general tax sharing), operated by the Finance Commission to assist the backward areas (equalization transfers, formula-based); b) a formula-based unconditional transfers and specific purpose transfers operated by the Planning Commission to implement development plans; c) specific purpose transfers with or without matching requirements.

This system of inter-governmental fiscal relations, characterized by transfer dependence and soft budget constraint, has created adverse incentives for prudent fiscal behaviour by the state sector. A recent study (Purfield 2004) confirms that transfer dependency, coupled with bailouts expectations, contributes to the growth in states' deficits. And, it is worth to note, high fiscal deficit of the states represents an important obstacle to the fiscal decentralization process begun in the '90s. This process have been forced by economic and political events, such as liberalization and globalisation in one hand, and the end of single party rule, with the emergence of coalition parties in power at the centre and the increasing importance of regional parties in the political affairs of the country, on the other hand (Rao 2004).

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police administration; prisons administration; fire services; judicial administration; fiscal administration; health services; elementary education; computer training for school children; public libraries; heritage protection; augmentation of traditional water sources.

[21] For example, the 11th Finance Commission recommended grants totalling to Rs.10,000 crore for local bodies during 2000-05, to be utilised (except the amount earmarked for maintenance of accounts & audit - Rs. 493.04 crore - and for development of database – Rs: 200 crore) for maintenance of civic services in rural and urban areas. The annual grant recommended was Rs.1600 crore for rural local bodies and Rs.400 crore for urban local bodies.

[22] The Planning Commission was not conceived in the Constitution but through a resolution of the cabinet, after 50 days of promulgation of the Constitution.

At present there are two types of local governments: urban local governments and rural local governments. In fact, in 1992 to bring to effect the process of decentralization - that is, the transfer of administrative, fiscal and political responsibilities to locally elected bodies[23] - the government of India introduced two Constitutional Amendments: the Seventy-Third, for rural decentralization, and the Seventy-Fourth, for urban decentralization. These amendments, which established the political decentralization, leaving the implementation of administrative and fiscal aspects to the states, provided for a uniform structure of *Nagar Panchayats*[24] for areas in transition from a rural area to an urban area, municipal councils for smaller urban areas and municipal corporations for larger urban areas.[25] Rural local governments operate through district (*Zilla*) *Panchayats*, intermediate[26] (*Taluka*) *Panchayats* and village (*Gram*) *Panchayats*[27] (see Table 4). Moreover, the amendments granted local self-governments a constitutional status and safeguarded their continued existence.

Rules and institutions are different between the two types of local governments and generally the fiscal power is higher for urban than for rural governments, as shown in Table 5.

As it is recognized, an important indicator of fiscal autonomy is the share of the revenue expenditure covered with own resources and also the percentage of own resources on total resources. This is necessary to know how much autonomous or dependent local bodies are on external sources. Table 5 shows that the percent share of own resources in total revenue of the rural local bodies was only 6.72 in 1998-99, declining to 5.99 in 1999-2000 and increasing in the

[23] In India, locally elected bodies are the *Panchayati Raj* Institutions *(PRIs)* (at the district, intermediate and village levels) and the urban local bodies at all levels.
[24] *Panchayat* means an institution of self-government constituted under article 243B of the Constitution. It is worth to observe that what is referred to as local self-government is in actual fact a circumscribed space where there is no legislative and judicial authority and where the issues on which citizens can make decisions is limited (De Souza, 2000).

[25] For the urban local bodies the 74th Amendment provides for "…*g) the devolution by the State Legislature of powers and responsibilities upon the Municipalities with respect to preparation of plans for economic development and social justice, and for the implementation of development schemes as may be required to enable them to function as institutions of self-government; h) levy of taxes and duties by Municipalities, assigning of such taxes and duties to Municipalities by State Governments and for making grants-in-aid by the State to the Municipalities as may be provided in the State law*."

