The Allocative Effects of Intergovernmental Flows in Less Developed Countries: A Case Study in India -- A Reply

THE ALLOCATIVE EFFECTS OF INTERGOVERNMENTAL FLOWS IN LESS DEVELOPED COUNTRIES: A CASE STUDY OF INDIA – A REPLY

by

ROY W. BAHL AND VELAYUDHAN PILLAI*

Mr. Rao raises three objections to our paper [1]. The first is that our statistical results show a substitutive effect of statutory grants on per capita expenditures, therefore we have improperly concluded that "there is no evidence of a substitutive effect for any grant program or for any expenditure category considered". The second is that we have not properly treated the "fiscal irresponsibility hypothesis". The third is that we have not considered the equity implications of expanding various types of grant programs.

It is true that, in general, federal funds will be "neutral", "stimulative", or "substitutive" depending upon whether they increase state expenditures by an amount equal to, more than, or less than the size of the intergovernmental flow(s) under consideration. Accordingly, the results in our Table 3 show that shared taxes, nonstatutory grants, and total federal funds have stimulative effects on state government expenditures. We reported that there was no significant relationship between statutory grants or loans and any class of expenditures. This does not imply, as Mr. Rao argues, that "the statutory grants or loans are increasingly employed by the States to substitute their own tax revenues rather than increasing their expenditures". The substitution argument would require a finding that the responsiveness of per capita expenditures to per capita statutory grants is significantly less than unity. Since our results show no systematic relationship between statutory grants and spending, our conclusion that there is no evidence of a substitutive effect would seem to hold.

Mr. Rao also objects that the concept of "fiscal irresponsibility" has not been subjected to any systematic analysis or quantification. Since statutory grants were distributed among states on a basis of the size of the deficit in this period, we argued that it is possible that state governments could have tried to increase their grant share by raising the projected deficits by inflating the projected expenditures and/or keeping the tax effort low [1, p. 78]. We discussed only the first possibility because the distribution of grants-in-aid in 1971 was governed by the recommendations of the Fifth Finance Commission, which, for the first time, included tax effort as an additional criterion in the distribution formula [2, p. 66]. Therefore, any "fiscal irresponsibility" resulting from statutory grants-in-aid should have occurred in the form of increased expenditure. Based on this premise we held that an expenditure "stimulation" from statutory grants-in-aid is a necessary condition to prove the "fiscal irresponsibility" hypothesis, and since no such effect was observed we concluded that the hypothesis has no empirical support.

Mr. Rao offers three reasons why expenditure stimulation is not a necessary condition for "fiscal irresponsibility". Unfortunately, his reasoning is flawed in two of the three cases and he offers no support for the third. He notes that if expenditure stimulation is the criterion of fiscal irresponsibility then one would have to infer that nonstatutory grants tend to encourage fiscal irresponsibility since that relationship was found to be stimulative. Our argument of fiscal responsibility clearly applies only to statutory grants [1, p. 78], i.e., it deals only with the case of a grant which is distributed on the basis of the projected size of the deficit. Second, he argues that expenditure stimulation is not solely due to fiscal irresponsibility. We clearly recognized this in developing the model and have attempted to control for other price, income, and taste variables. We argued only that expenditure stimulation was a necessary condition and never that it was sufficient. Third, Mr. Rao argues that states could inflate their proposed expenditure to magnify the proposed budgetary gap but actually continue to spend at lower levels. We would dismiss this argument on grounds that the claims of the state governments are periodically scrutinized by the Finance Commissions, and on an admittedly casual observation of the historically close relationship between the proposed and actual expenditures. Mr. Rao may have a point here, but he has offered no supporting evidence.

We note that if one intention of the Indian Federal Grant Program is to stimulate States to mobilize a greater amount of resources, our finding that only nonstatutory grants show a consistent stimulative effect has important implications because nonstatutory grants constitute less than one fifth of total Government of India aid to the States. Mr. Rao points out that an increase in the nonstatutory grant share would have undesirable equity effects ..."however, an important disadvantage of the nonstatutory grants, in the Indian Federation is that they have tended to be inequitous". The intention in our paper was to deal only with the allocative effects of Indian Grant Programs and we made no attempt to treat the resulting interjurisdictional equity effects.