CHAPTER I

“Decentralisation has not only an administrative value, but also a civic dimension, since it increases the opportunities for citizens to take interest in public affairs; it makes them get accustomed to using freedom and from the accumulation of these local, active, pernickety freedom, is born the most efficient counterweight against the claims of the central government, even if it were supported by an impersonal, collective will.”

- A. De Tocqueville (1805-1859)

1.1 Introduction

In the last three decades there has been a worldwide interest in decentralisation of government in all parts of the world particularly in India. The pursuit of decentralisation is widespread, as both developed and developing countries attempt to challenge central governments’ monopoly of decision-making power. In the western world, decentralisation is an effective tool for reorganization of the government in order to provide public services cost effectively in the "post-welfare state" era (Bennett, 1990; Wildasin, 1997). Developing countries are turning to decentralisation to escape from the traps of ineffective and inefficient governance, macroeconomic instability, and inadequate economic growth (Bird and Vaillancourt, 1999). Throughout post-communist Central and Eastern Europe, decentralisation of the state is the direct result of the transition from socialist system to market economy and democracy (Bird, Ebel, and Wallich, 1995). In Latin America, the origin of decentralisation is the political pressure from the people for democratization (Rojas, 1999).
Africa, decentralisation has served as a path to national unity (World Bank, 1999). One of the main policy objectives of market-based economic reforms is to improve living standards through economic growth. Decentralisation policies are being pursued by many developing countries as part of this general development strategy. Consequently, there has been increasing interest in the economics literature on the potential impact of decentralisation on economic development beyond the classical proposition that decentralisation should increase the efficiency of the public sector (Oates, 1972). The manner in which decentralization affects economic growth is indeed a complex issue because of numerous direct and indirect links between the two. As Oates (1993) points out, the static proposition that fiscal decentralisation enhances economic efficiency may have a corresponding effect on economic growth over time. On the one hand, the re-allocation of resources implied by decentralisation may have little or no effect on economic growth if the intergovernmental fiscal system does not function effectively due to poor design or government capture by local elites. On the other hand, decentralisation may improve the allocation of resources in the public sector thus leading to increases in human welfare by, for example, making government more responsive to the needs of local residents. However, these changes may have little or even no appreciable effect on measured changes in Gross Domestic Product (GDP).
1.2. Evolution of Indian Federalism

1.2.1. Evolution of two-tier federalism

India is a federation with constitutional demarcation of functions and sources of finance between Union, State and local governments. However, statutory introduction of the third tier is a recent phenomenon – after the 73rd and 74th amendments of the Constitution in 1992 gave the rural and urban local governments the constitutional status. Until this development, India had evolved as a two-tiered federal structure with the powers and functions demarcated between the Union and the States.

The decentralisation framework provided by the founding fathers of Indian Constitution was an experiment in adopting the federal idea to a large and extremely diverse economic, cultural, social and linguistic society. The heavy reliance on the 1935 Act was justified on the grounds of "continuity and harmony" (Chanda, 1965). Naturally, many important features of the Act including a heavy centripetal bias and administrative and judicial arrangements enacted for the limited purpose of colonial administration were formally incorporated into the Constitution.

The centripetal bias in fiscal matters was seen mainly in the assignment and vesting of residuary powers with the center. The most important factor that concentrated economic powers with the union government, however, was entry 22 in the concurrent list – "Economic and Social Planning" and the
consequent experiment on social engineering attempted through centralized planning in a mixed economy framework. What is however significant is the fact that the development over the years concentrated the financial powers with the Union government. The most important event that concentrated the financial powers of the Union government was the nationalization of major financial including banking and insurance institutions.

The Constitution of Indian Republic, like the 1935 Act, provided the three-fold division of powers. The matters of national importance were placed in the Union list, those of regional importance were placed in the State list and those that would require a co-operative solution were placed in the Concurrent list. The residuary powers were assigned to the Union government.

