CHAPTER -2

THE FISCAL FEDERALISM : THEORETICAL ISSUES
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The fiscal operations are typically carried out by many units of Government or jurisdictions. The United Kingdom, Switzerland and Holland operate with two tiers of Governments i.e., central and local, whereas in Canada, Australia, Germany and India there are three-tier arrangement i.e., Central, State (province) and Local. In India, this multiple unit system includes the Central Government, 28 State Governments, 7 Union Territory Governments and a very large number of local self-governments (Annexure A.6 & A.7). The multi unit fiscal structure, as it prevails in any particular country, reflects the historical forces of nation making, wars and geography. Typically, modern nations have emerged by combination of pre-existing sovereign jurisdictions, which then join into national units. In doing so, member jurisdictions may retain certain fiscal prerogatives while surrendering others, thereby joining in a compact arrangement, which determines the fiscal aspects of the federation apart from assigning or delegation of political powers.

Political history thus tells much in explaining the structure of fiscal arrangements in any country. There are also good economic reasons why certain fiscal functions should be operated on a more centralized level while others should be decentralized. The spatial fiscal structuring would be desirable on grounds of economic considerations only to satisfy three major functions i.e., allocation, distribution and stabilisation.

In order to satisfy these basic factors in fiscal federalism two fundamental questions arises, i.e.,

1. Which level of Government should provide various legitimate allocation and distributional functions so as to avoid potential incompatibilities and destructive competitions among the Governments and achieve a social welfare maximum?

2. The second question relates to the sorting of people among jurisdictions; how much people sort themselves among various jurisdictions, again with the goal of avoiding incompatibilities and intergovernmental competitions and achieving a social welfare maximum?
An attempt to answer these two questions is referred to as the theory of fiscal federalism, (Tresch, R.W. 2002)

(a) Stigler’s prescription for an optimal federalism,
(b) Oates’s Perfect Correspondence and
(c) Oates’s Decentralisation Theorem.

2.1 ALLOCATIVE EFFICIENCY: THE FUNDAMENTAL ALLOCATION ISSUE IN FISCAL FEDERALISM

Under these assumptions, the fundamental economic issues in fiscal federalism are: Why have a federalist structure in the first place? Alternatively, what possible economic advantages occur by having any lower level Governments at all? Let us consider,

$$\max_{(X_h)} W [U^h(X_h)]$$

s.t $$F \sum_{h=1}^{H} = 0$$

Where h= 1,2,......H included everything in the locality. If the National Government can affect a set of policies consistent with the first order conditions of this model, giving the existence of such problem as externalities, decreasing cost production and an inappropriate distribution of income. What can additional lower level Governments possibly do to enhance the economic well being of society? Why should the National Government not do every thing?

Many public sector economists have provided their answers to these questions but none of them is entirely satisfactory. These are explained below:

(a) Stigler’s Prescription for an Optimal Federalism

George Stigler (1957) in his short masterpiece, “Tenable Range of Functions of Local Governments” tried to find out optimal federalism. His justification for ‘local governments’ rests on two principles:
First, that representative Government works best. The closer the government is to its constituency better it is for the constituents. It is presumable because local governments perceive the utilities or demands of their constituents better than a National Government could. Second, those subsets of people within a country have the right to vote for themselves different kinds and amounts of public services.

According to Stigler, these two principles imply that decision-making should occur at the lowest level of Government consistent with the goals of allocational efficiency and distributional equity. He concluded that, an optimal federalist system could be achieved if the various legitimate functions of Government are best distributed among the Governments within the fiscal hierarchy. Higher-level Governments may be necessary to achieve either allocational efficiency or distributional equality. Stigler argues, “that the National Government is the proper Government for resolving the distributional question in order to avoid inconsistencies and competition among Governments (other theorists also followed on this point). In contrast, the responsibility for allocation of functions throughout the fiscal hierarchy turns naturally on the geographic scope of both externalities and decreasing costs, the traditional allocation issues in public sector theory. A Government body must be sufficiently large to capture all decreasing costs from a particular decreasing cost services, or to include all citizens affected by a particular externality generating activity, but it need not be any larger. Thus, the optimal sized jurisdictional unit varies with each specific instance of a decreasing cost service or an externality”.

