Chapter - 2

THEORETICAL FRAMEWORK

2.1. Fiscal Federalism: Theoretical set-up
2.2. Welfare gains from Fiscal Federalism
2.3. Meaning and Features of a Federal set-up
2.4. Economic Basis of Decentralization
2.5. Advantages of Decentralized Decision-making
2.6. Problems of Multi-level Finance Vertical and Horizontal Fiscal Imbalances
2.7. Financing Pattern
2.8. Efficiency Basis for Inter-governmental Transfers
2.9. Equity Arguments for Inter-governmental Transfers
2.10. The Basic theory of Fiscal Federalism
2.11. Fiscal Instruments in Federal System
2.12. Transference of Resources: Buchanan Scott controversy
2.13. Alternative Approaches to equalization: Musgrave
2.14. Fiscal Transparency and Budget Integrity
2.15. Summing up the theory of Multilevel Finance and Fiscal Federalism
Chapter - 2

THEORETICAL FRAMEWORK

2.1. Fiscal Federalism: Theoretical set-up

Fiscal federalism is an area of study in which the principles of economies are applied to the functioning of the public sector in a multi-level decision making framework. The basic issues of fiscal federalism are

1) Assignment of functions and sources of finance between different government levels.

2) Evolving mechanisms and policy instruments to resolve fiscal imbalances.

Such an arrangement ensures cost efficient provision of public services.

There has been a much interest in fiscal federalism in recent years. The merits of decentralization have been substantial enough to provide power among sub-central government units. The emergence of the European Economic Union has clearly demonstrated the advantages of having a large common market while preserving distinct regional identities. The international experience has shown that over centralization was one of the important reasons for the collapse of the Soviet Union in 1991. The centrally concentrated resource allocation could not build a strong economy, and the concentration of financial power could not entertain the regional integrity.
The analytical literature on fiscal federalism, right from the paper by Charles Tie Bout (1956) has analyzed the gains from fiscal decentralization. Fiscal federalism, like the political concept of democracy, is regarded to be an optimal institutional arrangement for the provision of public goods and services. It integrates the advantages of decentralization with the benefits from economies of scale. 'Inter-jurisdictional competition gives incentive for innovation and increase in productivity in the provision of public services. The nation-wide market for factors and products helps in the consideration of a set of equitable prices and thereby ensures more efficient resource allocation than a balkanized economy' (Tapas K. Sen, 1996).

2.2. Welfare gains from Fiscal Federalism

The welfare gains from fiscal federalism accrue from several factors. As the decentralization theorem demonstrates, fiscal federalism ensures that public services are provided corresponding to the diversified demand conditions in a federation (Oates, 1972). The matching of preferences with the supply of public services is enabled by the existence of a large number of jurisdictions with different mixes of public services and tax rates. The consumer-voters exercise their preferences either by voting on foot or by influencing public policies through a political mechanism (Tie Bout, 1956). The larger the number of jurisdictions, the wider will be the consumer choice. Also, the more diverse the demand for public services in different jurisdictions, the greater is the welfare gains from fiscal
decentralization. Welfare gains accrue from decentralized provision of public services not only due to the existence of a wider choice but also because the welfare costs arising from the ‘bundling’ of public services provided as a package on a ‘take it or leave it’ basis would be lower. In addition, as already mentioned, efficiency gains accrue also from inter-jurisdictional competition and the existence of a nation-wide market for factors and products (M. Govinda Rao, 1996).

Tapas K. Sen has also emphasized inter-jurisdictional interactions and inter-governmental transfer systems. ‘Fiscal federalism represents the polar case where federal fiscal arrangements are decided purely on economic principles. The existence or otherwise of a federal constitution is not a consideration, and the principles of fiscal federalism apply to both unitary and federal countries. What is relevant is the degree of decentralization and not whether a country is unitary or federal, under fiscal federalism. Everything – boundaries, tax and expenditure assignments, inter-governmental and inter-jurisdictional interactions and inter-governmental transfer systems- is determined purely on economic considerations. While such an analysis is clearly removed from reality, it certainly shows economic solutions to federal fiscal problems in a multi-jurisdictional community and helps us to set benchmark or ideal economic solutions to problems of federal finance’ (Tapas K. Sen, 1996).