1.2.2. Sub-State decentralisation

Formally, Indian federalism was evolved as a two-tier structure until 1992. Nevertheless, local government units existed both in urban and rural areas, which basically acted as agencies of the State government. In rural areas historically, Panchayat Raj (PR) institutions in villages provided basic community services and dispensed justice. The committee was appointed by the Government of India to review the functioning of these local government agencies India, (1957). The Committee recommended that: (i) these local governments should be constituted through democratic electoral
process, (ii) the elected members should represent the local interest and should ensure proper selection and supervision of various projects to conform to the preferences of the residents and (iii) the local governmental units should be vested with adequate financial powers. Subsequent to the recommendations of the Committee, most State governments introduced the third level of government in rural areas. In many of the States, a three-tier structure of local government unit was evolved with Panchayats established at village, Taluk (block) and District levels. Similarly, in urban areas, the State governments instituted municipal corporations, municipalities and notified area committees and devolved some revenue and expenditure powers to provide urban services.

However, the framework was not adequate and the system was not congenial for the development of local self-government in most of the States. The oligopolistic power structure in local jurisdictions did not provide the elected members a representative character. The socially disadvantaged groups who also belonged to poorer sections of society did not effectively participate in the decentralisation process. There was no mechanism to prevent the State governments from superseding the duly elected local governments nor was there any mechanism forcing them to hold regular elections to the local bodies. The fiscal powers of the local governments did not generate adequate revenues and they had to perennially depend upon the State government grants for providing services. In the
event, the third level did not really function as a unit of self-government and it could hardly provide the services corresponding to the varying needs and preferences of different localities.

The initiative taken by the Union government to rejuvenate these institutions resulted in the appointment of another committee which submitted its report in 1978 (India, 1978). The committee recommended a three-tier structure of rural governance, the only difference from the previous experiment was that a cluster of villages with eight to twelve thousand population (Mandal Panchayat) rather than for each village formed the lowest level of local government. The report recommended the devolution of fiscal, including borrowing powers to local bodies.

The statutory recognition to local governments was accorded with the 73rd Constitutional amendment in 1992. With this, each of the State governments was required to pass legislation appointing Panchayat Raj institutions. It was stipulated that election to these Panchayats was to be held within the stipulated period. The evolution of urban local governments was on similar lines. By necessity, the States had to create local bodies though the Constitutional recognition came only after the 74th amendment in 1992. Each State legislated separate Municipal Acts assigning the civic functions and sources of revenue. In general the assignment of revenues was inadequate. Though all municipal bodies could levy property taxes,
revenue productivity from the tax was low. Most of the States were allowed to levy "Octroi", a tax on the entry of goods into a local area for consumption, use or sale. In general, the standards of services provided by the municipal bodies were poor and the State governments had to create a number of independent agencies such as housing boards, water supply authorities, and various improvement trusts to ensure minimum services.

The amendment of the Constitution also assigned 37 activities to urban local governments. The new arrangement, in addition to those functions that were already assigned, also gave the functions of secondary and adult education, housing and land use, promotion and development of industrial and commercial estates, and electricity distribution to the urban local bodies concurrently with the State governments.

Indian experience shows that attempt to decentralize below the State level has come about more from the Center than the States. Many states did not find it necessary to decentralize below their level until the Constitution was amended. Of course, there are cases of some States such as Karnataka take a proactive approach to decentralisation. Such initiative was an exception rather than a rule. Thus, sub-state decentralisation in India is mostly a ‘top-down’ process.
1.2.3. Softening the hard budget constraint by States

There has also been a steady increase in the deficits of the State and this has added to the structural imbalances. Although the system has provisions for the central government to exercise strict control over States’ borrowings, the latter have found ways and means of softening the hard budget constraint. The prevailing situation calls for the need to introduce more stringent measures to contain States’ borrowings.