(b) Perfect Correspondence

Oates in ‘Fiscal Federalism’, solidified Stigler’s principle by suggesting the notion of a perfect correspondence: “--the optimal form of federal government, to provide the set of ‘n’ public goods would be one in which there exists a level of government for each subset of the population over which the consumption of a public good is defined. This would be sufficient to internalize the benefits from the provision of each good. Such a structure of government, in which the jurisdiction that determines the level of provision of each public good, includes precisely the set of individuals who consume the good. In the ideal model, each level of government, possessing complete knowledge of the tastes of
its constituents and seeking to maximize their welfare, would provide the Pareto-efficient level of output and would finance this through benefit pricing”.

Given the existence of a federalist system, the notion of a perfect correspondence sets natural limit on the size of each local government. Oates is certainly correct when he suggests that a perfect correspondence will produce a first-best social welfare optimum, assuming that local governments follow the first best allocational decision rules.

(c) Oates Decentralisation Theorem

Oates added a new constraint to the basic first-best general equilibrium model. It is assumed that there are two natural sub groupings, A and B, within the total population and all individuals within each subgroup have identical preference and it varies across A and B. Suppose, that society produces two purely private goods, X and Y, that are both consumed by all members of the society. Y is a purely private good, it is provided by the government either national or local. Assume finally, that the distribution of income is optimal, so that each subgroup can be viewed as containing a single individual.

Under these assumptions social welfare maximization can be presented as follows:

\[
\text{max } U^A(X^A, Y^A) = 0
\]

\[
\text{s.t. } U^B(X^B, Y^B) = 0
\]

\[
F(X^A + X^B, Y^A + Y^B) = 0
\]

We know that the first order conditions from this problem are:

\[
MRS^A_{X^A,Y^A} = MRS^B_{X^B,Y^B} = MRT_{XY} \quad \text{(1)}
\]

More over, with different tastes, \(X^A \neq X^B\) and \(Y^A \neq Y^B\) in general, at the optimum. Given the model as it stands, it obviously makes no difference whether a single National Government provides \(Y^A\) and \(Y^B\) according to (1), or whether each sub-group forms its own government and individually satisfies:

\[
MRS^A_{X^A,Y^A} = MRT_{XY} \quad \text{(2)}
\]

\[
MRS^B_{X^B,Y^B} = MRT_{XY} \quad \text{(3)}
\]
Suppose, however, the National Government were constrained to offer equal amounts of Y to each subgroup, so that $Y^A = Y^B$ with national provision of Y. Since, in general $Y^A \neq Y^B$ at the social welfare optimum, this would represent an additional binding constraint on the formal general equilibrium model, implying a lower level of social welfare at the optimum. It is easy to show that the new first-order conditions become:

$$MRS^A_{x_A,y_A} = MRS^B_{x_B,y_B} = MRT_{x,y} + \lambda_3/\lambda_2 F_X$$

Where:

$$\lambda_2 = \text{The Lagrangian multiplier associated with society's production possibilities, } F(\cdot) = 0.$$  
$$\lambda_3 = \text{The Lagrangian multiplier associated with the new constraint, } Y^A = Y^B.$$  

Local autonomy is obviously the preferred structure under these conditions because it avoids subjecting society to an unnecessary constraint upon government decision-making. Oates labels this result-the decentralization theorem:

"For a public good, the consumption of which is defined over geographical subsets of the total population and for which the costs of providing each level of output of the good in each jurisdiction is the same for the central or the respected local government, it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions."

The decentralization theorem does not actually solve the problem of justifying local level governments in a first-best policy environment. It is really an exercise in the theory of the second best, precisely because the National Government is forced to offer equal service levels to all subsets of the population. Nonetheless, this is a compelling restriction. The U.S citizens have long and successfully, argued for local autonomy over public elementary and secondary education on the grounds that a federal takeover, despite some financial advantages, would imply standardized education for all children.
The point is that for the particular second-best model, Oates chose as an autonomy is highly relevant for the United States and not just some arbitrary formal model that happened to be biased against national decision making.

In the light of these theorems, it seems that the theoretical underpinnings related to functional allocation and assignment of revenue resources and intergovernmental fiscal arrangements are to bridge the gap.

2.2 THEORETICAL UNDERPINNING

The theory of fiscal federalism tries to use micro economic theory for allocation of functions and sources of revenue among multi level governmental system. According to the concept of decentralization, each of the political unit would have control over the geographical area that would internalize benefits and costs of public goods. It means fiscal federalism applies cost-benefit analysis to allocate governmental functions to different levels of governments. Thus, that level of government, which supplies public services at least cost, should be entrusted with those functions.

