Fiscal Decentralisation to Local Governments in India
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Edited by

M. A. Oommen

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For

*Ammini*
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M.A. Oommen
INTRODUCTION

M. A. OOMMEN

An efficient fiscal system calls for a substantial degree of decentralisation in meeting its allocation function.
—Musgrave and Musgrave

The age of centralisation is receding fast. There is a distinct swing of the pendulum towards democratic decentralisation. Liberal democracy has failed to provide the poor and the weak, voice and choice in decision-making. In a multi-cultural and multi-lingual federal polity like India democratic decentralisation commands a natural appeal. Prima facie, it has tremendous potential to reduce transaction and coordination costs, besides enhancing equity. Fiscal decentralisation which is an integral subset of decentralisation assumes significance because without its proper functioning decentralisation becomes inoperative and meaningless. It has particular significance in the context of a multi-level system of governance with fiscal responsibilities vested in the centre, state and local governments. In the literature on multi-level public finance this is broadly referred to as ‘fiscal federalism’ or decentralised fiscal system.

India has created history in fiscal federalism in the world through the landmark 73rd/74th amendments to its constitution in 1992 which adds a third tier of local self-government to its federal structure. Indeed the overarching compulsion of the 73rd amendment was to reform and reconstruct rural India through panchayats. It is important to recall here what the then Minister of State for Rural Development, Venkat Swamy said while moving the 73rd Constitutional Amendment Bill in Lok Sabha on December 1, 1992: “The constitution (73rd) Amendment Bill cast a duty on the centre as well as the states to establish and nourish the village panchayats so as to make them effective self-governing institutions... . We feel that unless the panchayats are provided with adequate financial strength, it will be impossible for them to grow in stature”. The theory and practice of fiscal decentralisation in India naturally will have to undergo great change given this historic mandate. This volume is a collection of papers that address some of the issues relating to the emerging fiscal
decentralisation to local governments in India since the mid-1990s that span the post-constitutional amendment regime.

Democratic decentralisation is widely hailed as an intrinsic value. It is also accepted for its instrumental significance in providing efficient and equitable delivery of public service at the local level with people’s involvement. Despite its intrinsic and instrumental importance, several scholars and policy-makers oppose it and the major reason mentioned is that fiscal decentralisation will render macro economic management and goals difficult and unviable. But this is essentially an empirical question. The first paper in this volume by Anwar Shah is a strong defence against all fiscally-based arguments against decentralisation. He employs institutional and econometric analysis of 24 countries to arrive at his conclusions. Probably there is nothing unexpected in his inferences because decentralised fiscal system requires greater clarity in the roles and functions of the various players, transparency in the rules and greater care in the design of institutions. Shah’s critique of decentralisation and macro management in China the biggest unitary government in the world and in Brazil a federal system whose decentralisation efforts have acquired world wide acclaim recently is a useful part of his paper. His paper is a fitting backdrop to the papers in this volume that directly address the issues of fiscal decentralisation in India

What is meant by fiscal decentralisation? Before we explain it, it is important to clarify the concept of decentralisation itself. In some respect, it is a much-abused term because it is variously defined and differently understood. Quite often it is used in the limited sense of delegation or deconcentration, meaning the unbundling of burdens by a superior officer or a higher level government. Democratic decentralisation is far from this approach especially when we use it in the context of strengthening the local tier of governance. We may define decentralisation as empowering the local people through empowering the local governments or in the rural context of India the panchayats. Therefore, fiscal decentralisation means fiscal empowerment of the local governments. More specifically, it means devolution of taxing and spending powers to lower levels of government. The local government should have adequate authority and autonomy in regard to the management of the expenditure and revenue side of its budget [See Fukasaku and De Mello Jr. (1999)].

The historical context and the objectives to be served by decentralisation differ from country to country. Even so, it is important to examine the issues of fiscal decentralisation in India within the broad conceptual frame work of fiscal federalism (in this context see
D.K. Srivastava’s paper in this volume). This is a new area that needs more scholarly attention.

A multi-level federal polity which seeks to promote democratic decentralisation has to address or reexamine at least four basic questions in order to ensure a rational, efficient and equitable system of public finance. They are examined in the context of India below.

- **Functional mapping/Assignment of expenditure responsibilities:** In a multi-layered federal polity the basic question to be asked is: who should do what? What can be done best at a particular level should be done at that level and not at a higher level is the ideal principle of assignment of expenditure responsibilities. This is what is called the principle of subsidiarity and is meant to ensure allocative efficiency and reduce inefficiencies.