1.3. Intergovernmental Transfers and Regional Equity

1.3.1. The Transfer System

In all multilevel fiscal systems, efficient assignment if expenditure powers do not correspond to efficient revenue powers. Further, variations in revenue capacity among sub national units can cause horizontal inequity. The resulting vertical and horizontal fiscal imbalances have to be offset through a system of unconditional intergovernmental transfers. In addition, efficient provision of public services with significant spillovers at sub national levels or for merit good reasons, specific purpose transfers will have to be made6. It is generally recognized that (i) the transfer system should be formula based rather than negotiated; (ii) the design of transfers should not have adverse incentives in fiscal management and in particular, general purpose transfers should be designed to offset shortfall in revenue capacity and excess expenditure needs of sub national units and specific purpose transfers should be designed to ensure minimum standards of targeted services.
1.3.2. Central Transfers to States

The constitution of India makes an implicit assumption that the assignment system results in surpluses for the Central government and therefore, provides for transfers to States by way of tax devolution and grants in aid of revenues. To determine the transfers the Constitution provides for the institution of Finance Commission every five years by a presidential order. The Commission is required to recommend devolution of taxes from the center to the States and provide grants to the States in need of additional assistance. After the recent amendment to the Constitution sharing of total revenues from all centrally levied taxes rather than selected taxes is being done. The Eleventh Finance Commission, which submitted the report recently, has recommended the distribution of 28 per cent of net proceeds from central taxes to the States (India, 2000). In addition to the Finance Commission, with central planning gaining emphasis, the Planning Commission has also become a major dispenser of funds. It provides grants and loans to the States for plan purposes. The funds are distributed according to the formula evolved and modified by the National Development Council (NDC) from time to time. Besides these two agencies, various central ministries also make transfers for specific purposes. Some of the specific purpose transfer schemes are entirely funded by the Center and other are shared cost programs. Major programs on poverty alleviation, family planning and education fall in this category. In
1998-99, the transfers given on the recommendation of the Finance Commissions constituted 60 percent, those given by the Planning Commission 22 per cent, and the remaining were for central sector and centrally sponsored schemes.

Besides these explicit transfers, there are implicit transfers as well. These occur due to control of prices and regulations implemented in the context of a planned regime. The important sources of implicit transfers are subsidized loans to the State governments by the Central government. Moreover, resource transfers (not necessarily through governments) occur also due to subsidized lending to priority sector by the financial and banking system and more importantly, inter-state tax exportation.

1.4. **Equalizing impact of Central transfers**

Special category States have higher per capita income levels than many of the poorer States and yet, receive more favorable treatment in the transfer system. On the whole therefore, it would be correct to state that the transfer system is equalizing. The equalizing impact is primarily due to the Finance Commission transfers, particularly to tax devolution. Neither the grant given by the Planning Commission nor the specific purpose transfers given for central sector and centrally Sponsored Schemes have significant equalizing impact. The States are required to appoint a Finance Commission every five years to make recommendations on the transfers to
be made to urban and rural local bodies. They are required to make recommendations on the assignment of tax revenues to local bodies, sharing of tax revenues between the States and the local governments and their distribution among individual local bodies and grants to be made to them.

The experience of implementation of this by various States does not bring much cheer, however. Of the 28 States, five are yet to constitute the Commissions and in six States the Commissions are yet to submit the reports. In States where they have submitted the reports, very little has been done in terms of giving revenue raising powers to the local bodies. The volume of transfers made is inadequate mainly because the States themselves have been facing severe financial crunch. Due to paucity of information at local levels, sharing of taxes and grants are not based on any scientific criteria. Often, particularly to village panchayats, the distribution is done on a lump sum basis respective of their capacity or need. In fact, after deducting the cost of electricity at source by the State government, very little is available for actual spending by the local bodies. In many States, it is seen that the activity of village Panchayats are mainly to implement the centrally sponsored schemes (Aziz, 2000). Of course, these generalizations are simplistic and there are States where local bodies play more active roles than that has been portrayed here, but that is an exception rather than a rule.
The State transfers to local bodies do not show any clear pattern. Nevertheless, the revenue accruals are marginally higher in richer States. Even so, even after transfers are included the revenues are extremely low and the impact on the service levels is not very significant. Thus, even in high income States, the impact of local bodies both in urban and rural areas in providing public services is not significant. Exceptions to this are the cases of Maharashtra and Andhra Pradesh where, the urban local bodies have taken substantial loans to improve urban infrastructure. Of course, within the limited role that the urban local bodies play, in some of the States they are more successful in raising revenues and delivering public services. It is interesting to examine the factors determining their successes which should be a subject matter for a detailed inquiry.

