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Public Finance in Developing and Transitional Countries by Jorge Martinez-Vazquez and James Alm; Edward Elgar, Cheltenham, UK, 2003; pages 357; price £ 65

The book is a collection of essays presented in a conference held in the honour of Richard Bird whose extensive contribution to the fiscal literature emphasised that the unique standards or norms should not be trusted as the simplistic solutions are dangerously insufficient to deal with complications posed by the real world. His contribution to fiscal federalism has moulded the shape of federalism in several economies. He taught that tax reforms should be based on understanding of the country specific conditions. The other areas to which he has contributed profusely are government's expenditure policy and fiscal management process. The essays presented in the book are selected and arranged so as to reflect the contribution of Richard Bird to these specific areas. The book is organised into three sections covering the areas of inter-governmental fiscal relations; tax evasion, tax administration and tax compliance; and the fiscal policy.

The opening chapter offers an interesting discussion on role of middle level government in a federation in the context of equalisation policy of the central government. The pure decentralisation model, as suggested by theory, where a median voter can translate his preferences to the elected officials, is not suitable to explain the findings on intra-provincial equalisation. The sub-national governments may influence the equalisation policies of the centre through distribution of transfers received from the centre, particularly the transfers pattern to local levels by sub-national government may be different than that envisaged in the central government's policy. Similarly on the tax measures, the provisions made by the centre may and may not be passed down to local levels by the provinces. Overall impact of sub-national policy stance on equalisation policy can be judged by the simple rule based on elasticity where a lower cross-section income elasticity of expenditure than that of revenue indicates the presence of intra-province equalisation. The empirical tests in case of China, Russia and USA are indicative of the existence of equalisation mechanism in these countries. From the experience of these countries, it is concluded that the equalisation policies are driven more by disparities in wealthier states than by the average income level. The policy implication embodied in the analysis is that the centre should allow a liberal sub-national sector if it has already embraced the decentralisation and a relatively controlled sub-national sector if it has not fully embraced the decentralisation.

It is learnt from the experience of China, India and Vietnam that the main challenges in inter-governmental finances are to introduce appropriate institutions, extend fiscal decentralisation to local levels, assign significant powers to sub-national governments, and design appropriate tax policy so as to replace the revenues from public enterprises with taxes. There is a need to establish legal and administrative institutions required for efficient assignments to sub-national levels. It is essential for the evolution of efficient decentralisation that comprehensive budgeting system and an appropriate system for accountability and transparency are set in place.

The local public finances and the inter-governmental transactions are influenced by the spatial allocation of population resulting due to different degree of liberalisation in labour and housing markets. The spatial disequilibrium of population may require the local authorities to take some specific measures. There is a need, for example, to increase spending on public services in a region experiencing in-migration of population. If migrated labour is unskilled, the expenditure requirement may be higher than the revenue contribution made by the migrated labour. The policy response across countries has been different to deal with migration. In Germany, where population migration took place on a large scale after the unification, the central government resorted to indirect fiscal measures like infrastructure spending and investment subsidies to otherwise unprofitable enterprises to prevent the flow of labour from one region to another.

The appropriate measurement of decentralisation is crucial for analytical purposes as the inaccurate measure of the same may lead to wrong conclusions. For example, the higher level of autonomy, defined as a ratio of sub-national governments' own tax revenue to their total revenue, was found to have positive impact on sub-national fiscal situation, whereas the fiscal dependence, measured as a ratio of inter-governmental transfers to total sub-national revenues, was found to have negative impact on fiscal position of sub-national governments. Regarding the impact of decentralisation on economic growth, the earlier studies have found negative relationship between the two where fiscal decentralisation was defined in terms of share of sub-national expenditure in total expenditure of the government sector. The findings by Robert D. Ebel and Serdar Yilmaz, however, indicate that the fiscal decentralisation, defined in terms of revenue autonomy, has positive impact on economic growth. Another important contrast highlighted by the authors is that the fiscal decentralisation measured in terms of expenditure has led analysts to conclude that the higher fiscal decentralisation does not limit the public sector size. The analysis based on the revenue structure, however, indicates that higher autonomy may lead to smaller public sector.

Vito Tanzi and Tej Prakash discuss the possibility of enhancing efficiency in the use of publicly owned assets. There are numerous examples of public activities like railways, education, health, and military which are usually located in the lands of high commercial values. Many of these activities can be beneficially shifted to the locations of less commercial values. This sort of exercise calls for complete record of public assets and imputing values to the same to carry out cost-benefit analysis of public activities as was done in the Italy. In order to assess the full cost of public activities, it is advisable to see the opportunity cost of assets involved in such activities and also cost of various tax incentives given to these activities by the government. This type of exercise is conspicuous for its absence in most of the countries. Only a few countries like Australia and New Zealand have started to value public assets and also include assets in a comprehensive manner in financial statements.

Discussion on the tax administration and compliance points out that the simple theoretical statement, stating that the high probability of being caught and high amount of penalty for tax evasion improve the tax compliance, is insufficient to address the issue. In practice, there are many other social factors to play a crucial role in the degree of tax compliance in a country. One important institution to affect tax compliance is the social norm, *i.e.*, if people think that it is a norm to pay tax and everybody is paying it, there will be higher tax compliance.