[26] Intermediate level means a level between the village and district levels.
[27] For the rural local governments the 73rd Amendment states that "… *subject to the provisions of the Constitution, the Legislature of a State may, by law, endow the Panchayats with such powers and authority as may be necessary to enable them to function as institutions of self-government and such law may contain provisions for the devolution of powers and responsibilities upon Panchayats at the appropriate level, subject to such conditions as may be specified therein, with respect to : a) the preparation of plans for economic development and social justice; b) the implementation of. schemes for economic development and social justice as may be entrusted to them including those in relation to the matters listed in the Eleventh Schedule. The Legislature of a State may, by law, a) authorise a* Panchayat *to levy, collect and appropriate such taxes, duties, tolls and fees in accordance with such procedure and subject to such limits; b) assign to a* Panchayat *such taxes, duties, tolls and fees levied and collected by the State Government for such purposes and subject to such conditions and limits; c) provide for making such grants-in-aid to the Panchayats from the Consolidated Fund of the State; and d) Provide for constitution of such funds for crediting all moneys received, respectively, by or on behalf of the* Panchayats *and also for the withdrawal of such moneys there from as may be specified in the law*".

following years, reaching 6.85 in 2002-2003. This implies that more than 93 percent of their total revenues were derived from external sources. On the other hand, the urban local bodies raised 59.69 percent of their total revenues from own resources in 1998-99 but this percentage declined to 58.44 in 2002-02. Also the percentage of revenue expenditure covered by own resources is very different for rural and urban local bodies (9.26 percent and 68.97 percent, respectively, in 2002-03).

Again, the percentage of revenue derived from own taxes is much lower for rural local bodies than for urban local bodies (3.87 percent against 39.23 percent in 2002-2003). At present the revenue of the rural local bodies is principally constituted by grants and the dependence upon the state government even for carrying out the routine functions is quite heavy. Among the three-tiers of *panchayats*, the *Gram panchayats* are comparatively in a better position because they have some taxing power of their own, while the other two tiers are dependent only on tolls, fees and non-tax revenue for generating internal resources. Relative to the municipalities, even after the 74th Amendment, the Constitution does not provide to them for an autonomous domain of tax raising power, which continues to be decided and regulated by the state governments that specify the taxes (taken from the state list in the Seventh Schedule[28]) that the municipalities can levy and collect. Historically these taxes have comprised taxes on lands and buildings, on entry of goods into a local area for consumption, on animals and boats, on entertainment, on professions, trades, etc. There is an important variability among the states, but a uniform feature is represented by the significant control of the state governments in determining the tax, tax rates or even tax exemptions, since there is no distinct tax domain of the municipalities as such. Therefore, as recommended by the National Commission to Review the Working of the Constitution ("Venkatachaliah Commission"), a distinct and separate tax domain for municipalities should be recognized (Government of India, Ministry of Law 2002).

Local government bodies are covered in the state list[29] and are governed by the state statutes or, in the case of union territories, by the union parliament. Notwithstanding the above quoted

[28] The items included in the 7th Schedule under the state list are the following: 1) taxes on agricultural income; 2) duties in respect of succession to agricultural land; 3) estate duty in respect of agricultural land; 4) taxes on lands and buildings; 5) taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development; 6) duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: (a) alcoholic liquors for human consumption; (b) opium, Indian hemp and other narcotic drugs and narcotics, but not including medicinal and toilet preparations containing alcohol; 7) taxes on the entry of goods into a local area for consumption, use or sale therein; 8) taxes on the consumption or sale of electricity; 9) taxes on the sale or purchase of goods other than newspapers; 10) taxes on advertisements other than advertisements published in the newspapers [and advertisements broadcast by radio or television]; 11) taxes on goods and passengers carried by road or on inland waterways; 12) taxes on vehicles, whether mechanically propelled or not, suitable for use on roads, including tramcars; 13) taxes on animals and boats; 14) tolls; 15) taxes on professions, trades, callings and employments; 16) capitation taxes; 17) taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

[29] Recently, there has been a proposal to create of a separate "local list" for the local bodies, so redesigning the present central and state jurisdictions (see Government of India, Ministry of Law 2002).

amendments to the Constitution that made India one of the most politically decentralized countries among developing ones, in practice the implementation of the decentralization program is still lagging, specially in rural areas. In fact, while political decentralization has progressed satisfactorily - states modified their acts consistently with the requirements of the amendments, and most of them have carried out local elections -, administrative and fiscal decentralization are taking place at a much more hesitant pace, also owing to the reluctance of some state governments to share their fiscal powers with the local self-government institutions. As in every decentralized system, in India local bodies represent the nearest government to the people, charged with the responsibility of providing most of the basic services. The core services that would be granted by local bodies are identified as primary education, primary health, rural or municipal roads, drinking water supply, sanitation, and street- lighting. But few states have vested the local bodies with the necessary powers, funds and staff to enable them to perform the functions assigned to them under the statutes. It is obvious that the three “F” (functions, functionaries and finances) have to go together for any process of devolution to be meaningful. Therefore it is clear that the failure to assign human resources affects the growth of *panchayats* and municipalities as self-governing institutions. As made evident by the Venkatachaliah Commission, “*in the process of implementation of the 73rd and 74th Amendments, considerable gaps have been noticed. The Union Government and the State Governments continue to exercise powers in planning and the Panchayats and Municipalities do not enjoy autonomy - financial or administrative - as institutions of local self-government. While today Panchayats elect some three million members of whom one-third are women, the objectives envisaged in the Amendments have not been fully achieved (…) Even in the States which have shown political will to decentralize, devolution has not gone beyond entrusting to them responsibility for implementation of the schemes/projects conceived by the State or Union government. As a result, Panchayats have not blossomed into institutions of self-government. Instead they have been reduced to an implementing arm of the State Government* ” (Government of India, Ministry of Law 2002).

