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DECENTRALIZATION AND ECONOMIC DEVELOPMENT: INDIAN EXPERIENCE*

G. THIMMAIAH

Institute for Social and Economic Change
Bangalore 560072, India
gujjarappa@hotmail.com

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Abstract

Decentralization has come to be rediscovered in the post-cold war period as an effective means of achieving higher growth rate of GDP in both developed and developing countries. India opted for a quasi-federal political set-up to unify culturally diverse ethnic groups. But it resorted to unbridled centralization of economic policy making and as a result it failed to achieve higher rate of growth of GDP. Recently India has created another tier of decentralized units to increase the pace of development. This second wave of decentralization has been followed by the policy of economic liberalization and globalization. In order to make decentralization to promote higher growth of GDP in a liberalized economic environment, it is necessary to ensure that autonomy goes with transparency and accountability.

Key words: India; Decentralization; Economic development; Vertical and horizontal financial imbalances
JEL classification: H71, H72, H77, O23

I. *Introduction*

The role of decentralization in promoting economic development in both developed and developing countries has attracted considerable attention of economists [Oates (1972, 1985); Bahl and Linn (1992)]. Though historically, decentralization was used as a political solution to unite culturally diverse micro-nationalities to form a bigger nation-state, in the post-cold war period, it has come to be advocated for improving efficiency in the use of scarce resources to achieve higher rate of growth of GDP [Valk (1990)]. Decentralization enhances efficiency of delivery of a minimum bundle of essential public services according to diverse preferences of different localities. This process improves the ability of local areas to use their human

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resources far more productively, and reduces costs of coping with inefficient supply of basic public services. Further, decentralization generates demand for better economic infrastructure facilities and wields pressure on local political leaders and bureaucracy to ensure faster development as well as proper maintenance of infrastructure facilities which will throw up local entrepreneurs and attract private investment. Both these processes go to promote economic development

II. *Status of Decentralization in India*

The Indian constitution has created a national government called the union government and twenty-five sub-national governments which are called state governments. In addition, there are seven union territories directly under the control of the union government, though two of them (i.e., New Delhi and Pondicherry), have their own elected assemblies and executives. This constitutional set-up qualifies India to be called as a federation. Even so, the constitution of India has not used the word 'federation' but has called it a 'union of states'. The fear of secession of states following the creation of Pakistan made the framers of the constitution to avoid the word federation. The overriding powers given to the union government to hold the country together made it a quasi-federation

Yet another trend in decentralization has emerged in India. This is the second tier of decentralization below sub-national level. This relates to providing constitutional status to village assemblies and municipalities as the second tier of decentralization. The 73rd and 74th amendments to the constitution were enacted in 1993 and were put into effect from 1994 to create village assemblies and municipalities. With the creation of second tier decentralized unit, we now have 3586 urban local bodies (comprising of 95 municipal corporations, 1436 municipal councils, and 2055 nagar panchayats), and 234078 rural local bodies (comprising of 456 zilla panchayats and other forms of elected rural assemblies) [World Bank (1999)]. Elections are required to be held to these local bodies once in five years through adult franchise and by using simple majority voting process. Elections are conducted by an independent election authority provided under the constitution. However, it is necessary to note here that these second tier of decentralized units do not have constitutionally guaranteed powers and resources. They have to depend upon the devolution of powers and funds from the state governments concerned. They do not also enjoy legislative and police powers. The constitution has only guaranteed regular elections to these units. Even so, in India the term decentralization is used to refer to the second tier of devolution of powers to the village panchayats and municipalities. But there is no devolution of legislative powers to these institutions. Further, since these newly created local institutions are of recent origin, we have yet to observe any discernible pattern of central-local relationship. Hence, in this paper we have used the term decentralization to refer to the state governments as there is an explicit constitutional devolution of legislative, fiscal and administrative powers to the states. There are wide variations in area and population as also in the level of economic development between these twenty-five states. This is mainly because these states are not economic entities but were created by the central government based on linguistic-cum-ethnic cultures. Elections to state assemblies are also required to be held once in five years. Constitutionally provided election authority conducts the election to state assemblies. Some states have bicameral assemblies

while a few have only unicameral assemblies. Here also simple majority voting process is followed. Since we are going to discuss the decentralization with reference to sub-national state governments, the central-local relationship refers to central-state relations. The national government in India is generally addressed as the central government and the sub-national governments are called state governments.