The social norm can be influenced by the government by convincing the tax payers that they have a say in the way tax revenue is being spent. A feeling of strict administration among the people also strengthens the social norm. The approach towards tax administration and the treatment given to tax payers or to tax evaders for that matter is crucial in determining the degree of tax compliance. It is felt that a tax administration, where the role of enforcement is recognised but at the same time the role of tax administration as a facilitator and a provider of services to tax payers is also emphasised, is helpful in improving the tax compliance. Experience of the countries like Jamaica, South Africa and Russia indicates the importance of social norm in better tax compliance. Another problem in taxation, particularly in the transition economies, is the lack of modern system of cash-based transactions. For example, persistence of barter system in some sections of the Ukrainian economy is causing the problem of tax arrears. It is crucial to restructure the old state-owned enterprises which are characterised by chronic non-payment from customers and to suppliers, extensive use of barter system to settle debt, and soft budget constraints.

Globalisation has expanded the range of factors responsible for economic growth. Accordingly, the role of fiscal policy and taxation in influencing economic growth has also widened. It is argued in the book that the consumption tax is more conducive than income tax for growth because it involves no labour market distortions whereas a high income tax may cause distortions between leisure and working hours. Economic growth may be strengthened by promoting innovations either through expenditure or through tax incentives. Due to several procedural impediments involved in expenditure approvals, tax incentive may be seen as a preferred option to promote the innovative activities. Fiscal policy can, however, facilitate both redistribution and economic growth without depending on tax transfers given that the appropriate expenditure programmes like education and child development are put in place.

The fiscal decentralisation is often given partial credit for economic stability in several countries like Switzerland, Germany and United States. In Latin countries, however, fiscal decentralisation is often thought to be responsible for macro-fiscal instability due to lack of adequate institutions – rules and agencies. The econometric evidence suggests that the decentralisation based on transfers from the centre tends to increase the total size of government sector. Deficits at sub-national level are associated with national expenditure, deficits and macro-economic instability. Thus, it is critical to put in place rule based transfers and borrowing constraints on sub-national governments. The sub-national governments at the same time should have the capacity and autonomy to stay with hard budget constraints. The case studies of some Latin countries show that the institutional reforms on these fronts can help bringing under control the macro-fiscal management problems, which have been found to be associated with fiscal decentralisation. The experience of these countries indicates that the rule based transfers are most crucial in introducing fiscal discipline at sub-national level. Regarding borrowings, *ex ante* controls should be adequately combined with better enforcement of *ex post* consequences.

The book contains two essays on the specific issues dealing with the tax regime for tobacco products in the EU-accession countries and taxation of electronic commerce in developing countries. The low elasticity of demand for tobacco indicates that the high tax regime serves the purpose more of revenue generation and less of putting restraints on its consumption. It is argued that specific tax regime, instead of *ad valorem* rates, are more revenue productive and also more effective in restraining the consumption of tobacco. The discussion on taxation of electronic commerce deals with the digitised products like business services, software, music, games and videos which can be delivered electronically in intangible form. It is possible to tax the electronic transactions through withholding tax, a restricted force of attraction rule, formula apportionment, *etc*. It would, however, call for international co-operation to successfully tax these transactions.

The expositions in the book serve the purpose of a guide to a number of countries which are in process of devolving more powers to lower levels of the government. Discussion on relevance of sub-national governments provides critical insights particularly for developing countries like India where State Governments undertake large part of social sector expenditure. Sub-national government may enhance or impede the process of equalisation envisaged in the central government policies. The issues of tax administration and impact of fiscal policy on growth are dealt with in the context of the developing countries. The book highlights the need of decentralisation for the efficient delivery of public services as decentralisation brings tax payers closer to the spending authority, thereby enabling the tax payers to reflect their preferences to the elected representatives. The benefit of decentralisation is, however, often limited by the expenditures based on transfers form the centre. The rule based transfers and control on borrowings of the sub-national governments are crucial for the efficiency and fiscal-macro stability. Thus, the book discusses several policy inputs pertinent to developing countries like India. Currently, India is in process of devolving more financial powers to local bodies. The book has discussed various challenges and difficulties, which need to be dealt with to ensure efficient decentralisation. The existence of fiscal stress at the state level in India may have adverse effects on macro-economic stability. In this context, the crucial lesson contained in the book is the importance of rule based transfers and constraints on borrowing of the states. The book underscores the need of complete record of the assets used for the public activities and imputing values to the same. In most of the cases, in the Indian context as well as in the context of other developing countries, public assets like schools and defence establishments could be beneficially shifted to the places of less commercial value and additional resources could be generated. Similarly, the importance of social norm in improving tax compliance is significant lesson to be learnt. It is argued in the book that the fiscal policy can facilitate both redistribution and economic growth without depending on tax transfers given that the appropriate expenditure programmes like education and child development are put in place. In the Indian context, the Government's emphasis on various social sector and infrastructure expenditure in recent years, particularly under *Bharat Nirman*, seems to be a welcome move toward promoting growth and redistribution.

Thus, the book provides valuable inputs for the policy as well as analytical purposes. However, discussion on certain other related issues would have added further value to the book. For instance, it has been discussed in the literature that the fiscal decentralisation to local levels may result into concentration of power with a few wealthy individuals. The resources are often used for the benefit of select groups once the power is concentrated in a few hands at the local levels. This type of practice provides more opportunities for corruption and marginalises the benefits of decentralisation. The lack of infrastructure and sufficient skills required for budgeting and account keeping is also an impediment in the process of fiscal decentralisation.

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