The relationship between governmental units be it vertical (inter-governmental) or horizontal (inter-jurisdictional), is a complex phenomenon.
Although much of the literature on federal finance considers the advantages of ‘co-operative’ federalism, it is necessary to note that the relationship between governmental units is essentially competitive. Co-operation, in the extreme, could mean conformity to a centralized policy regime and this could imply the concept of federalism altogether. Nor is competition among governmental units necessarily undesirable. A competitive relationship among governmental units can be welfare-oriented, if it is monitored properly. As in the case of firms in the market, governmental units compete with one another to provide bundles of public services at varying tax rates. At the same time it is necessary to satisfy certain pre-conditions to ensure that competition among the jurisdictions leads to welfare gains. Interalia ensuring competitive equality among governmental units (like the prevalence of a large number of small firms in competitive equilibrium), and cost-benefit appropriability in each of the jurisdictions are the two important necessary conditions (Breton, 1987).

A federal set-up creates a multiple polity based on divided functions and powers among central, state and local governments. This chapter explains the principal theoretical issues involved in financial relations between different layers of the government in a federal set up.

2.3. **Meaning and Features of a Federal set-up**

Fiscal federalism deals with financial arrangements and their working in a federal polity. Federal system of government is a mixed blessing. It has the
advantage of economic integration which promotes industrial and defense capabilities of a nation. According to the traditional classification followed by political scientist, constitutions are either unitary or federal. A federation means a union of several states brought about by the instrument of a treaty or agreement. The modern concept of federalism is associated with the establishment of American federation in 1787. Since there is no agreed definition of a federal state, the model of the US is often taken as a reference point. Federalism is a dynamic and not a static concept. It can best be understood in terms of its essential features.

2.3A. Dual Government

In a unitary state, there is only one Government, namely the national government. However, in a federal state, there are two layers of government, the union government and the state governments. A component state has no right to secede from the federation. This distinguishes a federation from a confederation.

2.3B. Distribution of powers

A federal state involves a division of authority between the federal government and the states. The method of distribution may not be alike in different federal constitutions.

2.3C. Supremacy of the constitution

A federal state derives its establishment from the constitution. Every power (executive, legislative or judicial) whether it belongs to the union or to the state is controlled by the constitution.
2.3D. Authority of courts

As already noted, the legal supremacy of the constitution is essential to the existence of a federal system. There should be no violation of the provisions of the constitution by any level of government.

2.3E. Doctrine of Harmonious construction

Harmonious construction means that different entries in different lists are analyzed in the way that the conflict between them is avoided. One should accept that the constitution does not want to create conflict. Hence, wherever there appears to be a conflict between two entries in the two different lists, the two entries should be so interpreted that each of them is given effects.

2.3F. Doctrine of pith and substance

In a federal setup, the central and the state governments should keep themselves within the respective domain assigned to them. In other words, no government should trespass into the legislative powers reserved for the other. ‘A law made by a government which encroaches upon the field assigned to the other government is invalid. The rule of pith and substance means that a law enacted by a legislature which is competent to enact it small not become invalid merely because it incidentally touches a matter outside the competence of that legislature. It often happens that a legislation intending to deal with a subject in one list touches also upon a subject in another list’ (M.M. Sury, 2010).
2.4. Economic Basis of Decentralization

Devolution of funds follows devolution of functions. The financing pattern of a government can be examined and decided only in the light of functions assigned to it. In fact, two factors determine the level of expenditure of a government.

(a) Its functional jurisdiction and (b) the standard at which its different functions are to be performed.

