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MARKET PRESERVING FEDERALISM

WHERE DOES THE INDIAN FEDERATION STAND?

BY

Mala Lalvani

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DEPARTMENT OF ECONOMICS
UNIVERSITY OF MUMBAI
Mumbai 400 098

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Author(s)
Mala Lalvani
General Economics Unit

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Abstract

The second generation economic theory of federalism, also referred to as '*market preserving federalism'*, draws on the advances made by the new theory of the firm. It assumes that there is no natural reason for political officials to further the interests of citizens. However, appropriate political institutions, it is expected, would align the interests of political officials and citizens. This paper studies the Chinese experiment in its move towards market preserving federalism and evaluates the present day Indian federal structure vis-à-vis the basic tenets of market preserving federalism.

Key Words : Decentralization, Fiscal Federalism

JEL Code(s) : H11, H77

Market Preserving Federalism
Where Does the Indian Federation Stand ?

1. Introduction:

A worldwide interest in fiscal decentralization is being witnessed in recent years. At one end of the spectrum decentralization has been perceived of and advocated as a solution to many governance problems. While at the other end there are others who point to the potential dangers of Decentralization (Tanzi, 1995). Some of the most prominent dangers of decentralization include imposition of extensive regulations, impediments to development of a common internal market and greater corruption. However, if the decision to decentralize is taken then "***the proper design and establishment of key institutions for decentralized governance becomes critical***" (Ahmad and Tanzi, 2002). It is in this context that we speak of 'Market Preserving Federalism' as providing us with one such package for proceeding with decentralization.

Based on the degree of independent decision making exercised at the local level three varieties of fiscal decentralization may be distinguished. *Deconcentration* refers to dispersion of responsibilities from the central government to regional branches. *Delegation* refers to a situation in which local governments act as agents for the central government, executing certain functions on its behalf. Finally, *Devolution* refers to a situation in which not only implementation but also the authority to decide what is to be done, is in the hands of local governments. The traditional theory of fiscal federalism lays out a general normative framework for assignment of functions to different levels of government. The first generation economic theories of fiscal federalism emphasized that local governments have better information than national governments about local conditions and this would enable them to make better decisions (Hayek, 1945). Tiebout (1956) argued that competition among jurisdictions allowed citizens to 'vote with their feet' and choose the most suited jurisdiction. Along similar lines Musgrave (1959) showed how the appropriate assignment of jurisdictions over public goods and taxes increased welfare. These theories take for granted that political officials provide public goods and preserve markets.

Quian and Weingast (1997) offer a second generation economic theory of federalism, also referred to as 'market preserving federalism' which draws on the advances made by the new theory of the firm. The theory of the firm studies a range of incentive problems that affect firms and assume that no natural reason compels managers to favour shareholders. The theory shows how firm institutions and governance structures are structured so that interests of managers are aligned with interests of shareholders. In a similar vein, Quian and Weingast (1997) assume that there is no natural reason for political officials to further the interests of citizens. However, they argue that appropriate political institutions would align the interests of political officials and citizens.

Section 2 of the paper elaborates on the basic tenets of 'market preserving federalism'. Section 3 concerns itself with the Chinese experiment in its move towards market preserving federalism. Section 4 speaks of the Indian federal structure and provides a snapshot picture of the finances of state and local governments. Section 5 evaluates the Indian federal structure vis-à-vis the basic tenets of market preserving federalism. Finally, section 6 concludes.

2. Basic Premises of Market Preserving Federalism

The basic tenets of what has been termed as 'market preserving federalism' (Montinola, Qian and Weingast, 1995) include

- A hierarchy of governments with a delineated scope of authority exists so that *each government is autonomous within its own sphere of authority*.
- The *sub-national governments have primary authority* over the economy within their jurisdictions.
- The national government has the authority to police the *common market* and to ensure the mobility of goods and factors across sub-national jurisdictions.
- *Revenue sharing among governments is limited* and borrowing by governments is constrained so that all governments face *hard budget constraints*.
- The allocation of authority and responsibility has an institutionalised degree of *durability* so that it cannot be altered by the national government either unilaterally or under pressures from sub-national governments.

An institutional structure so designed aims to limit the extent to which a political system encroaches on markets. The most important implication of market-preserving federalism is the induced competition among jurisdictions. The implications of this would be:

(i) No government has monopoly of regulatory authority over the entire economy.

(ii) Competition among jurisdictions extends to factors also.

(iii) Hard budget constraint would suggest that local governments could go bankrupt thus incentivising proper fiscal management.

(iv) It provides the political foundations for markets. By placing authority in the hands of sub-national governments and keeping the central government out of this activity it prevents intervention of political goals that distort markets.

Drawing a parallel from the theory of the firm, Quian and Weingast (1997) suggest how the features of federalism viz., decentralization of information and authority and inter-jurisdictional competition can provide credible commitment to secure economic rights and preserve markets. More specifically, they suggest that providing the central government with less information and power in particular areas increase the credibility of commitment. This combines with the induced competition among local jurisdictions to provide local officials with incentives to pursue citizens' interests.