III. *Division of Functions and Sources of Revenue*

The constitution of India has made a detailed division of expenditure responsibilities and sources of revenue between the central and the state governments. This division by and large satisfies both the principles of federal finance and of fiscal federalism. All national functions like defense, foreign affairs, foreign trade, currency, banking, insurance, industry, minerals, labor, energy, air and rail transport, shipping, science and technology and urban development are assigned to the central government. The state governments are assigned with local functions like agriculture, primary education, primary health, roads, cooperation, social welfare, village panchayats etc. There are also concurrent functions like economic and social planning, forests and higher education which can be performed by both central and state governments but in case of conflict, the central government's power overrides the power of the state governments. The residual powers too vest with the centre. The central government spends about 37% of its current expenditure for development purposes whereas states spend as much as 63% [Thimmaiah (2000)]. Such skewed allocation of expenditure is further aggravated by the central government's share of about 49% in the total current expenditure.

In regard to the sources of revenue, most of the sources that have mobile tax base have been assigned to the centre and those that have immobile tax base have been assigned to the states. Thus import and export duties, excise duties on goods produced, (other than on liquors), taxes on non-agricultural wealth, gifts tax, estate duty, and corporate income tax are exclusively assigned to the central government. The state governments are assigned with taxes which have localized tax base like land tax, agricultural income tax, tax on the sale of goods for consumption, motor vehicles tax, tax on the production of liquor, tax on professions, tax on goods which enter into urban areas (octroi), stamps (excluding judicial stamps), and registration fees. There is an attempt to fragment the tax base based on its mobility. For instance, income tax is divided into that on agricultural income and on non-agricultural income. The former is assigned to the states and the latter to the centre. Even the tax on non-corporate incomes has to be levied and collected by the centre but the revenue has to be shared with the states. Besides these, there are taxes like tax on advertisements in modern media, which are expected to be levied and collected by the central government but the entire net revenue has to be handed over to the states. There are some taxes like tax on inter-state sales whose rates are fixed by the central government and the state governments are allowed to collect and appropriate the revenue. The constitution of India empowers the central government (under Article 293) to borrow from any source within the country as well as from abroad but restricts the power of the state governments to borrow only within the country. A further restriction is imposed on the power of state governments to seek the permission of the central government to borrow even within the country if states are indebted to the central government. The central government has got an edge over states in that the central govern-

ment collects as much as 55.33% of the total tax revenue of the country [Thimmaiah (2000)].

This detailed scheme of division of sources of revenue between the central and state governments has led to the central government getting more elastic sources of revenue and fragmentation of tax base as in the case of income tax, and overlapping of taxes on more or less the same base as in the case of central excise and states' sales tax [Thimmaiah (1976)]. The scheme has not only created the generally expected vertical and horizontal financial imbalances but also has given rise to cascading effect of commodity taxes in the Indian economy. While the framers of the Indian constitution were aware of the likely emergence of vertical and horizontal financial imbalances, they failed to comprehend the vertical tax overlapping and the resultant economic distortions which have become obstacles to the smooth operation of market forces in the Indian economy. The framers of the constitution provided for a constitutional body, i.e., Finance Commission, to review periodically the magnitude of vertical as well as horizontal financial imbalances and recommend financial transfers from the central government to the states to minimize them. However, there are no constitutional mechanisms except a limited provision under Article 263, to minimize tax overlapping and for achieving tax harmonization. The central government tried to achieve them through political consensus. But such attempts resulted in extending the centralization process to federal financial sphere also.

