

ON FEDERALISM AND REFORM IN INDIA

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My idea of village swaraj is that it is a complete republic...The government of the village will be conducted by a Panchayat of five persons annually elected by the adult villagers...this Panchayat will be the legislature, judiciary and executive combined...Here there is perfect democracy based on individual freedom.

Mahatma Gandhi, 'Question Box', Harijan, 26 July 1942

Introduction

Fifty years after Gandhi wrote the words above, India embarked on what may prove to be one of the most significant changes in its structures of governance, the 73rd and 74th amendments to the Constitution of India, which give local governments, rural and urban, a legal status that they formerly lacked. If these institutional reforms towards greater decentralization of governance do support the more efficient provision of public or collective goods to the majority of Indians, they will be as significant as the decentralization of the provision of private goods, through the relaxation of industrial controls and other deregulation, that has been the centrepiece of Indian economic reform since 1991. While the impetus for the changes in governance has been independent of the factors that precipitated the current economic reforms, the two sets of reforms are related, both broadly in terms of the general spirit of decentralization of control over economic activity, and more specifically in the area of government finances, which have been of concern from a macroeconomic perspective, and which will be a crucial aspect to ensure the success of the decentralization of governance. In this paper, I review the developments embodied in the two constitutional amendments, and relate them to broader reform issues.

Government and federalism

Economic theory provides some guidelines for which goods may be better provided collectively: goods where consumption is collective, or shared, such as infrastructure, or goods with significant social benefits beyond those that accrue to an individual, such as health and education. While collective provision does not have to be through the government, both equity and efficiency concerns often suggest an important role for government in this economic sphere. This leaves the question of the appropriate unit of government for the financing and the provision of these public goods. Economics also tells us something about the appropriate structure of layers of government, what we refer to broadly as federalism. This is particularly the case for fiscal issues of federal structure, namely the assignment of tax and expenditure functions to different levels of government. In India, however, the guidelines provided by economic theory are not well followed. Tax assignments are not clear-cut in India, even without considering the issues of intergovernment tax sharing. The central, state and local governments have overlapping tax assignments which are uncoordinated. Tax rates across commodities are not set at economically rational levels. There are multiple taxes on commodities with cascading effects. Some taxes act as internal tariffs, reducing the advantages of size in India's internal market.

The assignment of expenditure functions has not been subject to criticisms as severe as those on tax assignment, but the vertical fiscal imbalance, where Indian states rely considerably on central transfers, either statutory or discretionary, has been a source of problems. The increased use of discretionary transfers between levels of government increases influence costs within the system: resources are used up by potential recipients in trying to affect the decisions of those making the transfers. Another effect of the ascendancy of discretion over rules in intergovernment transfers has been the failure to advance equity goals through such transfers, with discretionary transfers counteracting the equalizing effects of formulaic ones made through the Finance Commission. Since equity is a major reason for centralization (internalizing externalities being the other), this is an undesirable aspect of the Indian federal fiscal system.

While most discussion of Indian fiscal federalism has been at the level of center-state relations, similar

issues arise at the level of state-local interactions. Local government institutions, reflecting the diversity of India, are quite varied. Each state is divided into districts, with further subdivisions (tehsils or talukas), for administrative purposes. Each subdivision contains a varying number of villages, which form the base of the panchayat system: village, "block", and district, each with representative councils at that level. Urban municipalities form a separate system, with four grades, based primarily on size. The creation or extension of representative democracy at these decentralized levels in the 1950 Constitution continued a trend begun under the British. However, state governments retained statutory control over all local governments. In practice, this often meant that state governments superseded elected local bodies, and managed local administration directly.

Historical experience

Efforts by the British to reorganize rural local governments began as early as 1870, and continued till independence. By 1947, elected panchayats, as a creation of the central government, were common, combining judicial with municipal/administrative functions. However, the Indian Constitution of 1950 emphasized the role of central government. State governments were given extensive responsibilities, but village self-rule was not emphasized in the document, except in Article 40, in the Directive Principles, which requires the government to "take steps to reorganize village panchayats and endow them with such powers and functions as may be necessary to enable them to function as units of self-government". Central and state government initiatives to implement this objective continued throughout the subsequent four decades.

