World Development Vol. 40, No. 8, pp. 1511–1521, 2012

0305-750X/$ - see front matter
ELSEVIER
www.elsevier.com/locate/worlddev
http://dx.doi.org/10.1016/j.worlddev.2012.04.005

Fiscal Decentralization and Development Outcomes in India: An Exploratory Analysis

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Summary. — This paper attempts to quantify the impact of fiscal decentralization in India on its social infrastructure and on rural development. Overall, the results in this paper indicate that Government of India within a federal framework has been fostering development equitably across its states, particularly through health and education expenditures aimed at improving human capital development. In this context, the importance of the two tier centre-states decentralization should be noted. However, the third tier of local governance, particularly the state-rural local bodies decentralization has been dismal and has not achieved significant results across states, which warrant the attention of the central and state governments.

Key words — fiscal decentralization, development outcomes, Panchayati Raj, Asia, India

1. INTRODUCTION

One of the central questions in Development Economics is why some countries have remained poor for a long period of time, though the general policy approaches to combat poverty are well understood. A corollary to the above question is why the similar package of policies differs in efficacy across countries. Similarly, an identical set of policies differs in effectiveness across provinces or states within a country. [1] Drawing on the Post-Washington Consensus, it may be argued that the inability to achieve similar results from policy packages across states is due to the constraints posed by country-specific organizational or institutional factors. One of the major institutional factors directly involved in the delivery of public services and in implementing development policies is the degree of decentralization. Therefore, a key to enhancing the efficacy of policies lies in a better understanding of the extent and process through which various forms of decentralization contribute to development (Appendix I).

What do we understand by decentralization? Decentralization can best be understood as a political process in the sense of the devolution of resources, tasks and decision-making power to democratically elected lower-level authorities, which are largely or wholly independent of central government (World Bank, 2000a). It is rational to argue that decentralization facilitates time-specific and location-specific knowledge to implement policies that influence people's welfare. Decentralization in political, fiscal, and economic systems affects development outcomes in a number of ways. First, decentralized provision of social and physical infrastructures should correspond with the diverse demand conditions in different regions and match their resource endowments better than central provision. Even with regard to the provision of quasi-public goods, identification of target groups of beneficiaries is easier and implementation of policies more effective when undertaken by decentralized governmental units (Ostrom, Schroeder, & Wynne, 1993). Thus, even when there is some controversy over the redistributive role of sub-national governments, their desirability in implementing poverty alleviation policies is generally agreed upon (Brown and Oates, 1987; Ladd and Doolittle, 1982; Pauly, 1973).

Second, competition among sub-national jurisdictions may promote innovations and enhance productivity. At the same time, as the decentralized governmental units function within a large country-wide unified market free from impediments to the movement of factors and products, it can provide a congenial environment for the efficient functioning of the market economy. Thus, drawing on the decentralization theorem introduced by Oates (1972), in an ideal decentralized system, existing resources will be allocated to yield the maximum possible output (locating on the production possibility frontiers) and the competitive environment including inter-governmental competition will be conducive for technological progress (shift in the frontier). In reality, the possibility of decentralization failing to overcome regional and local dimensions of poverty and inequality (Prudhomme, 1995; Rodden, 2002) may not be ruled out, mainly because the decision making power on local developmental initiatives is often highly dependent on central government bureaucracy. Further, decentralization may increase the probability of empowering local elites in capturing larger share of public resources at the cost of the poor (Dreze & Sen, 1996).

With the recent developments in the political arena where coalition government is at the center, and different regional parties who are mostly the partners of the coalition are at the states, the case study of the Indian experience of decentral-

* The authors are thankful to Dr. M. Govinda Rao, Director of NIPFP, New Delhi, Dr. Shashanka Bhide, Dr. Kanhaiya Singh of NCAER, New Delhi, and four anonymous reviewers of this journal for their valuable comments and suggestions on an earlier draft of this paper. Final revision accepted: February 20, 2012.

ization provides an important context of understanding the ways in which decentralization can influence overall socio-economic welfare and rural development. The Government of India passed a series of Constitutional reforms in 1993 to democratize and empower local administrative institutions beyond the two tiers of the center and the states. The third tier of local governance comprises a three-tiered structure of rural local bodies, and three levels of urban local bodies as per the 73rd and 74th Constitutional amendments, respectively.[2] Since then, the experiences of different states with respect to decentralization vary a lot mainly due to differences in fiscal decentralization, which is a major instrument of overall decentralization.

