

**INSTITUTIONS, POLITICS AND THE SOFT BUDGET
CONSTRAINT IN A DECENTRALISED ECONOMY: THE CASE
OF INDIA**

by

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Table of Contents

List of Figures and Tables	v
Abstract	vi
Declaration	ix
Acknowledgement	x
1. The Theory of Decentralisation in the Indian context	1
1.1. Introduction	1
1.2. Theoretical Perspectives on Decentralisation	2
1.3. The Basis for Decentralised Governments	7
1.3.1. Expenditure Assignments	10
1.3.2. Revenues	12
1.3.3. Inter-Governmental Transfers	13
1.3.4. Sub-National Borrowing	14
1.4. The Indian Federal System and Institutions	16
1.5. Trends in Indian Federal Finance	21
1.5.1. Expenditure Assignment in the Indian Federal System	21
1.5.2. Revenue Assignment in India	24
1.5.3. Inter-Governmental Transfers in India	26
1.5.4. Debt and Contingent Liabilities of State Governments	27
1.5.5. Human Development Expenditures and Outcomes in States	28
1.6. Factors that Impact Indian State Level Development	30
1.7. Thesis Structure	32
2. The Political Economy of Resources and Development in India	35
2.1. Introduction	35
2.2. Literature Review	41
2.3. The Model	46
2.3.1. Workers	50
2.3.2. Entrepreneurs	51
2.3.3. State Government	51
2.3.4. Model Predictions	53
2.4. Empirical Tests and Results	55
2.4.1. Empirical Tests	56
2.4.2. Results	58
2.5. Resource Curse and Growth	60
2.6. Conclusion	63

3.	Fiscal Federalism in India: Exploring the Budgetary Implications of Political Alignment and Institutional Quality	71
3.1.	Introduction	71
3.2.	Literature Review	74
3.3.	Data and Definitions	79
3.3.1.	Some Preliminaries	79
3.3.2.	Data Description	81
3.3.3.	Indices of Budgetary Management	82
3.3.4.	Political Indices	86
3.3.5.	The Impact of the Central Government (Power)	89
3.4.	Working Models and Hypotheses	90
3.4.1.	Revenue Deficit	90
3.4.2.	Gross Transfers from the Centre	94
3.5.	Results and Analyses	98
3.5.1.	Test Results for Revenue Deficit	99
3.5.2.	Test Results for Gross Transfers from the Centre	101
3.6.	Conclusion	102
4.	Political Competition, Welfare Outcomes and Expenditures on Human Development: The Experience of a Democracy	113
4.1.	Introduction	113
4.2.	Literature Review	117
4.3.	The Model	121
4.4.	Background, Data and Empirical Results	127
4.5.	Conclusion	135
5.	Decentralisation and the Soft Budget Constraint	142
5.1.	Introduction	142
5.2.	Literature Review	145
5.3.	The Model	151
5.3.1.	Features	151
5.3.2.	State Enterprises (PSU)	152
5.3.3.	Non State Enterprises	153
5.3.4.	Government Budget	154
5.3.5.	The Government Objective Function	155
5.3.6.	Determination of Welfare Levels under a Budget Constraint	156
5.3.6.1.	Hard Budget Constraint	157
5.3.6.2.	Soft Budget Constraint	158
5.3.6.3.	Complete Decentralisation	159
5.3.6.4.	Partial Fiscal Centralisation	161
5.3.6.4.1.	Soft Budget Case	161
5.3.6.4.2.	Hard Budget Case	162
5.4.	The Model with Endogenous ‘Effort’	164
5.4.1.	‘Good’ State of the World	166
5.4.2.	‘Bad’ State of the World	169
5.5.	Sources of Soft Budget Constraint and Interpreting the Indian Experience	174

5.6. Conclusion	180
6. Concluding Remarks	183
Appendix A: Appendix to Chapter 2	188
A.1. Comparison of the political equilibrium and the welfare maximising equilibrium	188
A.1.1. Proposition 1a	188
A.1.2. Proposition 1b	189
A.1.3. Proposition 2	189
A.2. Analysing the Resource Curse in the Indian context using Sachs and Warner's (1995) Methodology	191
Appendix B: Appendix to Chapter 5	196
B.1. Solution to the Hard Budget Constraint (General Case)	196
B.2. Solution to the Soft Budget Constraint (General Case)	196
B.3. Solution to the Soft Budget Constraint (Partial Fiscal Centralisation)	197
B.4. Solution to the Hard Budget Constraint (Partial Fiscal Centralisation)	198
B.5. Welfare level comparisons under SBC and HBC in 'good' states of the world	198
B.6. Welfare level comparisons under SBC and HBC in 'bad' states of the world	200
References	202

List of Graphs and Tables

Graphs

Graph 1: Growth and the Resource Curse	38
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Tables

