

## DECENTRALIZATION AND ECONOMIC DEVELOPMENT IN ASIAN COUNTRIES: AN OVERVIEW

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### I. *Introduction*

With the end of the Cold War, nations are more or less released from a tension for unification to prepare for international confrontation. It is not just a coincidence that, after the détente, we are observing a strong trend towards globalization and decentralization both of which require stable international relations. Under this trend, each nation seems to be looking for an optimal path balancing merits and demerits of the globalization and the decentralization.

Asia is no exception to this trend. It is now well known that some countries have achieved high economic growth by successfully surfing the waves of the globalization (Asian Miracle) and some were recently hit hard by the overwhelming capital flows hidden in the waves of the globalization (Asian Crisis). As for the trend of the decentralization, however, experiences of Asian countries are not yet well known, which motivated our international symposium entitled “Decentralization and Economic Development in Asian Countries.”

The symposium was held in January 2000 at Hitotsubashi University, organized by Asian Tax and Public Policy Program in the Graduate School of International Corporate Strategy and Public Policy Group in the Graduate School of Economics, both of Hitotsubashi University. Original papers for the symposium are collected in our proceedings,<sup>1</sup> and this

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<sup>1</sup> Those who are interested in our proceedings for the symposium, which also includes papers on Taiwan and Thailand, should contact us at [hsugi@econ.hit-u.ac.jp](mailto:hsugi@econ.hit-u.ac.jp). The symposium was financially supported by RNP (Research Network Project) of Graduate School of Economics, Hitotsubashi University.

special issue presents papers on experiences of eight Asian nations: Japan, Korea, China, Vietnam, Malaysia, Philippines, Indonesia, and India. Each paper has been revised and shortened for this special issue, and discusses primary motives for the decentralization moves, the progresses made so far, and the remaining policy issues yet to be tackled in each country; and they, together, show richness of the experiences in Asian countries. Some countries are still trying to stay away from the movement (e.g., Malaysia), while some are actively pursuing it by making various experiments (e.g., China). The diversity and the dynamism are what attract us most in our studies on Asian tax and public policies.

Figuring out the logic behind such diverse experiences in each country is like figuring out mysteries. Although we do not pretend to have figured them out, we think that our impression based on our conceptual framework and discussion in the symposium may be helpful for readers to begin with. In the following, we first present our conceptual framework to understand the relation between decentralization and economic development (Section 2), try to associate with it the experiences in Asian countries (Section 3), and conclude with discussion on issues that we think remain to be examined further (Section 4).

We hope that our overview facilitates readers' understanding of each paper and evokes further discussion on the relationship between decentralization and economic development not only in Asia but also in the world to have a better policy framework in the new century.

## II. *Conceptual Framework*

Decentralization is concerned with the power relationship between the central government and local governments. It is a delegation of authorities in the decisions on expenditure, taxation, regulations, bond issues, and so forth, from the central government to the local governments. The traditional literature on fiscal federalism has claimed the following fiscal doctrines for sound and efficient use of resources.

- (D1) Macroeconomic stability, income redistribution, and provision of public goods with externalities and scale economies should be the responsibility of the central government, whereas the provision of public goods of local nature should be that of local governments.
- (D2) Local tax bases should be those that are relatively immobile and reflect residents' benefits from local public goods and services accruing to them.

Such fiscal doctrines are based on the fact that there are costs and benefits of decentralization. The benefit is associated with informational advantage that lower level governments possess: They are better informed of regional needs and preferences over public goods and services. Moreover, pressure from inter-jurisdictional competition may motivate local governments to be accountable to their residents. Better information and competition will make regional public policy more accountable and suitable to the residents. All of these favor the delegation of expenditure responsibility to local governments.

Fiscal decentralization involves costs as well. From a macroeconomic standpoint, stability may be in danger if the central government loses its grip over coordinating public debt policies among localities as experiences in many developing countries show. Fiscal equity may not be also satisfied when regional fiscal capacities are not equalized among regions. Furthermore, if

we account for the fact that local governments would fail to coordinate their decisions with their neighbors, we realize that public goods with externalities and scale economies should be provided by the central government. These considerations suggest the central government's responsibility described in (D1) above.

The concern for the local governments' failure to coordinate their policies is also the reason for the choice of local tax bases in (D2). In particular, local taxation may be perverse when it is on mobile resources such as capital or on non-residents, because the former leads to tax competition resulting in underprovision of public goods and services, while the latter causes tax exporting. Devolution of revenue raising function, which we call revenue decentralization, is therefore controversial. As stated above, the literature on federalism favors decentralization of expenditures but is cautious about revenue decentralization. This implies that intergovernmental grants are favored to fill a gap between an optimal degree of expenditure decentralization and that of revenue decentralization, although there remains a question whether or not the transfers can be designed without sacrificing local autonomy in determining expenditures and without giving wrong incentives to recipients.

