Transition to Market and Normative Framework of Fiscal Federalism

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Abstract

The mainstream literature on normative framework on fiscal federalism has been largely developed keeping in view the advanced market economies. It is necessary to modify these before they are applied to developing transitional economies to take account of the characteristics of these economies, legacies of past policies, and the nature of their institutions. The paper analyses the effect of lack of development of market institutions and legacies of planning on fiscal decentralisation and intergovernmental fiscal relationships. It attempts to identify the important features of these economies that make the modifications in the normative propositions necessary. These include, impact of planning in distorting the budgetary systems, overhang of public enterprises and its inhibiting influence on the development of the market, controls over prices and output and the distortions and invisible regional transfers they create, physical barriers to mobility and trade across different regions, need to replace public enterprise profits with taxes and variety of instruments used to establish regional equity under planning and the problems that they can create in a market economy. The paper argues that normative principles of fiscal federalism and intergovernmental transfers will have to be modified to take account of these special features before they are applied in designing and implementing these policies in developing and transitional economies.

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Introduction

This paper deals with the challenges of fiscal federalism in planned economies. The discussion on fiscal federalism in the mainstream literature refers to decentralistion and not federalism *per se*. The benefits attributed to and costs associated with fiscal federalism refer to decentralisation.[1] In fact, fiscal federalism is supposed to deal with all multilevel fiscal systems irrespective of whether the system is federal or unitary. As stated by Oates (1977. P4), "…..the term federalism for the economist is not to be understood in a narrow constitutional sense. In economic terms, all governmental systems are more or less federal; even in a formally unitary system, for example, there is typically a considerable extent of *de facto* fiscal discretion at decentralised levels." Thus, the analysis in this paper refers to multilevel fiscal systems in all planned economies irrespective of whether they are formally unitary or federal.

The discussion in the paper relates to planned economies. Of course, centralised planning is negation of federalism. In centrally planned economies, the decisions on prices, outputs and allocation of resources are taken by the central planner and here, neither the market nor the subnational governments have any role in resource allocation. The subnational governments simply implement the functions assigned to them as agents of the central government. However, most of the centrally planned economies have made, and are making a transition from command to market, and in some countries, planned development strategy has historically co-existed with market determined resource allocation. In economies that followed central planning strategy for a long time, even as they make a transition to the market, the vestiges of planning continue to impact resource allocations and institutions of market are yet to be developed fully. They impact through controls over prices, outputs, inputs, impediments to free movement of factors and products and above all, lumpiness of past investments persist altering both sectoral and regional resource allocations in ways different from the market or their endowments. In the context, the norms of intergovernmental finance developed in the context of developed market economies need to be modified.

The normative framework on fiscal federalism has two major shortcomings: First, much of the mainstream literature takes a Benthamite view that governments are benevolent despots and do everything to counter market failures. Second, the normative framework in this body of literature has been developed in the context of developed market economies. The normative framework on intergovernmental fiscal arrangements developed in the context of advanced market economies will have to be considerably modified to take account of the special characteristics, institutions, and problems of developing and transitional economies.

The objective of the present paper is to identify the salient features of developing and planned economies impacting on intergovernmental fiscal arrangements and to suggest modifications in the policies and institutions. Section II summarises the normative framework in the existing fiscal federalism literature. Section III brings out the specific characteristics of planned developing economies having an impact on resource allocation. Section IV discusses the impact of planning on inter-regional resource flows in developing countries and identifies the areas requiring particular attention reforming fiscal decentralisation policies and institutions in these economies. Section V summarises the major conclusions.

II. Fiscal Federalism: The Normative Framework

Fiscal federalism is considered to be an optimal institutional framework for the provision of public services. The idea stems from the observation of Alexis de Toqueville more than a century ago, “The federal system was created with the intention of combining the different advantages which result from the magnitude and littleness of nations" (1980, vol. 1, p. 163). The critical issue therefore, is to map the functions with different levels of government to meet diverse preferences of people on the one hand, and reap economies of scale in the provision of the services on the other. The optimality in the Tiebout's world is reached as the footloose consumers 'vote on their feet' to choose the bundle of public goods and tax payments (Tiebout, 1956). Even when the consumers do not have footloose mobility and therefore, cannot effectively vote on their feet, optimality is achieved as fiscal differentials are capitalised in terms of market values of properties (Oates, 1969). Alternatively, the median voter exercises his 'voice' to choose the public service — tax mix to maximise welfare gains.