According to Oates (1972), assigning fiscal tasks to the different levels of government, there are number of factors that must be weighed against one another in the determination of the proper level of government to provide a particular public service. It is believed that the optimal degree of fiscal decentralization will vary substantially among different societies. The Central Government should assume primary responsibility for resolving the stabilization and distribution problems and for providing efficient outputs of those public goods that significantly affect the welfare of individuals in all jurisdictions. If these functions are placed at highly decentralized levels of government, it may result in undesirable levels of these types of programmes. In the case of national public good, the problem with decentralized jurisdiction is that it will tend to provide sub-efficient levels of the good because of the failure to take into account the benefits conferred on residents of other jurisdiction. This is because of inability of decentralized decision-making units to appropriate the social benefits of their programmes.

Invariably, those public services whose supply does not involve economies of scale should be decentralized. Such division of functions ensures economic efficiency in the
provision of public goods, accountability of the money spent and fiscal autonomy of lower level of government.

Therefore, those functions that supply public services to meet the varying tastes and preferences of citizens should necessarily go to the lower level governments. Those functions which are not involved in such variations in requirements and preferences and which enjoy economies of scale should go to the higher-level (national / state level) government. Wherever such clear-cut demarcation is not possible, it results in spatial spillover of benefits and costs. The National Government in such case should try to internalize them by providing financial assistance to local self-governments. This is the economic justification for grants from higher-level governments to lower level governments.

As for the resources of revenue, those whose basis are spatially mobile should necessarily go to the National Government and those, which are immobile, should go to the local governments. Besides, benefit levies are more efficient when they are administered at local level, as it is easier to assess the benefits and costs. The source, which involves redistributive role, should go to the National Government on efficiency ground.

According to Musgrave and Musgrave (1959), the basic consideration in determining the economic efficiency of the allocation function, we assume that a group of people, having landed on a new planet, considers what special arrangements should be made and also suppose that individual will permit their location choices to be determined by fiscal considerations. Now the question arises, whether social goods and services should be provided on a centralized or a decentralized basis and what spatial arrangement of fiscal organization is most efficient in rendering such public services?

The crucial feature of social goods is that of spatial limitation of benefit incidence. Some social goods are such that the incidence of their benefits is nation-wide, e.g., national defense, space exploration, cancer research and the Supreme Court, while other is geographically limited, e.g., a local fire engine or street lighting. Therefore, the members of the 'group' who share in the benefits are limited to the residents of a particular geographic region/ locality.
Allocation theory as applied to the public sector had led us to the conclusion that public services should be provided and their costs shared in line with the preferences of the residents of the relevant benefit region. Moreover, given the fact that a political process is needed to secure preference revelation, it follows that particular services should be voted on and paid for by the residents of this region. In other words, services which are nationwide in their incidence such as national defense, should be provided for National Government, services with local benefits e.g. streetlights, should be provided for by local units, still others such as highways should be provided for on a regional basis. In the multiple jurisdictions, each jurisdiction provides services whose benefits accrue within its boundaries and it should use only such sources of finance as will internalise the costs.

The theory of multiunit finance must provide an answer to the question of what constitutes, the optimum number of fiscal communities and the number of people within each community. To deal with this complex problem, let us begin with a simple model, which allows for one public service only, the benefit incidence of which is limited to all within a given geographical area and vanished beyond it. It is also assumed that consumers have identical tastes and income, so that, they agree on the desirability of social good provision. The crux of the problem is that the cost to each consumer will be less provided larger number of consumers takes part in the benefit. Since we postulate a pure social good so that the quality of service received per person is that the number of participants does not affect the quality of service received per person. The presence of savings from cost sharing due to large numbers leads to a single benefit area and, in fact to a unitary structure of fiscal provision. There are, however other considerations, which may pull in opposite direction towards a multiunit solution. Thus the design of optimal community size must strike a balance between the advantage of sharing in the cost to a given level of public services and the disadvantages of crowding. To bring out the nature of problem, we begin with the two simplifying assumption that people are similar in their preferences and income and that those public services are pure social goods.
2.2.1 OPTIMAL COMMUNITY SIZE

The choice of optimal size for a given service level is shown in figure 2.1. We assume that a given level of social goods is provided, the total cost of which equals Z rupees. Let us suppose further that each member pays a price equal to the marginal benefit received and the cost split equally among them. The AA curve then shows the per capita service cost (measured on Y axis) for various community size (measured on X axis). This cost decrease as numbers (N) increase. Since the cost remains equal to Z throughout, the curve AA is a rectangular hyperbola with per capita cost equal to Z/N. It reflects a form of 'decreasing per capita cost' with increasing number of consumers in the group. The Am Am curve, which is derived from the AA curve, shows the marginal savings of per capita service cost that results as the group number is increased. The optimal group size would be such as to include the entire community. The community would be expanded so long as Am Am were positive (i.e. AA were downward sloping), no matter how large the group became.