In considering the relationship between decentralization and economic development, we think that the doctrine (D1) above has an important implication. Namely, in early stages of economic development, the most demanded public goods would be those with externalities and scale economies such as defense, network infrastructure, social and economic stability, for which the central government should have responsibility. As the economy develops, however, with the fulfillment of the national public goods, people come to demand public goods of local nature to enrich their lives and productive opportunities. Hence, decentralization would be demanded for good reasons since public goods with local nature would be better provided by lower level governments.

If decentralization were proceeded carefully along with economic development, it would be welfare-enhancing; but if conditions for decentralization, e.g., fulfillment of national public goods and adequate human resources in local governments, are not met in an economy, decentralization can harm the economy. This observation leads us to the following doctrine.

(D3) Decentralization should be proceeded hand in hand with economic development for further development.

The doctrine also raises a new question on the design of intergovernmental transfers, because an increase in local expenses in the process of economic development widens the *vertical fiscal imbalance* with local governments' limited revenues under the doctrine on local taxes (D2). Furthermore, in the process of economic development, regional disparities are likely to grow since the economic development often requires concentration of resources and talents, which makes certain regions the growth poles and the rest the losers. Such disparities create *horizontal fiscal imbalance* among local governments. As we have already discussed, the delegation of tax-raising power is a controversial issue from economic points of view. Too much delegation can harm economic development by inducing tax competition and tax exporting among local governments, while too little delegation with inappropriately designed intergovernmental transfer system can be also harmful since moral hazard behavior of local governments would be encouraged. Hence, the following doctrine may be useful to consider.

(D4) In the process of economic development, each country must find an optimal degree of

revenue decentralization and a clever intergovernmental transfer system for further development.

### III. *Decentralization and Economic Development in Asian Countries*

Now, with four doctrines above, we overview experiences of the eight Asian countries in this issue.

#### 1. Task Assignment

As far as the task assignment is concerned, our impression is that it is fairly close to the doctrine (D1) in most countries. Namely, public goods with externalities and scale economies such as defense, network infrastructure, social and economic stability, are mostly provided by the central government, whereas local governments take some responsibility in the provision of public goods with local nature such as education, health, and maintenance of natural and social environment.

The degree of the local governments' authority in the provision of local public goods, however, is different from a country to another. For example, the ratio of local governments' expenditure to the total (i.e., central and local) expenditure, summarized in Table 1, ranges from over 70% (China) to below 20% (Malaysia). Although the ratio need not correctly measure the local governments' actual authority in the decisions of public goods provision, it suggests that the degree of expenditure devolution is quite different among countries.

A more interesting issue from conceptual viewpoints is the level of local governments to which responsibility and authority are delegated. For example, in Indian and Indonesian recent decentralization movement, more responsibilities are being delegated to lower levels of local governments. Our author on the Philippine case seems to be supporting this direction: "Being community-based political institutions, the local government units (LGUs) are the closest to the people. There are therefore efficiency gains in empowering them to determine and to deliver the goods and the services that the community needs", whereas our authors on the Indonesian case are skeptical of the movement there because of inadequate human resource capacities of the lower level local governments.

TABLE 1. SHARE OF LOCAL GOVERNMENTS' EXPENDITURE AND REVENUE

	Expenditure	Revenue		Expenditure	Revenue
China	71%	50%	Korea	65%	44%
India	51%	45%	Malaysia	18%	12%
Indonesia	23%	14%	Philippines	20%	8%
Japan	70%	40%	Vietnam	43%	n.a. <sup>2</sup>

Note: Numbers are approximate, calculated for recent years based on data presented in this issue, our proceedings, and personal communications.

<sup>2</sup> In a personal communication, our author explains as follows. In Vietnam, local governments do not have tax powers and in the unified budget the General Taxation Department is centralized. Revenues are assigned and shared between the center and provinces based on the arrangements specified in the budget law. The local government's can levy charges and fees which amount to less than 5 per cent of the total revenues.

## 2. Local Revenue

One of the taxes which closely follow the doctrine (D2) is the property tax; and it has indeed been adopted as a major local tax in all countries but Vietnam and China, transition economies. In each country, however, the local government's authority to determine the tax rates, as well as the authority to choose tax bases, has been seriously limited. Other major revenue sources of local governments are commodity taxes, various fees and charges, natural resources, and private and state enterprises.<sup>3</sup> Some of them may be justified from the benefit principle and the immobility of tax bases suggested in (D2), but others are not; and thus they may have some potential problems from the viewpoints of equity and efficiency as some of our authors suggest (c.f. Indonesian case).