3. The Chinese Experiment

In the past two decades China has transformed itself from a centrally planned economy to an emerging market economy and at the same time has achieved nearly 10% average growth rate. During this period China's per capita GDP has more than quadrupled. Montinola, Quian and Weingast, 1995 have provided an insightful description of the Chinese Experience. The 'Great Leap Forward' in 1958 and the Cultural Revolution in 1970 were two previous waves of administrative decentralization. Decentralization in the 1980s differed, however, in that it combined financial incentives, reliance on market mechanism, increased control by the lower governments and openness to international markets.

Fiscal Incentives

The fiscal contracting scheme between the central and provincial government was introduced and maintained between 1988-1993. Revenue income from each province was divided between 'central fixed revenue' all of which was transferred to the central government and 'local revenue', which was shared. The local revenue was then divided between central and provincial governments according to pre-determined schemes. Most of these schemes allowed the local governments to retain all the incremental revenue that they managed to procure. In the final stage some extra remittance from provinces to the central government and additional transfer payments from central government to the provinces took place.

In addition to budgetary revenue there also exist 'extra-budgetary' funds, which include certain categories of revenues collected by local governments and ministries including some retained profits of state owned enterprises. The extra-budgetary revenue is wholly retained by the local government. Moreover, the local government has complete authority over the determination of taxes or fees that fall into the category of extra budget. Limited knowledge about these budgets commits the central government not to tax these budgets. These changes have provided for substantial independence of local governments and ensured that governments in each region assumed primary responsibility for economic development in that region.

The Common Market Condition

The development of good and factor mobility across regions is considerable but remains imperfect. Huge floating migrant population and increased foreign capital inflow suggests that there is increased factor mobility across regions. The common market condition, however, is still imperfect. It is clearly evident that imperfect policing of the common market allows local governments to insulate themselves from competition and use their political freedom to erect trade barriers.

The Hard Budget Constraint

At all levels of government, fiscal budget constraints are relatively hard due to declining tax revenues and limited intergovernmental budgetary transfers. The one exception is the state banking system, which has become the most significant source of the soft budget constraint for governments at or above the county level. China's state banking system features a central bank supervising four specialised state banks. Under regional decentralisation, the regional governments at the provincial, municipality and county levels also gained great influence over credit decisions through the regional branches of the central bank and the specialised banks. The absence of a unified monetary system has allowed local governments access to credit in a way that has expanded money supply. In recent years, however, local governments' budget constraints in China have become harder, partly because local governments compete in spending their resources to attract foreign investments. They have greater incentive to stop subsidising inefficient and failing state firms.

Township and Village Governments

One result of China's reform is the spectacular growth of the market in the sector of Township-Village Enterprises (TVEs) which are owned by township and village communities and controlled by township and village governments. By the end of 1993, TVEs produced 30% of total industrial output in China. The incentives given to these firms account for their success. They include

(a) The structure of these firms offer residual claim rights to township and village governments.

(b) Two types of limits are imposed on the township and village governments their firms: (i) These governments do not have the authority to enact protectionist policies like trade barriers and (ii) a hard budget constraint is imposed on these governments. Not only can they go bankrupt but the central government cannot bail them out endlessly.

By fully controlling the assets of TVEs, the local governments have access to information that is not available to the central government. The Town-Village level governments seem to better approximate the market preserving type of federalism than the higher levels of government. Thus they are able to resist revenue predation in a credible way. Moreover, because the local governments are empowered with the responsibility of local goods provision, the state finds it in its own interest to prey less on TVEs. (Quian and Weingast, 1997). An important feature of decentralization in China is that local governments' power is limited because they do not control state banks and cannot create money. This governance structure where banks have credits but local governments have control and information over firms serves as a commitment to hard budget constraint.

Durability and Irreversability

The reforms provided considerable limits on the discretion of of the central government. They were associated with the emergence of strong regional economic powers. These limits endowed the reforms with a degree of durability, making reversal more costly if not impossible. Li Peng's efforts to recentralize investment and financial powers failed. The Governor of Guangdong province refused to cooperate and many other governors followed. Li Peng's failure illustrates the point that the limits on the discretion of the Central government gave an element of durability to the reforms. Five possible reasons could explain this turn of events:

1. The price of recentralisation had increased.

2. Some regional governments had accumulated wealth in ways that do not allow central government to easily confiscate the revenue.

3. Incentive structures within the government had altered considerably. Officials no longer cared to be promoted to posts in the higher level government because officials in the lower level government enjoyed greater autonomy.

4. The fall of socialism in Eastern Europe and Soviet Union had an important impact on China. It was soon realised that a reversal of the reforms that cut off access to international markets would result in shrinking of domestic production and unemployment.

5. Majority of the Chinese people gained economically under the reforms. The widespread feeling that reforms left people better off placed a constraint on any attempt to reverse reforms.