In several states all functions provided for devolution to local bodies, as envisaged in the constitutional amendments, have not been transferred. For example, out of 29 subjects, the government of Andhra Pradesh has transferred only 17 to rural local bodies and most of these transfers are partial, without the transfer of funds and functionaries. Functions like primary education, primary health care, drinking water supply, have not been devolved to local bodies in rural areas but are being looked after and operated by the line departments of the state government or by special boards/agencies. In many cases, even when a function is transferred to local bodies, the state governments do not vacate their operations from such areas, with the result that all local functions, in effect, have become concurrent. In other words, most of the states, despite transferring a number of functions, have not minded to give up their involvement in such matters and continue to maintain big staff at the state and district headquarters. Moreover, there is no specific accountability, in the sense that the role of three tiers of local bodies has not been clearly defined in the state legislations. In fact, very few states have translated all the subjects into activities and specific functions for three tiers of local bodies. Most states have listed all the functions as equally relevant for all the three tiers of local bodies. It is evident that in doing so there is a breach of the principle of subsidiarity, which establishes, as well known, that whatever can be done at one level should be done at that level and not at a higher one. In addition, in some states only *Gram panchayats* have been entrusted with all the functions included in Eleventh Schedule,[30] while the intermediate level and the district level *panchayats* have not been assigned any taxation powers and any functions except the supervisory ones (Mishra n.d). Another important function assigned to local bodies under the constitutional provisions is that of planning for economic and social development in their respective areas, but this function is not being performed in most of the states. This can be considered a violation of the spirit of the Constitution, though it is difficult to imagine an active role of local governments as to this function in a country where the deprivation is endemic and regional disparities are growing (on regional disparities see, for example, Buddhadeb and Prabir 2005).

In many states one of the main reasons of the limited devolution of functions and fiscal decision-making power is commonly imputed to the lack of reliable information on the spending and the revenue of the local bodies[31] that prevents the centre and the states from implementing a

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30 The functions included in the Eleventh Schedule of the Constitution are the following: 1. Agriculture, including agricultural extension; 2. Land improvement, implementation of land reforms, land consolidation and soil conservation; 3. Minor irrigation, water management and watershed development; 4. Animal husbandry, dairying and poultry; 5. Fisheries; 6. Social forestry and farm forestry; 7. Minor forest produce; 8. Small scale industries, including food processing industries; 9. Khadi, village and cottage industries; 10. Rural housing; 11. Drinking water; 12. Fuel and fodder; 13. Roads, culverts, bridges, ferries, waterways and other means of communication; 14. Rural electrification, including distribution of electricity; 15. Non-conventional energy sources; 16. Poverty alleviation programs; 17. Education, including primary and secondary schools; 18. Technical training and vocational education; 19. Adult and non-formal education; 20. Libraries; 21. Cultural activities; 22. Markets and fairs; 23. Health and sanitation, including hospitals, primary health centres and dispensaries; 24. Family welfare; 25. Women and child development; 26. Social welfare, including welfare of the handicapped and mentally retarded; 27. Welfare of the weaker sections, and in particular, of the Scheduled Castes and the Scheduled Tribes; 28. Public distribution system; 29. Maintenance of community assets.

31 "*In many States, the formats and procedures for maintenance of accounts by these bodies prescribed decades ago, are continued without making any improvements to take into account the manifold increase in their powers, resources and responsibilities. Most village level panchayats do not have any staff except for a full or a part-time secretary, because of financial constraints.(…) There is no mechanism for collection of data on the revenue and expenditure of the*

serious empowerment of local governments. Moreover, the lack of accountability of local bodies, because of inadequate provisions in law relating to audit of accounts, does not support decentralization. In addition, the high fiscal deficit of the states represents an important obstacle to the fiscal decentralization process (World Bank 2004).