In the case of Vietnam, another important local fiscal resource is reported to be community contribution in schools, health sectors, roads and small irrigation works. Its unique characteristics lies in the fact that it is voluntary but half-mandatory: "In the case of education, for example, there are various types of fees. Parents are required to pay activity fee, there are construction fees or contribution for capital spending and fees for extra classes. Most contributions, in principle, are voluntary, but parents have little option but to pay them. There are also contributions in kind including labor for the construction of school buildings, health centers or rural roads."

In most cases, it is reported that the local tax bases are so narrow that local governments, in general, are not raising enough revenue to meet their expenditure responsibility. It may be interesting to note here that local governments are not necessarily willing to take more revenue raising responsibility because raising revenue is often a politically unpopular tasks (c.f. Malaysian case). In any case, as we discuss further below, the facts above are the roots of various problems concerning the revenue decentralization and the design of intergovernmental transfer system.

## 3. Fiscal Evolution

Our doctrine (D3) claims that decentralization should be proceeded hand in hand with economic development. This doctrine seems to be applicable to evaluate the fiscal evolution of most countries.

First, it is reported that "decentralisation is a non-issue in Malaysia for a good reason. The Federal Government had a very strong hand in the economic development and transformation of the country, and it provided industrial and social infrastructure adequately throughout the federation without creating any major regional disparity. There is a general perception that the Federal Government is better situated to handle economic matters with the good effect of scale economy."

On the other hand, "[t]he Philippines embarked on an ambitious decentralization program in 1991 to strengthen democratic processes and enhance economic growth" although the process of decentralization seems to be fairly slow. In Indonesia, two new laws to promote decentralization in fairly drastic fashion are legislated in 1999. The authors, however, feel that

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<sup>3</sup> These items are also the sources of the so-called "extra-budget" and "off-budget" revenues in Chinese local governments. See our Chinese paper for more details on the interesting fiscal system.

“there is a need to provide for a good transition structure and for a long transition period to prepare Indonesia for meaningful and efficient decentralization. Instead of going “big-bang” approach, Indonesia should phase the regional autonomy and decentralization process to ensure macro-economic stability.” These two cases seem to be showing that certain degree of economic development is a driving force of the decentralization while its speed is important for sound development.

The same comment seems to be applicable to the Indian case. It is reported that, although the central government had a strong power until 1960's, local dissatisfaction demanded decentralization against which the central government has tried to keep its control by reforming transfer systems. Such an attempt, however, reached a flash point in the early 1980s, and after the death of Mrs. Gandhi, there occurred a big swing from centralization to decentralization. Our author comments that “this swing to the other extreme has weakened the powers of the central government in carrying out its assigned function of maintaining macro-economic stability. What is more, the central government has not been able to implement much needed economic reforms because of the divergent views held by different regional political parties on economic reforms. This has slowed down the pace of implementing the much needed economic reforms to achieve higher rate of growth of GDP.”

In Korea and Japan, where high degree of economic development has been achieved, long-awaited major political reforms toward decentralization seem to be occurring. In Korea, it was 1995 when people, for the first time, directly elected their chief executives and councilors; and it was also in 1995 that the decentralization promotion law was legislated in Japan to promote decentralization. Both of them seem to be clear evidences that, after certain degree of economic development, the two countries are committed to reform themselves by promoting decentralization.

In the cases of transition economies, we may have to be a little more careful in applying our doctrine. In Vietnam, it is reported that although the share of local expenditure has shown a sharp increase from 26% in 1992 to over 43% in 1998, in reality, with very little independent revenue raising powers, local governments do not have much power on expenditure decisions and often act just as agencies. Nevertheless, the decentralization in expenditure and revenue seem to be steadily going on in Vietnam under the fairly early stage of economic development.

In China, decentralization has started in 1979. Share of local revenues is now said to be about 70% (including extra- and off-budgets) and, as we all know, China is showing a steady growth under this highly decentralized system. This fact may suggest that local governments are in a better position in promoting economic growth in some process of economic development. Our author argues that fiscal structure was designed so as to give provincial governments strong incentives to develop regional economies in 1980's. Intergovernmental competition also seems to have disciplined the government sector in China not to disturb market economy in fear for being a loser of the competition. The competition, however, has caused several problems such as regional disparities. With dissatisfaction of some regions, if the Chinese political landscape changes (as in, for example, India), under the decentralized system, the country may not be able to well handle problems the regional competition creates.

#### **4. Revenue Decentralization and Transfer System**

As we discussed in proposing our doctrine (D4), the revenue decentralization and the

intergovernmental transfer system are likely to be important issues in the process of economic development, since an increase in local responsibilities requires more revenue for local governments and regional disparities are likely to grow in the development phase.