  The Indian Constitution which borrowed heavily from the Government of India Act, 1935 was a two-tier federation of states and union with a built-in bias towards centralisation\(^1\). It has been quite often characterised as quasi-federal. In a way the 73\(^{rd} / 74\(^{th}\) amendments were steps towards reversing this historical perversity. Given the vast concurrent functional domain in which both the Union and the States have jurisdictions, adding Schedule XI for panchayats and Schedule XII for the urban local bodies (ULBs) through these amendments could confuse the roles and responsibilities of the various tiers unless careful disaggregated mapping of functions into activities and sub-activities is made at the level of the local governments. This is needed for role clarity with reference to the state on the one hand as well as to the different tiers of the panchayats and ULBs on the other.

- **Revenue Assignments:** The fundamental question of financing the expenditure responsibilities raises the equally important question: who should tax where and what? Patterned basically on the Government of India Act, 1935, these questions were not the governing consideration in the division of revenue-raising responsibilities when the Indian Constitution was ushered in 1950. The Constitution envisaged a two-tier system where more productive and elastic sources of taxes like income tax,

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\(^1\) The Indian Constitution has borrowed approximately 250 Articles “verbatim or with minor changes in phraseology from the 1935, Government of India Act” [M. Brecher (1969): 207].
corporation tax, customs duties etc were placed in the Union list and taxes like land revenue, sales tax, stamp duties etc left in the State list. Local governments being a state subject had no independent tax handles except those assigned or shared by the state. Actual practice varied from state to state. Ideally as regards local tax, the broad consensus in the literature is that local governments should concentrate on immobile and residence - based taxes, such as property tax, entertainment tax, profession tax and the like. Oommen (2004), after examining 16 state Panchayat Acts passed after the 73rd Constitutional amendments identifies as many as 28 taxes and rates that are assigned to the gram (village) panchayats. And all of them are eminently local in character. But the local governments even after the 73rd / 74th Constitutional amendments do not enjoy any autonomy in the exercise of the taxing powers. They are legislated and regulated by the States. Even so, own source revenue (OSR) is important not only to ensure autonomy but also to induce better ‘fiscal responsibility’ [See Ter-Minassian (1997)]. As Richard Bird (2000) has pointed out the voter residents will hold local politicians and bureaucrats more accountable if public services are financed by taxes they pay.

> Evolving an efficient and equitable transfer system: Essentially this means making institutional arrangements for rectifying the vertical and horizontal imbalances arising in intergovernmental fiscal relations. Ideally the expenditure responsibilities of a government, and its revenue capabilities should match. This matching called the ’principle of fiscal equivalence’ seldom happens in practice especially in a multi-tiered federation. The vertical mismatch between responsibilities and resources has to be bridged and arrangements have to be made for that. Besides the vertical imbalances, the inter-jurisdictional disparities in economic and fiscal capabilities due to differences in resource endowments, historical developments and even social disabilities of the residents (a visible phenomenon in caste-ridden India) cannot be ignored. In a democratic system especially when it is avowedly committed to reducing regional disparities, these horizontal disparities will have to be continuously addressed. Transfers to carry out some agency functions on behalf of a higher government (it could be the federal or state government) do not strictly form part of the general transfer system. Thus the
task of a good inter-governmental transfer system is (a) to
determine normatively the size of the divisible pool which ideally
has to be related to the expenditure responsibilities a government
has to shoulder and the revenue potential and performance which
of course has to be normatively screened to discourage
imprudence and (b) to equitably distribute the pool among the
sub-national governments, keeping the objectives of
decentralisation laid out in the constitution or mandated by the
state legislature. By providing for the creation of the institution
of state finance commission (SFC) at the state level through the
73rd/74th constitutional amendments, India has created an
important necessary condition towards rationalising state-local
fiscal relations and transfer arrangements. In India the quality
and effectiveness of the sub-state level transfer system depends a
great deal on the quality of SFC recommendations. Given the
reality that Indian rural local governments consist of a large net
work of village panchayats at the cutting edge level which need
be carefully fostered, the transfer system should be simple and
transparent. It is important to avoid complicated grant allocation
formula that cannot be supported adequately by existing data,
local taxes that are structured to accomplish other goals than
revenue – raising, conditional grants that require a monitoring of
the use of funds and expenditure mandates that have stringent
compliance requirements. [See Bahl (1999)].

♦ Accountability mechanism: Decentralised governance is
legitimised through appropriate accountability mechanisms.
Managing expenditures therefore becomes crucial. As Richard
Bird observes: “Budgeting, financial reporting and auditing
should be comprehensive, comprehensible, comparable,
verifiable and public. It is equally important, however, to ensure
that budgeted resources are applied as efficiently and effectively
as possible to achieve desired public outcomes” [Bird (2000): 4].
By creating the institution of gram sabha, the assembly of voters
at the village level (Article 243A) with powers to review budgets,
hear audit reports and so on, the 73rd amendments have carried
the accountability institutions to the door steps of the people from
the extant narrow realms of financial accounting.

