

## **THEMATIC DEVELOPMENT OF FISCAL FEDERALISM AND ITS IMPLICATIONS IN CENTER AND STATE FINANCIAL RELATIONSHIP**

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### **ABSTRACT**

Fiscal federalism is one of the most debated topics in public finance literature. It has been widely discussed and researched by economists and policy makers at various contexts. Further, it exclusively discusses the theoretical underpinnings and empirical dimensions of intergovernmental transfers at various contexts including India. The study narrates the theoretical development taken place in fiscal federalism and its implications in Centre and State financial relationship. Existing literature pertaining to fiscal federalism have been indicated the nuances of fiscal transfers, determinants, challenges and constraints of the same. In addition to that First generation fiscal federalism (FGFF) studies the performance of decentralized systems under the perception of generous social planners. Second Generation Fiscal Federalism (SGFF) studies the fiscal and political enticements confronting subnational personnel. The study paved the premises for conceptual clarification of fiscal federalism and its frontier of implications.

**Keywords:** Fiscal federalism, Macroeconomic, FGT, FGFF, SGTF

### **INTRODUCTION**

Fiscal federalism is merely a sub-field of public finance. It addresses the whole range of issues relating to the vertical structure of the public sector. It is basically an understanding which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government (Oates, 1999). The term 'fiscal federalism' was first introduced by Richard Musgrave in his master piece *The Theory of Public Finance* in 1959 and popularized by Wallace E Oates in his classic *Fiscal Federalism* (1972). As it is an amalgamation of two complex words, the former word (fiscal) usually refers to government finance while latter one (federalism) is used to mean both 'federal' and 'unitary' political system. However, the interpretations of the composite term (i.e fiscal federalism) are beyond the range of word meanings. Federalism can be generally viewed as a system of government in which entities at lower level (states / provinces) or sub-national governments

share power with a national government. In other words it is a division power between a central authority and various constituent units of the country. Although under federal system, the powers and responsibilities are divided between national and sub-national units, the central government cannot order the state government to behave *in* the stated way. The sub-national government has powers of its own for which it is not answerable to the national government.

The field of fiscal federalism gained popularity in early 1990s with a clear world-wide trend towards fiscal decentralization (Ter-Minassian 1997). Until then it was more or less an unexplored area. The increased attention is mainly because it determines the optimal degree of fiscal decentralization; underlines the functions, assignments, source of findings of different levels governments; and designs the transfer mechanism to uphold equity and efficiency (Rao and Singh, 2005). More specifically, it concerned with the proper assignment tax powers and expenditure responsibilities between national and sub-national level government, and design of a proper transfer system and most importantly the splitting up of policy responsibilities among different levels of government and their fiscal interactions.

## **THEORETICAL FRAMEWORK ON FISCAL FEDERALISM**

The review of fiscal federalism is considerably vast and hence a modest attempt has been made to review them by paying more attention to some specific theories which are considered very relevant to the research. To begin with, some of the old and new theories of fiscal federalism need to be clarified. The traditional theory of fiscal federalism lays out a general normative framework for the instruments for carrying out these functions (e.g. Richard Musgrave 1959, Oates 1972). This theory contented that the central government should have the basic responsibilities for the macroeconomic stabilization function and for income redistribution in the form of assistance to the poor. The main stream literature on fiscal federalism pertain to decentralization, not federalism per se. Fiscal Federalism deals with degree of decentralization, not whether the system is unitary or federal (Oates, 1972). The traditional theories on fiscal federalism recently classified into first-generation theory and second-generation theory.

### **First Generation Theory (FGT)**

The first generation theory (FGT) or the traditional theory of fiscal federalism is associated with decentralization of expenditure responsibilities and centralization of revenue responsibilities for the purpose of achieving ‘efficiency’ and ‘equity’ in the federation (Joshi and Jain, 2016). FGT emphasis the importance of transfers and address the problems of vertical and horizontal imbalances. It is largely normative and assumes that national and sub-national decision-makers are ‘benevolent’ and maximize the social welfare. Therefore, FGT is also known as classical normative theory of fiscal federalism (Chandra 2012).

Musgrave (1959) divides the public fiscal departments into three branches such as allocation, distribution and stabilization, and these branches has to determine the respective role of the different levels of government in the implementation of economic policy and applying them to tax and spending problem in the federal environment (Oates 1968). He called these branches as multilevel finances (Musgrave, 1959). The stabilization branch deals with the problem of full employment with stable price in the economy and its functions mainly at the central level of any federal countries. The distribution branch deals with the problem of “Optimal distribution Income” and its functions mainly at the sub-central level of government. Thus in a federal system the stabilization and distribution branches of the public fiscal department must perform their functions primarily at the central government level (Musgrave 1959 and Oates 1968). There is so much of problem in the allocation branch (Musgrave 1959), in case of allocation branch, the local as well as central government has important responsibilities in the provisions of needed public goods and services (Oates 1968). A public sector with both centralized and decentralized levels of decision-making in which choices made at each level concerning the provision of public services are determined largely by the demands for these services of the residents of (and perhaps others who carry on activities in) the respective jurisdiction Oates (1972).