Indeed, in all countries, these two issues seem to be important agenda. As for the revenue decentralization, many authors show their concerns for the lack of accountability and incentives of local governments in improving their tasks, due to the lack of authorities in revenue-raising power (e.g., Philippines, Vietnam, and Japan). As for the intergovernmental transfer system, many authors feel that the mechanism to solve the horizontal fiscal imbalances (i.e., inequality among regions) is insufficient in their current transfer system (e.g., Malaysia, Vietnam, and Korea). On this point, however, Japan provides some interesting case.

Our authors claim that too much equalization elements in the Japanese transfer system have been harming the economy. Based on a surprising fact that ratio of local government's expenditure to regional income has been persistently higher in prefectures with lower income due to the massive transfers from the central government aiming for their votes, the authors conclude that "both prefectures of lower income and the central government have been stuck in a disincentive trap where the momentum for improving fiscal responsibility has been lost." Fundamental reforms in the intergovernmental relationship seem to be an urgent issue there.

Experimental and innovative reforms in revenue decentralization and transfer system have been attempted in China. In the reforms between 1977 and 1993, the central government tried to provide local governments with incentives for revenue collection, especially from the state owned enterprises which were then allowed to keep profits and thus beyond the central government's fiscal control. The basic incentive mechanism is that of the merit pay system in which local governments with more revenue-raising efforts can retain more revenue. Although this mechanism was partially weakened by the 1994 reform in which the central government has more independent tax bases and its own tax collection agencies in an attempt to stop the declining trend of the central government's revenue, the existing system of extra-budget and off-budget is said to be a driving force of the China's revenue decentralization process.

#### IV. *Remaining Issues*

As our overview shows, papers presented in the symposium provide rich information and insights into the practice of fiscal decentralization in Asia. As we understand, the issue of decentralization is of great importance, but is complicated and involves many dimensions. It is our hope that the symposium encourages further discussion of this issue. We would like to conclude our overview with a list of remaining issues that we think are left for future research.

(1) *Intergovernmental Transfers*. As we have just discussed, the design of intergovernmental transfer system is one of the most important issues in each country. Given that the central government is more efficient in raising revenue and local governments are more efficient in providing public goods and services, the resulting vertical fiscal gap must be closed by intergovernmental transfers. When the grants scheme is subject to discretion, however, it may soften the local budgets. That is, ex post equity and efficiency concern, or political demand would induce the central government to provide more transfers to local governments with fiscal distress. This transfer, anticipated by the grant recipients, can lead to ex ante moral

hazard behavior. Namely, local governments would not make enough efforts to economize their fiscal management and/or direct their resources to more risky projects. Then we have to face trade-off. On one hand, sufficient fiscal resources need to be ensured for local governments to fulfill their obligation in public expenditure and to mitigate horizontal fiscal imbalance across regions due to uneven distribution of local tax bases. On the other, such transfers may soften the local budgets, which distorts their incentives for efficient management. How to compromise these cost and benefit of intergovernmental transfers yet remains to be examined.<sup>4</sup>

(2) *Levels and Sizes of Local Governments.* Local governments involve multiple tiers. To which level of local government expenditure and tax functions should be delegated, and how local governments should be restructured are also open questions. In principle, a jurisdiction should be better matched with an area to which benefits of its provision of public goods and services accrue. Furthermore, to ensure accountability of the local governments avoiding the efficiency problem discussed just above, sufficiently rich revenue source should be granted to local governments with different local capacities. These arguments seem to be suggesting fairly large size of local governments as destinations of the fiscal authorities in decentralization. This suggestion, however, misses the fundamental benefits of decentralization to place functions of government closer to the people. In reality, we may also have to be concerned with the shortage of human resources with talents and skills in policy makings under the decentralized system. Furthermore, it is reported that in some countries, current transfer systems are providing incentives for unification and/or break-up of local governments (e.g., Philippines). Both theoretical and empirical works must be done to provide a guide for this issue.

(3) *Decentralization and Economic Development.* Our symposium was intended to discuss issues of fiscal decentralization and economic development. Although there was extensive and fruitful discussion among the participants in the two-day meeting, views on the relationship between the decentralization and economic development are mixed. In order to have better understanding on the relationship, we feel that we need to incorporate political and social factors, in addition to the economic factors that we are mostly concerned with in this overview. Currently, most Asian nations are confronted with a new challenge of restructuring their public sectors. With an emergence of new worldwide economic environment, it is now becoming obvious that traditional political institution of governing a nation would not survive in the coming years. Although inconclusive about the exact nature, we all share a view that fiscal decentralization must have a close relationship with the economic development, and the decentralization process would be one of the most important factors which determine the future of each country. We hope that experiences in Asian countries stimulate further discussion on the issue among theorists as well as policy makers.

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<sup>4</sup> This issue is going to be discussed in our next symposium in 2001.