IV. *Unbridled Centralization Process in India*

The Indian political system operated with one party rule both at the centre and at the state levels until 1960's. No doubt, it ensured harmony between the central and state governments. But it also fostered unjustifiable centralization process in financial sphere, in addition to the constitutionally designed legislative and political centralization. In other words, the central government can dismiss an elected state government on the ground of mis-governance, change the boundaries of states and in case of conflict between the legislation of states and that of the centre, the latter's power overrides. These encouraged the central government to direct the state governments' policies even in areas that were constitutionally assigned to them. It created grumbling dissatisfaction even when there was only one party rule both at national and at state levels. It became more vocal and got an open outlet when different parties started ruling at state level. Thus when it was realized that the constitution has created a politically powerful central government but a more balanced federal financial structure, the central government probably thought it necessary to expand the centralizing process and exercise control over state governments in the financial sphere also. This is because certain provisions of the constitution like exclusive sources of revenue and notably an independent Finance Commission, ensured financial autonomy to the states. The Finance Commission can probe, (they have probed in the recent past), into the financial position of the central government. The Commission can pull up the central government for any violation of the financial provisions of the constitution which affect the states' finances. Therefore, the central government was not sure of exercising control over the financial powers of the state governments within the framework of the constitution [see Thimmaiah (1985)]. In order to overcome this hurdle, the central government started using an extra-constitutional body, i.e., Planning Commission.

Article 282 in the Indian constitution empowers both the central and state governments to make specific grants for any public purpose. The state governments have no surplus funds

to indulge in this luxury. The central government on the contrary has come to use this provision extensively by empowering the Planning Commission to provide grants to the states for purpose of undertaking development programs and projects under five-year plans. Thus the institution of Planning Commission became a conduit for legitimizing the process of financial centralization in India. This extra-constitutional institution was encouraged by the central government to evolve alternative mechanism of financial relationship between the central and state governments in planning and development. The Planning Commission determines the plan size, objectives, priorities, strategies and programs and schemes, of course, with the consent and participation of the state governments. Owing to the logistic disadvantage of the central government, the responsibility for implementing the plans drawn up by the Planning Commission has been entrusted to the states. Because of their constitutional existence, they could not be forced to accepting the dictates of the Planning Commission. They had to be induced to shoulder the responsibility of implementing the plans. A traditional but effective means of inducement in a federation is through the bait of financial assistance. This was effectively practiced in Australia, Canada and U.S.A. in the name of cooperative federalism. Though the constitution specifically provided an institution, the Finance Commission for devolving finances, it was declared inadequate for determining financial assistance for the state plans. Consequently, the scope of recommendations of the Finance Commission came to be restricted to non-plan part of the states' financial needs through the terms of reference and all financial transfers for plan purpose were made the domain of the Planning Commission.

In this alternative mechanism of financial relationship, a major portion (70%) of financial assistance for plan purpose came to be provided in the form of loans and only 30% in grants. This alternative scheme of financial transfers effected through the instrumentality of the Planning Commission continues even to this day. In contrast, the Finance Commission does not recommend loan assistance to all the states. Its recommendations involve mandatory share in the net yield from all central taxes, block grants, tax rental compensation aid, compensatory grants (in lieu of tax on railway fares). Occasionally, the commissions also rescheduled and even wrote off of a portion of central loans to states and interest on them.

The central government has not been satisfied with even this alternative mechanism of fiscal devolution. It has gone beyond both Finance and Planning Commissions and has started providing financial assistance through individual central government ministries. Such direct discretionary financial transfers can also be made under Article 282. But this provision is supposed to be used sparingly and only under exceptional circumstances. Here again a part of the assistance is given in the form of loans.