There are different theories to understand how should the responsibilities for providing public goods and services be shared among the central, state and local governments. According to the theory of fiscal federalism, functions which involve national interest, economics of scale, lumpy investments, and substantial spatial externalities (spill over) should be left to the national government. Sanitation, street lighting, fire safety are services should be assigned to local governments. In short, expenditure and service responsibilities should be assigned according to the benefit area of each service.

2.5. Advantages of Decentralized Decision-making

Decentralized decision-making meets the political-economic aspirations of the people at the sub-national level. Decentralization of political and administrative powers is a virtue because it institutionalizes the participation of those affected by local decisions. Following are the main advantages of decentralization in a democratic establishment.
1) Decentralization of governmental set-up allows better matching of public goods supply to local needs, tastes, and preferences and hence increases social welfare.

2) State/local governments are more responsive and accountable to people than national government. Linkages between the decision to spend and to raise resources improve fiscal discipline.

3) Mobilization of resources at the state/local level reduces dependence and strain on the finances of national government.

2.5A. Tiebout Hypothesis

According to Charles Tiebout, competition among local governments ensures efficiency in the supply of public goods, just as competition in market among firms ensures efficiency in the supply of private goods. He has argued that competition among local governments will result in these governments supplying the goods and services individuals want and producing these goods in an efficient manner.

2.6. Problems of Multi-level Finance Vertical and Horizontal Fiscal Imbalances

Though a federal system provides for divided governmental functions and power, Imbalances often arise between functional responsibilities and financial
resources at different layers of the government. This is so because revenue-raising capacities and revenue needs of various federating units are different. This is a characteristic feature of all federations, particularly of the countries whose economies are more dynamic. Even in older federations (like the United States, and Canada) financial conflicts persist between the national and sub-national governments.

The mismatch between functions and financial powers occurs partly because of changing responsibilities of different levels of government and partly due to the dominant position of the central government relating to tax powers.

Therefore, vertical imbalances of resources and expenditure responsibilities emerge between different levels of the government, calling for transfers of resources from the Centre to the States. This is the familiar problem of federal fiscal set-up. Financial imbalances at the vertical level (Centre versus States), and at the horizontal level (among the states) are sought to be removed through constitutional arrangements, and in some countries through political bargaining as well.

2.7. Financing Pattern

2.7A. Taxes

Tax revenue is generally the main source of financing public expenditure at different levels of the government. In most democratic countries, taxation powers
of central, state, and local governments are mentioned in the constitution itself. Taxation powers of the government at different levels may be mutually exclusive or overlapping. For example, most tax fields in Canada are jointly occupied both by the federal and provincial governments. Personal income tax, Corporation income tax, general sales tax, and consumption tax (excise duties) are levied by the federal as well as provincial governments in the country. The joint occupancy of tax fields has often caused friction not only between the federal and provincial governments but also among the provinces themselves. Mark Krasnick, a Canadian fiscal expert, observed, “The fact that both the federal government and the provinces occupy the lucrative income and commodity tax fields implies that in addition to any competition or conflict that may exist among the provinces, competition also exists between the federal government and the provinces. This conflict concerns the manner in which the tax capacity of a particular tax base is shared between the two levels, or, to use the common jargon, the way in which tax room is apportioned.

In India, the Centre and the states have no such concurrent powers of taxation. Taxes with inter-state base and those in the case of which all-India uniformity in rates is desirable, to facilitate industry and trade, are vested in the central government. Taxes which are location-oriented and related to subjects of local consumption are with states. Broadly speaking, taxes on production are levied by the Centre and taxes on Sale and Purchase by the state governments. The
absence of joint occupancy of tax fields has successfully minimized double taxation, tax rivalry between the Centre and the states, and duplicate tax administration.