The purpose of this volume is to bring together in one place some
important papers that critique the progress and problems of fiscal
decentralisation in India. Political empowerment however important it may be will carry no operational significance unless it is backed up by efficient and equalising fiscal institutions, fiscal instruments and funds. The whole question of asymmetry in power and the imbalance in the exercise of it cannot be addressed without efficiently addressing the vertical and horizontal imbalances in resource power. Indeed, tremendous political empowerment and opportunities do emerge from the extension of participatory democracy through the institutions of gram sabha, village panchayat, affirmative provisions for dalits and adivasis (the so-called SC/ST categories) and women. That two general elections to local bodies have happened since 1995 in all the states is also a great progress in a country where elections to municipalities and village panchayats were postponed for 15 to 20 years at a stretch without any compunction. The stark ground reality however is that despite all these, much did not happen on the fiscal federalism front and therefore substantive gains in decentralised governance and local democracy also failed to make headway.

The brief conceptual framework of fiscal decentralisation already discussed will be helpful to review the progress made. All the papers other than the first one by Anwar Shah critique the progress of fiscal decentralisation in India or examine issues that follow from this. As regards the assignment of expenditure responsibilities are concerned very little progress has happened except in a few states. Schedule XI of the constitution mentions, 29 subjects like agriculture, animal husbandry, education and so on and could not be equated to the lists under Schedule VII meant for a two-tier federation. All the 29 subjects assigned for panchayats are state-concurrent and concurrent with the centre also in several cases. There is need for role clarity to avoid duplication and overlapping. Unless there is role clarity as between the activity domain of the state on the one hand and the urban local bodies and the three tiers of panchayati raj institutions (PRIs) on the other, decentralisation can only result in more confusion, delay in implementation and increasing the difficulties in evolving an efficient transfer system. While all states have passed conformity Acts following the 73rd Amendment, some of them have just repeated the 29 subjects mentioned in the XIth schedule as functions of all the three panchayat tiers. Only a few states like Andhra Pradesh, Kerala, Gujarat and Madhya Pradesh have broken the 29 subjects into activities and sub-activities. Among these states only Kerala has put this into practice. Following the establishment of the new Union Ministry of Panchayati Raj in May, 2004, several nation-wide initiatives were launched to strengthen democratic decentralisation and activity mapping
The constitution (as amended) assigns planning responsibilities also to the local governments. But only Kerala, Himachal Pradesh, Madhya Pradesh, Bihar and West Bengal have ventured to statutorily recognise the constitutional mandate to prepare plans for ‘economic development and social justice’ as well as undertake spatial planning at the local level as a function of local bodies as stipulated in Articles 243 G, 243 W and 243 ZD. Actually only Kerala carried it to its logical consummation. Mandating local governments to prepare area plans through these new Articles is an admission that the central and state plans have been in many ways incomplete and unresponsive to the urgent needs of the people scattered in far-flung locations. Indeed local governments are now recognised as partners in achieving the nation’s development goal.

Once you decide on functional devolution to a particular tier the normal procedure is to assign budgetary heads and transfer funds to each transferred item. If this is strictly followed decentralisation to local governments need not involve additional funds. The paper by Indira Rajaraman and Darshy Sinha in this volume is a pioneering case study in regard to the 29 functions assigned to PRIs in Madhya Pradesh, Chhattisgarh, Rajasthan and Orissa. After examining the budget heads and sub-heads for the 29 subjects falling under the XIth Schedule the authors seem to be constrained to point out many “idiosyncratic ways of accounting for their expenditure”. While the profile of functional transfer followed in Madhya Pradesh is somewhat helpful in reviewing the structure and magnitude of devolution, this is not equally so in the other three states studied by them.

The most astonishing feature of decentralisation of governance in India has been the complete absence of a uniform accounting system that would render transparent the transfer of functions mandated. This is a major deficiency. Rajaraman and Sinha offer several policy recommendations, four of them exclusively for states and two of them for the centre. Uniform accounting procedures across the states, panchayats and municipalities is a desirable reform that needs immediate action. It may not be wide of the mark to note here that the Appendix IV of the Kerala State Budget presented since 1997-98 gives detailed budget heads and sub-heads for each local government as well as for each institution transferred to the local governments as part of decentralised governance in the state.

Turning to tax assignments, a review of conformity legislations shows that the pre-amendment (73/74) regime continues in almost all the states.
No state seems to have anticipated the expanding needs of decentralised governance and made appropriate changes in the revenue assignments to local bodies. Generally intermediate and district panchayats are not assigned taxing powers Rajasthan, UP, Bihar and Punjab are prominent exceptions. Although gram panchayats (GPs) have been earmarked a large number of tax and non-tax items of revenue their autonomy is severely constrained by rules, procedural restrictions and conditions. Most states also continue to follow the practice of ‘assigned taxes’ (the state government imposing a levy or surcharge on its own taxes and/or the state government collecting the taxes assigned to local bodies and disbursing them). In order to meet the growing demands of decentralisation, there is need to make the tax and non-tax revenues of local governments more productive and elastic through rationalising the tax base, rates and more importantly tax administration along with greater autonomy and empowerment to the GPs.