Figure 2.1: Choice of Optimum Size for Given Service Level

The situation changes if the cost of crowding is allowed, let OB trace the per capita cost or disutility of crowding for various sizes of the group while Obm shows the marginal per capita crowding cost. The optimal size of the community will then be given by ON₂, where Obm is equated with Am Am, calling for N₂ members in this case. The community will be expanded in numbers so long as the extra per capita savings from cost sharing within a larger group exceeds the incremental per capita costs of crowding. Beyond this point, further expansion of the group would reduce total welfare and is therefore not undertaken. Various governmental units of size ON₂ will thus be established with per capita costs for each unit set at OC, with a total population P and giving total services cost Z in each community. There will be P/N₂ jurisdictions with per capita cost of Z/N₂.

If the service level increases and the AA and Am Am curves shift up, the optimum size of the group increases. Thus, for a higher service level involving cost ‘Z’, the per capita service cost curve rises to A’A’ and the marginal curve to Am’ Am’ with the optimal group size increasing to On₄ at a per capita service cost of OD and with the group enlarged to N₄ members.

2.2.2 OPTIMAL SERVICE LEVEL

Now we have to determine the optimal service level for any given group size. This is shown in figure 2.2.

Figure 2.2: Choice of Optimum Service Level for Given Community Size

Service levels are measured along the horizontal axis and per capita unit service cost on the vertical axis. DD is an individual's demand scheduled for the service and since tastes and income levels are identical for all, it is representative for all members of the community. SS is the cost schedule for the service showing cost of the community as a whole. The unit of the facility is here shown to rise with the service level, the scope of $S_1$ $S_1$ depending on the nature of the facility and its production function. $S_2$ $S_2$ is the supply schedule, which presents itself to the individual if the community contains $N_2$ members. $S_4$ $S_4$ reflects the supply schedule in an $N_4$ member community and so forth. The vertical level of $S_2$ $S_2$ is one half of $S_1$ $S_1$, that of $S_4$ $S_4$ is one quarter of $S_1$ $S_1$ as and so on. Assuming a tax structure, which divides total cost equally, all face the same SS schedule. Since the same quality is available to each member of the community, the services level purchased by various sizes of community will be determined at the intersection of the DD curve with the supply curve pertaining to the particular community size. Thus the level of services purchased with $N_1$ members will be that corresponding to the intersection of $S_1$ $S_1$ with DD namely $OQ_1$, the level purchased by $N_2$ members will be $OQ_2$ and the level desired by an $N_2$ member community will be $OQ_4$, as shown in the diagram.

2.2.3 OPTIMAL STRUCTURE

Figure 2.3: Combination of Optimum Size and Service Level

Service level, $Q$

$Q_{10}$

$Q_1$

$Q_2$

$Q_3$

$Q_4$

$Q$

Size of community, $N$

$N_2$

$N_3$

$N_4$

$N_{10}$

In the final step, these two considerations are combined in figure 2.3, with community size \( N \) measured on the horizontal axis and service levels \( Q \) on the vertical axis. In figure 2.1 we find that a service level involving a total cost \( Z \) calls for a community size \( N_2 \), at a higher level. Involving cost \( Z' \) calls for size \( N_4 \) and so forth. This relationship is traced in line NN of figure 2.3, which shows the optimal community size at least \((Z, Z' \text{ etc})\) of figure 2.1. Turning to figure 2.2, we find that community size \( N_1 \) calls for services level \( Q_1 \), size \( N_2 \) calls for \( Q_2 \) and so forth. This relationship is traced in line QQ of figure 2.1, showing the optimum service levels for various community sizes. The overall optimal solution is at \( E \), where the two lines intersect, the optimal service level being \( O \), and the optimal group size \( N_7 \).

2.2.3.1 EXTENSION OF MODEL

The model of efficient design thus calls for multiple fiscal units differing in size and regional scope. Some will be nationwide, while others sub-national. Now a number of complications must be introduced:

a) Difference In Tastes: It is not possible that tastes of all individual are similar, local fiscal units will be similar but tastes differ from individual to individual. Since people differ in their preferences for public services, for the efficient solution people with similar tastes to should grouped together. Thus, the system will contain multiple units, some similar and some different with regard to both size and composition of the public sector. At the same time, if the groups split into smaller units they have to pay cost for it. It means as the number of people in any one jurisdiction is reduced, some of the advantage from larger number groups is lost. Nevertheless, provision for local goods through a multiple system of differentiated fiscal units will remain more efficient than a uniform pattern of central provision.

b) Difference In Income: The resulting structure of fiscal units will differ also because people have different incomes. Different income groups prefer different social goods. Demand will be more income-elastic for some services than for other services. As a result, residents whose income varies a little from the average of the community, they
satisfy themselves with less facility. Because of this, people with equal income will desire to join in the same community.