Article 282 was not at all intended for making regular financial transfers and that too, on such an extensive scale as shown in Table 1 below. It may be observed that during the first, second, third and even the fourth plan periods, Finance Commission's transfers were relatively lower than other financial transfers. During the subsequent plan periods the relative share of Planning Commission and other financial transfers increased sharply. The first, second and the three annual plan periods saw the peak of financial centralization in India. The plan transfers were by and large discretionary and the volume of assistance and the loan-grant components were determined on a case by case basis in respect of each of the schemes. After that congress party lost power in many states. Many state governments led by non-congress parties asserted their right to receive major portion of financial assistance through the instrumentality of the Finance Commission. Hence, the proportion of Planning Commission's transfers started

TABLE 1. FINANCIAL TRANSFERS FROM THE CENTRE TO THE STATES IN INDIA

(Rs.billion)

Plan period (1)	Central Tax Revenue (Gross) (2)	States' share in Central Taxes. (3)	Percentage of (3) to (2). (4)	Finance Commission Transfers (5)	Planning transfers & Other Transfers (6)	Total transfers (7)
I Plan (1951-56)	23.17	3.44	14.85	4.47 (31.24%)	9.84 (68.76%)	14.31
II Plan (1956-61)	36.52	6.68	18.29	9.10 (32.01%)	19.50 (67.99%)	28.60
III Plan (1961-66)	78.55	11.96	15.23	15.90 (28.39%)	40.10 (71.61%)	56.00
Annual Plans(1966-69)	71.70	12.82	17.88	17.82 (33.33%)	35.65 (66.67%)	53.47
IV Plan (1969-74)	194.76	45.62	23.42	54.21 (35.90%)	96.80 (64.10%)	151.01
V Plan (1974-79)	415.77	82.76	19.91	108.73 (43.01%)	144.05 (56.99%)	252.78
Annual Plan (1979-80)	119.74	34.07	28.46	36.63 (44.90%)	44.96 (55.10%)	81.59
VI Plan (1980-85)	909.14	235.44	25.90	255.87 (40.94%)	329.13 (59.06%)	585.00
VII Plan (1985-90)	1952.84	492.04	25.20	551.17 (40.77%)	800.68 (59.23%)	1351.85
VIII Plan (1990-95)	3676.03	993.37	27.02	1093.91 (38.67%)	1734.64 (67.33%)	2828.55

Note: Figures in brackets indicate percent to total transfers.

Sources: (a) Government of India, Ministry of Finance, *Indian Public Finance Statistics, 1991 and 1998-99.* (b) Government of India Ministry of Finance, *Reports of the Finance Commissions.*

declining as compared to those of Finance Commission's transfers. Alongside, in 1969, plan transfers were put on a systematic footing by making inter se distribution on the basis of a formula and the grant-loan portion was fixed at 30:70. In the event, to maintain its discretion, the central government started increasing discretionary transfers. In other words, the central government continued to provide discretionary transfers through individual central ministries so as to keep non-statutory and non-formula based devolution of funds above 50%. As a consequence of these unexpected developments, today we have three mechanisms through which the central government makes financial transfers to state governments. The first mechanism is the constitutionally provided Finance Commission. The second is on the advice of the Planning Commission, which is an extra-constitutional body created, no doubt, for a genuine purpose. And the third is the political-cum-bureaucratic transfers at the discretion of the central ministries. While the first two are formula-based, the third is mainly discretionary.

V. *Swing from Centralization to Decentralization in India*

Against this background of centralization process, it is interesting to know how subsequent political developments paved the way for second tier of decentralization process which has provided constitutional status to rural (village panchayats) and urban (municipalities) local governments. The congress party, which was the main ruling party in both centre and states, lost its power in many states in 1967. It also lost power at the centre in 1977. The state governments, led by non-congress parties, started asking for more political autonomy, administrative powers and financial devolution from the centre. This tug of war reached a flash point in the early 1980's. After the death of Mrs. Indira Gandhi when Mr. Rajiv Gandhi came to power at the centre, he was advised to create decentralized panchayat raj institutions below the state level which would, in turn, ask for more powers and financial devolution from the state governments. It was believed that this will create a countervailing force below the state level and will reduce the influence of the state level political leaders. In the initial scheme of decentralization to the second tier, the centre also retained the power to make direct financial devolution to local governments. This strategy was implemented by Mr. Rajiv Gandhi though with some difficulties. This effort confirms the hypothesis that decentralization is chosen by the political leaders as a solution to shift the political pressure resulting from unresolved conflicts originating from regional and local issues [Bird and Vaillancourt (1998)]. But this second tier of decentralization process in India has not really reduced the power and influence of state level political leaders. On the contrary, at the state level more and more regional parties have emerged and started getting elected to power on regional issues. The net result has been to weaken the national political parties.