To achieve the constitutional goal of making local bodies as units of self-governance the Eleventh and the Twelfth Finance Commissions have had the mandate in their terms of reference to recommend measures needed to augment the consolidated Fund of the states to supplement the resources of local bodies. In the view of the Eleventh Finance Commission, the states may take the following measures for augmenting their consolidated Funds to supplement the resources of *panchayats* and municipalities:

i) *land taxes*: taxes on land/farm income in some form may be levied to strengthen the resource base of the local bodies. The amounts so collected may be passed on to the local bodies for improving and strengthening the civic services. Local bodies may also be involved in collection of these taxes;

ii) *surcharge/cess on state taxes*: "cess" on land based taxes and other state taxes/duties may be levied to mobilize resources for augmenting specific civic services and for improving their quality. For example, a "cess" or surcharge of 10 per cent on sales tax, state excise, entertainment tax, stamp duties, agricultural income tax, motor vehicles tax, electricity duties etc. may give significant additional revenue which could be devolved to the local bodies for improving the basic civic services and for taking up schemes of social and economic development;

iii) profession tax: article 276 of the Constitution provides for levy of a tax on professions, trades, callings or employment for the benefit of the state or local bodies at a rate not exceeding Rs.2,500 per taxpayer per year. Many states either do not levy this tax or levy it at very low rates. States should levy this tax with a view to supplement the resources of local bodies or they should empower the local bodies to levy it.

Notwithstanding these recommendations, not much seems to have been implemented so far, because the state governments pay more attention to the devolution part of the recommendations than to the recommendations related to fiscal aspects. Also the local bodies are more interested in the devolution package rather than the reforms suggested in the fiscal system owing to their being closer to the people who are to be taxed. So that the fiscal effort made by local bodies is very poor;

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various tiers/levels of the rural/urban local bodies at a centralised place where it could be compiled, processed and made available for use. In the absence of any reliable financial/budgetary data, no realistic assessment of the needs of the panchayats and municipalities for basic civic and developmental functions can be made nor can any information be generated on the flow of funds to the local bodies for the implementation of various schemes for economic development and social justice." (Government of India 2000).

particularly *Gram panchayats* do not make any stated efforts to levy taxes that they are empowered to levy and collect. Also the performance of urban local bodies, though better than that of Gram panchayats, is not satisfactory, as shown in Table 5.

4. Fiscal decentralization China *versus* India

During the 1990s a common trend seen in China and India is the impulse towards fiscal decentralization. In the case of China, the 1994 fiscal reform attempted to recentralize the tax system and to reform the tax sharing system to place intergovernmental transfers on a more systematic footing. The main goals of the reform were to simplify the tax system introducing a revenue-sharing system, to raise the revenue to GDP ratio, to raise the central government's ratio to total revenue to increase equalization transfers, and to make the fiscal federal system more stable by shifting from negotiated transfers to a rule-based tax assignment. Only the first objective seems to have been achieved, while transfers have been inadequate and are not based on expenditure needs, and expenditure assignments have not been basically changed since 1994 (Ahmad, Li and Richardson 2002).

Since 1992 India tried to develop a three tier federal system, strengthening the third level of government through Constitutional amendments to transform local bodies as units of self-government. However, the push to decentralize below the state level has been stronger on the center side than on the states side, so the process of local government reform is still under way and the local governments play a very limited role both in raising revenues and in spending (Rao 2002).

It seems, therefore, that the two countries are not committed to decentralization.

As it is well known, the standard economic rational for decentralization rests on efficiency, equity and macro-stability grounds[32]. In developing countries decentralization is also seen as a mean to achieve several goals that government interventions have failed to attain, such as the stimulation of economic growth, the reduction of poverty, the reinforcement of democracy, but mainly the improvement of service delivery to large populations[33]. The theory of fiscal federalism set forth in Oates (1972), derived from the classic Musgrave model of public sector responsibility for stabilization, distribution and allocation (Musgrave 1959), provides rationale and instructions to

[32] A different approach to decentralization is followed by Breton (1996). In his seminal work he argues that the most important reason for decentralizing the public sector is that decentralization stimulates intergovernmental competition, and when competition breaks down, or produces undesirable outcomes, decentralization fails. On decentralization failures see also Breton (2002).