But it may be noted that, if the price (or taxes) which people are willing to pay, for a given supply of social goods, will be higher if their incomes are larger. As a result, the cost of social goods for one who has low income will be less if their neighbours have higher incomes and hence are willing to carry a larger share of the cost. This situation creates a further tendency for the wealthy to congregate. But it also induces the poor to follow the wealthy and the wealthy to exclude the poor via zoning.

2.3 A CASE FOR LOCAL LEVEL GOVERNMENTS

Therefore, one of the primary tasks in the study of local finance is to place the local governmental functions and finance in the perspective of national and State finances and to clearly define their role in national economic development. A pluralistic society is unattainable without some degree of economic pluralism.

As the local bodies are assigned certain functions confined to their area of operation, the question arises as to what are the resources transferred to match them. Any transfer of central resources to local units is a matter of the extent of devolution. The resource allocation as between levels of government assumes significance when a local body is created by a statutory enactment with defined functions allocation whether by the Central or State Government.

Any attempt at a function-resource correspondence is rendered difficult for any time frame, even though it is considered democratically relevant and economically convincing. Local government is not merely a democratic device, but also through it the essentially collective local needs as distinct from the national or provincial, could be satisfied. The building up of social overheads so necessary, cannot take place fast enough unless the local bodies are entrusted with the responsibility of mopping up resources for the purpose.

The separation of functions and resource allocation is a centrally guided operation and therefore, resource raising and expenditure programmes are a part of general budgetary
system and do not entail special principles of local finance as such except some administrative guidelines. In this model there is a greater integration of the economic process, because the economic policies of the different levels of government may vary considerably from each other. The absence of integration does not necessarily result in a less than optimum national welfare, even as integration also may not achieve it. On the contrary, a major consideration in justification of local bodies for local interests is that total welfare is increased in the process. Before we consider the local fiscal system, it is appropriate at this point to dwell with the economies of local government.

In terms of micro-economic theory, it is said that efficiency in the allocation of a society’s resources can be pushed to pareto optimum level if the decision making process is decentralized at individual unit level. Based on this law, an economic case for local government has been developed by Oates. In the resources allocation at the disposal of the public sector, i.e., the government, the most efficient distribution among the units is that conforms to the pareto-optimum. As between the central, provincial authorities, which constitute the public sector, the resource allocation has to follow the interest proximity path.

The market mechanism normally provides for the production and distribution of goods in accordance with the individual’s revealed preferences, but the citizens do not adequately reveal them in respect of public and merit goods. As the preferences are inadequately revealed, the market is unable to maximize / minimize their supply. Say for instance, provision for the maintenance of defence, police and law, nuclear station, environmental preservation etc. cannot be provided at all by market means. Essentially then, when the market mechanism fails to operate in a delivery of certain kinds of goods and services in appropriate quantities, the government alone as a public agent, can provide them or is expected to provide them.

Thimmiah (1983) observed, “the government is expected to step in when the market fails to efficiently allocate the society’s resources. Therefore, the government as a collective institution is justified for the supply of public and merit goods which are essential for the very existence of a society”.

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However, not all the public goods can be provided by any one level of government. A specific authority depending upon the prevailing technology of production can make an efficient provision for any type or class of goods. Whether the demand for any public goods is from the whole group of citizens of the State or part thereof, determines as to which unit can undertake the supply of such goods most economically.

For instance, defence, railways and air transport, malaria eradication, space exploration etc., are managed efficiently by the National Government, even as lighting and scavenging of town roads are better provided by a local body. It is the size of the public and the area which we may term as the market that determine any particular unit’s efficiency in supplying in supplying them to its consumers. We may safely say that some class of public goods involves economies of scales in their provision. Others are to be spatially restricted to achieve economy and efficiency in their supply. The need to delimit the provision of various types of public and merit goods spatially arises and as such, provision at the optimum level and at least cost can be made only when the demand for such public services varying, according to the tastes and preferences of citizens are met. Precisely, it is this consideration for spatial delimitation in the supply of goods and services that gives a strong theoretical support for a multi-level governmental system. Logically, it may be deduced that larger the variety of public and merit goods, more can be the units of government, as between the central and the smallest unit. But, theoretically it cannot be so, as economies of scale operate against multiplication of levels of authority beyond a point. Hence, given a range of economy of scale and cost of service delivery, the number of levels of government cannot indefinitely be increased.