While the central government could form committees and make recommendations, the constitutional structure (Article 246 (3)) requires states to pass legislation regarding local government. The diversity of initial conditions and subsequent experiences led to considerable variation in the institutions of rural local government across the states of India. This makes generalizations difficult, but several broad observations are possible. While direct or indirect elections for the three tiers of rural local government were part of the legal structure, in practice, it was easy and common for state governments to postpone elections or suspend local governing bodies. Another fairly common feature of the panchayat system as it evolved in independent India was the close involvement of politicians from the state level, in particular, Members of the Legislative Assemblies (MLAs). This was in keeping with the dominance and direct control of the state government over the local level. Central and state bureaucrats also exercised considerable control over local decision-making.

A major reason for this lack of effective autonomy of the panchayat structure was the lack of independent fiscal capacity at this level. While rural bodies have had the notional power to tax, and assess fees and penalties, in practice their tax base was severely circumscribed, and they often lacked authority to enforce collection. Thus, funds chiefly came from higher levels of government, with the tiers of local government acting as lobbyists for funds, and conduits for money received. The soft budget constraint (perceived and actual) further reduced incentives for local resource mobilization. Local revenue collection could be negligible - as little as Re. 1 per capita - even in states such as West Bengal, with a relatively strong commitment to decentralization.

While before independence the observation of traditional panchayats suggested that their primary role was as petty courts, with limited administrative functions as providers of public goods, there was a continual effort to incorporate the tiers of rural local governments in the process of development planning and implementation after independence. However, the administrative structures of planning in India tended to reinforce the role of bureaucrats and higher level politicians, at the expense of local government. Of course, standard pork-barrel politics was operational, with powerful MLAs or MPs able to deliver local amenities to garner votes. The judicial role of panchayats was also given some attention. Since Article 50 of the Constitution requires separation of the judiciary and the executive, an attempt was made, especially after 1959, to create separate nyaya panchayats (NPs) to handle judicial matters. This would also serve to avoid overburdening panchayat institutions, since they now were expected to perform a wider range of developmental functions. In practice, the NPs saw a decline in their activity, at the same time state courts' workload was rising. Despite the informality and flexibility of procedures in the NPs, there were considerable delays and arrears at that level. This can be attributed to the lack of training of personnel, of institution building in general, and ultimately to a lack of adequate funding of the NPs. Overall, then the NP system came to be seen as a failure, and became effectively moribund.

As was the case for rural local governments, municipal or other urban governments in India derived their status and powers solely from state level legislation. Therefore, laws and practice have varied substantially across states, but I will try and summarize some common patterns. As is the case with rural governments, urban governments have been relatively restricted in the scope of their activities. In particular, police functions are typically effectively controlled at the state level, rather than locally. Unlike rural governments, urban bodies are relatively more fiscally self-reliant. Only about 25% of their funds came from outside sources, chiefly state grants, in 1979-80. However, urban governments have had difficulty in raising revenues from their own sources. Overall, municipal revenues grew much more slowly than did central and state level receipts.

One of the reasons for difficulty in municipal revenue generation in some states has been the abolition of octroi in those states. Municipal governments in some states traditionally relied very heavily on octroi and other relatively inefficient trade and transport taxes. Property taxes, while significant, have also been subject to problems. A property tax is theoretically the least distortionary for local government, which must be especially sensitive to the mobility of factors of production. However, municipal authorities have been reluctant to use or enforce such taxes effectively. Some of the problems seem to be managerial, being the use of outdated procedures for assessment and collection of such taxes. One of the consequences of the constraints imposed by lack of effective revenue raising is that, even in prosperous parts of Indian cities, the level of provision of local public goods and services such as water, electricity, garbage collection, and roads is strikingly low. There is also a great deal of inefficiency in provision, though this may not be that different from other cases of monopoly provision. Finally, as is the case with rural governments, state governments have sometimes used their powers to supersede urban bodies, and administer municipalities or cities directly, reducing direct accountability, and effective decentralization.