The quality and effectiveness of fiscal decentralisation local governments depends on the design of an efficient intergovernmental transfer system, which in Indian context depends on the recommendations of the state finance commission (SFC) created as per Articles 243I and 243Y of the Constitution every five years. Based on these Articles and given the basic provisions of Article 243 G, 243 W and 243 ZD we may spell out the broad objectives of the state local transfer system as follows:

- Reducing the vertical and horizontal imbalances and working towards an equalising system.
- Providing basic services to every citizen irrespective of the choice of her residential location.
- Planning for economic development and social justice.
- Strengthening GPs which is crucial to promote efficient delivery of services at the local level, to reflect people’s preferences via gram sabha and mobilise own source revenue (OSR) to ensure self-governance, accountability and participation.
- Deepening local democracy.

In brief SFCs are responsible to examine not only the revenue sharing arrangements between the state government and the local governments, but the entire gamut of subjects concerning the financial health of local bodies. To achieve these goals, every SFC has to adopt a normative approach in assessing the receipts and expenditure of state as well as of local governments besides their fiscal capabilities and cost disabilities and arrive at a reasonable estimate of resource gap and decide on the manner
of distribution between the panchayats and the urban local bodies. The criteria and principles for interse distribution also will have to be spelt out.

Two generations of SFCs have submitted their reports. Kerala, Tamil Nadu, Punjab and Bihar have submitted their third SFC reports. Bihar has appointed its fourth SFC. A pertinent question to be asked is, have the SFCs performed their onerous tasks satisfactorily? The answer is a firm no. There are only very rare exceptions. The eleventh and twelfth union finance commissions (referred also as Central/National finance commissions) have severely criticised the selection of SFC chairpersons and members, the quality of recommendations and the indifferent attention given to the recommendations made by the SFCs by the state and so on. This volume contains a paper by V.N.Alok that surveys as large as forty SFCs of the first and second generation vintage and brings together in one place the major recommendations and critically review them. The poor performance of SFCs is one of the reasons for the poor progress in ushering in a sound state sub-state level fiscal system in India. [See paper by Oommen].

More than thirteen years have passed since the conformity legislations to the 73rd/74th constitutional amendments have been passed by the various state assemblies. M.A. Oommen’s paper in this volume for the first time in India gives a detailed account of the trend in the expenditure and revenue decentralisations to both rural and urban local bodies for 15 major states and for all India. The magnitude and trend in regard to state sub-state level transfers are also evaluated. The volume of public expenditure handled by the local governments is negligible reckoned in terms of total public expenditure comprising the centre and the states and also when compared to most countries of the world. The disturbing fact is that even this small share has been declining over the years [See Oommen, Srivastava]. Seeing the fiscal decentralisation scenario one is led to think that all the rhetoric about decentralisation has been sound and fury signifying very little in reality. Fiscal autonomy is the hallmark of genuine decentralisation. In this respect urban local bodies which raise over 52 per cent of their expenditure from their own revenue is much better placed than their rural counterparts, the panchayats (See Srivastava, Oommen).

Any one who reviews the conformity Acts including the subsequent amendments made, and watches the decentralisation progress in the various states will be impressed by the statutory modifications and also by the institutional changes made to devolve more functional, financial and administrative autonomy to local governments by the Kerala state. The methodology of decentralised planning launched and institutionalised in
the state despite several weaknesses it has definitely helped to widen the avenues of people’s participation. D.K. Srivasta’s paper presents Kerala’s fiscal decentralisation in a wider theoretical backdrop and draws lessons for the country as a whole.

There is a strong hypothesis in the public finance literature that grants-in-aid or more broadly transfers from higher to lower tiers of government can have disincentive effects on the revenue mobilisation of the recipient government. P. Shaheena’s paper (based on her Ph.D dissertation) in the volume is important because she puts this hypothesis to empirical test based on data relating to Kerala’s plan grants and other transfers to gram panchayats using rigorous statistical tools. The regression results confirm her hypothesis that untied plan grants have a dampening effect on revenue mobilisation. The mobilisation of revenue from major taxes (building tax, profession tax and entertainment tax) is significantly and positively related to their respective bases. Tax efforts relating to optional taxes can be affected by unconditional grants.

The paper by K. Krishna Kumar, K.K. George and V.K Praveen is also equally important because it examines to what extent the flow of grants-in-aid from the central and state governments to gram panchayats had been governed by the principle of horizontal equity, an overarching concern in intergovernmental transfers. This study also uses Kerala village panchayat data. In India there is need for further studies in intergovernmental transfers at the sub-state level focussing on efficiency and equity considerations.

