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## Fiscal Decentralization in Asia: Challenges and Opportunities

Jorge Martinez-Vazquez

Georgia State University, [jorgemartinez@gsu.edu](mailto:jorgemartinez@gsu.edu)

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# Fiscal Decentralization in Asia

## Challenges and Opportunities

Jorge Martinez-Vazquez

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# Fiscal Decentralization in Asia

## Challenges and Opportunities

Jorge Martinez-Vasquez

Asian Development Bank

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Asian Development Bank  
6 ADB Avenue, Mandaluyong City  
1550 Metro Manila, Philippines  
Tel +63 2 632 4444  
Fax +63 2 636 2444  
www.adb.org

For orders, please contact:  
Department of External Relations  
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# Introduction

Decentralization reform continues to play a prominent role in Asia after being on the public policy agenda for several decades. As has happened in other countries around the world, the roles and expectations for subnational governments have increased substantially in most Asian countries since the 1990s. Currently subnational governments face a range of challenges, including the global financial and economic crisis, rapid urbanization and demographic changes, and environmental challenges and climate change, all of which increase the level of difficulty for effective service delivery.

Although decentralization reform has been an evolving process, this process has not been linear, and it has often been subject to moves toward recentralization. For example, in 2009 Pakistan dissolved local governments and elected mayors, replacing them with appointed officials. But at any rate the decentralization process continues to be a dynamic one in many Asian countries. For example, in the People's Republic of China (PRC) there is a shift of emphasis from economic development toward quality public services offered by subnational governments and greater geographical equity to "build a harmonious society," while in Indonesia, property taxes are finally being decentralized and the basic laws from the "Big Bang" reforms of 1999–2001 are being overhauled. In Japan, the government continues to implement the "Trinity Reforms" to provide greater subnational fiscal autonomy; in Viet Nam progress has been steady and considerable but challenges remain in terms of fiscal autonomy and political and administrative decentralization at the lower levels; and in Cambodia, the Lao People's Democratic Republic, and Nepal there is renewed interest in building sound systems of intergovernmental finance.<sup>1</sup>

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<sup>1</sup> This note draws upon recent information in Blane Lewis and Bob Searle, Asia-Pacific in Jorge Martinez-Vazquez and Paul Smoke (eds.) *Second Global Report on Decentralization and Local Democracy* (GOLD), 2010; United Cities and Local Governments.



# The Centrality of the Fiscal System

For subnational governments in Asian countries to meet their responsibilities and deal with the challenges they will be facing in the future, there will be a need to strengthen their intergovernmental fiscal systems in the following areas:

- (i) expenditure assignment and management,
- (ii) local revenue generation and autonomy,
- (iii) intergovernmental transfers, and
- (iv) local government borrowing and investment finance.

This fundamental task is the main focus of this note. However, we must make it clear that other institutional components also will need to be in place, including administrative decentralization and political decentralization. The lack of strong, politically decentralized institutions continues to be a challenge in a significant number of Asian countries.

# The Extent of Decentralization in the Region

If the extent of decentralization is measured by using the standard criterion of the share of subnational governments in total expenditures (Table 1), many Asian countries exhibit among the highest levels of decentralization in the world. Compare these with, for example, Australia and New Zealand (Table 2). Also, there is great diversity in the region, with East Asia way ahead of South Asia and Southeast Asia (Table 3).

We find that 70% of total expenditures are allocated at the subnational level in the PRC, 66% in India, 60% in Japan, and 45% in both the Republic of Korea and Viet Nam. Measured by the share of subnational governments in total revenues, the level of decentralization is lower, but still quite substantial, at 40% in both the PRC and Japan, 35% in Viet Nam, and 33% in India. Note that the vertical distribution also differs quite considerably across countries. Lower tiers are predominant (versus upper tiers) in Indonesia, Japan, and the PRC. In India they are balanced at 33% for upper and lower tiers in the case of expenditures (but not at all in the case of revenues).

However, all of these figures need to be interpreted with caution since the actual levels of expenditure and revenue autonomy can be quite different from what is actually reported. For example, as noted above, expenditure shares in India are balanced at 33% for upper and lower tiers, but in reality lower tier governments in most Indian states have very little expenditure autonomy from their state governments. Another example is the case of Viet Nam, where despite the fact that subnational governments have a 35% share of total revenues, none of these governments have discretion to change tax rates or any other aspect of the taxes assigned to them.