Competition Among Jurisdictions: Factor Mobility

While Tiebout (1956) argued that competition among jurisdictions enhances efficiency via 'exit', Quian and Weingast (1997) believe that jurisdictional competition also serves as a disciplinary device to punish inappropriate market intervention by lower level governments officials. Competition for mobile sources of revenue prevents local political leaders from imposing taxes and regulations. Only those restrictions that residents are willing to pay for will survive. Similar arguments suggest that federalism's jurisdictional competitions have led to the endogenous emergence of harder budget constraints (Quian and Roland, 1996). In a federal system mobility of resources across jurisdictions raises the opportunity cost of bailing out inefficient firms or wasteful public expenditures. Jurisdictions that consistently make inefficient expenditures will not be able to attract mobile resources. Thus, competition changes the incentives of local politicians.

A striking evidence of labour mobility is noticeable in China. Although many restrictions remain on migration, the floating labour pool is enormous. Total labour exported from Sichuan province reached 3 million per year. Remittances from migrants have totaled as much as 3-5 billion Yuan annually. Considerable amount of competition is also noticed among regions for foreign capital. Two main components in this competition are: (a) laws, regulation and taxes that promote economic development, including property rights and (b) infrastructure and access to markets. Shaanxi province imitated Guangdong's system of opening up trade. It released its control over 125 commodity prices and withdrew 12,289 tax offices. Because local governments compete in spending their resources to attract foreign investments, they have greater incentive to stop subsidising inefficient and failing state firms.

The form of decentralisation inherent in the reforms in China provides an important set of limits on the behaviour of all levels of government. Decentralisation has not only set limits on the central government but has also induced competition among local governments serving both to constrain their behaviour and providing them with positive incentives to enhance local economic prosperity.

4. The Indian Federal Structure: A Snapshot Picture

The federal structure of India till the passage of 73rd and 74th CAAs in 1993 and 1994 was a two-tiered structure with the central government at the helm of affairs and the state governments forming the second tier. We begin with providing the reader with a snapshot picture of the combined finances of all state governments. The change in scenario in the post reform period of the 90s would become apparent when we examine key fiscal indicators in the 90s and compare it with the figures in the 80s, as has been listed in Table 1 below. The years 1990/91 and 1991/92 mark a clear divide in the fiscal position of the Indian economy. Hence in this study we have chosen to sub-divide our sample into two: 1980/81 to 1989/90 is the pre-reform period and 1992/93 to 1999/00 is the post reform period. The build up to the crisis in 1990/91 and 1991/92 are considered as outliers and hence have been eliminated from both our sub-samples.

TABLE 1

VARIABLES	**(Average) 1980/81 TO 1989/90**	**(Average) 1992/93 TO 1999/00**
State govt. gross fiscal deficit/ Gross Domestic Product	2.8 %	3.45 %
State govt. revenue deficit/ Gross Domestic Product	-0.1 %	1.36 %
State govt. total liabilities/ Gross Domestic Product	17.9 %	20.4 %
State govt. expenditure on revenue acct./ total expenditure of state govt.	72.2 %	81.7 %
State govt. expenditure on capital acct./ total expenditure of state govt.	27.8 %	18.3 %
State govt. expenditure on revenue acct./ Gross Domestic Product	11.1 %	13.9 %
State govt. expenditure on capital acct./ Gross Domestic Product	4.25 %	3.1 %
State govt. total Expenditure/ Gross Domestic Product	15.4 %	16.9 %

The overall picture of state government finances is gauged from the deficit figures. Gross fiscal deficit of state governments as proportion of GDP (Row 1) shows a deterioration of 0.65 percentage points. What is worrisome, however, are the revenue deficit figures (Row 2). Revenue deficit figures as per cent of GDP has risen from -0.1% to 1.36% In nominal terms, revenue deficit has risen from an average of Rs. 271 crores in the pre reform period to Rs.17646 crores in the post reform period i.e. an increase of 65 times. The total liabilities of state governments as per cent of GDP (row 3) has worsened by 2.5 percentage points. In nominal terms, liabilities of state governments have risen from an average of Rs.52684 crores in the 80s to Rs.234687 crores in the 90s i.e. an increase of 4.5 times. The states thus seem to be getting trapped in the vicious circle of high revenue deficits leading to larger borrowings entailing higher outgoings on interest payments, which in turn lead to larger revenue deficits.

On the expenditure front, we find that despite all the ‘right noises’ about pruning of expenditures, state government expenditures as proportion of GDP (Row 8) have worsened in the 90s. The ratio shows an increase of 1.5 percentage points. In fact, the composition of total expenditures, into expenditure on revenue and capital account, has taken a turn for the worse.

Expenditures on revenue account are incurred on goods and services for current consumption and do not result in creation of assets. These expenditures have risen from 72.2 % of total state government expenditure in the 80s to 81.7 % (row 4) in the 90s. Expenditures on capital account, which result in creation of durable assets, were as low as 27.8% of total expenditures in the 80s. This has fallen further to 18.3% in the 90s (Row 5). As per cent of GDP, expenditure on revenue account which was 11.1% in the 80s has risen to 13.9% in the 90s, while capital expenditure, which was a meager 4.25% in the 80s has fallen to 3.1% in the 90s.