1.5. Evolution of Democratic Decentralisation in India

The roots of local self-governance in India could, perhaps, be traced to the Vedic times. However, the Village Governments established by tradition were not exactly democratic in character. The institution of Local Self Governments received considerable attention during the British rule, but the focus was essentially on the urban local bodies. It is only after Independence that the debates over Mahatma Gandhi's vision of gram swaraj, led to a consensus and a provision was made in the Constitution under the Directive Principles of State Policy which reads "The state shall take steps to organize village Panchayats and endow them with such powers and authority as may
be necessary to enable them to function units of self-government" The Constitution Seventy-Third Amendment Act, 1992 was a recognition of the fact that the PRIs had not been able to acquire the status of viable and responsive people's bodies. This was attributed to factors such as the absence of regular elections, arbitrary and prolonged supersessions, insufficient representation for weaker sections, and inadequate devolution of powers and lack of financial resources. In order to impart certainty, continuity and strength to the Panchayati Raj Institutions, the Act provided for Gram Sabhas and Panchayats at the village level; direct elections to all seats and to the offices of Chairpersons of Panchayats; reservation of seats for the Scheduled Castes and Scheduled Tribes in proportion to their population and similar reservations in the election of the Chairpersons of Panchayats; reservation of not less than one-third of the seats for women; fixed tenure of 5 years and holding elections within a period of 6 months in the event of supersession of any Panchayat; legislative measures for devolution of powers and responsibilities upon the Panchayats with respect to the preparation and implementation of plans for economic development and social justice, sound finance of the Panchayats through tax assignments and grants and setting up of a State Finance Commission every 5 years to help determine the transfer of resources to local bodies. A new Eleventh Schedule was appended to the Constitution of India listing out 29 functions including agricultural extension, minor irrigation, drinking water, minor
forest produce, khadi, village and cottage industries, rural housing, fuel and fodder, education, health, public distribution system etc.

1.5.1. Assignment between Center and States

The functions related to money supply, external borrowing, international relations, defense, atomic energy, space, national highways, airways, international waterways, and those having significant scale economies are assigned exclusively to the center. The functions involving benefits spanning across States and matters with significant developmental potential are undertaken concurrently with the States. These include economic planning, energy, education, health and family welfare. The functions with statewide implications are assigned to the States. Most progressive tax handles have been assigned to the Center. The taxes assigned to the States include land revenue, taxes on agricultural incomes and wealth, stamp duties and registration fees, tax on sales and purchase of goods, excise duties on the sale of alcoholic products and tax on motor vehicles and tax on goods and passengers transported through roads and inland waterways. From the viewpoint of revenue productivity, sales tax is the most important tax handle. The residual functions and tax powers vest with the Center. The most anomalous part of the assignment, however, is the distinction between 'goods' and 'services' for tax purposes. Entry 54 in the State list empowers the States to levy “taxes on the sale and purchase of goods other than newspapers”. Taxation of services does not find a specific mention in any of
the lists. The Central government has been levying the tax on selected services on the basis of residuary power. The compartmentalized tax treatment of goods and services has violated neutrality in taxation, rendered the levy of coordinated system of consumption tax difficult, and has led to significant evasion and avoidance of the sales tax (NIPFP, 1994). The Constitution also provides for the appointment of the Finance Commission to transfer funds from the Union to the State governments by way of tax devolution and grants every five years. The functions of the Commission include: distribution of the proceeds of sharable taxes, giving grants in aid to the States in need of assistance, recommending measures to augment resources of the States to supplement the resources of the Panchayats and Municipalities, and addressing any other matter referred to the Commission in the interest of sound finance. Since the adoption of Indian Constitution, Eleven Finance Commissions have submitted their reports. Over the years, Planning Commission too has been giving substantial assistance to the States to finance developmental plans. The assistance is given both as grant and loan in the ratio 30:70 for the non-special category States and 90:10 for the special category States. In addition to Finance and Planning Commissions, Central Ministries give assistance to the States to implement Central schemes. The Central sector schemes are entirely funded by the Central government and the States are merely implementing agencies. The
centrally sponsored schemes are shared cost programs requiring the states to make matching contributions, the matching ratio differing with projects.