Assignment of a tax means transfer of taxation power from a higher level to a lower level of government. Taxation power includes the following: the right to levy the tax, collects the tax, and appropriates the proceeds from the tax. Thus, there can be three interpretations of assignment of a tax. In the first case, the higher level government may levy and collect a tax but hand over the entire proceeds to a lower level government. Taxes levied by the Government of India under article 269 of the Constitution are a case in point. Secondly, the higher level government may levy a tax but allow the lower level government to collect it and retain fully the proceeds there from. Taxes levied by the government of India under Article 268 of the Constitution fall under this category. Finally, the higher level government may transfer a tax to a lower level government lock stock and barrel, a situation which defines assignment of a tax in its strictest sense.

2.7B. Transfers

Transfers (tax sharing and grants) are used to correct vertical fiscal imbalances. However, before such transfers are effected, it should be ensured that taxes, duties, and levies are assigned to the lower level government.
2.7. B.(a) Need for Transfers

The need for transfers arises because the own revenues of a lower level government are generally insufficient to meet the expenditure required for providing services. Very often central government retains with it elastic revenue sources such as Income tax, Excise Levies, and Custom Duties. Contrarily, inelastic sources of revenue (such as sales tax, excise on liquor, and motor vehicle tax) are allotted to state governments. The gap between 'own resources' and 'expenditure needs' indicates the level of dependence of state governments on the central government. The theory of fiscal federalism justifies intergovernmental transfers on the following grounds.

(1) Fiscal Gap correction

Fiscal gap occurs when there is a mismatch between the expenditure needs and revenue powers of a state. Fiscal capacity and fiscal needs differ because geographical and climatic conditions are more favorable in some areas as compared to others. Hence, the access to revenue base varies from region to region. Similarly, per unit cost of services varies depending upon the nature of terrain, and density of population. Sometimes fiscal gap may occur due to inappropriate assignment of revenue sources and functional responsibilities.

(2) Minimum standard of services

Transfer from the Centre to the states may be needed to upgrade the existing level of services to ensure a common minimum standard across regions.
(3) Inter-jurisdictional spillovers

Spillovers (or spatial externalities) occur where the benefits of locally provided services spread to persons who are not legally required to contribute to costs of the service. The benefits of the services which generally spill over to neighboring jurisdictions include public transport, subsidized educational and medical facilities, anti-pollution measures, parks, and recreational facilities. Inter-governmental grants are a major and often the most practical way of correcting the spillover effects.

2.7. B (b). Forms of Transfers

Transfers from the higher level to a lower level of government are made in the form of tax sharing, grants and loans.

1. Tax sharing

Formula-based tax sharing is a predictable source of revenue and the state government automatically gains from the buoyancy of the shared central taxes. There are two types of tax sharing mechanism, under the first method (called global sharing), the whole of the central tax revenue forms a pool for sharing with the state governments. A certain percentage of the total tax revenue of the Centre is allocated to the state governments. The second method (called scheduler or itemized sharing) involves sharing of revenue from individual central taxes.
2. Grants

Grants have the advantage of being targeted towards fiscally disadvantaged states to reduce horizontal fiscal imbalances, where these grants should be considered as conditional utilization. Grants are given mainly for the purpose of equalization. Grants are given upon genuine financial needs of a state. It is possible that even before tax devolution from the Centre, some high income states have surplus in their revenue account. Three types of grants are being given by the central government to states.

2.1. General Purpose (or Unconditional) Grants

These are given to offset fiscal disadvantages arising from lower taxable capacity and higher cost of the services provided due to bad terrain. Such equalizing grants have to be general and their basic purpose is to enable different states to provide services.

2.2. Specific Purpose (or Conditional) Grants

These grants are used to ensure minimum levels of specified public services which are to be provided by state governments. Afforestation, slum improvement and literacy drives create benefits not only to local residents but also to community as a whole. Such schemes should preferably be financed through grants from the center to the states.
2.3 Incentive Grants

These are given for the purpose of encouraging states to streamline their operations. These grants must depend on the measures taken by the state governments to strengthen their financial position.