The structural imbalance in state government finances stems from limited resource base of states in relation to growing expenditure commitments. The vertical fiscal imbalance between central and state governments arise because the central government has certain inherent advantages in raising revenue and state governments have greater responsibilities on the expenditure front. Constitutional provisions have therefore been made for intergovernmental transfers. Resources are transferred from central to state governments via three channels (i) grants (ii) share in central taxes and (iii) loans. Rao and Singh (1998a) sum up the constitutional assignment of expenditures and revenues between centre and states as follows:

(i) The constitution exhibits a clear centripetal bias in the distribution of fiscal powers.

(ii) The assignment of tax powers follows the principle of separation.

(iii) Constitution allows levy of some taxes which can create severe impediments to inter-state sale of goods by the exporting state has caused perverse transfer of resources from the poorer ‘consuming’ states to the more affluent ‘producing’ states. Similarly states can levy octroi – a tax on the entry of goods into a local area for consumption, use or sale. Such taxes have enabled the states to export the tax burden.

(iv) Devolution of a high proportion of income tax and excise duty has robbed the central government of the incentive to collect revenues from these sources and concentrate on non-shareable taxes like customs duty. However, the recent initiative of giving the states a fixed share of 29 per cent of total tax revenue as recommended by the 10th Finance Commission is expected to remedy the situation.

The economic rationale for intergovernmental transfers include offsetting of fiscal imbalances ensuring horizontal equity across states and competitive equality (Rao and Singh, 1998b). The change in pattern of these transfers and their composition is evident from Table 2.

TABLE 2

VARIABLES	(Average) 1980/81 TO 1989/90	(Average) 1992/93 TO 1999/00
Gross transfers from centre /state government total expenditure	43.83%	39.62%
Grants from centre / state government total expenditure	12.62%	11.95%
Share in central taxes / state government total expenditure	16.21%	16.19%
Loans from centre / state government total expenditure	15.00%	11.48%

We find that gross transfers which financed 43.83 % of total state government expenditures in the 80s has fallen by 4.25 percentage points in the 90s. Of the total expenditures, while grants and share in central taxes have shown a marginal reduction, it is the share of loans, which have declined. However, it is grants that have always been the subject of much discussion. A notable feature of federal arrangement in India is the existence of multiple channels of transfer. Grants to state governments are via three sources viz., Finance Commission, Planning Commission and as Central Sector and Centrally Sponsored schemes by the various ministries.

Finance Commission (FC) transfers are statutory in nature with no element of discretion involved. Grants recommended by the Finance Commission are determined on the basis of projected gaps between non-plan current expenditure and post-tax devolution revenues. The broad procedure followed in case of giving grants by the Finance Commissions (FC) comprises of the following steps:

(i) Assessment of overall budgetary requirements of Centre and states.

(ii) Projecting states' own current revenues and non-plan current expenditure.

(iii) Distributing assigned taxes on the basis of origin.

(iv) Distributing shareable taxes, personal income tax and union excise duties, between Centre and states and among states.

(v) Filling the gap between projected expenditure and revenues after tax devolution, with grants.

It has been pointed out that on account of this gap-filling methodology, the overall resource position of the Centre and the resources required have never been comparatively assessed. Larger devolutions have resulted in higher fiscal imbalances at the Centre.

As regards tax sharing the criteria used have changed over the eleven FCs with a noticeable surge in the level of econometric methods used. We give a synoptic view of the changes that have occurred over various FCs.

TABLE 3
CRITERIA FOR SHARING UNION TAXES & WEIGHTS

(%)

	8th F.C.	**9th F.C.**			**10th F.C.**	**11th F.C.**
		1st report	**2nd report**			
			U.E.D.	**I.T**		
Population	25	25	25	29.94	20	10
Distance	50	50	50	40.12	60	62.5
Inverse of Income	25	12.5	12.5	14.97	–	–
Poverty Ratio	–	12.5	–	–	–	–
Index of backwardness	–	–	12.5	–	–	–
Area	–	–	–	–	5	7.5
Index of Infrastructure	–	–	–	–	5	7.5
Tax Effort	–	–	–	–	10	5.0
Fiscal Discipline	–	–	–	–	–	7.5

Notes:

8th F.C.	applicable to 90% of shareable IT (Income Tax)
9th F.C. (1st Report)	40% of U.E.D. (Union Excise Duty)
9th F.C. (2nd Report)	90% of shareable IT 37.575% of U.E.D.
10th F.C.	100% of shareable IT 40% of U.E.D.

Source: Report of 11th FC

The grants given by *Planning Commission* follow the Gadgil formula since 1969 thus eliminating any bias in the award of these grants. The modified Gadgil formula which has been in use since 1980 distributes resources on the basis of the following criteria (a) 60% on the basis of population (b) 25% on the basis of per capita income (c) 7.5% on the basis of performance (i.e. tax effort, fiscal management, national priorities including literacy, female welfare programs and land reforms) and (d) 7.5% allocation is made for special problems.

Finally, we also have the *central sector and centrally sponsored schemes*, which are fully or partly funded by the centre through grants. It is this component of total grants that has evoked much controversy. The central ministries concerned propose these schemes which are approved by the Planning Commission. Besides the discretionary element implicit in these transfers, the conditions imposed by the centre have distorted the states own priorities and programs. The states have been unhappy with their inadequate involvement in the formulation these schemes. They have also expressed their grievance against these grants on the ground that the system of matching grants in the schemes favors the richer states because they are better placed to provide the matching amount.