The superiority of fiscal federalism in efficient provision of public services is characterised by the 'decentralisation theorem'. The theorem states, " …. .. in the absence of cost savings from the centralised provision of a (local public) good and of interjurisdictional externalities, the level of welfare will always be at least as high (and typically higher) if Pareto-efficient levels of consumption are provided in each jurisdiction than *any single, uniform* level of consumption is maintained across all jurisdictions" (italics added; Oates, 1972, p. 54). Notably, in this formulation, the lower efficiency arises from uniform provision of public services and not due to centralisation *per se.* Nevertheless, ability of the centralised system in meeting diverse preferences is limited by informational and political constraints and hence, the superiority of fiscal decentralised provision of public services (Oates, 1999).

The assignment system in the normative framework necessarily results in vertical imbalances. For efficiency reasons, all broad based taxes are assigned to the centre and most expenditure functions are assigned to subnational levels, and therefore, vertical imbalance is unavoidable and the intergovernmental transfer system has to resolve the imbalance. This is also because redistribution and stabilisation functions are considered to be mainly the functions of central government and allocation function is considered to be predominantly in the domain of the subnational governments. While the matching of revenue and expenditure decisions at the subnational level as far as possible is important, the efficient system of assignment envisages that tax powers should be assigned to subnational levels to the point where the marginal efficiency loss due to subnational levy is matched with marginal efficiency gain from fiscal autonomy.

The objective of the transfer system in this framework is to offset the imbalance between the assignment of revenues and expenditures at central and subnational levels and interjurisdictional mobility of persons ensures efficiency in the system. The rationale for horizontal transfers in this case is purely for equity reasons, to offset the fiscal disabilities arising from lower than stipulated revenue capacity and higher unit cost of providing public services. Such transfers are also considered to improve efficiency in resource allocation, particularly when inter-jurisdictional mobility of labour does not equalise the capital – labour ratio across regions.

Thus, the case for horizontal equalisation in intergovernmental transfers, rests mainly on equity grounds. Differences in the capacity to raise revenues and unit cost of providing public services among subnational jurisdictions create different 'fiscal residuum' or net fiscal benefits (Buchanan, 1952). The problem is exacerbated when there are origin based taxes and similar other factors alter the net fiscal benefits in different subnational jurisdictions (Boadway and Flatters, 1982). Horizontal equity is established by giving unconditional transfers so that all subnational units are enabled to provide a given normative level of public service, at a given tax price.

The debate on the issue of whether the horizontal equalisation transfers are efficiency enhancing or involve efficiency cost is an issue that has remained unresolved.[2] In a static sense, if the productivity of investments reflects endowment of resources, the transfers to poorer regions reduce the overall productivity and hence, are efficiency reducing. In contrast, if the low productivity in disadvantaged regions is because of the scarcity of public capital (social and physical infrastructure), we have the case where both equity and efficiency objectives are complementary. In other words, if the public spending from the transfers in fiscally disadvantaged jurisdictions result in generalised externalities and enhance the productivity of capital, the equitable transfers are efficiency enhancing.

The efficiency reason for intergovernmental transfers arises from spillovers. The assignment system, however done, does not match with the geographical boundaries of the jurisdictions and spillovers have to be resolved through the transfer system. Alternatively, some of the functions assigned to the subnational governments have significant nation-wide externalities and therefore, it is necessary to ensure minimum levels of such services for reasons of efficiency. Open-ended specific purpose transfer with matching requirements is supposed to ensure efficiency on this account.

In the actual design of the transfer system, there are serious operational questions, which cannot be resolved easily. The first, has to deal with the proper combination of conditional and unconditional transfers. The second issue, pertains to the extent of horizontal and vertical distribution. There is no unambiguous way to measure the degree of vertical imbalance and the extent of violation of horizontal equity. As regards specific purpose transfers are concerned, it is impossible to measure the degree of externalities to work out optimal cost sharing arrangements or matching ratios. Finally, even if some approximations on fiscal disabilities and matching ratios are made, there are many non-economic including political objectives, and the actual transfer system, differs from the ideal. Nevertheless, the attempt should be to approach the ideal both in designing it and in its evaluations.

The departures from the above normative framework are seen mainly in the political economy approaches, which question the very welfare-maximising objective of governments. These behavioural and institutional approaches have provided new insights and helped in better understanding of the multilevel fiscal systems. Thus, Prodh'omme (1995) questions the superiority of decentralisation over centralised provision of public services, but his conclusions are judgmental and not logically argued. In a more rigorous and meaningful analysis, Bardhan and Mookherjee (2000), show that the fiscal decentralisation is gainful only if the elite capture at local level is less than it is at the central level. As stated by Bardhan (2002, p.194), "Even though the extent of relative capture of governments at different levels is crucial in understanding the likely impact of decentralisation initiatives, there has been very little work on the subject, either theoretical or empirical." Similarly, Breton (2002), discusses several cases of decentralisation failure which basically arise from behavioural assumptions made in the analysis. These analyses generally bring out the dissatisfaction with the mainstream analysis in its ability to address the fiscal decentralisation issues in the more realistic institutional contexts.