Oates (1972) has formalized the “Decentralization Theorem” constitutes the basic foundation for the magnitude of the welfare gains and the gains from decentralization have their source in the famous tiebout model (Oates 1999) also examined the traditional theory of fiscal federalism, the role of the state and their functions on fiscal performance, fiscal instruments and fiscal decentralization in different level of government in the new direction and may referred as the first generation theory of fiscal decentralization (Oates 2005). The theory focused on situation where different levels of government provided efficient levels of outputs of public goods “for those goods whose special patterns of benefits were encompassed by the geographical scope of their jurisdictions” such situation came to be known as “perfect mapping” or “fiscal equivalence” (Tyagi 2012).

The first generation theory determines the internal functioning of state organizations residually; it favors a familiar market failure argument the presumption of which is that both central and local government act in the public interest (Garzarelli, 2004). Rao and Singh, 2005 examines in the theoretical terms that, fiscal federalism helps to understand the factors determining the optimal degree of fiscal decentralization, the assignment of functions and sources of finance of governments on different vertical levels and to design the inter- governmental transfers schemes to fulfill the objectives of ‘equity’ and ‘efficiency’.

To conclude much of the gains attributed to fiscal federalism, in the mainstream literature pertain to decentralization, not federalism per se (Rao and Singh, 2005). The traditional (or first

generation) theories mainly discussed efficiency enhancement in the allocation of public resources and focused on fiscal decentralization and the role of the state in which the expenditure responsibilities and it favor's the centralization of revenue responsibilities for the purpose of achieving 'efficiency' and 'equity' (Joshi and Jain, 2016). The first generation theory assumed that governments as 'benevolent' that does not see any problem on service delivery functions to sub-national governments, assuming that decentralization of public goods and services brings efficiency in their provisions/States (Chandra, 2012). He also discussed that first generation literature on fiscal federalism failed to focused on the incentives effects of transfer systems around the world provide political officials with poor incentives to foster local economic prosperity. There is no such empirical studies has been found pertained to the first generation theory of fiscal federalism.

### **Second Generation Theory (SGT)**

The second generation theory is an emerging theory which gives more importance to incentives generated by sub-national tax collection for fostering prosperity. The SGT has had significance implications for the design of transfer systems, so that equalization goals can be achieved without diminishing the incentives of public officials to foster thriving sun-national economies (Chandra, 2012)

First Generation Fiscal Federalism (FGFF) is largely normative in nature and assumes that public decision makers are benevolent maximizers of the social welfare (Musgrave1959, Oates 1972, Rubinfeld 1987).

In the context of the evaluation of the public sector, a wide range of new ideas and theories have merged to highlight the structure and functioning of federal systems. They are known as 'Second Generation Theory of Federalism' (SGTF) (Naganathan, 2007).

Second Generation Fiscal Federalism (SGFF) constructs on FGFF and assumes that public officials have a goals prompted by political institutions that often systematically diverge for maximizing citizen's welfare of the country (Oates 2005, Garzarelli 2004, Weingast 1997).

The second generation literatures on fiscal federalism have been discussed and widely seen by many researchers in terms of its resource availability. The coverage of SGTF includes principal agent problems, the economics of information, the new theory of the firm, theory of contracts and organization. It has been discussed by many academicians, scholars, and researchers both in theoretical and empirical terms. First, let us discuss the theoretical reviews on second-generation fiscal federalism.

The key theoretical construct of “market-preserving federalism”, (MPF; Weingast, 1993) is defined by five conditions: (i) hierarchy of governments with delineated authorities (the basis of federalism); (ii) primary authority over local economies for subnational governments; (iii) common market enforced by the national government (iv) hard subnational government budget constraints and (v) Institutional allocation of political authority (Singh and Srinivasan 2006).

Weingast (1995) examines the role of government and the political institution that reliably commit the state to honor economic and political rights. Federalism or decentralization of state activity favor individual initiatives and serve as market preserving device. The market preserving federalism is a central factor for an economic development of the state. The political dilemma of an economic system is that, the state strong enough to protect the private market to confiscate the wealth of its citizens. The political foundation of markets is to develop the markets “getting price right” and the economic role for political institution is to provide the appropriate foundations for economic policy-making and secure system of economic and political rights.

Qian and Weingast (1997) discusses that a properly structured federal system and a market economy can interact in ways that can be mutually reinforcing to provide a system called “market preserving federalism”.

Inman and Rubinfeld (1997) characterizes the traditional theories as “Economic Federalism” which they contrast with the recent models that explicitly account for political processes and their impact on outcomes. One of the major advantages on economic decentralization of public governance (or fiscal federalism) as proposed by the SGFT is that it can act as a laboratory of rapid trial and error learning for public policy.