The unit of authority may be conceived on two basis: (1) population and area wise as corporations, municipalities, villages, District, etc. and (2) service-wise as water and sewerage, street lighting, primary education, etc. While the former provide a number of public services restricted to a specific area, the later is restricted to a specific services delivery generally over a wider region.

In brief, we may say that there are some public and merit goods, which have a Statewide coverage and others a limited spatial coverage. The latter class of goods caters to the varying tastes and preferences of the citizens and thus only can be supplied efficiently
and at least cost. The supply of spatially limited public sector goods naturally devolves on State, provincial and local governments.

The principle of the sphere of interest can be effecting provided the resources corresponding to them are assigned to the resources corresponding to the respective local authorities. The means of financing the production of these goods implies the fund-raising powers of the local bodies. There cannot be a supply price as in the case of free market goods for each public and merit goods. It is truly said that any kind of trading in public goods for a voluntary payment (i.e. an exchange price) prevents many citizens for enjoying them. This leads to many undesirable results. Therefore, only through a compulsory levy of taxes can the cost of supply of public goods be recovered. This principle applies, generally to all levels of governments. But in the case of particular type of public and merit goods and at the level of local unit, the cost of service principle cannot be applied always. Aggregative, however, the tax system as such must be able to account for the sum total of the cost of public and merit goods at all levels.

The function-resource correspondence and the service cost of public goods assume theoretical and practical importance when once we accept local units as part of a multi-governmental system. The issue of local finance can be posed as under:

(i) In a multi-level fiscal system, what should be the basic principles of transfer of functions, resources and finances to local bodies?

(ii) When revenue and expenditure heads are transferred to them, what are the guiding considerations in local taxation and expenditure programmes?

In the matter of functional assignment to local authorities, the spatial delimitation concept is considered earlier. Such functions as are confined to the limits of a local body and scarcely have any spillover effect are best suited to be assigned to local authorities. Traditionally, these functions are: sanitation and health, street lighting, water supply, primary education, roads and culverts, town planning, epidemic control, vaccination, etc. The significance of some of these functions has changed due to economic and political causes over time. Some functions identified as local have become the concern of the National Government. Similarly, a few areas considered as State-level are passed on to the local bodies. Both technology and economic development add new functions to the
The principle of efficiency is an administrative criterion. The principle of suitability is that the tax must be most suitable to the local body to administer. That is, the tax must have an exclusively local base and the local body must be able to manage the tax easily with its limited taxmanship. The adequacy rule is self-explanatory. The tax given over to local bodies must be productive enough to yield adequate revenue to meet their expenditures. This particular requirement is of special significance in countries like India with a large number of local bodies, each differing in size, resource base, etc. The resource-revenue response is dissimilar and quite likely that some taxes may not find a base in certain local bodies. So, even with the same resource heads revenue potential may differ widely. Therefore, along with a common pattern of distribution of revenue sources, there should also be some heads of revenue, which can work as balancing factors to correct inter-local inequalities and also ensure a national minimum throughout the country in local service functions.

The guiding principles of resource division enunciated earlier can be meaningful only when the State and local revenue heads are constitutionally separated. But rarely the local bodies are anywhere provided with such safeguards. Therefore, however desirable such separation be, the local authorities have to depend for their autonomy on the good sense of the State Government and the democratic opinion and vigilance of the population.

According to Thimmaiah, the functions and sources of revenue are divided between National and lower level governments on the basis of the above principles. It is but natural that more elastic sources of revenue with nation-wide base go to National Government and less elastic sources of revenue having immobile and localised tax base go to lower level governments. This result in vertical federal fiscal imbalance, i.e., imbalance between the expenditure needs and own revenues of local governments would be much more than that of the National Government. Financial transfers are also justified from offsetting the special externalities and spillover effects of the expenditure functions undertaken by the lower level governments.
However, other adverse effect of multi-level government, namely, tax and expenditure overlapping cannot be eliminated through fiscal transfers. They require expenditure and tax policy co-ordination and harmonization.

Multi-level governments also have some advantages, that it encourages competition between governments in the supply of public services and hence improve efficiency in their design and delivery. It is also assumed that the operation of multi-level governments in a country encourages government’s authority to reap the benefits of comparative advantage in production and supply of a variety of public and social goods to the citizens. Yet another advantage assumed is that the multi-level governmental system reduces the size of the Government through competition.