The broad picture that emerges as regards the finances of state governments in the post-reform period of the 90s is that of a lack of fiscal discipline on the part of state governments. Total expenditures as a per cent of GDP continue to remain as high as they were in the 80s; the direction of expenditures continue to remain biased in favor of expenditures on revenue account and the proportion of capital investments continues on its falling trend. As regards transfers from state governments in the form of grants, there has been some effort to move in the direction of reducing the share of central sector and centrally sponsored schemes, which have been resented by state governments and the share of statutory grants has increased. However, the effort on this front is very small in quantitative terms. A much bigger push in this direction is required if central government transfers are to help state governments set their houses in order.

The role and functioning of local bodies in the 13 major states since 1990/91 can be gauged from some summary statistics provided in the tables below.

TABLE 4
TOTAL RECEIPTS / SDP

(per cent)

	All Local Bodies in 13 states	C.V (of 13 states)	Spearman's rank Correlation with PCY
1990/91	3.08	67.96	0.07
1991/92	3.03	68.44	0.17
1992/93	3.09	63.38	0.15
1993/94	3.05	64.42	0.05
1994/95	3.08	61.63	0.19
1995/96	3.10	60.17	0.10
1996/97	3.24	58.38	0.03
1997/98	3.37	55.51	-0.24

The ratio of total receipts to State Domestic Product shows an increase from 3.08 per cent in 1990/91 to 3.37 per cent in 1997/98. The coefficient of variation (C.V) shows that inter-state disparities have reduced as per this indicator. The Spearman's rank correlation coefficient with per capita income is seen to be low but positive in all years except in 1997/98. The negative rank correlation in 1997/98 suggests that high income states have performed poorly in that year.

TABLE 5

TOTAL EXPENDITURE / SDP

(per cent)

	All Local Bodies in 13 states	C.V (of 13 states)	Spearman's rank Correlation with PCY
1990/91	9.25	148.83	-0.05
1991/92	8.11	164.06	0.30
1992/93	7.61	161.43	0.20
1993/94	8.84	178.90	0.13
1994/95	8.62	191.07	0.17
1995/96	8.78	170.93	0.06
1996/97	11.99	179.20	0.01
1997/98	18.75	180.63	-0.18

The ratio of total expenditures to SDP in all local bodies of the 13 states has doubled from 9.25 per cent in 1990/91 to 18.75 per cent in 1997/98. An increasing role of local governments is clearly evident. Inter-state disparities, as seen from the C.V. have risen sharply from 148.83 per cent in 1990/91 to 180.63 per cent in 1997/98. The negative rank correlation in 1997/98 suggests that lower income states have incurred higher expenditures as per cent of SDP in that year. The extent of expenditure decentralization that has occurred is seen from Table 6 below

TABLE 6
TREND IN DECENTRALISATION
(Expenditure of local bodies as proportion of state & local expenditure)

(per cent)

	All Local Bodies in 13 states	C.V (of 13 states)	Spearman's rank Correlation with PCY
1990/91	23.97	107.3	0.03
1991/92	21.72	108.8	0.37
1992/93	21.09	106.5	0.31
1993/94	23.77	109.0	0.28
1994/95	24.86	111.0	0.20
1995/96	23.28	97.1	0.21
1996/97	28.44	113.3	0.31
1997/98	38.07	118.6	0.08

Expenditure decentralization, measured as the proportion of local expenditure to combined state and local expenditure shows an increase from 23.97 per cent in 1990/91 to 38.07 per cent in 1997/98. Th C.V. shows that inter-state variations as regards decentralization too have increased. The positive correlation coefficient suggests that higher income states have made greater efforts at decentralization. The extent of decentralization across states over the sample period under consideration is tabulated below.

TABLE 7
MEASURE OF DECENTRALISATION
(LOCAL EXPENDITURE / STATE-LOCAL EXPENDITURE)

(per cent)

	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98
Andhra Pradesh	62.75	65.66	62.25	68.77	69.23	66.35	71.66	71.46
Gujrat	20.76	19.44	18.63	18.75	18.19	18.73	18.15	17.85
Haryana	9.57	10.05	10.76	9.21	5.35	6.23	6.63	5.91
Karnataka	58.15	43.15	58.51	59.78	54.67	56.52	60.17	56.79
Kerala	3.74	3.24	3.42	3.55	3.75	4.29	6.14	7.44
Madhya Pradesh	12.83	11.87	12.99	11.97	10.74	12.29	14.44	20.37
Maharashtra	69.60	59.68	58.54	59.47	60.09	65.11	74.93	96.38
Orissa	2.21	2.12	2.11	2.82	7.12	2.93	2.91	2.74
Punjab	8.27	7.87	7.91	8.08	7.47	7.78	7.06	7.11
Rajasthan	21.06	14.36	17.83	17.26	15.33	18.88	20.07	17.65
Tamil Nadu	10.93	9.75	10.64	10.61	10.26	8.80	11.38	12.85
Uttar Pradesh	10.40	7.90	8.36	9.71	8.71	8.94	7.61	8.42
West Bengal	2.70	4.00	3.57	4.27	3.88	4.32	3.99	3.42

The states of Maharashtra and Andhra Pradesh have made significant efforts to decentralize. At the other end of the spectrum are Orissa and West Bengal, where efforts at decentralization have been very small. Comparing the extent of decentralization in 1990/91 and the figure for 1997/98 we find that a number of states show a reduction in the extent of decentralization. These include Gujrat, Haryana, Karnataka, Punjab, Rajasthan and Uttar Pradesh.