To summarize, India's experience with local government has been mixed. While there have been repeated efforts to decentralize, particularly in the rural sphere, state and central governments - the latter through the bureaucracy - have retained substantial control of functions. Local governments have had limited fiscal autonomy, and often little incentive to develop fiscal capacity. While federalism at the level of center-state interactions has received considerable attention, decentralization of governance beyond that has been limited in practice. Having said this, it should be noted that local government in India is no worse, and often better than, that in other developing countries: its problems are far from unique.

Reform of local government

While Gandhi's vision of Panchayati Raj was not prominent in the Constitution, the influence of his ideas, as well as the overwhelming importance of the population of the countryside, continued to shape policy directions. A long and checkered history of attempts at reform culminated in the 73rd and 74th amendments to the Constitution of India in 1993. These amendments required individual states to pass appropriate legislation, since local government remained a state subject under the constitution, and individual states have proceeded to do so.

What were the key features of the change brought about by the amendments? With regard to rural local governments, the uniformity of the number of tiers, criticized in early versions of the bills, was retained, with an exception only for the smallest states, those with populations below 2 million. This imposes a three tier structure (village, intermediate block/taluk, and district) on the larger states, including those such as Kerala, which, after much experimentation and debate, had chosen to have two tiers of local government prior to the amendment. However, this may be a relatively minor issue. The crucial change is the reduction of state government discretion in the holding of elections to local government bodies. Under the new laws, elections to panchayats must be held every five years. Elections to constitute new bodies must be completed before the term expires. If a panchayat is dissolved prematurely, elections must be compulsorily held within six months, the new body to serve out the remainder of the five year term. These provisions will presumably prevent situations such as that in Tamil Nadu, where at one stage panchayat elections were not held for fifteen years, being repeatedly announced and then postponed by successive state governments. With regard to urban local governments, there is a similar strengthening of the electoral requirements, preventing lengthy supersessions of local powers by the state government, and replacing appointed posts with elected ones.

The 73rd amendment gives considerable attention to the nature of elections for the three levels of panchayats. Direct elections are specified for seats at all levels. Seats are reserved for scheduled castes and scheduled tribes in proportion to their population, and offices of chairpersons at all three levels are also reserved in proportion to their population in the state. One third of the seats and of offices of chairpersons are reserved for women. Chairpersons at the intermediate and district levels are to be elected by the panchayat membership, while either direct or indirect elections of chairpersons are permitted at the village level. State level election commissions are to be created to supervise and manage the electoral processes. At the intermediate and district levels, chairpersons of panchayats one level below can be made members, as can MPs, MLAs and MLCs (Members of Legislative Councils).

The act provides for one additional potential avenue of representation and accountability of local government. Each village or group of villages will have a gram sabha, comprising all registered voters in the area. The functions of the gram sabha are left up to the states, and are not further specified, but the Karnataka panchayat act of 1983 provides some indication of how these may function. This act (now, of course, superseded) provided for periodic meetings of gram sabhas, to consider the report of the panchayat, proposals for new programs for village development, implementation of sanitation and drainage schemes through voluntary labor, programs of adult education, and similar issues.

Another vital feature of the reform is its attention to the financial resources of local government. State governments are expected to provide adequate funds for local governments, through grants, the assignment of tax revenues, and authority to collect taxes, tolls and fees. This will not be entirely discretionary, since in each state a finance commission must be established (with five year terms, as is the case with the central Finance Commission) which will determine the principles for providing local governments with adequate resources. This creation of state level finance commissions is particularly significant, since it has the potential to enhance the independence of local governments. The envisaged structure parallels that of the central Finance Commission, as well as being similar to the provisions of the Karnataka panchayat act of 1983. States will retain considerable discretion and control, but the experience at the center-state level suggests that state finance commissions, though advisory in nature, will have an important role. States will also be responsible for making provisions with respect to the maintenance and auditing of lower level government accounts.