Decentralisation is a subject that is attracting scholarly attention. The intrinsic value and instrumental importance of democratic decentralisation is now fairly well acknowledged. India is one country in the world that is statutorily committed to build and promote local governments and local democracy. This study shows that the progress made leaves many things to be desired. Even so, decentralisation has to grow in greater strength and stature to usher in a viable democracy based on equitable development in this country and also elsewhere in the world.

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CHAPTER ONE

FISCAL DECENTRALIZATION
AND MACRO ECONOMIC MANAGEMENT

ANWAR SHAH

1. Introduction

A large and growing number of countries around the globe are re-examining the roles of various orders of government and their partnerships with the private sector and the civil society with a view to creating governments that work and serve their people (see Shah, 2004 for motivations for a change). This rethinking has led to a resurgence of interest in fiscal federalism principles and practices as federal systems are seen to provide safeguards both against the threat of centralized exploitation as well as decentralized opportunistic behaviour while bringing decision making closer to the people. In fact federalism represents either “coming together” or “holding together” of constituent geographic units to take advantage of the greatness and littleness of nations as in a flat (globalized) world nation states are observed to be too large to address small things in life and too small to address large tasks. But federal fiscal systems to accommodate “coming together” or “holding together” according to some influential writers pose a threat to macro-stability. They argue that decentralized governance structure is incompatible with prudent fiscal management (see e.g. Prud’homme 1995, Tanzi, 1995). This chapter investigates the conceptual and empirical bases

* An earlier version of this chapter was presented as an invited lecture at the 2005 Annual Congress of the International Institute of Public Finance, August 22-25, Jeju Island, Korea. The author is grateful to Professor Juergen von Hagen for suggesting this topic. Thanks are also due to an anonymous referee for helpful comments and Javier Arze and Sarwat Jahan for research assistance. The views expressed here are those of the author alone and may not be attributed to the World Bank.
of these arguments. More specifically, the paper addresses the following questions:

- Are there greater risks of macroeconomic mismanagement and instability with decentralized fiscal systems (federal vs. unitary countries)?
- What has been the experience to-date in macroeconomic management in federal vs. unitary countries? Or what has been the impact of decentralization on fiscal discipline and macro stability?

To address the above questions, we take a simple institutional cum econometric analysis perspective. The institutional perspective uses as benchmark fiscal institutions in federal versus unitary countries. This is a useful perspective as the working of federal constitutions place a greater premium on vertical and horizontal coordination. It should nevertheless be recognized at the outset that the practice of fiscal federalism in various federal countries may lead to significant degree of centralization in decision-making as in Australia, India and Mexico and as a corollary some unitary countries could in practice may be quite decentralized such as Colombia. Thus there can be no one to one mapping between federalism and decentralized decision making although as a group federal countries are more decentralized than unitary countries. The econometric perspective overcomes this deficiency by considering measures of the degree of fiscal decentralization but is weaker in capturing the institutional details. In view of these limitations of the individual approaches, the paper uses a combination of both the approaches to have a better understanding of the underpinnings of the relationship between fiscal decentralization and economic performance.

The strengths and weaknesses of fiscal and monetary policy institutions under alternate fiscal regimes are examined drawing upon neo-institutional economics perspectives on fiscal institutions (see von Hagen, 2002, 2005 and von Hagen, Hallet and Strauch, 2002). A neo-institutional economics perspective aims to reduce transactions costs for citizens (principals) in inducing compliance with their mandates by various orders of governments (agents). A fiscal system that creates countervailing institutions to limit the opportunistic behavior of various agents and empowers principals to take corrective action, is expected to result in superior fiscal outcomes. In the context of this paper, relevant question then is what type of fiscal system (centralized or decentralized) offers greater potential for contract enforcement or rules or restraints to
discourage imprudent fiscal management. The paper undertakes a qualitative review of institutional arrangements for monetary and fiscal policy in federal and unitary countries. This is supplemented by two country case studies and a broader cross-country econometric analysis to examine fiscal outcomes under alternate fiscal systems. These results are used to draw some general lessons of public policy interest.

The chapter concludes that, contrary to a common misconception, decentralized fiscal systems offer a greater potential for improved macroeconomic governance than centralized fiscal systems. While empirical evidence on these questions is quite weak, nevertheless it further supports the conclusion that fiscal decentralization is associated with improved fiscal and economic performance. This is to be expected as decentralized fiscal systems require greater clarity in the roles of various players (centres of decision-making), transparency in the rules and greater care in the design of institutions that govern their interactions to ensure a fair play and limiting opportunities for rent-seeking. The rest of the paper is organized as follows. Section 2 discusses the institutional environment for macroeconomic management. This is elaborated separately for monetary and fiscal policies and in each subsection literature review is supplemented by econometric analysis and Brazil and China country case studies. A final section (section 3) draws some general conclusions.