Table 1 Estimated Subnational Government Shares of Total Public Expenditure and Revenue in Asian Countries, 2009 (%)

Country	Share of Total Public Expenditure			Share of Total Public Revenue		
	Subnational	Upper Tier	Lower Tier	Subnational	Upper Tier	Lower Tier
Bangladesh	15.0	5.0	10.0	2.0	1.0	1.0
India	66.0	33.0	33.0	33.0	30.0	3.0
Indonesia	35.0	7.0	28.0	8.0	5.5	2.5
Japan	60.0	20.0	40.0	40.0	20.0	20.0
Korea, Republic of	45.0	15.0	30.0	25.0	10.0	15.0
Pakistan	33.0	28.0	5.0	7.0	6.5	0.5
Philippines	25.0	11.0	14.0	10.0	2.5	7.5

*continued on next page*

## 4 Fiscal Decentralization in Asia

Table 1 *continued*

Country	Share of Total Public Expenditure			Share of Total Public Revenue		
	Subnational	Upper Tier	Lower Tier	Subnational	Upper Tier	Lower Tier
PRC	70.0	20.0	50.0	40.0	15.0	25.0
Thailand	10.0	5.0	5.0	2.0	1.0	1.0
Viet Nam	45.0	30.0	15.0	35.0	25.0	10.0

PRC = People's Republic of China.

Source: Blane Lewis and Bob Searle. 2010. Asia-Pacific. In Jorge Martinez-Vazquez and Paul Smoke (eds.) *Second Global Report on Decentralization and Local Democracy*. 2010; United Cities and Local Governments.

**Table 2** Estimated Subnational Government Shares of Total Public Expenditure and Revenue in Organisation for Economic Co-operation and Development Countries, 2009 (%)

Country	Share of Total Public Expenditure			Share of Total Public Revenue		
	Subnational	Upper Tier	Lower Tier	Subnational	Upper Tier	Lower Tier
Australia	36.0	30.0	6.0	20.0	17.0	3.0
New Zealand	9.0	n/a	9.0	8.0	n/a	8.0

n/a = not applicable.

Source: Blane Lewis and Bob Searle. 2010. Asia-Pacific. In Jorge Martinez-Vazquez and Paul Smoke (eds.) *Second Global Report on Decentralization and Local Democracy*. 2010; United Cities and Local Governments.

**Table 3** Estimated Subnational Government Shares of Total Public Expenditure and Revenue across Continents, 2009 (%)

	Local Revenues as Percentage of Total Public Revenues	Local Expenditures as Percentage of Total Public Expenditures
Africa	3.2	7.9
Asia		
South Asia	1.5	16.0
East Asia	20.0	40.0
Southeast Asia	5.3	15.5
Eurasia	n/a	26.5
Europe (2008)	13.0	23.9
Latin America	4.0	11.1
Middle East and Western Asia	n/a	4.6
North America	17.8	26.8

n/a = not applicable.

Source: Blane Lewis and Bob Searle. 2010. Asia-Pacific. In Jorge Martinez-Vazquez and Paul Smoke (eds.) *Second Global Report on Decentralization and Local Democracy*. 2010; United Cities and Local Governments.

# Main Issues and Challenges in the Fiscal Architecture

**Adequacy of local revenues and autonomy.** Significant vertical fiscal imbalances are present in Bangladesh, India, and Pakistan, and at the local level in the Philippines, the PRC, and Viet Nam. In addition, revenue autonomy is low outside Japan and the Republic of Korea, and much less in Indonesia and the Philippines. More autonomy, but only at the provincial level, exists in India, Pakistan, and the PRC. Problems with the property tax are also prevalent; for example, in Indonesia and the Philippines it is still a central tax. There is also inadequate diversification of the local tax base, and in the Republic of Korea, a multiplicity of nuisance taxes exists, while in Cambodia assignments from 2001 were never implemented. A relative neglect of fees and user charges is also encountered, with some exceptions. Problems balancing local and central roles in revenue collections exist in Bangladesh, India, Pakistan (central and provincial), the PRC, and Viet Nam (all central).