[33] The issues relevant to the question of whether fiscal decentralization generates the positive results that its supporters claim is addressed in Tanzi (2002).

assign these functions to different levels of government. Though at the beginning the conventional fiscal decentralization theory has been applied in industrialized country, it seems not difficult to justify its application in developing and transition countries: while the justifications for centralization of the stabilization and distribution functions are relatively straightforward, the issues concerning assignment of responsibility for both the expenditure and revenue dimensions of the allocation functions are more complicated, due to the potential undermining of a number of assumptions underlying public finance theory in general, and fiscal federalism in particular, so that the theory has to be adapted.[34]

Among the conditions of a successful decentralization, apart an adequate institutional design[35], the followings can be mentioned (Bahl 1999):

- fiscal decentralization should be viewed as a comprehensive system, characterized by some key elements - such as elected local councils, locally appointed chief officers, significant local government discretion to raise revenue, significant local government expenditure responsibilities, budget autonomy, hard budget constraint, accountability, transparency, borrowing powers, freedom from expenditure mandates, unconditional transfers from higher levels of government;
- finance follows functions, in the sense that first should come the assignment of expenditure responsibility to local governments, and then the assignment of revenue responsibility should be determined;
- there must be a strong central ability to monitor and evaluate decentralization, which implies the preparation of a fiscal analysis unit and an extensive data system that allows quantitative monitoring and evaluation;
- one intergovernmental system does not fit the urban and the rural sector, since sub national governments have different capabilities to deliver and finance services and to borrow;
- fiscal decentralization requires significant local government taxing powers, which improves the accountability of elected officials but implies the correct identification of the sub national tax bases;
- central government must keep the fiscal decentralization rules that it makes, guaranteeing the transfer of power with constitutional changes if necessary;

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[34] For example, a grater centralization of some functions may be justified on the ground that widespread poverty may make preferences more homogeneous across local jurisdictions. For a discussion of these arguments see Smoke (2001) and bibliography therein.

[35] Recently it has been underlined the importance of the institutional design: ”decentralization is neither good or bad for efficiency, equity, or macroeconomic stability; but rather its effects depend on institution specific design” (Litvack, Ahmad and Bird 1998).

- intergovernmental fiscal arrangements must be simple, which requires the local governments to devote fewer resources to administration and the central government to face lower monitoring and evaluating costs;
- the design of the intergovernmental transfer system should match the objectives of the decentralization reform, considering that different kinds of intergovernmental transfers have different types of impacts on local government finances;
- fiscal decentralization should consider all levels of government, to allow citizen participation at a level that insures that voter preferences matter, and to result in accountability of government officials;
- impose a hard budget constraint, which implies that local governments with fiscal autonomy must balance their budget without recourse to year-end assistance from the central government;
- recognize that intergovernmental systems are always in transition and plan for this, which implies that central governments must have flexibility in their fiscal decentralization plans to adjust to changes, for example, in disparities among regions, quality in basic infrastructures and technical capacity of local governments;
- there must be a champion for fiscal decentralization, that is potential strong supporters that must be identified in the people and their elected representatives, the president, the parliament or congress, urban local governments and external advisors, such as international organization that provide encouragement and some technical assistance for fiscal decentralization.

Trying to evaluate several of the above described guidelines with respect to the Chinese and Indian systems, we can observe that both the countries have not followed the advice that fiscal decentralization should be viewed as a comprehensive system. The four more relevant dimensions of intergovernmental fiscal relations are, as known, the assignment of expenditure responsibilities, the assignment of revenue sources, the provision of intergovernmental fiscal transfers and the rules governing sub-national borrowing and debt. Till now India seems to have considered decentralization mainly in terms of the local election system, without the transfer of all functions provided for devolution to local bodies and the assignment to them of the fiscal decision- making power. In fact, for not losing power most state governments have been and are still reluctant to give up whether significant control over the expenditure budget or part of their tax bases. As underlined by the Planning Commission (2002-2007) in its report on urban development, state governments continue to take decisions on such matters as rates of user charges, property tax coverage, levy or withdrawal of “octroi”, role of parastatals in water supply and sanitation services, etc., with little reference to the urban local bodies that are affected by these decisions. Hence, these decisions do not always have the effect of strengthening the constitutional role of the elected local bodies that often are a subordinate entity under the day-to-day control of the state governments, beholden to the state for not only development of the cities but often even for survival (Government of India 2001). The situation is even worse for rural local bodies. With regard to China, the 1994 fiscal reform greatly changed the national revenue sharing system, gave local governments more control over the administration of local taxes but no significant degree of tax autonomy and no substantial expenditure assignments. It is true that the central government is expanding the financial capacity of local authorities but, notwithstanding this increased capacity, their budgets still need approval from higher levels of government.