There are a variety of reasons to modify the fiscal federalism analysis available in the mainstream literature before it is applied to the multilevel fiscal systems in developing and transitional countries. This is because developing countries have a predominant primary sector, coexistence of a large traditional sector with low market penetration and a small modern sector, segmented labour markets, low level of savings and investment, imperfect competition with significant trade distortions and scarcity of foreign exchange. The adoption of planned development strategy in them has further distorted the markets (Newbery, 1987). It is not appropriate to uncritically apply the normative framework of fiscal federalism to address policy issues in such countries. Secondly, most of these economies have adopted planning in a mixed economy framework. In some that have chosen to make a transition from centralised planning to market-based resource allocation, the vestiges of planning continue to influence resource allocation outcomes. Developmental planning adopted by developing countries in the past and the vestiges of centralised planning in the economies making a transition from plan to market do influence the fiscal federalism outcomes and therefore, need to be analysed in greater detail. As stated by Oates (1999, p. 1145), "While the existing literature in fiscal federalism can provide some general guidance, …my sense is that most of us working in the field feel more than a little uneasy when proffering advice on many of the decisions that must be made on vertical fiscal and political structure. We have much to learn."

III. Planning and Federalism

The success of the Soviet economy in achieving rapid progress by adopting centralised planning strategy had led many developing countries in the world to adopt planned strategy for investment allocation with heavy reliance on the public sector in the 1950s and the 1960s. While the Soviet Union itself and similar socialist countries adopted centralised planning, many other developing countries such as, India and Pakistan adopted a planned development strategy with co-existing private and public sectors. The nature and operation of vertical public sector in these countries vastly differs from market economies. It is important to understand the salient characteristics of these countries having a bearing on the assignment system as well as inter-regional resource flows. When many of the instruments of planning create inter-regional resource transfers which, often are invisible, it is difficult to taken them into account in the explicit transfer systems. In this section, some important characteristics of the planned economies with implications for assignment of taxes and expenditures on the one hand, and creating invisible transfers on the other, are highlighted.

The rapid progress achieved in the initial years after the Bolshevik revolution led many developing countries to adopt the Soviet style economic planning. These included the countries of the Soviet block and similar other socialist countries including China and Vietnam. With all investments centrally directed, the subnational units in these countries were merely deconcentrated implementing agencies of the centre. The absence of property rights rendered the role of taxing properties, incomes and wealth largely irrelevant in these fiscal systems. With public enterprises taking a pivotal role to generate resources for investment, the location of these enterprises determined the pattern of regional development. Furthermore, often, the difference between government proper and public enterprises in the provision of public services gets blurred in these economies as many enterprises are directed to provide public services such as schools and hospitals. In general, there is soft budget constraint, particularly at subnational levels. The closed nature of these economies takes away the role of competition altogether. In these economies, the advantages arising from the 'magnitude' and 'littleness' of nations attributed to federations by Alexis de Toqueville over a century ago does not simply accrue. In these economies, there is no meaningful role for the subnational governments. As stated by Chelliah (1991, p.7), "Comprehensive central planning, involving as it does, centralised decision making in relation to production activities and disposal of resources in the 'national interest' is the negation of the principle of true federalism."

The perverse incentives and institutional weaknesses in socialist economies made them inherently unsustainable. It is precisely for this reason that, economic federalism fails in centrally planned economies (Inman and Rubinfeld, 1997). The inherent contradictions of the system led to the collapse of the pure "centrally planned socialist regimes." There has been a dramatic reform in not only in central and eastern Europe, but also in large Asian countries with strong socialist persuasion such as China and Vietnam. The most notable features of reform in these countries are privatisation and restoration of the role of markets, opening up of the economies and decentralisation (Bird, Ebel, and

Wallich, 1995). The three features are complementary and reinforce each other to make a transition from command to market economy.

Although considerable progress has been made in each of these areas, these economies function in a relatively centralised institutional environment. These countries are in transition and planning in some form or other continues co-existing with market based resource allocation. Further, the vestiges of planning and command economy in these economies continue to impact on resource allocation with important implications for fiscal federalism. These include the continued use of administered prices as an instrument of resource allocation, prevalence of soft budget constraints, contingent liabilities and fiscal risk associated with these, physical restrictions and impediments to internal trade, restrictions on the mobility of labour and capital, and finally, the historically given spread of physical infrastructure and stock of capital invested in state enterprises.