**Expenditure management and service delivery.** A lack of clarity in expenditure assignments is quite prevalent; this is more of a problem in the Republic of Korea and Thailand, and in India at the state–local level. This is much less of a problem in Japan. Inappropriate expenditure assignments are also problematic, for example, “unemployment and social insurance schemes” in the PRC assigned at the local level. Unfunded expenditure mandates are a growing issue in Bangladesh, India, Japan, the Republic of Korea, Pakistan, and the Philippines.

**Budget discretion.** Sufficient budget discretion is an issue in Indonesia and Viet Nam, but not in Japan or the Philippines. The continued use of off-budget operations in the PRC continues to be a problem, and previous budget approval and control by higher level authorities is an important issue in Bangladesh and the PRC (at the subprovincial level). In Viet Nam, provincial governments have almost complete control over local government. Incentives for local expenditure efficiency are lacking, and generally the quality of public services is quite low, outside Japan and the Republic of Korea.

**Intergovernmental transfers.** Throughout the entire region, heavy reliance and dependence on transfers and revenue sharing can be found. In addition, there is a lack of attention to horizontal fiscal imbalances and the design of equalization grants: the PRC, despite very large fiscal disparities across provinces and local governments, still implements trivial equalization grants. Complex conditional or specific transfer designs are also found, for example, in the Republic of Korea and Thailand. Also, there is only limited use of incentives-innovative transfer mechanisms (e.g., performance-based grants). India has introduced incentives for budget performance; the Republic of Korea offers traditional conditional grants; and Japan and to some extent Bangladesh have incentives for tax effort. In Indonesia they have been discontinued. In the Philippines there are transfer intercepts for loan repayment. Viet Nam is using local service scorecards.

**Local government borrowing and investment finance.** Local government borrowing and fiscal responsibility frameworks are lacking or problematic. In India borrowing takes place to cover

current budget deficits and is common at all levels of government; in the PRC, local governments are not allowed to borrow but their actual debt levels threaten instability; and in Japan subnational debt is one-third of gross domestic product. Local governments, such as those in Cambodia, Indonesia, and Thailand, often have poor and unreliable access to credit. Special intermediate institutions to lend to local governments are rare; the Philippines is an exception. Central bailouts are not a problem so far; automatic intercepts of transfer funds are used in only a few countries. Low revenue autonomy is not conducive to borrowing.

**Management capacity.** Variations in management capacity are large in the region. Several countries exhibit excellent to good quality tax administration and expenditure management: Japan, the Republic of Korea, and to a slightly lesser extent the PRC and Viet Nam. Subnational tax administration and expenditure management show inefficiencies in countries like Indonesia, the Philippines, and Thailand, but several reforms are under way. India and Pakistan have a weak tax administration at the subnational level. Expenditure management practices are also generally weak, even with the secondment of central government employees. At the bottom we have Bangladesh with rather weak and sometimes corrupt tax administration implemented in a deconcentrated fashion. Does a genuine desire to decentralize exist? There is a need to clarify legislation and development of local government in Cambodia, the Lao People's Democratic Republic, Nepal, and Sri Lanka. In Malaysia, the "One Malaysia" policy has led to centralization.

# The Way Forward

Different countries in the region are at different levels of development and refinement of their decentralized fiscal frameworks. The recommendations that follow, therefore, apply to different countries to different extents, covering a broad range of development, from very nascent stages to those which only require refinements.

## An Agenda for Reforming Expenditure Assignment and Management

A clear assignment of expenditure responsibilities should be at the top of national reform agendas for local government finance. The following topics must be addressed:

- (i) Exclusive responsibilities must be identified.
- (ii) For concurrent competencies specific responsibilities for various aspects—regulation, financing, and implementation—must be assigned.
- (iii) Higher level controls on local expenditures must be appropriately limited.
- (iv) With limited administrative capacity, asymmetric assignments between central and local governments should be considered.
- (v) Methods to translate responsibilities into expenditure needs and financing requirements should be developed.
- (vi) Unfunded mandates must be avoided.
- (vii) Funding and staffing of deconcentrated offices of line ministries should be downscaled or eliminated if services are devolved.
- (viii) Implementation of expenditure decentralization needs to be strategic (capacity building and technical assistance).