B (3) Loans

Financial resources from the higher level of government to lower level of government also flow in the form of loans. These loans are generally given for capital projects.

2.8. Efficiency Basis for Inter-governmental Transfers

Inter-governmental transfers as stated above, have both efficiency and equity bases. The main plank of efficiency basis for transfers is that non-benefit taxes such as a proportional income tax creates wedge between the marginal utility of public goods and the marginal utility of private consumption sacrificed to pay his taxes. One way to correct this situation is to introduce transfers from those individuals whose marginal disutility from taxes is lower than the marginal utility derived from public goods to those individuals whose marginal disutility from taxes is higher than the marginal utility from public goods. Thus, these transfers are required not for any equity reasons but to achieve Pareto optimality and such transfers shall be necessarily unconditional (Breton, 1965).
2.9. Equity Arguments for Inter-governmental Transfers

The arguments for intergovernmental transfers on equity grounds have been made either in terms of ensuring horizontal equity among individual states or to bring the inter-regional equity. Unconditional transfers on equity grounds have been put forward by Buchanan (1950). Buchanan’s arguments are based on three premises.

1) It is more sensible to consider the relationship of central governments to individuals rather than the states. "Equity in terms of states is difficult to comprehend and it carries little ethical force for policy implementation".

2) Equity should be defined to include both taxes and benefits. Buchanan, therefore, defines equity in terms of equality in fiscal residuum, which is, taxes minus benefits. Benefits from government expenditures are assumed to accrue equally to all individuals within a state.

3) The requirements of horizontal equity are more meaningful than those of vertical equity.

Buchanan demonstrates that so long as there are income differences among the states, even when both the Centre and the states separately treat equally, overall horizontal equity is not ensured. In order to ensure horizontal equity the central government could levy geographically discriminating tax rates. But that may not be constitutionally permissible. It could also lead to unintended
allocative distortions. It, therefore, prefers unconditional transfers from people in richer states to those in poorer states to bring about horizontal equity (M. Govinda Rao and R.J. Chelliah, 1991).

Buchanan's analysis highlights an important source of inequality in federal systems. The differences in the capacity to raise resources among the states for a given level of public service consumption, the states with lower revenue raising capacity have to levy higher tax-price.

2.10. The Basic theory of Fiscal Federalism

The traditional theory of fiscal federalism lays out a general normative framework for the assignment of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions (e.g., Richard Musgrave 1959; oats 1972). At the most general level, this theory contends that the central government should have the basic responsibility for the macroeconomic stabilization function and for income redistribution in the form of assistance to the poor. In both cases, the basic argument stems from some fundamental constraints on lower level governments. In the absence of monetary and exchange rate prerogatives and with highly open economies that cannot contain much of the expansionary impact of fiscal stimuli, provincial, state and local governments simply have very limited means for traditional macroeconomic control of their economies. Similarly, the mobility of economic units can seriously constrain attempts to redistribute income. An aggressive local program for the
support of low-income households, for example, is likely to induce an influx of the poor and encourage an exodus of those with higher income who must bear the tax burden. In addition to these functions, the central government must provide certain "national" public goods (like national defense) that provide services to the entire population in the country. Decentralized levels of government have their raison d'être in the provision of goods and services whose consumption is limited to their own jurisdictions. By tailoring outputs of such goods and services to the particular preferences and circumstances of their constituencies, decentralized provision increases economic welfare which results from the more uniform levels of such services that are likely under national provision. The basic point here is simply that the efficient level of output of a "local" public good is likely to vary across jurisdictions as a result of both differences in preferences and cost differentials. To maximize overall social welfare thus requires that local outputs vary accordingly (Wallace E. Oates, 1999).