The transition from command to market economy has impacted on the finances of subnational governments in a variety of ways. Central governments, in their attempts to contain fiscal imbalances, often push the deficits down. While some countries, notably Vietnam accomplished almost six percentage point reduction in expenditure – GDP ratio over the period 1990-94 to reduce the inflation rate from a three digit number to a single digit level, the general approach has been to reduce transfer to local governments while keeping the functional assignment unchanged. This has led to either declining standards in public service provision as in Russia or in countries with a tradition of soft budget constraints, accumulation of arrears and contingent liabilities, as in China (World Bank, 2002) and Hungary (Bird, Ebel, and Wallich, 1995). The central government continues to play the dominant role in resource allocation and this is true of countries such as Russia, that have formally adopted federal constitutions. Thus, in transitional economies, subnational governments are yet to acquire a meaningful role in the provision of public services. In particular, no country has assigned any broad-based revenue sources to subnational governments. Local governments have little autonomy in expenditure decisions.

The second category of economies in which planning has impacted on fiscal federalism are those which have adopted development planning as a strategy to accelerate growth in a public sector dominated mixed economy framework. The countries such as, India and Pakistan fall into this category. The low levels of saving and investment, existence of poor infrastructure and absence of industrial base, combined with export pessimism motivated these countries to channel available savings to priority areas of investment. In a mixed economy, this had to be achieved by assigning 'commanding heights' to the public sector, and the private investments had to be channeled into priority areas through a system of industrial licensing. Elimination of domestic competition was combined with high degree of protection through a combination of physical restrictions on imports and very high tariffs to eliminate external competition altogether. As this could lead to large monopolies and highly skewed distribution of incomes and wealth, various legislations to control restrictive trade practices on the one hand, and confiscatory levels of taxation on the other, were introduced.

Thus, fiscal policy in planned economies in a mixed economy framework was designed to (i) finance investment by raising the level of domestic saving, especially public saving; (ii) transfer household savings to public investment; (iii) reduce inequalities in income and wealth; and (iv) aid in social engineering of the volume and direction of economic activity (Bagchi and Nayak, 1994). The way in which fiscal policies were calibrated in these large economies had significant impact on the operation of multilevel fiscal systems. In particular, while the size and diversity of such economies required a significant fiscal decentralisation, the adoption of planned development strategy called a high degree of centralisation in both fiscal and financial systems. In virtually all these economies, economic liberalisation in recent years has loosened the grip of planning and has brought in significant changes. However, the legacies of the past policies and structure if institutions continue to impact on the operation of the multilevel fiscal system.

Thus, planning in both centrally planned economies making a transition to the market and those with mixed economy framework has impacted in the nature and functioning of fiscal federalism. While, as mentioned earlier, many of the economies have decided to increase fiscal decentralisation alongside making a transition to the market, the reform issues will have to cover many areas not covered in the normative framework put forward in the mainstream literature. It is, therefore, important to understand the implications of planning on fiscal federalism for designing an agenda for reform in these countries.

IV. Development Planning and Fiscal Federalism

This section discusses the implications of the adoption of the strategy of investment planning in developing and transitional economies on fiscal federalism and eventually on the efficiency and equity in the delivery of public services in these economies. As mentioned earlier, despite the progress achieved in fiscal decentralisation, privatisation and freeing of product and factor markets, the autarchic fiscal system and the institutions set up to implement the systems continue to impact on the functioning of multilevel fiscal operations in these economies in a variety of ways. Some of the important implications of planning on fiscal federalism are discussed below.

Impact of planning on budgeting system

The development planning strategy has had important implication on the way in which investment budgets are determined in developing and transitional economies. In India for example, the process has resulted in the segmentation of both central and state budgets into 'plan' and 'non-plan'. While in principle, the expenditure on new schemes is supposed be classified as plan, those incurred for the maintenance of the completed schemes is considered non-plan. Thus, spending classified as plan does not necessarily represent investment expenditures. This segmented budgeting practice has prevented a holistic approach to the provision of public services. The emphasis on having larger plans at the state level has resulted in three important outcomes. First, the states have made larger allocations to plans without paying attention to the maintenance of assets such as roads, bridges and irrigation works, which are in their domain. Second, competing claims for scarce resources and eagerness to take up a large number of schemes have led to spreading the resources thinly with significant cost and time over-runs. Finally, the need to increase the plan size has led to raising resources by the state governments without much regard to their distrotionary implications (Rao, 2002).