Other aspects of the reform include the creation of a new (eleventh) schedule in the Constitution, of 29 subjects (including agriculture, animal husbandry, land and water management, irrigation, roads, education, electricity, and welfare programs) as panchayat responsibilities; specific responsibilities for preparing development plans; the creation of district planning committees to consolidate the plans prepared by panchayats and municipalities; and additional provisions concerning eligibility for and composition of rural local governments. All of these provisions have been debated, and often criticized, in some detail. In the next section, I will evaluate some of the salient issues.

The 74th Amendment, known as the Nagarpalika Act, provides a parallel set of reforms for urban and transitional areas. For areas in transition from rural to urban, nagar panchayats are to be constituted, and, for most purposes, are combined with municipalities. The composition of municipalities remains under the guidelines of the states, subject to the population categories outlined in the amendment (5,000 to 10,000 for a nagar panchayat, 10,000 to 20,000 for a municipal council, etc.). A noteworthy feature is the legislative creation of tiers within larger municipalities, in the form of wards and zones, with their own committees. As noted above, a key feature of the legislation is the strengthening of local election procedures, with members at the ward and municipal level being chosen by direct elections. The zonal committees are more of an intermediate level, their composition being the chairpersons of the ward committees in the zone.

Many of the provisions of the Panchayat Act, including composition, reservations, duration, and the role of state finance commissions, are directly applied to municipalities in the Nagarpalika Act. Paralleling the creation of the eleventh schedule in the Constitution, the legislation also creates a twelfth schedule for municipalities, including public health and sanitation, communications, and various welfare services. Law and order are not on this list. Finally, the act requires the constitution of planning committees at the level of districts and metropolitan areas.

Evaluation

It seems that the strengthening of local government can do two things in the direction of greater decentralization, greater responsiveness to local preferences, and, hence, greater efficiency, despite an argument that it strengthens the center by weakening state government control. First, it provides an easier route for channelling central funds directly to the local level. While this may not seem to get away from "top-down-ism", it can have two positive effects. It reduces the possibility of "skimming" of funds as they pass through multiple levels of politicians and bureaucrats; and, furthermore, the political influence equation is different between the center and a locality, versus the center and a medium-sized or large state: no single locality or district matters politically in the way a large entity such as a state can. Thus, two types of influence costs might be reduced. It may also be noted that the more general economic reforms have increased the power of the states, for example, by freeing them to attract private investment, and reducing central control over the location of industrial activity. Finally, it should be noted that state governments retain considerable power over local government: for example, MLAs can simultaneously be members of panchayats, and states will set the terms of reference for their finance commissions. Thus, the perception of the 73rd and 74th amendments as weakening the states vis-a-vis the center is, in my view, of limited consequence.

The second positive consequence of stronger local government, one that may be more important from the perspective of genuine decentralization and responsiveness, is that such governments may be able to raise funds more effectively. While there are always potential economies of scale in raising revenue, the Indian fiscal system has been marked by a greater degree of centralization of revenue relative to expenditure than in other federations. At the center-state level, this has meant that states rely heavily on transfers from the central government. This is less true at the state-local level, with 10-25% of urban local governments' funding coming from grants and other transfers. However, while local governments do not rely heavily on external funding, it has often been noted that the level of services that they provide is quite low on average. Expanding the authority of local governments, by giving them a firmer legal status and more certain terms of office, may help in opening up avenues of raising revenue. This will complement the potentially firmer position of fiscal transfers to local government bodies through the working of state finance commissions. In the long run, and if financial markets continue to develop as one would expect, based on the ongoing and proposed reforms in the financial sector, local authorities may also be able to borrow from the market for capital expenditures.