Also the second rule (finance follows function) seems to be neglected in both the countries. Relative to the central ability to monitor and evaluate decentralization, in India there is no mechanism for collection of data on the revenue and expenditure of the various levels of local bodies at a centralized place. The National Development Council[36] meets infrequently and is ineffective as a monitoring institution (Rao 2004). In China local governments are the administrative organs of the state under the leadership of the State Council and monitoring should be easier because local autonomy is of subordinate autonomy, that is lower levels of government must complete tasks derived from higher levels of government and what local autonomy they exercise can only be within the guidance of those higher levels (Unescap b, n.d.). In fact, the center has relatively limited information on local government finance.

Only India set up a different system of local bodies in rural and urban areas with different expenditure responsibilities and financing powers, which means to recognize explicitly the differences among local bodies in the capabilities to deliver and finance services. On the contrary, China has a unitary fiscal system; the establishment of the taxation separation system in 1994 has not been equivalent to the reform of that unitary fiscal system, which requires to hand down part of fiscal power to local governments. Currently both the countries have not given local government significant taxing powers.

In China local governments are based on a hierarchical system with a characteristic of leadership at different levels, the lower level being subordinate to higher level, and this feature is recognized in the Constitution that, however, has not been changed to recognize to local governments the more independent power on fund raising under the existing centralized fiscal system. Still, a range of factors contributes to the durability of decentralization, limiting the

[36] The National Development Council is presided over by the prime minister and comprised of cabinet ministers, deputy chairman and members of the Planning Commission and the chief ministers of the states.

discretion of the central government to attempt a reversal[37]. On the contrary, the Indian central government amended the Constitution to establish local bodies in rural and urban areas, but it has left in the hands of the states the implementation of the decentralization process that till now has not been resolutely pursued. It is worth to remember that historically India has had a strong centralized system, which may justify the delay to achieve effective federal governance.

About the design of the intergovernmental transfer system, it has been recognized (Rao, 2004) that in India it is necessary to redesign the transfer system to improve accountability, incentives and equity[38]. The reform of the transfer system must begin with the avoidance of overlapping roles of the Finance Commission and the Planning Commission - preferably leaving in the responsibility of the Finance Commission the entire transfers, while the Planning Commission should focus on physical infrastructure - and must offset both vertical and horizontal fiscal imbalances. Also the consolidation of the more than 220 centrally sponsored schemes is an urgent need, even though they represent only 5 percent of transfers. With regard to China, the fiscal revenue sharing schemes limit intergovernmental budget transfers. Nevertheless, the system of earmarked transfers seems to be too complex and undersized to fill the gap between the excessive assignment of core expenditure responsibilities to lower level governments (counties and townships) and their limited fiscal capacity. Moreover, there often is substantial diversion of earmarked funds at sub national levels to meet short-term cash outlay requirements. Also equalization grants are undersized and have a very poor impact on addressing horizontal fiscal disparities across sub national governments (World Bank 2001). The need of revision is clear[39].

Finally, the rule of hard budget constraint in China is faced by all levels of government and sub-national governments are prohibited from borrowing[40]. On the contrary, in India in fact sub-

[37] For example, as a result of the reforms, new, rival power centers have emerged in China. Local governments, specially those in areas with the largest growth, now have substantial independent sources of revenue, authority, and political support. Moreover, though local officials are still appointed and dismissed by the central government, their authority is implied and enhanced by their access to and control of local information and resources. Also the gradual decline of the personal authority of national leaders and the rise of local governments has weakened the reach of the Chinese Communist Party into the lower levels of government, and many lower government officials now bestow their loyalty to localities, not the central government. Finally, as the private market economy has expanded, the ability of the central government to monitor and control local economic behavior has weakened enormously (Montinola, Qian, and Weingast 1995).

[38] According to Vaillancourt and Bird (2004), India's complex system appears both to have been significantly equalizing and on the whole to have contributed to achieve a degree of cohesiveness in a large and diverse country, even if it may be criticized as providing some undesirable incentives with respect to fiscal management of the states.

[39] In recent years, the central authorities started to examine all the earmarked grants and some of them have been converted into equalization grants. For example, about RMB 4 billion of subsidies for food in urban areas were transferred into the transitory equalization grants in 2001. The same was done with earmarked grants for the development of borders regions (Zhang and Martinez-Vazquez 2003).