The most important aspect of planning process in countries such as India is that segmentation of the budget into plan and non-plan categories has led to the separation of the transfer system for plan and non-plan purposes. Both the streams are general purpose transfers intended to offset fiscal disabilities, but are distributed on the basis of different and often, conflicting criteria. The separate mechanisms employed to determine plan and non-plan transfers have led to the states' adopting strategies with adverse incentives to fiscal management, besides inequity and inefficiency in the delivery of public services.[3]

In many of the transitional economies such as Vietnam, Laos, and China too, the investment budget is determined differently from recurring budget. The investment budget is determined by a combination of bottom-up and top-down process with the central governments eventually including only a small fraction of the projects demanded by the local governments. The process distorts the prioritisation, causes under-funding, loss of time and cost over-runs. In these countries too, segmented treatment of investment and recurrent expenditures has prevented a holistic view and strategy of their budgets.

In transitional and developing economies, rationalising the budgeting systems is an important component of reform agenda. As the economies decentralise their fiscal systems further, it is important to have a comparable and uniform system, proper process of determining the budgets, internal and external control mechanisms. Many transitional countries still do not have uniform budget codes and nomenclature. In many of these countries, the accounting system is highly centralised which does not enable decentralised expenditure management, the treasury control is not effective and external control through independent audit does not exist. The reporting systems from line ministries and local governments are not standardised besides being weak. Countries such as Vietnam, Cambodia, and Laos follow the erstwhile French system of budget classification, just as countries such as India, Pakistan, and Bangladesh follow the Anglo-Saxon tradition. In these countries, considerable effort is needed to changeover to the GFS classification system. In most socialist countries, traditionally, budget was considered a secret document. Reforms in the systems of budgeting and reporting are extremely important as these economies decentralise their fiscal systems further.

Commanding state enterprises: implications on the fiscal federalism

An important feature of the planned economies is the lead role played by state enterprises in economic activities. In these economies, resource mobilisation is done through state enterprise profits. Thus, the volume and pattern of resource mobilisation is determined by the way in which public sector prices are administratively determined. With economic liberalisation and opening up of the economy, the revenue importance of state enterprises declines. Besides, as taxes replace public enterprise profits, it has different implications for relative prices and allocative efficiency.

The predominance of state enterprises and its declining role with market-based liberalisation has important implications for fiscal federalism. Mobilising resources through public enterprise profits rather than taxes has different implications for the assignment of revenue sources to central and subnational governments. In many planned fiscal systems, subnational governments derive significant revenues from the state enterprises owned by them and as the economy is liberalised, subnational taxes have to be developed. However, assignment of taxes in most of the planned economies to local governments is meagre though in planned democratic federations such as India state governments collect almost 37 percent of their total revenues from own sources. In many of these economies realty markets are not well developed, property owners are a powerful elite and obviously property taxes do not contribute much to the revenues of local governments. Thus, in many of the transitional economies, inability to substitute declining revenues from local state enterprises with local taxes can reduce fiscal autonomy of local governments.

The impact of declining state enterprise revenues on fiscal decentralisation is generally seen in both reducing enterprise revenues and reducing transfers to subnational governments. In most transitional economies, the subnational governments get significant revenues from state enterprises under their control and vanishing revenues either because of inability to face greater competition in a liberalised open environment increase their fiscal dependence. Reduction in state enterprise revenues if not compensated by increasing tax revenues can increase the deficits. One probable result of this is to push the deficits down by transferring expenditure responsibilities to subnational governments. Thus, in Hungary, the responsibility for welfare expenditures and social safety net was transferred to localities in 1993. In Russia the central government transferred social expenditures amounting to 6 percent of GDP to localities and in the next year transferred the responsibility for important national investments to subnational governments (Bird, Ebel, and Wallich, 1995).

The consequence of pushing down the functions without planned economies such as India finances has been to reduce the standards of public services or raising revenues from revenue handles assigned to them without any regard to economic effects of such levies. The state and local governments in India, for example, are known to raise revenues from residence based and distortionary taxes, which has created impediments to internal trade and violated the principle of common market (Rao, 2002). This can also lead to a build-up of expenditure backlog and arrears in payments as seen in Bulgaria, Romania, Russia, and Ukraine, or undesirable borrowing as in the case of Budapest and Russia's oblasts (Bird, Ebel, and Wallich, 1995).

Public enterprise revenues of subnational governments can be an important source of distortion and inequity. In the case of commodities that are relatively inelastic with respect to prices, sales outside the jurisdictions result in the collection of monopoly profits from the non-residents, and this is akin to inter-jurisdictional tax exportation. Besides, the sub-national governments may follow strategies to attract trade by reducing prices in the case of commodities that are price elastic and increasing prices in the case of commodities that are relatively price inelastic. This can result in significant relative price distribution.