During the 1990's, the congress party lost its dominant power both at the centre and in many states. Regional political parties became prominent and they have been wooed by the weakened national parties to help form the government at the centre. This swing of political power from the hands of national parties to the regional parties has no doubt weakened the centralization process and has strengthened the bargaining power of the state governments vis-a-vis the central government. But this swing to the other extreme has weakened the powers of the central government in carrying out its assigned function of maintaining macro-economic stability [Thimmaiah (1999)]. What is more, the central government has not been able to implement much needed economic reforms because of the divergent views held by different regional political parties on economic reforms. This has slowed down the pace of implementing the much needed economic reforms to achieve higher rate of growth of GDP.

VI. *Vertical Financial Imbalance and Financial Devolution*

The scheme of division of expenditure responsibilities and sources of revenue between the central and state governments has created vertical financial imbalance. This is not peculiar to India but common to all decentralised fiscal systems. However, what is unique in India is that the constitution recognizes the possibility of vertical financial imbalance and provides for a Finance Commission to review periodically (at least quinquennially), the financial requirements of the states as reflected by their disabilities in the cost of providing basic public services

and revenue raising capacity and to recommend financial devolution from the central government so as to neutralise such disabilities. Though the recommendations of the Finance Commission are not binding on the centre, with a few exceptions, it has become a convention to accept them. So far eleven Finance Commissions have reported and their recommendations have been by and large accepted and implemented. Though the second, third and fourth Commissions did not favour the states which had relatively lower revenue raising capacity, the later Commissions have become more favourable to the low income states. Thus the Finance Commissions have not only tried to reduce vertical financial imbalance but also have attempted to minimize horizontal financial imbalance after 1970's. The successive Finance Commissions have been using redistributive criteria for distributing the states' share in the net yield from central taxes [Thimmaiah (2000)]. While their criteria have been appreciated, their methodology of determining the relative shares of different states in the total devolution has come under severe criticism [Thimmaiah (1981)].

The Planning Commission recommends central assistance for state plans to help, encourage and stimulate state governments' interest and activity in the field of economic development. They are provided mostly to enable the states to undertake development schemes, which have been given priority in the five-year plans. Many of these development functions are within the domain of the state governments and they do not possess sufficient funds to undertake new and innovative activities under these functions. Since the centre is blessed with surplus funds made possible by its elastic sources of revenue, it has successfully used this financial string to dictate national policies to the state governments through the five-year plans. The quantum of plan assistance is determined by the central government ministries in consultation with the Planning Commission. For this purpose, plan schemes are divided into two categories: (1) Schemes sponsored by state governments and (2) those sponsored by the central government. The former schemes are those which are suggested and initiated by the state governments and approved by the Planning Commission. These are included exclusively in the 'state sector' of state plans. They include irrigation, power, education and health services. The latter schemes are those which are sponsored by the centre in consultation with state governments concerned and Planning Commission. They include primary education, public health and social welfare schemes. They are called "centrally sponsored schemes". From the fourth plan period, another set of schemes were sponsored by the Planning Commission and entirely funded by the central government, which are called 'central sector schemes'. They include employment guarantee, small and marginal farmers' development, drought prone area development etc. For state sector as well as centrally sponsored schemes, plan assistance is provided 30% in grants and 70% in loans. However, in a few cases of centrally sponsored schemes, states are required to make matching contributions of varying proportions. But the entire cost of 'central sector schemes' is borne by the central government in the form of conditional grants.

For the purpose of providing plan assistance, states are categorized into 'special category' and 'non-special category' states. Small states which do not have adequate revenue base and which face certain natural disadvantages are categorized as special category states. They include Jammu & Kashmir, Himachal Pradesh, Sikkim, Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura. For these states plan assistance is provided 90% in grants and only 10% in loans. What is more, they are permitted to divert 25% of plan assistance for non-plan purpose. Non-special category states do not enjoy these privileges. For distributing plan assistance among non-special category states, a set of criteria have been used.