2.0 Institutional Environment for Macroeconomic Management

Using Musgrave’s trilogy of public functions namely allocation, redistribution and stabilization, the fiscal federalism literature has traditionally reached a broad consensus that while the former function can be assigned to lower levels of government, the latter two functions are more appropriate for assignment to the national government. Thus macroeconomic management - especially stabilization policy -- was seen as clearly a central function (see e.g. Musgrave, 1983: 516; Oates, 1972). The stabilization function was considered inappropriate for sub-national assignment as (a) raising debt at the local level would entail higher regional costs but benefits for such stabilization would spill beyond regional borders and as a result too little stabilization would be provided; (b) monetization of local debt will create inflationary pressures and pose a threat for price stability; (c) currency stability requires that both monetary and fiscal policy functions be carried out by the centre alone; and (d) cyclical shocks are usually national in scope (symmetric across all regions) and therefore require a national response. The above views have
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been challenged by several writers (see e.g. Dafflon, 1977; Sheikh and
Mihaljek, 1995; Huther and Shah, 1996) on theoretical and empirical
grounds yet they continue to command considerable following. An
implication that is often drawn is that decentralization of the public sector
especially in developing countries poses significant risks for the
“aggravation of macroeconomic problems” (Tanzi, 1996, p.305).

To form a perspective on this issue, we reflect in the following section
on the theoretical and empirical underpinnings of the institutional
framework required for monetary and fiscal policies.

2.1 Institutional Setting for Monetary Policy

Monetary policy is concerned with control over the level and rate of
change of nominal variables such as the price level, monetary aggregates,
exchange rate and nominal GDP. The control over these nominal variables
to provide for a stable macro environment is commonly agreed to be a
central function and monetary policy is centralized in all nation states,
federal and unitary alike. Nevertheless, there are occasional arguments to
add a regional dimension to the design and implementation of monetary
policies. For example Mundell (1968) argues that an optimal currency area
may be smaller than the nation state in some federations such as Canada
and USA and in such circumstances, the differential impact of exchange
rate policies may be inconsistent with the constitutional requirement of
fair treatment of regions. Further complications arise when the federal
government raises debt domestically, but provincial governments borrow
from abroad: This is the case in Canada as federal exchange rate policies
affect provincial debt servicing. Similarly Buchanan (1997) argues against
the establishment of a confederal central bank such as the European Union
Central Bank as it negates the spirit of competitive federalism.

In a centralized monetary policy environment, Barro (1996) has
cautions that a stable macro environment may not be achievable without
a strong commitment to price stability by the monetary authority. This is
because if people anticipate growth in money supply to counteract a
recession, the lack of such response will deepen recession. The credibility
of a strong commitment to price stability can be established by
consistently adhering to formal rules such as a fixed exchange rate or to
monetary rules. Argentina’s 1991 Convertibility Law establishing parity
in the value of the peso in terms of the US dollar and Brazil’s 1994 Real
Plan helped achieve a measure of this level of credibility. Argentine’s
central bank strengthened credibility of this commitment by enduring a
severe contraction in the monetary base during the period December 1994 to March 1995 as speculative reactions to the Mexican crisis resulted in a decline in its foreign exchange reserves. Alternately, guaranteeing independence from all levels of the government, for a central bank whose principal mission is price stability could establish the credibility of such a commitment (Barro, 1996, Shah, 1994, p.11). Barro considers the focus on price stability so vital that he regards an ideal central banker as one who is not necessarily a good macro economist but one whose commitment to price stability is unshakable. He said, “The ideal central banker should always appear somber in public, never tell any jokes, and complain continually about the dangers of inflation” (1996, p.58). Empirical studies show that that the three most independent central banks (the National Bank of Switzerland - the Swiss Central Bank, Bundes bank of Germany, and the US Federal Reserve Board) over the period 1955 to 1988, had average inflation rates of 4.4 per cent compared to 7.8 per cent for the three least independent banks (New Zealand until 1989, Spain and Italy). The inflation rate in the former countries further showed lower volatility. The same studies also show that the degree of central bank independence is unrelated to the average rate of growth and average rate of unemployment. Thus Barro argues that a “more independent central bank appears to be all gain and no pain” (1996, p.57). The European Union has recognized this principle by establishing an independent European Central Bank. The critical question then is whether or not independence of the central bank is compromised under a decentralized fiscal system. One would expect, a priori, that the central bank would have greater stakes and independence under a decentralized system since such a system would require clarification of the rules under which a central bank operates, its functions and its relationships with various governments. For example, when Brazil in 1988 introduced a decentralized federal constitution, it significantly enhanced the independence of the central bank (Shah, 1991, Bomfim and Shah, 1994). Yet, independence of the central bank in Brazil remains relatively weak compared to other federal countries (see Huther and Shah, 1996). On the other hand, in centralized countries the role of the central bank is typically shaped and influenced by the Ministry of Finance. In one extreme case, the functions of the central bank of the UK (a unitary state), the Bank of England, are not defined by law but have developed over time by a tradition fostered by the UK Treasury. Only in May 1997, has the newly elected labour party government of Prime Minister Tony Blair assured the Bank of England a free hand in its pursuit of price stability. Such independence may still on occasions be compromised as the Chancellor of the Exchequer still retains a presence
on the board of directors as a voting member. New Zealand and France (unitary states) have lately recognized the importance of central bank independence for price stability and have granted independence to their central banks. The 1989 Reserve Bank Act of New Zealand mandates price stability as the only function of the central bank and expressly prohibits the government from involvement in monetary policy. The People’s Bank of China, on the other hand, does not enjoy such independence and often works as a development bank or as an agency for central government “policy lending” and in the process undermines its role of ensuring price stability (see World Bank, 1995 and Ma, 1995). For monetary policy, it has only the authority to implement the policies authorized by the State Council. The Law of the People’s Bank of China, 1995, article 7 states that its role is simply to “implement monetary policies under the leadership of the State Council” (see Chung and Tongzon, 2004).