An important outcome of the public enterprise activity is the off-budget financing of public services. In economies which have strong presence of state enterprises, they are directly made to provide many public services, such as, running of schools, hospitals, housing, construction and maintenance of roads and bridges. Although with the advent privatisation, these activities had to be transferred to subnational governments, in many countries, enterprises continue to finance public service provision to a considerable extent. The use of extra budgetary sources to finance public services is particularly significant at local levels. In China for example, it is estimated that the off-budget financing of expenditures in 1996 was estimated at over 20 percent of GDP. This included quasi-fiscal expenditure of enterprises of about one percent of

GDP (World Bank, 2001, Wong, 1999). In Russia, local tax offices permit illegal tax breaks to firms setting up their own kindergartens and providing other social services. Similarly, in Bulgaria, the state enterprises play an important role in health, education, infrastructure, and culture (Martinez-Vazquez, 1995).

Another important implication of the public enterprises is the way they have been used to soften the budget constraints at subnational levels. In many countries the local bond market is yet to be developed and borrowing from the financial system involves considerable contingent liabilities. In India, acute fiscal difficulties by the state governments have led them to use the state enterprises as conduits to undertake additional borrowing and soften the budget constraint (Rao, 2001). Thus, an outcome of the predominant public sector has been to add significant contingent liabilities and fiscal risk to subnational governments in planned economies.

In most developing and planned economies, governments play an important role in production and distribution activities through their enterprises. It is generally presumed that when the production and distribution activities are controlled by the government, it is not necessary to put the regulatory system in place as these enterprises are supposed to be aware of their social responsibilities. As most of the economic activities are run under public monopoly situations, there is no need to have a regulatory system to ensure fair competition. However, as these enterprises are privatised and market discipline is introduced, introducing effective regulatory system becomes imperative.

Developing subnational tax system

An important feature of the plan development strategy seen in both developing and transitional economies is the determination of prices according to the government fiat rather than the market principles. This is a part of the public sector dominated import substituting strategy. The consequence of this has been that the allocation of resources both between different industries and regions in these economies are markedly different if the prices were market determined. Thus, administered prices have important implications for both efficiency and equity in a multilevel fiscal system.

The most important local tax that needs to be developed to strengthen fiscal decentralisation is the local property tax in these countries. In order to develop property tax as a significant contributor to local revenues, it is important to establish clear property rights and develop legal and regulatory systems.[4] In many socialist countries such as Vietnam and China, assignment of property rights and development of a legal system are still in transition. In India, property rights have been assigned and legal institutions exist. But often, the records are not properly maintained and vestiges of planned regime – rent control act, urban land ceiling act continue to plague rationalisation of the property tax system. Also, the property owning class as a pressure group in a local government can be a formidable hindrance to the development of a modern property tax system.

Substituting the administered prices with taxes is a major reform agenda in many planned economies. This changes the revenue assignment system for, in many transitional economies the subnational governments do not have tax powers and enterprise income has to be substituted by transfers. Some countries such as Romania, still assign local enterprise taxes to subnational governments and in some others local governments stake "source entitlement" claim. Nevertheless, by and large, the substitution of administered prices with taxes has been to centralise tax collections. On the one hand, move to decentralise functions has resulted in greater expenditure responsibilities and on the other, substitution of enterprise income with taxes leads to centralisation of tax powers. The prime example of this is in China where after recentralisation of tax powers in 1994, the fiscal dependence of the subnational governments have significantly increased.

Meaningful fiscal decentralisation requires significant subnational taxing powers. Linking tax and expenditure decisions at the margin is critical to ensuring expenditure efficiency and accountability. At present, in most transitional economies, local governments do not have significant tax powers. Even when they are given some tax powers, the subnational governments have shown general reluctance to raise revenues from the sources assigned to them. In countries such as India, decentralisation in tax powers is only up to the state level (Rao, Amar Nath, and Vani, 2004). Even so, the states levy a host of inefficient taxes including a cascading type sales tax and tax on the inter-state sale. Below the state level, even in urban areas, the property tax is not well developed and this has led the local governments to levy inefficient taxes such as the tax on the entry of goods (octroi) into local areas.

There is much to be done in assigning appropriate tax bases and developing tax administration in these economies. Despite the claim that at local level provides incentive for revenue collections by increasing tax compliance, the experiences of a number of socialist countries such as Russia, China, and Laos have shown that tax compliance will actually decline when tax collection is decentralised. It is therefore, important to pay attention to the design of decentralisation in these economies as they make a transition to the market.