2.11.A. Fiscal Instruments in Federal System

To carry out their functions, the various levels of government require specific fiscal instruments. On the revenue side, government will have access to tax and debt instruments. But in a federal system there is a further method for allocating funds among the different levels of the public sector: intergovernmental grants. One level of government may generate tax revenues in excess of its expenditures and then to transfer the surplus to another level of government to finance part of their budget.
B. Taxation in a Federal set-up

The difference in the mobility of taxed units at the central and decentralized levels has important implications for the design of the vertical structure of taxation. Taxes, as we know, can be the source of distortions in resource allocation, as buyers shift their purchases away from taxed goods. In a spatial setting, such distortions take the form of locational inefficiencies, as taxed units seek out jurisdictions where they can obtain relatively favorable tax treatment. High excise duties in one jurisdiction, for example, may lead purchases to bear un-productive travel costs in order to purchase the taxed items in jurisdictions with lower tax rates. The most well-known case of local public services is the Tiebout model in which local jurisdictions use benefit taxes that effectively communicate to households the cost of consuming different levels of local public goods; this results in an efficient pattern of consumption of these goods. But this is true not only for households. If local governments provide local inputs that increase the productivity of capital employed in their jurisdictions, then they should levy benefit taxes on capital in order to provide the set of signals needed for the efficient deployment of capital in order to provide the set of signals needed for the efficient deployment of capital across localities (Oates and Schwab, 1991).

C. Fiscal Federalism: Expanding the scope of the analysis

The normative framework for most of the literature in fiscal federalism consists of the traditional principle of welfare economics. From, this perspective,
institutions are evaluated in terms of their efficiency in resource allocation and the
distribution of income. However, the choice of a system of governance involves
other values as well: the extent of political participation, the protection of
individual rights, and the development of various civic virtues. Political theorists
throughout the ages have explored the ways in which different political system
address these various objectives of the polity. In addition, the vertical structure of
government may have important implications for the way in which the public
sector functions and its impact on the operation of a system of markets.

2.12. Transference of Resources: Buchanan–Scott controversy

J.N. Buchanan, a supporter of equity approach, argues that higher fiscal
pressure in poor states compared to that in richer states will provide an incentive
for migrating to richer areas. The highly skilled technicians, professionals, and
potential entrepreneurs are more tax-conscious. A higher fiscal pressure on them
will result in migration. On the other hand, the skilled labor, which is an abundant
resource, remains unaffected except where there is a negative tax. According to
the efficiency criteria, the returns to factors of production tend to be lower in
poorer regions than the corresponding returns in richer states. In a federation if the
federal government intervenes through its fiscal policy and tries to transfer
resources from the rich to the poor regions, it would retard the rate of growth of
the national product (Om Prakash, 1994; p.5).
The validity of the contentions of Buchanan and Scott depends upon the model, which the low-income states adopt. For Scott, the model of a low income state is that where both natural resources and other factors are scarce and national output will be the highest only when the scarce capital, labour and enterprise attracted to the best soil, ports, mines etc. federal transfers frustrate this attraction unless such transfers are guided by the objective of maximizing production (Tripathi, 1950).

The model of low income as conceived by Buchanan, presents a picture in terms of scarcity of capital, abundance of unskilled labour and unequal endowment of other natural resources and according to him, it is the most "representative of reality, both Scott and Buchanan have given two extreme pictures of the model, but in reality there may be a good number of states falling between these two extreme positions (Om Prakash, 1994).

In view of the existence of heterogeneity in resource endowments in the different states of a federation, the marginal productivity of the resources transferred to the poor states will be higher to the extent to which such states have rich resources potentiality awaiting to be developed (Adarkar, 1933).