Expanding fiscal capacity is by itself not sufficient. Fiscal effort also matters. For example, the issues of tax enforcement, of incentives to restructure taxes, and of user charges are critical. Will local governments be any better at this than they have been, and better than state governments in the past? Three things should help. First, the firmer political footing for local government should increase accountability to local constituencies. This will increase the pressure to deliver public goods and services more effectively, and to raise the resources to do so. Second, local governments may now have greater freedom to access and manage their funds: even a seemingly small change such as the ability to maintain funds in local banks instead of the state treasury can provide considerably more effective control, and increase the incentive to raise funds. Third, the small size of local constituencies, relative to the size of states, makes it easier to impose hard budget constraints on local governments, forcing them to look to internal sources of funds. None of this is going to be automatic. I noted problems in the administration of urban local taxes, both political and managerial: these will take time to overcome. In the case of rural areas, in many cases the panchayats will be starting from scratch in developing revenue sources. Again, this will not be easy, but there are successful examples of villages that sustain a high level of corporate organization when there are net material benefits to be obtained from such organization. To aid this kind of outcome, several complementary aspects of reform, in addition to political responsiveness and managerial efficiency, will need attention. I address these in the next section

First, I take a brief look at equity concerns. A major fear since independence has been that pushing decisions below the level of the central or state government would be problematic for equity, in view of the danger of capture of local government by "traditional rural oligarchs". Not only has this danger lessened over the decades since independence, but in many cases coalitions of such oligarchs at the state government level have been equally problematic. What has helped to reduce this concern at the local level is people's experience of democracy at the national and state levels, where they have realized the power of numbers. The existence of

a free press, the spread of the media in general, and explicit efforts by some state governments have also been important in safeguarding the interests of the disadvantaged. Furthermore, there may be genuine possibilities for encompassing coalitions at the local level, particularly where the institutions of democracy shift the balance of power. This has already happened to some extent at the state government level, where coalitions of relatively disadvantaged groups have emerged in some cases. These should provide a check on the problem of inequities at the local, particularly rural, level. Finally, in terms of the provisions of the amendments, if the new state finance commissions use formulas which weight equity in deciding their levels of transfers, this may be at least as good as the existing system of discretionary grants. At the level of central-state transfers, it is Finance Commission transfers that have been equalizing, not discretionary transfers. Thus, while India is still far from Gandhi's rural idyll, it does seem that the new decentralized structures need not be inimical to equity.

What remains to be done

As I have suggested above, the issues of too much uniformity and too much reduction of state power may be relatively unimportant in practice. States have each passed their own legislation to implement the provisions of the constitutional amendments, and in some cases, for example Karnataka, it has been suggested that they have used the occasion to enhance state power at the expense of lower level governments. Karnataka is a particularly striking case, because it had effectively and quite successfully decentralized on its own, prior to the amendments. Several other states are perceived as having been reluctant to devolve any real power. This may be related to controlling funds from the central government, and rent-seeking in general. These initial developments suggest that true decentralization may be a slow process. This was perhaps to be expected: passing laws does not guarantee their implementation or enforcement. However, it remains the case that a constitutional amendment creates a potential that might not exist otherwise: higher level governments have had their discretion reduced by the existence of lower tiers. Just as the Finance Commission has, over the years, and despite its weaknesses, provided a rule-bound institutional mechanism for making transfers to state governments, one can anticipate that state finance commissions will also develop in ways that support local government.

Another aspect of the reforms, the ability of MPs and MLAs to be members of some levels of rural local government, also raises some related concerns. It suggests that local government may still remain a political tool of state or central politicians, rather than being responsive to local constituencies. This, too, may not matter in the long run, if local coalitions can outweigh interests of individual politicians. One has seen this process go through cycles at the level of center and state as well. The current situation certainly seems to involve state level coalitions having the balance of power. What will be crucial in possible bargaining situations is who controls what resources. Again, genuine fiscal decentralization will be vital, as stressed by the Tenth Finance Commission in its report.

Turning to the broader scope of governance, another set of potential problems may be the narrow scope of local government as specified in the amendments. While a long list of local government responsibilities has been created in the new eleventh schedule of the Constitution, law and order are not among them. This issue came up in discussions of the Karnataka reforms of 1983, and the idea of devolving law and order to the district level was mooted, but was completely absent from the constitutional amendments. The discussion there was in terms of the police only, but the same concerns arise with respect to the bureaucracy and the judiciary. Local government cannot mean only increased responsibilities. Adequate financial resources are needed to carry out those responsibilities. To the extent that government provides public goods, and taxes its own constituents to finance that provision to overcome free rider problems, it must have the authority to implement and to enforce. Decentralization of administrative functions without complementary decentralization along other dimensions of governance, particularly enforcement, is less likely to be successful. This includes not just classic law and order, but also tax enforcement and enforcement of contracts.