Table 1.1: Indicators of Expenditures of Indian States	22
Table 1.2: Indicators of Revenues of Indian States (Including Central Transfers)	25
Table 1.3: Indicators of Social Sector of Indian States	29
Table 2.1: Descriptive Statistics	67
Table 2.2: 2SLS Estimation of the impact of 'resource curse' (current and initial levels) on SDP levels	68
Table 2.3: 3SLS Estimation of the impact of 'resource curse' (current and initial levels) on SDP levels	69
Table 2.4: 2SLS Estimation of the impact of 'resource curse' through institutions on Economic Growth	70
Table 3.1: Basic Statistics of Selected Indian States	105
Table 3.2: Major Fiscal Indicators (All States)	106
Table 3.3: Data Description	107
Table 3.4: Indices for Budgetary Institutions	108
Table 3.5: Summary of Indices	109
Table 3.6: An OLS Analysis of Determinants of State level Deficits	111
Table 3.7: An OLS Analysis of Determinants of transfers from Centre to State	112
Table 4.1: 2SLS Estimation of developmental outcomes due to Electoral Competition	137
Table 4.2: Source of Data used in the Empirical Exercise	138
Table 4.3: Average Values (1985 – 2000) of the Variables Used in Empirical Analysis	139
Table 4.4: OLS estimates of Factors affecting Developmental Outcomes	140
Table 4.5: 2SLS Estimation of developmental outcomes due to Electoral Competition (Excluding 'Health Professionals')	141
Table T1: OLS Estimation of association between growth (1985-2000) and resource intensity (1985)	194
Table T2: OLS estimation of the impact of resources on Institutions	195

Institutions, Politics and the Soft Budget Constraint in a Decentralized Economy: The case of India

Abstract

This thesis tries to build a set of theoretical and empirical premises of the important issues pertaining to a decentralized government structure. While the questions that we attempt to answer in this thesis are varied, the common theme that runs through the essays is its focus on issues from a regional perspective. Our empirical outcomes are based on the Indian federal system, more specifically, the 15 major states of India, which account for over 90 per cent of the population and 95 per cent of GDP. The period under consideration is 1985 – 2000. We consider this to be a crucial period because a lot of stress in state finances emerged during this period. The research questions we broadly seek to answer are the following:

1. What are the causes of differences in developmental levels across the major Indian states?
2. What is the role of political alignment in determining the budgetary considerations of states?
3. What accounts for differences in human developmental outcomes across the states?
4. In normative terms, can it be argued that a decentralized structure need not automatically lead to the formation of a hard budget constraint? Further, can it be claimed that under certain circumstances, particularly when dealing with State-run natural monopolies, that a soft budget constraint may lead to better outcomes?

The starting point of our analysis or the first essay (Chapter 2) deals with the question as to why have Indian states had different levels of development and growth? The existing literature argues that states, which have followed better policies in terms of macroeconomic probity and identification of developmental issues, have had better

outcomes, which we feel is an inherently circular argument. The existing literature does not answer the basic issue of what prompted certain states to follow better policies? We add to the burgeoning literature on growth in Indian states, by looking at institutional quality. We argue that some states in India have better institutions than others, and these have set better policies. We suggest that the level of political accountability and the quantum of ‘point resources’ such as minerals would have an impact on the quality of institutions. The idea being that a region can be ‘cursed’ with high mineral wealth and having unaccountable politicians. This can lead the politician to try to subvert institutional quality in these regions to facilitate ‘rent seizing’, leading to lower developmental and growth prospects for such states. We try to prove this through a theoretical model as well as an empirical exercise.

The second essay (Chapter 3) is more empirical in its construct and analyses the impact of political affiliations and the quality of fiscal institutions on regional budget constraints. While we do not make any normative judgments here regarding the welfare implications of soft budgets, we argue that the correct political alignment and poor fiscal institutions might combine to lead a state to greater fiscal profligacy. This is because of the inability to have institutional checks on expenditures and due to a higher probability of an *ex post* bailout by the central government, through higher *ad hoc* transfers.

The third essay (Chapter 4) considers not merely ‘budgetary output’ levels such as the quantum of expenditures, in isolation, but looks at the ‘outcomes’ of such expenditures, viz. the impact of expenditure on health on an ‘outcome’ indicator like Infant Mortality Rates (IMR). across the major Indian states. We argue that analyzing the budgetary allocations on any expenditure tells us merely half the story. Since the Indian states are constitutionally required to spend more on human development

expenditures such as health and education as compared to the central government, the correct way to look at 'effective' expenditure would be to analyse the determinants of variation in 'outcome' indicators. We in our essay, consider variations in IMR to be our measure of 'outcomes'. We suggest that political accountability might have a major role in determining human developmental outcome levels through better utilization of expenditures.

Since we argued in the second essay that the potentially harmful impact of poor fiscal institutions and political alignment, is softening of the budget constraint, our final essay (Chapter 5) is a theoretical piece of work, which looks at the micro-foundations of a 'soft budget constraint' and tries to analyse the normative issue of the welfare considerations in this regard. We try to prove two concomitant factors in the federalism and soft budget literature. First, contrary to some of the existing literature, decentralization, need not automatically increase a commitment to the hard budget and second, in normative terms, under certain circumstances, a 'soft budget' is preferable to a 'hard budget'.

Declaration

This work contains no material which has been accepted for the award of any other degree or diploma in any university or other tertiary institution and, to the best of my knowledge and beliefs, contains no material previously published or written by another person, except where due reference has been made in the text.

I give consent to this copy of my thesis, when deposited in the University Library, being available for loan and photocopying.

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Arnab Gupta, 18th October, 2004.

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