For a systematic examination of this question, Huther and Shah (1996) relate the evidence presented in Cukierman, Webb and Neyapti (1992) on central bank independence for 80 countries to indices of fiscal decentralization for the same countries. Cukierman et al. assess independence of a central bank based upon an examination of 16 statutory aspects of central bank operations including the terms of office for the chief executive officer, the formal structure of policy formulation, the bank’s objectives as stated in its charter, and limitations on lending to the government. Huther and Shah (1996) find a weak but positive association between fiscal decentralization and central bank independence confirming our a priori judgment that central bank independence is strengthened under decentralized systems. Table 1, equation 1, using a cross section of 40 countries for the period 1995-2000 provides econometric analysis of the impact of expenditure decentralization on central bank independence. The results confirm positive impact of expenditure decentralization on central bank independence.

Increases in the monetary base caused by the Central Bank’s bailout of failing state and non-state Banks represent occasionally an important source of monetary instability and a significant obstacle to macroeconomic management. In Pakistan, a centralized federation, both the central and provincial governments have, in the past, raided nationalized banks. In Brazil, a decentralized federation, state banks in the past made loans to their own governments without due regard for their profitability and risks causing the so called $100 billion state debt crisis in 1995. Brazil, nevertheless later dealt with this issue head on with successful privatization of state-owned banks in late 1990s and through prohibition of
government borrowing from state banks or from the central bank (Levy, 2005). Thus a central bank role in ensuring arms length transactions between governments and the banking sector would enhance monetary stability regardless of the degree of decentralization of the fiscal system.

Available empirical evidence suggests that such arms length transactions are more difficult to achieve in countries with a centralized structure of governance than under a decentralized structure with a larger set of players. This is because a decentralized structure requires greater clarity in the roles of various public players, including the central bank. No wonder one finds that the four central banks most widely acknowledged to be independent (Swiss Central Bank, Bundesbank of Germany, Central Bank of Austria and the United States Federal Reserve Board) have all been the products of highly decentralized federal fiscal structures. It is interesting to note that the independence of the Bundesbank is not assured by the German Constitution. The Bundesbank Law providing such independence also stipulates that the central bank has an obligation to support the economic policy of the federal government. In practice, the Bundesbank has primarily sought to establish its independence by focusing on price stability issues. This was demonstrated in the 1990s by its decision to raise interest rates to finance German unification in spite of the adverse impacts on federal debt obligations (see also Biehl, 1994).

The Swiss Federal Constitution (article 39) assigns monetary policy to the federal government. The federal government has, however, delegated the conduct of monetary policy to the Swiss National Bank, a private limited company regulated by a special law. The National Bank Act of 1953 has granted independence in the conduct of monetary policy to the Swiss National Bank although the bank is required to conduct its policy in the general interest of the country. It is interesting to note that the Swiss National Bank allocates a portion of its profits to cantons to infuse a sense of regional ownership and participation in the conduct of monetary policy (Gygi, 1991).