Decentralization on the receipts front is measured as the ratio of own revenue to total expenditure. The progress on this front is seen from the Table below:

TABLE 8
OWN REVENUE / TOTAL EXPENDITURE

(per cent)

	All Local Bodies in 13 states	**C.V (of 13 states)**	**Spearman's rank Correlation with PCY**
1990/91	9.61	76.77	0.44
1991/92	10.98	68.17	0.18
1992/93	11.54	71.08	0.47
1993/94	10.22	73.88	0.49
1994/95	11.49	92.36	0.40
1995/96	11.06	83.14	0.42
1996/97	8.26	96.65	0.30
1997/98	5.36	100.54	0.40

The ratio of own revenues to total expenditure for all local bodies has shown a falling trend since 1995/96. Clearly, revenue decentralization has not kept pace with expenditure decentralization. The C.V. for this variable shows an increase in inter-state disparities and the rank correlation coefficient is seen to be positive in all years. Thus the ratio of own revenues to total expenditure has been higher in high income states. However, this correlation too has witnessed a falling trend since 1995/96.

6. Evaluating the Indian Federal Structure *vis-à-vis* Basic Tenets of Market Preserving Federalism

The first two tents of market preserving federalism require that ***sub-national governments be autonomous in their own jurisdiction***. The Indian federal structure scores badly in this count. Vertical disharmony between the central government and the state governments to some extent is implicit in the Constitution itself. A large number of fiscal operations have been placed in the concurrent list where both centre and states are responsible, but the central government has been given the position to override the state governments. The intrusion of the central government into state subjects is clearly noticeable in the allocations made to the state governments in the form of 'central sector and centrally sponsored schemes'. *Vertical tax overlapping* in commodity tax systems has led to vertical disharmony. The levy of union excise duties by the centre, sales tax by the states and Octroi or entry tax by local bodies has made the tax system complex and non-transparent. Another problem related to assignment of taxes is the *adverse incentives on the central governments tax efforts* created by the tax sharing arrangement. The various Finance Commissions have recommended differing shares of income tax and union excise duty to be allocated to the states as was elaborated upon earlier. The tax sharing arrangement resulted in a decline in tax collections from income tax and an increase in customs duties which were exclusively retained by the centre. The tax sharing arrangement has resulted in an increase in the administered prices of public monopolies instead of revising union excise duties. The Tenth Finance Commission in order to reverse the disincentive effect gave up the practice of sharing a proportion of the two taxes and recommended that 26% of the gross proceeds be shared with the states. This proportion has been raised to 29.5% by the Eleventh Finance Commssion. (see Roa and Singh, 1998a, 1998b for a more detailed discussion).

For the local government level, the 73^{rd} and 74^{th} Constitutional Amendment Acts define local government functional responsibilities quite extensively but do not delineate them vis-à-vis the responsibilities of state governments. Of the 29 functional responsibilities assigned to rural local bodies, 10 minor responsibilities are exclusively that of local governments while 19 are concurrently the responsibility of state and local governments. 37 areas of responsibility have been assigned to the urban local bodies but the state governments continue to retain considerable authority over the functions which are now notionally in the urban local government domain (Singh, 1997).

The Indian Federation scores poorly when the first two tenets of market preserving federalism are considered. Two solutions could be attempted to rectifying this problem. Firstly, A Constitutional Amendment clearly delineating responsibilities of each tier of government would clarify matters. Alternatively, we could follow the co-operative model of federalism as has been implemented in U.S.A. and Canada. Both federal and state governments have the power to levy income tax but as many of the states levy the taxes on the base determined by the federal government, the disharmony has been considerably reduced. As regards commodity taxes too considerable degree of vertical coordination exists between federal and state governments in both Canada and U.S.A. (Rao and Singh 1998b).

The third tenet of market preserving federalism requires that from the perspective of preserving market incentives, the authority of the national government over markets be limited to ***policing the common market*** across regions and provision of national public goods which should not be left to sub-national governments (such as monetary policy). Article 301 of the Constitution of India provides for free trade and commerce throughout the territory of India. Provision has, however, been made for Parliament and state legislatures to impose restrictions on trade if felt necessary in 'public interest'. *Prima facie* Article 301 should have ensured a common internal market in India. However, a large number of restrictions and regulations were imposed by policy makers and the advantages of a large 'common market' were never experienced in India. The Third Constitutional Amendment in 1954 gave greater powers to the Central government to impose controls on trade in 'public interest'. The Essential Commodities Act of 1955 resulted in both central and state governments imposing many more regulations. This Act was withdrawn in 1991 and several restrictions were removed. However, many such restrictions, particularly those imposed by state governments continue to hold good. One such example pointed out by Bagchi (2002), in his insightful article dealing with the issue of the common market in India, is the Maharashtra Cotton Monoply Procurement Scheme (MCMPS).