[40] Before the 1994 reform, budget deficits were financed through a combination of credits from the People's Bank of China and domestic and international borrowing as debt revenues. Since 1995 budgets at all levels of government have to be balanced and any violation of the balanced budget approved by the legal process results in administrative prosecution against parties directly responsible. In spite of that, the reform's effectiveness on hardening the budget constraint has been undermined by several elements, and often local governments incur soft budgets. The central

national governments face soft budget constraint, mainly because of the vertical fiscal imbalance whose size also depends on the possibility to have *ex ante* budget deficit that creates an incentive to increase expenditure and to undermine financial discipline. The consequence is a bail out by the higher tier government[41]. Sub-national governments have some freedom to borrow but the greater share of their borrowing comes from the central government or public financial institutions.

Despite the differences between the two countries, there are important issues of common interest (Rao 2001). The challenges of fiscal decentralization in transitional economies concern, among other things, the development of an efficient fiscal system, the replacement of command and control system with market based instruments, and the evolvement of responsive intergovernmental fiscal relations.

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government now finances its budget deficits only through domestic and international borrowings, and in the state budget such borrowing is no longer counted as debt revenues (Jing and Zou 2003).

[41] The expectation of bailouts has encouraged Indian states and local governments to adopt high-risk deficit financing strategies. And whereas a major direct default has yet to occur, indirect defaults by urban development authorities, controlled by state governments, have occurred and bills owed by states sometimes go unpaid (McCarten 2003).

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Table 1 Government layers by countries

China	*23 provinces*(°) (Anhui, Fujian, Gansu, Guangdong, Guizhou, Hainan, Hebei, Heilongjiang, Henan, Hubei, Hunan, Jiangsu, Jiangxi, Jilin, Liaoning, Qinghai, Shaanxi, Shandong, Shanxi, Sichuan, Yunnan, Zhejiang), *5 autonomous regions* (Guangxi, Nei Mongol, Ningxia, Xinjiang, Xizang (Tibet)), *4 municipalities* (Beijing, Chongqing, Shanghai, Tianjin), and *local governments* (prefectures, districts, counties, cities, towns and villages).
India	*28 states, 7 union territories** (Andaman and Nicobar Islands*, Andhra Pradesh, Arunachal Pradesh, Assam, Bihar, Chandigarh*, Chhattisgarh, Dadra and Nagar Haveli*, Daman and Diu*, Delhi*, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu and Kashmir, Jharkhand, Karnataka, Kerala, Lakshadweep*, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Mizoram, Nagaland, Orissa, Pondicherry*, Punjab, Rajasthan, Sikkim, Tamil Nadu, Tripura, Uttaranchal, Uttar Pradesh, West Bengal), and *local governments (*Nagar Panchayat, municipal councils, municipal corporations)

Source: Our adaptation from CIA, The World Factbook.

Notes

(°) China considers Taiwan its 23rd province. Hong Kong and Macau are special administrative regions.
(*) Urban-based forms of local government include: the Bangkok Metropolitan Administration (BMA); the Municipality, governing urban centres in the provinces; and the City of Pattaya .Rural-based forms of local government include: the Provincial Administrative Organization (PAO) that constituting local government at a provincial level; the *Tambon* Administrative Organization (TAO), constituting local government at a sub-district level; and The *Sukhapiban* or Sanitary Committee, a local government in a rural centre.

Table 2 Comparison of selected items

	1980	*1990*	*1995*	*1999*	*2000*	*2001*	*2002*
Total population (Million)							
China	987.1[a]	1,143.3[a]	1,211.2[a]	1,259.1[a]	1,267.4[a]	1,276.3[a]	1,284.9[a]
India	673.0	835.1	931.0	998.0	1,017.0	1,027.0[b]	1,052.0
Population rural (Percentage of total)							
China	80.6	73.6	71.0	69.1	63.8	62.3	...
India	76.9	72.8	73.0	72.0	71.6	72.2[b]	71.0
Population growth rate (Percent per annum)							
China	1.2	1.4	1.1	0.8	0.8	0.7	0.7
India	2.1	2.1	2.0	1.6	1.8	1.2	2.4
GDP per capita (US$) (*)							
China	206	312	581	788	856	911	966
India	257	373	376	437	453	465	471
External debt (Millions of US$) (**)							
China	15,828.0[c]	52,545.0	106,590.0	151,830.0	145,730.0	170,110.0	168,538.0
India	20,581.0	83,628.0	94,464.0	98,313.0	99,098.0	97,320.0	...
Population employed in agriculture (Percentage of population employed)							
China	75.2	73.7	72.1	68.6	67.9	67.2	66.4
India	69.7[d]	64.0[d]	61.9[d]	60.1[d]	59.6[d]	59.2[d]	...