This chapter also examined empirically some additional questions on the impact of fiscal decentralization on monetary stability. These included impact of fiscal decentralization; on growth of money supply; on control of inflation; and inflation and macroeconomic balances. Regression results reported in Table 1, equations 2, show that growth of money supply is primarily determined by central bank independence and fiscal decentralization has an insignificant positive impact. Similarly, fiscal decentralization has a negative but insignificant impact on price inflation (Table 1, equation 3). Finally, the impact of fiscal decentralization on inflation and macroeconomic balances was found to be insignificant (Table 1, equation 4).
Table 1: Fiscal Decentralization and Fiscal Performance – Selected Regressions

<table>
<thead>
<tr>
<th>Dependent Variables</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
<th>(9)</th>
<th>(10)</th>
<th>(11)</th>
<th>(12)</th>
<th>(13)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure Dec. (Fraction subnational expenditures)</td>
<td>.46*</td>
<td>26.18</td>
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<tr>
<td>Fiscal Dec. Qualitative index - principal components</td>
<td>-67.80 (-1.25)</td>
<td>.02 (.22)</td>
<td>.08 (.47)</td>
<td>-.03 (-.29)</td>
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<tr>
<td>Fiscal Dec. Qualitative composite score index</td>
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<tr>
<td>GDP growth average 1990-00</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>.27* (2.08)</td>
<td></td>
</tr>
<tr>
<td>Log GDP per capita</td>
<td>-.06** (-3.39)</td>
<td>-11.86** (-5.51)</td>
<td>.26 (1.07)</td>
<td>55* (2.39)</td>
<td>27 (1.26)</td>
<td>67** (3.61)</td>
<td>.49** (6.27)</td>
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<tr>
<td>GDP per capita</td>
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<tr>
<td>Log initial GDP per capita</td>
<td>2.71 (1.46)</td>
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<tr>
<td>Initial GDP per capita</td>
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</tbody>
</table>

Notes: (1) Central Bank Independence (Cukierman Index) (2) Money Supply – M2 growth (3) Inflation – growth in GDP deflator (4) Mgmt of Inflation & Macroeconomic Balances (5) Mgmt of Public debt & External Balance (6) Overall Fiscal Policy Quality Ratings (7) Efficiency in Revenue Mobilization (8) Tax Effectiveness (9) Consolidated public accounts & Tax as a percentage of GDP (10) Budget Balance as a % of exp. (11) Total Debt to GDP Ratio (12) Public Sector Mgmt and Institutions (13) Growth Rate of GDP
<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>P-value</th>
<th>Coefficient</th>
<th>P-value</th>
<th>Coefficient</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Political Stability Index</td>
<td>-.04**</td>
<td>(-6.82)</td>
<td>.53e-2</td>
<td>(-.27)</td>
<td>-.51**</td>
<td>(4.34)</td>
</tr>
<tr>
<td>Exchange Rate Regime</td>
<td>-.13**</td>
<td>(-3.63)</td>
<td>48.65</td>
<td></td>
<td>.71**</td>
<td>(3.65)</td>
</tr>
<tr>
<td>Inflation - CPI change</td>
<td>.32e-2</td>
<td>(1.32)</td>
<td>-.09*</td>
<td>(-2.62)</td>
<td>.01</td>
<td>(.58)</td>
</tr>
<tr>
<td>Central Budget Balance</td>
<td>1.59</td>
<td>(1.68)</td>
<td>8.58</td>
<td>(.39)</td>
<td></td>
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</tr>
<tr>
<td>Central Bank Independence</td>
<td>-25.82*</td>
<td>(-2.24)</td>
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<tr>
<td>Growth Income per capita</td>
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<td>(-2.23)</td>
<td></td>
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<tr>
<td>Population</td>
<td>1.15e-9*</td>
<td>(2.30)</td>
<td></td>
<td></td>
<td>.50**</td>
<td>(3.02)</td>
</tr>
<tr>
<td>% population over 65</td>
<td></td>
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<tr>
<td>Log Population</td>
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<td>-1.7*</td>
<td>(-2.43)</td>
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<tr>
<td>Urbanization</td>
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<td></td>
<td>.16</td>
<td>(1.17)</td>
<td></td>
<td></td>
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<tr>
<td>Fiscal Transfers as % of SN Revenues</td>
<td></td>
<td></td>
<td>15.63*</td>
<td>(2.24)</td>
<td></td>
<td></td>
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<tr>
<td>Openness to Trade</td>
<td>.59e-2</td>
<td>(1.06)</td>
<td>.01</td>
<td>(1.36)</td>
<td>-.17e-2</td>
<td>(-.38)</td>
</tr>
<tr>
<td>Freedom Index</td>
<td>-.11</td>
<td>(-.63)</td>
<td>-.09</td>
<td>(-.53)</td>
<td>.12</td>
<td>(1.08)</td>
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<tr>
<td>Ethnic</td>
<td>.63</td>
<td>(1.38)</td>
<td>.80</td>
<td>(.38)</td>
<td>-.14</td>
<td>(.46)</td>
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<tr>
<td>Origin Law English</td>
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<td>(.68)</td>
<td>.29</td>
<td>(.84)</td>
<td>.53*</td>
<td>(2.87)</td>
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<tr>
<td>English</td>
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<td></td>
<td>.26</td>
<td>(.94)</td>
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