Oates (2002) discusses the traditional theory of fiscal federalism and its modern extensions. The three main areas considered in the traditional theory are: (a) welfare gains from decentralization, (b) assignment of resources and responsibilities between the tiers of government, and (c) fiscal instruments for the resolution of vertical and horizontal imbalances.

Garzarelli (2004) examines the second generation theory of fiscal federalism through contemporary economic and industrial organization theory. The two classical motivations in support of federalism are incentives and knowledge motivations for fiscal decentralization. He finds that incentive based on organizational approach rather than the knowledge motivations for decentralization and also has more balanced approach in the SGT. The FGT is primarily inspired on knowledge motivation, whereas the SGT can easily accommodate the knowledge motivation for decentralization. The famous tiebout model also offers an organizational approach rests on knowledge motivation for decentralization. He also recommends for the future studies those knowledge-based approaches to economic organization which the SGT itself with and to

develop organization model of fiscal federalism based on the knowledge motivation.

Oates (2005) has point out that it is much more difficult to describe the second-generation theory, because it is an emerging perspective that it's quite wide ranging in the issues and it is very difficult to addressed and analyse the method it's employed. He examined some of the new insights emerged in fiscal federalism and the ideas on centralization and decentralization and a change in structure on federal systems called as market preserving federalism. He observed some of the new implications for the structure of the public sector, design of fiscal institutions and policy making and also discussed about the vertical structure of government and the form and working of fiscal institutions. He fined that in the second generation fiscal federalism theory, sub national governments are considered to be pursuing their own interests rather than being benevolent (Kappeler et al, 2012).

Weingast (2006) Market-preserving federalism put forth an ideal form of federal system. Where political authority is institutionalized in this system, sub national governments have primary authority over public goods and services for local autonomy. Multiple governments have clearly delineated responsibilities and all governments face the financial consequences of their decisions as hard budget constraints. The federal government preserves the internal common market. Theoretically we can divide principals of federalism in two parts described. First one is the principle of division of functions and finances. Second is the principle of federal finance.

Singh and Srinivasan (2006) examine the role of India's federal system in its economic growth and development in future. They also analysed and compared India's economic performance with china's federal system in terms of analysis the impacts of tax assignments, expenditure authority and the intergovernmental transfer system such as quality of governance and expenditure, the efficiency of tax system, fiscal health of different tiers of government and the impacts on growth and regional inequality.

Weingast (2009) discuss the performance of first and second generation fiscal federalism. The fiscal and political incentives facing subnational officials and the design of intergovernmental transfers will correct the vertical and horizontal equity of the subnational government. The transfer system is to provide higher marginal incentives to foster the local economic prosperity. The fiscal incentives approach shows that the form of tax system affects the subnational government policymaking, particularly policies with respect to the market. He also proposed that tax decentralization, by explicitly connecting the effects of spending policies with the revenue budget, provides incentives to focus on growth-enhancing policies and to reduce rent-seeking and wastages in government policies. (Kappeler et al, 2012).

Chandra (2012) critically examines the FGT and SGT of fiscal federalism and the problem of

fiscal federalism in different perspective. He also discussed that second generation theory is an ongoing effort to build a theory in response to face a fiscal challenge of the countries and explained the present day institutional arrangements led to growing interest in fiscal federalism in recent times. The second-generation theory included both the incentive and knowledge motivations for fiscal decentralization.

Joshi and Jain (2016) the second generation fiscal federalism is in favour of the decentralization of both expenditure and revenue responsibilities; and it gives minimal role to revenue-sharing and inter-governmental transfers and supports the market preserving federalism (MPF). Nune (2017) in India, the market has been growing fast by replacing the centralized economy during the Nehruvian and the Indira Gandhi epochs. In the market economy, the role governments at all levels are essential as they have to design and implement policies and programmes to develop social and economic infrastructure to suit the local needs of the governments. To achieve this, financial autonomy is important for the State and Local bodies.

To conclude the second generation theory on fiscal federalism mainly focused on market preserving federalism (MPF) is an alternative way to approach federalism related to 'new institutional economics'. It sees political decentralization in terms of its capacity to sustain a productive and growing market economy (Rangarajan and Srivastava 2011). Market Preserving Federalism also refines the economic case of federalism and provides insights into the entailments of different federal structures for efficiency, equity and political stability (Rao and Singh (2005)).

## **CONCLUSION**

Fiscal federalism is the important device to execute the financial decentralization and also enrich inter-governmental fund transfers. There has been huge literature on fiscal federalism largely confine to role of the state, determinants, challenges and changing dynamics in inter-governmental transfers. Governments across the world encompassed with unique features in governance but federal fiscal transfers pertain to common platform under systematic approach of inert-governmental financial devolution. In India, there has been number of committees formed to address the challenges in federal financial transfers where Union government apparatus in allocation have unleash significant crisis of financial management of the states as the State government constitutionally obliged to cater the various responsibilities which cost huge exchequer. However, array of the literature on the selected domain depicted the numerous issues pertaining to fiscal federalism. Fiscal federalism is not only addressed the pecuniary and technical transactions but the legitimate right and power devolution of the governments.

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