Until December 1969, plan assistance was provided mainly on project basis and as a result only those states which could prepare viable development projects used to receive more plan assistance. This was opposed by other states. Hence in December 1969 a set of objective criteria was decided upon to distribute plan assistance among the states. They were: 60% on the basis of proportion of 1971-population of each state, 10% on the basis of per capita income, 10% on the basis of on-going irrigation and power projects, 10% on the basis of tax efforts and 10% on the basis of special problems faced by the states. After some years, these criteria came to be opposed by low income states. So they were modified to increase the weight given to per capita income to 20% by removing the criterion of on-going irrigation and power projects and distributing this 20% of plan assistance only among those states whose per capita incomes were below the national average. Even these changes came to be opposed by high income states as they were deprived of 20% of plan assistance. So in December 1991, the criteria were again changed [Thimmaiah (2000)]. Though some of these criteria are amenable to measurement, many of them are vague as for instance 'special problems' of the states. Even the criteria used for measuring fiscal management are not precise. As a result, discretion (subjective judgement?) of the Planning Commission has come to play a prominent role in distributing plan assistance among the states.

We have already pointed out above that the relative significance of plan assistance has increased in the total financial devolution in India. This is evident from the fact that from a meager amount of Rs.0.08 billion in first year of the first five-year plan it increased to Rs.84 billion in the first year of the ninth plan. This has been the result of mindless proliferation of programs/schemes/projects. Experience has revealed that the Planning Commission and the central ministries interfered with state governments' decisions to adjust some of their plan schemes to suit their local needs and conditions and as a result there was wastage of resources and frustration among state governments. This was because plan schemes were prepared on the assumption that the central government ministries, which framed centrally sponsored schemes, knew not only more about national priorities of development, which could be accepted as they had the advantage of operating on the national scale, but also about the detailed methods of achieving their goals. This exaggerated claim has not been supported by experience. State governments were definitely superior in regard to the knowledge of local needs and logistics of implementation. There were instances whereby the central government's insistence on certain schemes like national malaria eradication scheme, not severe in all states, as it was so in West Bengal where leprosy was a more serious disease, came to be abused. Wherever the states strictly adhered to the patterns suggested by the central government, the schemes succeeded in stifling local initiative and enterprise. Finally, the central government has not been able to supervise physical progress in implementation of plan projects. Only financial supervision has been undertaken and as a result there has been no guarantee about the end-results of programs/schemes/projects.

Apart from these lapses in regard to the utilization of plan assistance by the state governments, loan content has been more in this assistance than the grant content, which has resulted in increasing the indebtedness of non-special category states to the central government. An important reason for this has been that the state governments have come to use loan funds for non-development purpose. For instance, about 90% central loans were provided for development purpose and only 10% went for non-development purpose in 1951-52. By 1961-62, the proportion of non-development purpose increased to 29%. Now it is around 25%.

However, this varies from state to state, relatively low income states using higher proportion of central loans for non-development purpose which obviously imposes a burden. The burden of central loans on the states has been examined in great detail by Thimmaiah (1977). Even the loans, which were given for development purpose, have not been effectively used by the states for self-liquidating projects. Consequently, once the state governments got into the 'debt trap' of central loans and when it was realized that they could not repay earlier loans, they were encouraged to borrow fresh loans to repay the old loans. Thus the development process under the five-year plan regime and the scheme of financial assistance for state plans are so 'engineered' even with the consent of the state governments as to make them perpetually indebted to the central government. This increased indebtedness has obviously reduced the financial autonomy of the states in India.