1.5.2. **Assignment between State and local governments**

With the constitutional amendments in 1992, roles and responsibilities of rural and urban local governments have been specified. Accordingly, in separate schedules, a list of 29 items to rural local bodies and another list of 18 items to urban local bodies have been specified. However, revenue and expenditure assignments in the lists are concurrent with the States’ responsibilities. Actual devolution of specific revenue sources and expenditure functions to local governments depends on the willingness of the State government to devolve functions and powers to the local governments. The rural local governments have very limited own sources of revenues. Only the village panchayats have some independent revenues. The transfers to the local bodies are required to be determined by the State Finance Commissions. The responsibilities of these Commissions include (i) distribution of States’ revenues between States and local bodies and determining inter se allocation of the latter, (ii) assignment of tax and non-tax powers to village panchayats and urban local bodies; and (iii) determination of the grants in aid to the local governments from the consolidated fund of the State.
1.6. State Finance & Budget

An important implementation rule for efficient fiscal decentralisation is that sub national governments should have hard budget constraints (Bahl, 2002). Although in principle, the States have hard budgets, in practice, they can soften the constraint in a variety of ways (Lahiri, 2000; Anand, Bagchi and Sen, 2002). The practice of collecting taxes in advance and keeping contractors’ bills pending is well known. The States can also increase their liabilities in Public Account, particularly through small savings loans. Another method used is by creating special purpose vehicles for investments in activities such as irrigation. They also resort to borrowing from public enterprises. In recent years, the States have been borrowing heavily from financial institutions such as NABARD, LIC, HUDCO, and IDFC to finance infrastructure. We have already referred to borrowing from multilateral lending agencies. All these are in addition to the ways and means advances and overdrafts from the RBI. The sales tax - the most important source of states’ own tax revenue is also the most important source of distortion. Administrative considerations have led to the levy of the tax predominantly at the first point of sale. All pre-retail sales taxes cause cascading. The tax is levied also on inputs and capital goods and this exacerbates the problem. Pursuit of multiple objectives has caused minute differences in tax rates. Interstate competition in sales tax to attract trade and investments has complicated the tax structure further. In this “race to the bottom” the Union
Territories have played a destabilizing role. The competition has led the States to adopt the self-defeating schemes of fiscal incentives in terms of sales tax holiday and deferment. In addition, to meet exigencies of revenue, the States have levied turnover taxes, additional sales taxes and entry taxes. All these have contributed to complicated, cascading and opaque tax systems. The tax on tax, mark up on tax and tax on mark ups have altered relative prices in unintended ways. The complicated tax systems and wide discretions to officials have resulted in negotiated tax payments and high compliance costs. In addition, the Central sales tax levied by the exporting state has distorted relative prices and segmented the market. This has also been a major source of inequitable inter-State tax exportation. Like in other federations, the Constitution seeks to ensure free inter-state trade and commerce across the country. Article 301 of the Constitution in India declares, “Subject to the other provisions in this part, trade, commence and intercourse throughout the territory of India shall be free”. However, the parliament has powers to impose restrictions if it is required in “public interest” (Article 302) so long as the restrictions are not discriminatory (Article 303). Similarly State legislature can impose restrictions in “public interest” without discrimination, but with the prior sanction of the President of India (Article 304).
1.7. Statement of the Research Problems