2.13. Alternative Approaches to equalization: Musgrave

Musgrave (1961) undertook the pioneering work on the theoretical models of fiscal equalization as an approach to a more general theory of political
federalism. Musgrave was mainly concerned with the distributional and state revenue effects of different kinds of equalization grants from Centre to state governments. He distinguished between three approaches to fiscal equalization, described as

1. Equalization of outlays or performance;
2. Equalization of differentials in function and power;

Musgrave contended that intervention of the Centre in the finances of the provinces, through fiscal transfers or otherwise can relate to two distinguishable sets of objectives, one, addressed to states, i.e., groups of individuals comprising the states; and two, individual citizens of the federations, whatever state they may be residing in. According to Musgrave (1961), the former approach is more federalist, and the latter, more centrist. In the former case, the individual citizen is subject to the policies of the state in which he is living, but the central government through its intervention may influence the terms at which public services are provided at the state level. In the second case, the central fiscal may try to “equalize differentials in the position of federal citizens which arise from their respective citizenships in particular states. Thereby the central fiscal attempts to isolate federal citizens from the fiscal consequences of their respective state citizenships.
Musgrave outline several equalization plans with alternative objectives in the context of the first alternative, i.e., taking the states (groups or individual) as a whole, rather than its citizens as individuals. In particular, he sets out alternative “equalization plans” aimed respectively at (1) equalization of actual outlay; (2) equalization of differentials in need and capacity; (3) equalization of potentials for state finance.

2.14. Fiscal Transparency and Budget Integrity

Fiscal transparency, which is considered to be one of the cornerstones of good governance, has been gaining critical importance in the recent era in the context of prudent fiscal management and achievement of macroeconomic balance. Fiscal transparency requires providing comprehensive and reliable information about past, present and future impact of economic policy decisions. Clear transparency in government fiscal operations at state levels would require to be strengthened with the process of fiscal consolidation and the financial sector reforms so that it enhances the fiscal effort of the government. The need for adequate availability of information through state budgets is not only important to assist policy makers but also for investors to take decisions. Further, fiscal transparency benefits citizens by giving them the information they need to hold the government accountable for its policy choices.

It may be mentioned that the International Monetary Fund (IMF) introduced a code of good practices on Fiscal Transparency in 1998. This led to a
voluntary program of fiscal transparency assessments by the countries. In 2007, the IMF revised the codes by taking into account several recent developments.

The four pillars of the code are as follows:

1. Clarity of roles and responsibilities,
2. Open budget processes,
3. Public availability of information, and
4. Assurances of integrity.

2.15. Summing up the theory of Multilevel Finance and Fiscal Federalism

From an economist’s perspective, fiscal federalism is an optimal institutional arrangement for the provision of public services. All countries are federal and yet, they differ in terms of varying degrees of centralization. The optimal degree of centralization from the economic point of view is achieved when the net cost of federating is minimized.

The theory of fiscal federalism clearly indicates the supremacy of the central government in handling redistributive and stabilization functions and the welfare gains that can accrue by decentralizing the allocative decisions. The more diverse the preferences of people across regions and jurisdictions, the greater are the welfare gains from decentralization. Also, it is demonstrated that welfare gains
from decentralization are inversely related to the price elasticity of demand for public services.

A number of models have been applied to achieve optimal degree of decentralization assuming either geographical fixity of population or foot loose mobility, but it is found that it is not possible to arrive at a self policing system; for, the degrees of optimal decentralization are necessarily different for revenue raising powers and for expenditure functions. The imbalances exist not only vertically between different layers of government, but also horizontally among various sub-central jurisdictions mainly due to the differences in their capacities to raise revenues and variations in giving public services. Besides, the existence of externalities results in non optimal provision of public services calling for Pigovian transfers.

Arguments for intergovernmental transfers have been advanced on both efficiency and equity grounds. The efficiency rationale for transfers has been put forward mainly to correct the distortions arising from non-benefit taxes, spillover and for 'merit' goods reasons. Equity arguments for transfers have been put forward to enable horizontal equity in a federation. However, the most important equity argument for intergovernmental transfers is to offset fiscal disadvantages of particular states, arising from the incapacity in their revenue rising and responsibilities to provide public services. Inter-governmental transfers enable the states to provide the normatively determined level of public services at the average tax price.