What is worse, the terms and conditions of central loans are decided by the central government. In a free market situation they are negotiated by both the parties. But the state governments are not consulted at all on the rate of interest to be charged, repayment period and even the total amount of loan which the central government can give at a given point of time. As a result, every year a large proportion of the capital receipts of state governments are returned to the central government in the form of repayment and what remains with them as net loan is hardly adequate for their own development purpose. This is presented in Table 2. It may be seen that net transfer of financial resources from the centre to the states has declined during the period of economic reforms in India. This is so even if we exclude central loans from the process of financial transfers.

VII. *Expansion of Public Sector and Fiscal Deficits*

It is necessary to remember that one of the main strategies of Indian five-year plans has been to achieve a socialistic pattern of society by expanding the public sector so as to control the commanding heights of the economy. This strategy was implemented both by the central and state governments which has been mainly responsible for unbridled growth of public sector in India. The expansion of public sector was not confined to the generally accepted functions of the government. It was extended to trade, business, banking, insurance, transport, mining, manufacturing and even to tourism and bread making. This increased the number of public enterprises and the corresponding government investment in them. As on today there are 240 public sector enterprises owned by the central government in which it has invested Rs. 2 trillion. But the net profit from these enterprises has been as unimpressive as Rs.90 billion. Such expansion of public sector through investment in many unjustifiable enterprises has been financed by borrowing which has led to increasing fiscal deficit of both the central and state governments.

Table 3 shows the indicators of central and state governments' deficits in India. The state governments' fiscal deficit coupled with the corresponding deficit of the central government generated macro-economic instability in the Indian economy which led to foreign exchange crisis in 1991. Even after implementing some required economic reforms, it has not been possible to reduce the fiscal deficits of the central and state governments mainly because of the continuation of the pattern of financing development programs/projects under the five-year plan regime. This remains an unresolved economic policy issue in India. Besides, fiscal

profligacy of both the central and state governments and their failure to reform the structure of their expenditure have contributed to the persistence of fiscal deficits in India.

VIII. *Decentralization and Economic Development in India*

In the final analysis, we have tried to find out to what extent decentralization to the sub-national state level has contributed to the level of economic development in India. For this purpose, we have regressed per capita income (PCI) of India at current prices on the ratio of state governments' expenditure to the total expenditure of the centre and states (Es/Et); ratio of state governments revenue to the total revenue of the centre and states (Rs/Rt); and ratio of gross savings to GDP (S/GDP) of the country. We have used double-log form. The period covered is from 1985-86 to 1996-97.

TABLE 2. NET TRANSFER OF RESOURCES FROM THE CENTRE TO THE STATES IN INDIA

(Rs.billion)

Item	1991-92	1995-96	1999-2000
1	2	3	4
A. Total receipts of the Centre (1+2+3)	1218.50	1977.66	3437.78
1. Gross tax revenue	673.61	1112.37	1699.79
2. Non-tax revenue	159.61	281.91	530.34
3. Capital receipts	385.28	583.38	1207.65
B. Transfer of resources from the Centre to	447.86	695.53	1259.80
1. States share in central taxes	171.97	292.98	458.71
2. Non-plan grants	26.00	58.78	45.18
3. Non-plan loans	54.65	98.73	254.08
4. Plan grants	56.51	86.71	175.75
5. Plan Loans	79.99	88.65	210.00
6. Centrally sponsored schemes	58.74	69.68	116.08
C. Tax shares and grants as % of total revenue receipts of Centre	30.5	27.9	30.48
D. Gross transfers to states as % of Centre's total receipts	36.8	35.2	36.65
E. Reverse resource flow from States to Centre	99.90	184.14	333.38
1. Loan repayment	31.49	53.25	81.65
2. Interest payment	68.41	130.89	251.73
F. Net transfers from Centre (B-E)	347.96	511.39	926.42
G. Net transfers from Centre as % of its total receipts	28.6	25.9	26.95