Substituting physical controls with market-based instruments

An important feature characterising the three transitional economies is the prevalence of price and quantity controls. With market based liberalisation and opening up of these economies, price (including interest rate) and quantity controls will have to give way to monetary and fiscal policy instruments. Disbanding command and control systems associated with Soviet style planning and replacing them with fiscal and regulatory instruments calls for changes in decentralisation system as well. In most such economies, some controls over prices have continued even though most of the commodities are subject to market discipline.

Removal of impediments in internal trade and mobility

There are a number of other controls and regulations introduced as part of the planning process. These have created serious impediments in the movement of factors and products within the federation. Thus, a major advantage of fiscal federalism of enabling a nationwide common market while allowing for diversity in preferences is negated. The impediments have been erected to serve the needs of planning or rationing to meet the scarcity situations. These have imposed several hindrances to the movement of factors and products across the country. Thus there are restrictions on the movement of labour and capital and restrictions on the movement of products from one region of the country to another. There are also cases where physical barriers are placed on the movement of commodities from one place to another within the country. In many socialist countries such as China and Vietnam, migration from one region to another and often from rural to urban areas is prohibited resulting in a large number of illegal migrants without proper access to basic services on the fringes of major cities. In many countries, the easiest way to collect revenues is by erecting barriers on highways and arterial roads and collecting (often illegal) taxes. However, in countries like India, poor information base has led to erection of checkpoints at several places to facilitate tax collections. Thus, there are checkpoints for administering sales taxes, state excises on alcoholic products, taxes on motor vehicles, to check exploitation of forest products also at police checkpoints. These have been erected not only on state borders but also inside the states. In addition, there are taxes on the entry of goods into local area (octroi) for which separate checkpoints are erected by the municipalities.

Despite lesser emphasis on the plan and change in scarcity conditions over the years, a number of fiscal and regulatory impediments have continued to surface in most developing and transitional economies. Besides physical controls, there are also fiscal impediments with unintended allocative consequences. Removal of impediments to ensure free movement of factors and products throughout the country is necessary to improve competitiveness and this will be an important challenge in transitional economies of Asia. An important advantage of federalism is the access to large common market and in most planned economies, this is not realised.

Balanced regional development, inter-regional inequity and invisible transfers

In planned economies, there are two explicit ways by which regional allocation of resources is generally brought about. First, the central government's own investment in different regions or the regional policy pursued by it, determines the level of economic activity and the private sector resource flow. Central investment in infrastructure in different regions determines the flow of private investments. In most planned economies, the objective of 'balanced regional development' pursued by the governments cause the investment pattern not according to the resource endowments in different regions but often vitiated by the distortions caused by central investments. Interestingly, often, despite the claims about balanced regional developments, the investment decisions are taken on political considerations – on the basis of bargaining powers and political influence of different regions. In India for example, despite a lot of emphasis given to regional equity, as on March 2002, four high income states with the population of 29.5 percent and generating state domestic product of 34 percent accounted for 22.1 percent of investments and 31.6 percent of employment in central enterprises. In contrast, five low income states with a population of 44.7 percent and generating income of 28.4 percent of the country accounted for only 26 percent of investments and 42.1 percent of employment. Thus, often, the claims made on balanced regional development is more a rhetoric than a reality. Interestingly, even as large investments were made steel plants in state with large deposits of manganese and coal as in Bihar, Madhya Pradesh, Orissa, and West Bengal, the forward linkages from these large investments were nullified by having "freight equalisation policy" – policy of subsidising freight charges to equalise the prices of steel across the country.

The second explicit method of impacting on regional resource allocation is through intergovernmental transfers. In some socialist planned economies, the expenditure assignment is delegated or deconcentrated and the transfers are given mainly to carry out these functions. However, in large countries, fiscal decentralisation is a reality. However, even in these economies, the determination of the volume and design of the transfer system are important reform issues. In most countries, transfer system is negotiated. There is no objective mechanism to determine the volume of transfers nor are there distribution formulae. In many countries, transfers are determined in the process of determining budgets. This includes Hungary, Poland, and even Vietnam. In the last case, actually, norms are built into the determination of expenditures (World Bank, 1999). In Russia until 1994, the ex-post subventions are negotiated between deficit regions and the Ministry of Finance with serious incentive problems. Institution of a rule based transfer system is an important challenge in these countries.

In India, the constitution itself provides a mechanism for determining the transfer system. The Finance Commission appointed by the President every five years is supposed to determine the total tax devolution and grants as well as their distribution among various states. The functioning of the Finance Commission, however, has left much to be desired. The Commissions, in effect follow the "gap-filling" approach with serious disincentives for fiscal management. In addition, with the emergence of the Planning Commission as an institution determining the resource allocation of the public sector, a parallel transfer system has been developed to meet plan expenditure requirements. Both the Planning and Finance Commissions give unconditional transfers; the Planning

Commission, in addition, channels central government loans to state governments. Besides these agencies, individual ministries give specific purpose transfers.