As fiscal decentralization was not initiated by states themselves, but was thrust upon them by the center through the 1993 Constitutional reforms, the attitudes toward decentralization varied across states. Though the literature on fiscal federalism explains the economic gains from decentralized decision making and related issues (Rao & Singh, 2005), there are very few empirical studies examining the causal relationship between fiscal decentralization and development outcomes in India.[3] Much of the demonstrated gains are in the nature of assertions or qualitative statements. This study attempts to analyze and quantify the impact of fiscal decentralization in India on its social infrastructure that needs to be supplied by governments as they are not optimally provided by the private sector and on rural development where about 70% of the population lives. In this study, the ratio of per capita expenditure of Panchayati Raj (rural) institutions to per capita expenditure of urban local bodies is used as a measure of states-rural local bodies decentralization in the context of third tier level of local governance.

The following section discusses some important issues concerning fiscal decentralization in India. The next section examines the measures of spatial disparity in social infrastructure development across states. The following section analyzes the impact of decentralization on social infrastructure and on rural development. A final section brings out the overall conclusions of this study.

2. FISCAL DECENTRALIZATION IN INDIA—MAJOR ISSUES[4]

The basic framework of inter-governmental relationships in Indian federation is given by the Constitutional assignment of functions and sources of finance. The seventh schedule to the Constitution of India specifies the Union list—the exclusive domain of the central government, the State list—the exclusive domain of the state governments, and the Concurrent list where both levels have joint jurisdiction.

An important feature of the Constitutional assignments in India is the centripetal bias in the assignment of powers. First, almost all broad based taxes, with the sole exception of sales tax, are assigned to the central government. Second, effectively, states do not have independent borrowing powers. When a state is indebted to the center, it must seek the center's permission to borrow. As all the states are indebted to the center, their market borrowing is determined by the Union Ministry of Finance in consultation with the Planning Commission and the Reserve Bank of India. Also the states cannot incur overdrafts with the Reserve Bank of India for more than 10 continuous working days. The Constitution not only assigns overwhelming powers to the central government, but also has overriding powers in the event of a conflict in a concurrent jurisdiction.

The centripetal bias is not merely the consequence of Constitutional assignment. The adoption of planned development strategy and allocation of resources according to priorities determined by the planning agency have also contributed immensely to the centralization of economic power. Although planning was originally to be implemented in a decentralized manner, the involvement of sub-national governments in resource allocation has in practice been limited. Comprehensive central planning is the negation of federalism; and planning even in a mixed economy framework has significantly contributed to the concentration of economic power with the center. In the event, the potential benefits of decentralization have not been realized. It is worth noting that decentralization elsewhere with the similar characteristic of the center having more power over the states has positive outcomes. For example, though the central government maintains control of certain major expenditures, such as education and health, South Africa's governance system has been restructured, which allow for the policy implementation on a local level. Such decentralization has significantly contributed to the post-apartheid unification (World Bank, 2000b, chap. 5).

Achieving the potential benefits of fiscal decentralization in the Indian federation has been further obstructed by the various fiscal and regulatory impediments to the movement of factors and products across the country (Rao, 2004). Some of these impediments were created for the economic management of supply shortage of essential commodities. The fiscal impediments were the consequence of the free-riding behavior of the states, particularly the attempt to export the tax burden to nonresidents. These impediments, along with high levels of protection, distorted relative prices and created a high cost economy.

Another reason for centralization has been the failure to specify the powers and functions of governmental units below the state level, until the 73rd Constitutional amendment was given effect recently. The state governments, following the Balwantrai Committee report, adopted the local self government unit in rural areas (Panchayati Raj), right from the village level. However over the years, in many of the states these institutions became inactive with elected councils being superseded for indefinite periods. In some states, notably in Andhra Pradesh, Karnataka, and West Bengal there was an attempt at rejuvenating these local self governments at the village level by activating them politically, making greater devolution of powers and finances to them and in some cases, consolidating them into more viable economic and administrative units. However, frequent changes in the ruling party in Karnataka and Andhra Pradesh rendered these experiments abortive, though in West Bengal it has continued. With the 1993 Constitutional amendment, however, it is now mandatory to have a uniform system of Panchayati Raj throughout the country. The 11th schedule of the Constitution specifies a list of 29 subjects to be carried out by local governments (Appendix II). Many states have already transferred responsibilities for the 29 subjects listed in the 11th schedule of the Constitution through legislation, in reality not all subjects have been carried out by rural local bodies in those states.

For example, among the South Indian states, Karnataka, and Kerala have decentralized their local governance effectively by providing responsibilities to rural local bodies for all 29 subjects not only through legislation, but also through actual implementation (Appendix III). On the other hand, Andhra Pradesh and Tamil Nadu have paid less attention to decentralization. Though Andhra Pradesh has agreed through legislation to transfer 17 out of 29 subjects to rural local bodies, in reality only nine subjects have been given until