Source: UNESCAP Statistics Division. Database updated on 11 March 2004

Notes

a - end of year. b - census figures as at 1 March 2001. Data for other years are from the United Nations Population Prospects, the 2002 Revision. c - for 1985. d - data refer to labour force.

(*) Gross domestic product per capita in United States dollars are derived by converting the national currency into United States dollars based on the average official exchange rates for the period. The official exchange rate might differ significantly from market exchange rates.

(**) Data refer to total debt stocks, defined as the sum of public and publicly guaranteed long-term debt, private non-guaranteed long-term debt, the use of International Monetary Fund credit, and short-term debt.

Table 3 Intergovernmental transfers, 1997-2001

	1997	1998	1999	2000	2001
			(In percent of GDP)		
Transfers from the central government to local governments	*3.8*	*4.2*	*5.0*	*5.2*	*5.8*
Revenue returned	2.7	2.7	2.6	2.6	2.3
Fixed subsidy under the old system	0.2	0.1	0.1	0.1	0.1
General purpose grants	0.3	0.3	0.5	0.9	1.4
Earmarked transfers	0.7	1.1	1.7	1.6	2.0
			(In percent of total transfers)		
Transfers from the central government to local governments	100.0	*100.0*	*100.0*	*100.0*	*100.0*
Revenue returned	70.5	62.7	53.0	48.9	38.9
Fixed subsidy under the old system	3.9	3.4	2.9	2.7	2.0
General purpose grants	7.5	7.5	10.2	17.9	24.5
Earmarked transfers	18.1	26.4	33.8	30.6	34.6
Transfers from local governments to the central government					
Fixed subsidy under the old system	0.8	0.8	0.7	0.7	0.6

Source: Ahmad, Singh and Fortuna (2004).

Table 4 Number of local bodies at different tiers

Rural Local Bodies		*Urban Local Bodies*	
1. Gram/Village *Panchayats*	236,350	1. Municipal Corporations	109
2. Panchayats Samities	6,795	2. Municipalities	1,432
3. Zilla *Panchayats*	531	3. Nagar *Panchayats*	2,182
4. Autonomous District Councils	9		
Total	237,824	Total	3,723

Source: Government of India (2004)

Table 5 Revenue and expenditure of local bodies (rural and urban) in percent of total

A) All India Revenue and Expenditure of Panchayati Raj *Institutions (All Tiers)*

	1998-99	*1999-2000*	*2000-01*	*2001-02*	*2002-03*
Revenue					
Own Tax	3.64	3.04	3.24	3.61	3.87
Own Non-Tax	3.08	2.95	2.86	2.77	2.98
Assignment + Devolution	30.19	29.23	28.10	27.46	27.69
Grants-in –Aid	56.34	58.92	57.76	58.85	58.95
Others	6.75	5.85	8.04	7.31	6.51
Total Revenue	*100.00*	*100.00*	*100.00*	*100.00*	*100.00*
Expenditure					
Revenue Expenditure	71.18	73.25	75.36	75.92	73.05
Capital Expenditure	28.82	26.75	24.64	24.08	26.95
Total Expenditure	*100.00*	*100.00*	*100.00*	*100.00*	*100.00*
Own Revenue as % of Revenue Expenditure	*8.91*	*8.40*	*7.82*	*7.88*	*9.26*

B) All India Revenue and Expenditure of Urban Local Bodies (All Levels)

Revenue					
Own Tax	41.30	39.10	38.53	38.85	39.23
Own Non-Tax	18.39	16.92	18.12	18.97	19.21
Assignment + Devolution	19.18	20.09	20.45	18.12	17.69
Grants-in –Aid	15.70	17.09	15.36	17.64	16.48
Others	5.43	6.80	7.54	6.42	7.39
Total Revenue	*100.00*	*100.00*	*100.00*	*100.00*	*100.00*
Expenditure					
Revenue Expenditure	75.28	73.97	74.10	76.69	76.24
Capital Expenditure	24.72	26.03	25.90	23.31	23.76
Total Expenditure	*100.00*	*100.00*	*100.00*	*100.00*	*100.00*
Own Revenue as % of Revenue Expenditure	*75.87*	*69.03*	*70.81*	*71.78*	*68.97*

Source Own calculations based on the Report of the 12th Finance Commission (2005-2010)

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