Earlier, I noted the failure of nyaya panchayats. The lesson from that experience is not that decentralization of judicial processes will not work, but that the existing structures of the judicial components of government must be decentralized with adequate resources provided for its success. The problems of delay and arrears are pervasive at all levels of the Indian judicial system. In the context of the bureaucracy, the incentives of the central and state bureaucrats in their interactions with local government need to be considered more carefully. Clearly, this was not something for constitutional legislation, but it will require the development of new modes

of administrative organization, with locally chosen administrators and managers becoming more important. An important issue must be how the central planning apparatus, whose language still permeates the administrative approach in India, and which provided some of the original motivation for the reform of local government (through the desire to have more effective local implementation of centrally conceived economic plans), will adapt to allow local provision of what ought to be local public goods. One is tempted to suggest, in the light of the direction taken by economic reforms in trade and industry, that the idea of central planning has outlived its usefulness in India, and local governments should not be shackled by its constraints.

So far, in this paper, I have focused exclusively on the structures of government. Yet self-governance and civil society are currently fashionable ideas. If I interpret civil society to be the entire gamut of nongovernmental organizations (NGOs) and collective institutions, I do not see any lack in India. Volunteer organizations, interest groups and social welfare associations are multiplying, alongside and overlapping with traditional occupational and religious groupings. To some extent, these can be substitutes for lack of effective government: in Delhi, middle class neighborhood residents' associations form to finance and carry out the provision of basic local services such as garbage collection, that are supposed to be performed by local government, but are not (or not effectively). One can view this as an improvement over nothing at all. However, it is important to remember that the rationale of government comes from the publicness of public goods, and the suboptimality of voluntary provision due to free rider problems. Voluntary membership in neighborhood associations at rates of 40%, with minimal dues, may be less efficient than more effective taxation and public provision of some services: this may also take advantage of economies of scale and scope.

A counter argument may be that if government is ineffective, self-governance is better. This is the theme of studies of self-governance in areas such as local irrigation institutions. However, even here, it is recognized that such institutions are ultimately feasible only in a system where laws and rules at a broader level are enforced clearly and consistently by government. In a wider perspective, any collective action on a large scale will involve some specialization and delegation of functions. Government is just one aspect of this fact. In a democracy, individuals agree to be ruled by laws made by elected representatives, who are themselves subject to those laws. Voting is only one of several ways that constituent preferences can be articulated. While self-help and voluntary collective action to achieve certain ends are extremely important at the micro level, ultimately, government is the main institution of governance. It must be shaped to serve this role effectively. In this context, one may also note that the relative ineffectiveness in India of specific purpose urban authorities - such as housing boards, water supply boards, and pollution control boards - stems from their lack of incentives and responsiveness, rather than with the concept itself. Effective delegation by local governments of specific tasks may make sense, just as a firm may create subsidiaries or divisions to handle specific products.

The final point in this discussion is the need for accountability of local government to its citizenry. Effective rules or laws are essential whatever the degree of decentralization of government. Therefore, decentralization must be accompanied by more efficient organization of the primary institutions that make, interpret and enforce laws. Of these, the judicial system may be the immediate place to start. Given a smoothly operating and independent judiciary, democracy - which gives constituents the ability to replace their representatives routinely and easily - will be more effective than if it is only a revolving door for opportunism. Accountability requires the law and democracy to work together.

In this framework, the role of NGOs and other nonofficial institutions is twofold. First, any collective group, whether a firm or a volunteer organization, may be engaged in producing something of value, ranging from purely private to purely public goods. For each such institution there are issues of efficient internal organization. These include taking advantage of any economies of scale or scope, having a system of corporate governance, and providing incentives to individual organization members. The second aspect of any such group (and in some cases the primary, or even only role) is its interaction with government in pursuing its goals. This is typically thought of as lobbying. It can be hidden and corrupt, trying to circumvent laws or rules, or it can be open and beneficial, trying to enforce existing laws, or change them to make them better. Political action by consumer or other public groups of the latter form, outside the electoral process is, therefore, an additional means for achieving accountability of government. In this sense, the different forms of collective action are complementary, and reducing the size of constituencies increases responsiveness in this way also, by making it

easier for public interest groups to operate.