It is true that the operation of a National Government and several State and local governments in a contiguous geographical area will provide an opportunity for competition between governments of same level in providing public services to the citizens. But this competition cannot take place between National, State and lower level of governments, because their functions are complementary to each other. Because of this difference in the functions, allocated to National, State and local self-governments, the scope for competition in supply of social and public goods is limited.

In the area of revenue sharing, the degree of such complementarity is still lower as the sources of revenue are allocated between National, State and local self-governments on the basis of spatial spread and mobility of tax base over the geographical area of the federation. Through sources of revenues whose base has nation-wide and mobility across the boundaries of the State and localities, are normally assigned to National Government. The sources of revenue, which have localised base, are assigned to State Government or even to local governments. Since National, State and local self-governments operate on the same geographical area, some sources of revenue, which are not related to spatial allocation, face the problem of substitutability. In consequence, overlapping of revenue sources occur as between State Governments and local self-governments. But the scope for competition between State Governments and between local self-governments is very high because they perform not only the same functions but also raise revenues from same sources, though in separate spatial boundaries.
The economic justification of local self-governments was confined only to the allocative function of the government. Other functions, redistributive function and stabilization function, were exclusively assigned to National Government. But in some of the developing countries like, India, economists have rejected the earlier view and expanded the functions of local self-government so as to include not only redistributive function but also stabilization function. In India under the planning regime the redistributive measures were confined to only social welfare programmes. It was only during 1970’s that anti poverty programmes started emerging. At the same time many State Governments had already formulated some limited social security programmes like old age pension, widow pension, educated unemployment benefit and such other specified group welfare programmes. Some of these programmes no doubt degenerated into populist schemes. Even then the State Governments did not bother about the financial implications of such programmes in the context of movement of people across the boundaries of the States to claim such social security benefits. Such leakage was only short lived as many adjoining States also started similar programmes to wow the voters. Similarly, while National Government is responsible for determining and regulating the money supply, issue of currency, coinage and price control, in actual practice whenever prices rise the Central Government asked State Governments to take appropriate action to control prices by taking effective measures to prevent hoarding of essential commodities. Thus we have a situation where both the Central and the State Governments are performing redistributive as well as stabilization functions. We have to modify the old concept and reconcile it with the reality through the medium of complementarity of the functions of National, State and local self-governments.

The existing functions of the urban local governments have evolved over the past one century or so. Functions of ULBs and PRIs have been identified as local in nature not on the basis of any economic logic but on the recommendations of the successive committees. To give an example, the Rural-Urban Relationship Committee (1966) observed that: “the goals of the local government in the context of the changed conditions may be listed as follows:

- to function as local units of self-government,
- to provide local public services and conveniences,
- to ensure planned and regulated development of urban areas,
• to mobilize local resources and utilize them to the maximum good of the community,
• to promote social, economic and cultural development in an integrated manner”.

The Committee further elaborated the detailed obligatory and discretionary functions of ULBs, likewise Askok Mehta Committee in its model Constitution Amendment Bill suggested broad functions relating to Panchayati Raj Institutions as:

“The council shall perform such executive administrative functions within their respective territorial jurisdiction as the State Government may, by law, confer on them including functions relating to;

• the promotion of economic and social development,
• implementation of plans relating to economic and social development made by the Central Government or State Government,
• the State Government shall, with a view to decentralize the power, endeavour to devolve progressively greater powers and responsibilities on the councils to enable them to function effectively as institutions of self-government.”

The 73rd and 74th Amendments to the Constitution have broadly indicated functions of PRIs and ULBs in the 11th (Annexure A.3) and 12th (Annexure A.4) Schedules respectively. A convention to assign certain specific functions to ULBs has developed over the years. Now certain new functions have come to be added to them, i.e., environmental protection and town planning, urban poverty alleviation, welfare of weaker sections, etc.

Some of the functions like primary education, which was earlier, considered as of local nature having come to be transferred to the State level agencies because of the national concern for achieving uniform standard of service like universal literacy. Some functions like water supply handed over to independent agencies like Jal Sansthans (in case of Uttar Pradesh) because of the high capital costs involved in supplying water and high degree of technical manpower required. Electricity is also privatized by some of the ULBs.
However, the problem of allocation of functions in regard to PRIs is yet to be settled. This is so because these institutions did not function for a long time. In other words, they did not exist for a long period to evolve their own locally needed functions. Therefore, the State Governments had a free hand in specifying their functions. In this context, while formulating the 73rd and 74th Amendment to the Constitution, suggestion was made to prepare and add the 4th list to the Constitution as the local self-government list specifying the subject of local matters i.e., after the ‘Union list’, ‘State list’ and the ‘Concurrent list’ a suggestion was made to add local self-government list. However, this was not supported by the National Commission on Urbanization on the ground that it would create rigidity and would come in conflict with the interests of the State Government.