## An Agenda for Improving Local Revenue Generation and Autonomy

The overarching goal should be to increase reliance on own revenues with meaningful discretion. In addition

- (i) reforming and modernizing property tax administration must be a priority; and
- (ii) diversifying subnational tax bases:
  - a) avoiding nuisance taxes and economic distortions;
  - b) creating a shortlist of other good local taxes: vehicle taxes, business license taxes, and betterment levies on real estate;
  - c) implementing business taxes which offer opportunities (using sales turnover as a proxy, but avoiding conflict with national value-added taxes);
  - d) furthering local tax autonomy through introduction of a local “piggyback” personal income tax with a flat rate and possibly payroll taxes; and

- e) Implementing “green” taxes related to waste management, water- and air-polluting activities, and the production of energy.

## An Agenda for Reforming Intergovernmental Transfers

Reforming intergovernmental transfers has several requirements. Among them are the following:

- (i) assuring predictable, regular, and transparent transfer mechanisms;
- (ii) securing an appropriate balance among the various types of transfers (using separate instruments for separate goals);
- (iii) expanding and improving the use of equalization transfers based on a formula using measures of expenditure needs and fiscal capacity and introducing an explicit rule for the pool of funds to be distributed determining the source in origin (fraternal—or contributions by richer jurisdictions versus vertical—or contributions by the central government, and in the latter case, also determining the amount as a percentage of central government revenues);
- (iv) reviewing and improving mechanisms for allocating resources under conditional grants (rule based as opposed to discretionary);
- (v) consolidating specific grants where large numbers of poorly coordinated programs exist into fewer “block” grants—providing larger but still conditional discretion to subnational governments;
- (vi) implementing performance-based grants for encouraging budget process reforms and improvements in service delivery; and
- (vii) rationalizing capital grants (what is being pursued) and coordinating with borrowing policies.

## Local Government Borrowing and Investment Finance

To varying degrees, many countries in Asia, such as Indonesia and the Philippines, allow for local government borrowing within a regulated framework. Prudent, fiscally responsible local government borrowing needs to be promoted in many countries in the region. Legal and regulatory frameworks for local government borrowing need to be strengthened in places such as the PRC. Options and support mechanisms for local government borrowing must be expanded, including support, where appropriate, to intermediate financial institutions or municipal development funds (such as in the Philippines). Given the needs for public infrastructure, other financing mechanisms should have wider adoption (tax increment financing, betterment levies [valorization], and public–private partnerships).

## Better Framing of Institutional Reform

The reforms above should be reinforced by other measures of an institutional nature:

- (i) Strengthen regular and systematic dialogue between subnational governments and the central government on intergovernmental financial policy.

- (ii) Address government fragmentation and address existing scale-vs.-representation issues (Bangladesh with five levels, and very high fragmentation in Thailand).
- (iii) Where deconcentrated units coexist with decentralized governments, identify the right roles for and interactions between deconcentrated and devolved government entities.
- (iv) Rethink the role of parallel institutions (social funds, etc.) to subnational units and try to limit them and incorporate them into the main subnational government stream.



# Concluding Thoughts

Each country is unique; the basic reform principles aforementioned need to be tailored to the economic, political, fiscal and social realities of individual countries. While there is no point in pursuing reforms that are politically infeasible, it is also important to strengthen horizontal accountability and make decisions about reform based on good information and evidence. There is considerable value-added to regional and global cooperation, sharing experiences, and learning by doing, in pursuing subnational finance reform.

Governments in the region should invest in building subnational administrative capacity, especially at the local level.

It needs to be recognized that getting decentralization right can take quite some time, and the process is almost never a linear one because of its high level of political content. Even when institutions which are decentralized from fiscal, administrative, and political perspectives are working well, we should expect these institutions to evolve and change over time. Decentralization is a continuous process, and not a stage that once reached remains immutable.

## **Fiscal Decentralization in Asia** Challenges and Opportunities


This publication discusses the decentralization issues faced by countries of Asia and the Pacific. It includes practical suggestions on how to proceed in this area to achieve economic growth, macroeconomic stability, poverty and income distribution, services delivery improvements, and political accountability. This note elaborates on adequacy of local revenues and autonomy, expenditure management and clear service delivery mandates, horizontal imbalances and limited use of incentives in intergovernmental transfers, financing needs and local government borrowing, and local management capacities as the major challenges in a decentralized fiscal architecture. The recommendations to address the above challenges also note the long-term nature of these reforms.

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1550 Metro Manila, Philippines  
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