The most important issue in both developing planned economies and transitional economies with a strong plan legacy is that considerable improvements need to be made in the transfer systems. Negotiated transfer system and those with significant disincentives to fiscal management have to be replaced by formula based system to offset fiscal disabilities. Further, the institutional mechanism to devolve the transfer system needs to be evolved to make the system objective and transparent.

In addition to regional policies and intergovernmental transfers, there are various sources of implicit inter-regional transfers that alter resource allocation across regions. One source of such transfers is various price and quantity controls. Administered determination of prices and quantities determines the profitability of different industries and depending on the resource endowments, different regions. Another important source of implicit transfer is the collection of revenues from origin-based taxes and consequent inter-regional tax exportation. Origin based tax system, and cascading type of taxes can cause significant inter-regional resource transfers. These economies are characterised by oligopolistic markets and with mark-up pricing situation, the producing subnational units collect significant revenues from the consumers in consuming units. In Indian case, the implicit transfers estimated from subsidised lending to states significantly eroded the progressivity of explicit transfers in India during the period, 1985-95 (Rao, 1997).

Distortions and Inequity

Planned economies through their various policy instruments to control the resource allocation introduce several sources of distortion and inequity. Thus, fiscal federalism in these countries ceases to be an efficient institutional arrangement. The distortions are introduced by the way the budgets are determined, the determination of administered prices, impediments to internal trade and movement of labour and capital, closed nature of the economy and commanding heights role assigned to the public sector. Most of the planned economies are making a transition to more market-oriented decentralised systems. However, until the transition is complete, the multilevel fiscal arrangements will have to take these distortions and inequity into account in formulating their federal fiscal policies.

V. Concluding Remarks

The paper argues that the normative framework developed in the mainstream literature on fiscal federalism in the context of advanced market economies needs to be modified to take these special features of developing and transitional economies into account. Indeed, there is some literature that considers the more realistic objective function of maximisation of returns by individual government agents rather than the usual Benthamite social welfare maximisation, and this has provided significant insights. However, what is needed is a shift in the paradigm of analysis itself. This paper does not pretend to provide such an analysis. It merely attempts to examine the special features of planned economies casting shadows on the federal fiscal arrangements and indicate the areas where mainstream literature on fiscal federalism needs modification.

The paper identifies a number of areas where the planned development strategy can impact on fiscal federalism. Of course, central planning is the negation of federalism. However, virtually all economies have made a transition from command economy to market-based resource allocation, but vestiges of planning continue to impact on resource allocation. Similarly, some countries have adopted planned development strategy within a mixed economy framework. The paper analyses the impact of planning on assignment system, overlapping in the assignments, and the implications for intergovernmental transfers arising from the planned development strategy.

There are a variety of ways in which planned development strategy affects the efficiency and equity in multilevel fiscal systems and fiscal federalism can become an optimal institutional arrangement in these countries only when significant reforms are undertaken. These include reforms in planning and budgeting practices, reforms to substitute public enterprise profits with taxes at subnational levels, developing market based instruments to substitute physical controls, evolving the transfer system to take into account invisible transfers, and reforms in the fiscal system to reduce distortions.

On the policy side, the scope of reforms in fiscal federalism in developing countries is much more complex and broader than merely looking at the issues in assignment and transfer systems. The reforms in fiscal federalism are inextricably intertwined with privatistion, planning and budgeting, reforms in administered price mechanism, various regulations relating to the movement of factors and products, besides the issues discussed in fiscal federalism. Any attempt to look at the issues in isolation will make the reforms less potent and ineffective.

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Endnotes

[1] Breton (2000) distinguishes federalism from decentralisation in terms of the ownership of inextinguishable constitutional powers of the levels of government.

[2] In the literature, there has been considerable debate on the issue of efficiency versus equity in the transfer system. In the earlier phase, the discussion between Scott (1950) and Buchanan (1952) remained inconclusive. The controversy was revived again in the 1980s, with Boadway and Fatters (1982) arguing that the equalising transfers are efficiency enhancing whereas Courchene (1984) argued that there is trade-off between equity and efficiency. The issue, however, has remained unresolved.

[3] For a detailed analysis of the adverse incentives and efficiency and equity implications of the transfer systems, *see*, Rao and Singh (2005).

[4] For a detailed discussion of evolving property tax systems in transitional countries, *see* Malme and Youngman (2001).