There is more that can be said about issues of efficient implementation of services that have traditionally been undertaken by the government. The trend in many countries is towards privatizing as much as possible to gain efficiency of delivery and pricing of local public goods. However, where basic needs and equity remain concerns, this course may be undertaken hesitantly, and with continued regulation. It may be, however, that even regulated competition is better than local government monopoly provision. Just as the central and the state governments, after economic liberalization, have been able to begin turning to the private sector for the provision of some goods and services, such as telecommunications and electricity, local governments, once they are established as credible entities, may be able to contract out local functions, such as sanitation, where benefits are local and user fees can be collected, to private organizations. Again, these kinds of developments are not automatic, but the creation of independent local bodies creates the potential for them to take place, and for decisions about what to contract out to be taken more efficiently.

Conclusion

Reform of local government in India has had a different impetus and history than the changes put in motion by the 1991 balance of payments crisis. However, they are closely connected by the issue of reducing fiscal deficits, and the management of government finances in general. This connection may not be positive. For example, it is now well recognized that the structure of fiscal federalism in India has contributed to the overall problem of government deficits. The states, used to operating with soft budget constraints, have seen their finances deteriorate, and the post-reform squeeze has tended to reduce their spending on social and economic services such as education and health. In this climate, there are real concerns about the fiscal impact of local government reform, that it may accentuate fiscal indiscipline

While there is a danger of increased fiscal deficits as a result of decentralization (something of that nature occurred in Brazil, for example), I think the Indian case offers some positive prospects, for the following reasons. First, the decentralization is down to the local level, unlike the Brazilian case, which gave the states more fiscal autonomy. As noted earlier, smaller constituencies make it easier to impose hard budget constraints. Second, the central Finance Commission has done a relatively good job, within its constraints: greater problems have arisen with more discretionary transfers, including categorical grants and loans. This has, up to now, been the only system operating between the state and local levels. The creation of state finance commissions has the potential to reduce such discretionary transfers from the states to local governments, and to increase the transparency and efficiency of such transfers.

While making intergovernment transfers more efficient will help, raising resources more effectively is crucial. Here also, the broader set of reforms may turn out to be complementary to the reform of local government. One may think of the underlying goal of economic reforms in India as the achievement of a more efficient use of capital, to support higher growth. Relying on smoothly functioning (and well-regulated) financial markets to allocate capital, in this view, is crucial for government as well as for the private sector. Historically, state and local governments have relied on trickle-down funding through the central planning process, which has often not been responsive to the wants of local residents. Since many municipal service projects involve long-lasting capital and equipment, the building up of local capital has been hindered. The creation of urban local governments with independent status, legal authority and regularly elected officials, raises the possibility that local governments may eventually be able to borrow money in the financial markets for local sanitation, roads and schools. For this to work, of course, hard budget constraints must exist: state governments must not too easily bail out municipalities in trouble. Clearly, this development will take time, but it should be noted that the central government has taken the first steps towards market borrowing itself, representing a major break with past practice.

Ultimately, of course, the question is whether decentralization will permit the more efficient use of the funds now to be put in the hands of local governments. Greater responsiveness to constituents as a result of democratic decentralization should certainly help. But it will also require the transfer of existing staff from central and state government to local government, and the reorganization of administration at all levels. This is

among the complementary reforms that still await attention.

Gandhi's vision of village republics was one of voluntary, cooperative poverty. The directions I have highlighted are very different. I have deliberately emphasized the possible complementarities between the strengthening of local government in India and economic reforms that are distinctly un-Gandhian in nature. And yet, while the means may be different, reflecting the economist's cynical (or realistic) view of human nature, as opposed to Gandhi's idealism, the ends are not that different: education for all, clean water, maintenance of order, and respect for the dignity of individuals.