Inter-state tax competition in the Indian federation has resulted in serious inefficiencies in the state tax systems on account of (i) divergence in sales tax rates (ii) free riding and inter-state tax exportation and (iii) erection of trade barriers (Govinda Roa and Nirvikar Singh, 1998a). The NIPFP (1994) study gives a detailed analysis of the sales tax system in different states. It has pointed out that *multiplicity of tax rates* has resulted in tax competition amongst states. For instance, foodgrains are exempt in half the number of states but taxed at 4% in the food surplus state of Punjab. Edible oil is taxed at 1.5% in Maharashtra and 9% in Bihar. Medicines are taxed at rates higher than cars in 8 out of the 14 major states. Competition to attract electronic goods has led to significant reduction rates of tax on these goods. Inter-state competition has led to states attempting to pass on the tax burden to non-residents, a phenomenon termed as *'tax* *exportation'*. States levy origin based sales tax at the first point of sale. The also levy taxes on raw materials, intermediate inputs and capital goods. When the exports of the more developed states is higher than their imports, the residents of poorer states pay taxes on larger volumes of imports at higher rates. The major impediments to free trade across states include (i) tax on inter-state trade of goods and (ii) Octroi. While inter-state sales tax is on the export of goods, octroi is similar to import duty. Octroi has resulted in rampant corruption and harassment to taxpayers. On account of problems associated with it, states like Karnataka and Madhya Pradesh have replaced it with an Entry tax. The purview of this entry tax has been widened in some states. Tamil Nadu has added 15 new items which would be subject to an entry tax. Maharashtra too has imposed an entry tax on a number of commodities to be implemented through physical checks at the state's borders. The prevailing trend runs counter to removing trade barriers and reaping the advantages of 'common market' as recommended by advocates of market preserving federalism.

In addition to fiscal barriers, several *non-fiscal impediments* too have been imposed to restrict inter-state movement of goods and factors. Most states impose the condition that knowledge of local language is precondition for government employment. Some states impose the restriction that non-residents cannot conduct trade and commerce in the state without a local partner. Some states stipulate that enterprises get concessions and incentives only if they employ local personnel.

One step towards reform in the domestic tax scenario has been the introduction of the modified version of VAT, the MODVAT, at the central government level. The earlier 8%, 16% and 24% rate structure was rationalised to a single 16% rate in the 2000/01 i.e. the CENVAT. However, Mukhopadhyay (2002) points out that effectively no such progress has been made. On the contrary some fresh rigidities have been introduced in the system. At the level of state governments it has been decided that all states would implement VAT from April 1, 2003. The decision to implement a common rate of 12.5 % across states is a major step forward towards reforming the domestic tax structure. However, the talk of delay in implementation in some states and strikes and protests in others does seem to suggest that the transition to VAT across the country is unlikely to be a smooth one.

A remedial measure strongly recommended by Bagchi (2002) to reform the domestic tax regime and establish a common market in India is the invoking of Article 307. This provision allows the appointing of an authority to implement the common market provision of the Constitution, since the central government itself happens to be a party to measures that contain free trade. He strongly feels that even implementation of the VAT would be impossible without arrangements for policing by an adequately empowered authority. According to him, "the remedy for the impediments to the operation of the common market in India lies in setting up an independent authority as envisaged under Article 307" (Bagchi 2002, p2307).

The fourth requirement to preserve market incentives requires that ***borrowing by all levels of governments be limited*** and that a ***hard budget constraint be imposed on sub-national governments***. This condition requires that all levels of governments exercise restraint in borrowing and also that the sub-national governments be subject to strict discipline by the central government. The hard budget constraint would suggest that there be no expectation of bailouts by the central government. In the Indian economy, both central and state governments find themselves in a precarious situation. The total debt to GDP ratio for the central government stands at 62% in the Revised Estimates of 2000/01. Internal debt to GDP ratio was recorded to be 52.9% in 2000/01 (R.E). Interest payments were seen to absorb as much as 72% of total tax receipts in 2000/01. These large and growing interest payments have substantially reduced the central governments potential to spend on social sectors and infrastructure.

The Constitutional provisions seek to impose a discipline on state governments by necessitating central government approval for the states, which are indebted to the central government. *Prima facie* it would appear that the state governments are subject to hard budget constraint. However, the present scenario as it stands is that the outstanding stock of debt of state governments amounted to 23.1% of GDP at the end of March 2001. The states' debt to GDP ratio has increased from 17.9% in 1995/96 to 23.9% at the end of March 2002. The rising debt levels have led to growing interest burden. The interest payments comprised 21.6% of revenue receipts of states in 2001.