Thus the 73rd and 74th Amendments have only added 11th and 12th schedules by listing certain specified broad functions without making them binding either on the State Government or on the local bodies.

The team of framers of the Indian Constitution recommends for the creation of a Finance Commission in the Constitution. Accordingly, the Indian Constitution created the Finance Commission under Article 280 to make recommendations on the devolution of financial resources from the Central Government to the State Governments. The finance Commission attracted the attention of the Committees and Commissions, which was previously appointed to examine the finances of the ULBs in India. The Rural-Urban Relationship Committee (1966) recommended that well before the appointment of the Finance Commission by the President, the Governor of each State should appoint a body to be known as the Municipal Finance Commission to examine the financial requirements of the local bodies for meeting their financial obligations for various obligatory services and development schemes. This Municipal Finance Commission should not only act as a financial insurance for local bodies of the State Governments, but would also act as insurance for the local bodies to make the best use of the taxes allocated to them. The State Governments, the Committee observed may include the financial implications, from the recommendations of the Municipal Finance Commission in their proposals for the National Finance Commission appointed under Article 280. Subsequently, the Committee on Budgetary Reforms in Municipal Administration appointed by the Government of India, which submitted its report in July 1974, endorsed these recommendations. Later, the National Commission on Urbanization, which
submitted its report in August 1988, also suggested the appointment of State Finance Commissions to recommend the quantum and distribution of devolution of financial resources from the State Governments to the ULBs.

The Ashok Mehta Committee, which prepared a model of Constitutional Amendment Bill for the creation of PRIs, also recommended for the creation of a Finance Commission to review the financial position of PRIs and make recommendations on this devolution of financial resources from the State Government to PRIs. Thus the idea of having a Finance Commission separately for Municipal bodies, which was mooted as early as 1963, took the shape of a common commission for both ULBs and PRIs, under the 73rd and 74th amendments to the Constitution.

Both the 73rd and 74th Amendments to the Constitution have made provision for appointment of State Finance Commission to make recommendations on the financial transfer to the ULBs as well as PRIs. While the 73rd Amendment under Article 243-I has provided for a Finance Commission, the 74th Amendment under article 243-Y makes reference to the Finance Commission provided under Article 243-I, which should look into the financial needs of the ULBs also.

2.4 SUMMARY

Fiscal federalism revolves around the two questions, (i) Which level of government provides which functions, so as to avoid potential incompatibilities and destructive competitions among the government and achieve a social welfare maximum? (ii) How much people sort themselves among the various jurisdiction again with the goal of avoiding incompatibilities and intergovernmental competitions and achieving a social welfare maximum? Different theories of fiscal federalism have tried to answer these questions. In the present study we only examine the theories given by Stigler and Oates.

Stigler gave two principles of local governance and concluded that decision-making should occur at the lowest level of government consistent with the goals of allocational efficiency and distributional equity. To achieve an optimal federalist system, various legitimate functions of government are best distributed among the governments within the fiscal hierarchy. The National Government is the proper government for resolving the
distributional question in order to avoid inconsistencies and competition among governments. Oates solidified Stigler’s principle by suggesting that the optimal form of federal government in which each level of government, possessing complete knowledge of the tastes of its constituents and seeking to maximize their welfare, would provide the Pereto-efficient level of output and would finance this through benefit pricing.

Those functions that supply public services to meet the varying tastes and preferences of citizens should necessarily go to the lower-level governments. Those functions which are not involved in such variations in requirements and preferences and which enjoy economies of scale should go to the higher level (National/State) of government. Whereas in practice such clear-cut demarcation is not possible and it results in spatial spillover of benefits and costs. The National Government in such a case should try to internalise them by providing financial assistance to local self-governments. This is the economic justification for grants from higher-level governments to lower-level governments. The resources of revenue, those whose base is spatially mobile, should necessarily go to the National Government and those, which are immobile, should go to the local governments. Benefit levies are more efficient when they are administered at local level, as it is easier to assess the benefits and costs. The sources, which involve redistributive role, should go to the National Government on efficiency ground. After studying the theoretical explanation of fiscal federalism, the legal framework of local bodies in India will follow.