One issue that this thesis addresses is the sustainability of the fiscal deficits in the long-run. The researcher examines this issue to assess whether the current budgetary policy would ultimately lead the government into insolvency. Another issue that is taken up in this thesis is the validity of the tax smoothing hypothesis. Given that deficits are cyclical and taxation creates an excess burden, and also examine whether governments follow a tax smoothing pattern in order to spread out the tax burden over time. Third, the researcher question whether different components of government expenditure affect the aggregate economy differently. Overall the objectives of the study consist of to offer a new methodology to assess Fiscal Decentralisation in State Finance of Tamilnadu, Offer a new test procedure for testing the mediating effects on Fiscal Decentralisation in State finance Tamilnadu and to assess the macroeconomic impact of incusing growth developmental expenditure on State Finance.
1.8. Research Questions

The following research questions are quite relevant to the crucial purpose of the study and seeking to understand the mediating effects on fiscal decentralisation in state of Tamilnadu.

1. What are the various factoring affecting Fiscal Decentralisation in state finance of Tamilnadu?
2. What is the mediating factor for affecting Fiscal Decentralisation in State Finance, Tamilnadu?
3. What are the relationship between the dimension of Revenue, Expenditure and Budget and fiscal decentralisation?
4. What is the most influence factor(s) for Revenue?
5. What is the most significant factor for Expenditures?

1.9. Research Objectives

1. To study the tax and non-tax revenue of the Tamilnadu.
2. To identify the mediating factor for fiscal decentralisation in revenue and expenditure of the state
3. To suggest the suitable strategic model for fiscal decentralisation for the state finance.
There are ten (10) dimensions were framed for this study. Since the research is formative model the dimensions are determined on the basis of Researcher experience.
1.10. Significance of the Study

The proposed study is an attempt to study about the mediating effects of decentralisation in State Finance of Tamilnadu. On other side, the division of spending responsibilities and revenue sources between levels of government, national, regional, local etc.,. The present research pays its attention to the amount of decentralisation given to national, regional and local governments to determine the expenditure and revenues of Tamilnadu. This will help for enhancing the decentralisation in State finance of Tamilnadu.

1.11. Limitation

The research goes on the pre-determined path subject to certain limitations:

1) The research restricted to only in State Finance of Tamilnadu.
2) While collecting the Secondary data where hesitate to close their details as there were fully representation occurred in State Finance, during the Period of 1999 -2000 to 2008 -2009.
1.12. Organisation of Thesis

Chapter I  This chapter deals with a general introduction and background of the study about global, national and regional trends in public finance. Besides the above, this chapter gives a brief account of the institutional factors, significance of the study, statement of problem of the study, limitations of the present study, and finally outlines of the structure of the study.

Chapter II  Reviews literature with respect to the mediating effects on fiscal decentralisation of State Finance of Tamilnadu. Presents various important factors affecting the performance contained in works of several researchers, identifies the gap in past research, outlines the objectives of the study, the previous empirical findings and models developed to analyze are thoroughly examined.

Chapter III  Presents a detailed discussion of research design, the research hypotheses to be tested, and the methodology used to test the critical factors affecting performances and its hypotheses presents a simple conceptual model for testing the critical dimensions.

Chapter IV  Summarizes the outcomes of the statistical and econometrical analysis that are used to test the hypotheses.

Chapter V  Identifies the findings of the study pertaining to the hypotheses, the implications for the sector as a whole and individually, drawn from the findings of the research, recommendations for the future research, and conclusions of the study.
1.13. Conclusion

The economic development has been achieved over the years through the planning process which has created the growth trajectory in the state economy. Emerging of large scale organized sector in the state economy has boosted the capacity to mobilize resources from internal and external sources for further economic development. The present study reveals that the service sector which is the growth promoter and an engine of the growth in recent years. Decentralisation has administrative, political and fiscal dimensions. The three dimensions are interdependent and the effectiveness of decentralisation requires calibration of the three dimensions together.