Despite the apparently hard budget constraint, state governments have succeeded in accessing borrowed resources. States have borrowed against *small savings* Since 1999/2000 the scheme of transferring the entire net proceeds of small savings to states has been introduced. Since then the accretion is credited to the National Small Savings Fund (NSSF) and the amount lent to the states does not appear on the budget of the central government. State governments have also borrowed from provident funds of employees. The cost of borrowings via this route is high as the Centre adds the transaction costs of administering the schemes of small savings to the interest payable to depositors. There is also the cost of income tax concessions allowed on small savings. Borrowing by the states from *provident funds* of Employees also is beyond the control of the central government. A third route which has been tapped by state governments to borrow funds is via bonds which have been floated by *public sector enterprises* under the guarantee of state governments. *Ways and means advances and overdrafts* from RBI has been the fourth source of funds for state governments. Strictly speaking these provisions were made only to tide over temporary mismatches in state government budgets. However, since there is no special requirement for WMAs and overdrafts to be cleared at the end of a financial year, many states have used these funds for financing their fiscal deficits. (Lahiri 2000).

Implicit in the first part of the fourth condition for market preserving federalism that there be limited borrowing by all levels of government is that maximum reliance be placed on ***own sources of revenue by all levels of government***. The theory of market preserving federalism stresses the importance of government's incentives and emphasises the linking of local government's revenue collection with their expenditure.

The ratio of own revenues to total expenditure for all local bodies has shown a falling trend since 1995/96. For state governments we find that own tax revenues as proportion of total expenditures showed an increasing trend from 1993/94 to 1996/97 when it reached a peak of 2.39%. Since then a declining trend is noticeable till 1998/99. Clearly, revenue decentralization has not kept pace with expenditure decentralization.

A major source of own revenue for local governments is property tax. The system of property taxation levied on rateable value of immovable property as prevalent in India has remained a stagnant source of revenue. The presence of rent control has led to a great divergence between market rents and the *assessed value of rents.* Consequently, the property tax, based on assessed value of rents, has lost much of its revenue earning capacity. When considering reforms in this direction special mention may be made of the Bangalore Municipal Corporation, in a bold measure, has introduced a self-declared property tax scheme which has become the talk of the metropolis. The new scheme is based on the assumption that the existing properties - residential, part-residential and non-residential have not been assessed properly for municipal tax purposes. Individual properties were being assessed by municipal officials and the procedures left room for corruption. Most of the property was under-assessed and, hence, the property tax receipts are not what they should be. The scheme divides both residential and non-residential properties and each is further divided between portions used for residential purposes and that let out for rental incomes.(P.R.Brahmananda,*TheHindu*,May31,2000.Also,http://www.blonnet.com/businessline/2000/05/31/stories/043120aa.htm). Also, the Mumbai Municipal Council too is actively considering a Capital Value based property tax model (Karnik, 2001).

Finally, on the fifth aspect of market preserving federalism viz, **durability of reforms**, one could say that we have taken the crucial first step of trying to institutionalize decentralization by passing Constitutional Amendments. Incorporating these features of awarding legal status to the third tier of the federation in the Constitution in a way ensures that it is beyond the discretion of 'political will'. There may be some quarrel about the nitty gritty of the Acts, but there can be no two views about the fact that strengthening the third tier of government is an essential prerequisite for development.

Significant progress could have been made in the direction of ensuring durability by the introduction of The Fiscal Responsibility and Budget Management Bill (FRBM) which was introduced in the Lok Sabha in December 2000. This could have been a significant step towards tying the hands of the government. It had a target reducing revenue deficit of the central government by half per cent annually and to nil in a five year period. It also sought to bring down Gross Fiscal Deficit to 2% of GDP within a period of five years. If the FRBM could have been passed in its original form it would have ensured that succeeding governments would not have indulged in fiscal profligacy like their predecessors. The Union Cabinet has, however, watered down the Bill by deciding to delete its key provisions, including elimination of revenue deficit, reduction in fiscal deficit, curbing government borrowings from the Reserve Bank of India, and curtailing expenditure in case of revenue shortfalls. According to government officials, these provisions were seen as restricting the Centre's flexibility in ensuring macro-economic stability. The effort in this direction has therefore come to nought.

7. Summing Up

China's success on the economic front in recent years has made both economists and policy makers in India sit up. It is not as though China satisfies all the tenets of 'market preserving federalism', but it is slowly but surely moving in that direction. As regards the Indian federation, one could say that it has come a long way. Undoubtedly, finances of central and state level governments in India are in a bad shape. Fiscal profligacy on the part of state governments has resulted in high revenue deficits and large borrowings have resulted in unsustainable interest burden. However, we must not ignore the customary 'silver lining'. The introduction of the 73rd and 74th CAAs have made decentralisation a reality. Undoubtedly, problems being faced by the local bodies are coming to the fore. However, the fact that problems at the level of implementation are being realised, could be looked upon as an indication of the fact that implementation is being attempted and that is no mean achievement. The effort to introduce fiscal discipline via the Fiscal Responsibility Bill has not succeeded, but the move in the direction of imposing a hard budget constraint, ensuring durability of the reform process via constitutional amendments, relying on own revenues, all of which comprise 'market preserving federalism' is certainly noticeable in India too. A 'bigger push' it is hoped will come sooner rather than later.

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