Source: Reserve Bank India Bulletins

TABLE 3. MAJOR DEFICIT INDICATORS OF CENTRAL AND STATE GOVERNMENT IN INDIA

Deficit Indicators	CENTRAL GOVERNMENT					STATE GOVERNMENT			
	1980-81	1985-86	1990-91	1995-96	1997-98 (RE)	1985-86	1990-91	1995-96	1997-98 (RE)
Gross Fiscal Deficit as % of GDP	6.1	8.3	8.4	5.4	6.1	3.1	3.5	2.9	3.6
Net Fiscal Deficit as % of GDP	–	–	5.7	3.8	4.3	2.2	2.7	2.4	3.1
Current Account Deficit as % of GDP	1.5	2.2	3.5	2.7	3.1	0.3	1.0	0.7	1.4
Conventional Deficit as % of GDP	1.8	2.0	2.1	0.9	0.2	0.1		−0.3	0.2
Primary Deficit as % of GDP	5.5	7.2	6.0	0.9	1.5	1.6	1.5	1.0	1.4
Monetised Deficit as % of GDP	2.6	2.3	2.7	1.8	0.9	–	–	–	–

Source: Reserve Bank of India Bulletins.

The regression results are presented below:

$$PCI = 14.4636^{*} + 0.0552\ Es/Et + 0.9867^{**} Rs/Rt + 2.9324^{*} S/GDP.$$
$$(18.3494)\ (0.2323) \qquad (2.0211) \qquad (4.6669)$$

R=0.8189; *Significant at 5% level; **Significant at 10% level.

Surprisingly we find that revenue decentralization as indicated by the ratio of state governments' revenue to total revenue of the centre and states seems to influence the level of per capita income, of course, in addition to saving ratio. This finding would suggest that expenditure decentralization has not contributed significantly to raise the level of per capita income in India probably because, the magnitude and pattern of expenditure allocation have been dictated by the central government and the Planning Commission from above under the five-year plan regime. On the contrary, if the state governments' revenues increase either through the growth of their own revenue or through increased financial devolution from the centre or both, they will allocate and use them more effectively so as to raise the per capita income of the country. While such an explanation may go to support decentralization with devolution of more financial powers as well as funds to sub-national state governments, past experience of the way that state governments have been using their revenues does not support devolution of more financial powers as well as funds to the states without effecting reforms in their fiscal system.

In India, though the constitution has assigned redistributive functions to the national government, it did not pay much attention to the need to introduce a national social security

system. No doubt the central government relied too much on very high rates of nominal tax rates as redistributive tool. But on the expenditure side, the central government trusted the 'trickle-down' process of five-year plans to raise the standard of living of the poor people in a vast and disparate country which was ridden with feudal vestiges. But by mid-1960's it was realized that mass poverty had increased in India. Therefore, state governments, being nearer to the voter-citizens, started performing redistributive functions from the expenditure side. While the central government imposed heavy direct taxation and invested vast amount of funds in public enterprises in the name of creating a socialistic pattern of society, it was the state governments which designed their expenditure programs for providing some social security to different target groups among the poor. This policy has no doubt led to competitive populism resulting in increased budget deficits [Thimmaiah (1996)].

The central government, on the other hand belatedly realized the failure of five-year plans to improve the living conditions of the poor people through the 'trickle down' process of development. It started anti-poverty programs during the fourth five-year plan period, which have continued to expand in number, coverage and variety. Some of the 'populist programs' started by the state governments have even come to be copied by the central government, as for instance, the famous mid-day meals scheme of Tamil Nadu has become a centrally sponsored national nutrition program. Thus regional political parties are asserting their right to perform redistributive functions through the expenditure responsibilities assigned to them under the constitution. Specific-target-group-oriented social security/welfare programs are partly responsible for the growing current account deficits of the state governments in India. Therefore, it is difficult to argue that increased devoliution of funds to the state governments in India will promote economic development through efficient allocation and effective utilization of scarce financial resources in the country. No doubt it is argued by Rao (1998), that it would be more appropriate for the central government to raise revenue through progressive taxation and for the state governments to design and implement development and welfare programs. This argument is based on the assumptions that it will avoid economic distortions originating from tax overlapping and information and transaction costs of designing and implementing development and welfare programs are lower at state level. These assumptions are not sufficiently obtained at the state level in India. They will have to be ensured before we switch over to such a fiscal decentralization scheme.

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