

Presented at:
**Roundtable on Division of Revenues between the Levels of Government
in Federal Countries and Fiscal Equalization**
Location: Brasilia, Brazil
Date: March 30 & 31, 2005
An event co-organized by the Forum of Federations

India: Fiscal Federalism and Approach to Equalization

D.K. Srivastava

National Institute of Public Finance
and Policy, New Delhi

Published by the Forum of Federations • www.forumfed.org • Publié par le Forum des fédérations

Indian States: Some Basic Features

- 28 States; Number growing with increasing fragmentation
- Heterogeneity in terms of size of population, income (per capita GSDP), area, distance from centers of economic activities, nature of terrain, cost conditions

Table :States Arranged According to Size of Population (2001)

Below 1 crore		In lakh	1 to 5 crore		In lakh
1	Sikkim	5.4	11	Jammu & Kashmir	101.4
2	Mizoram	8.9	12	Chhatisgarh	208.3
3	Arunchal Pradesh	11.0	13	Haryana	211.4
4	Goa	13.5	14	Punjab	243.6
5	Nagaland	19.9	15	Assam	266.6
6	Manipur	21.7	16	Jharkhand	269.5
7	Meghalaya	23.2	17	Kerala	318.4
8	Tripura	32.0	18	Orissa	368.0
9	Himachal Pradesh	60.8			
10	Uttaranchal	84.9			
5 to 8 crore			Above 8 crore		
19	Gujarat	506.7	25	West Bengal	801.8
20	Karnataka	528.5	26	Bihar	830.0
21	Rajasthan	565.1	27	Maharashtra	968.8
22	Madhya Pradesh	603.5	28	Uttar Pradesh	1662.0
23	Tamil Nadu	624.1			
24	Andhra Pradesh	762.1			
Source: Census 2001					

Table 1.2: Comparing States: Basic Size Indicators: Area and Per Capita GSDP					
(Comparable GSDP in nominal terms: average over 1999-00 to 2001-02)					
	Area	Per capita		Area	Per capita
		GSDP(Ave			GSDP(Ave
	('000sq kms.)	Rs.		('000sq kms.)	Rs.
Bihar	94.16	6539.3	Andhra Pradesh	275.05	18869.3
Uttar Pradesh	240.93	10797.7	Tripura	10.49	18974.0
Orissa	155.71	11234.3	Nagaland	16.58	20469.3
Jharkhand	79.71	11717.0	Karnataka	191.79	20703.3
Assam	78.44	12288.0	Sikkim	7.10	20928.7
Madhya Pradesh	308.25	13340.3	Mizoram	21.08	21244.7
Chhatisgarh	135.19	13710.3	Tamil Nadu	130.06	22587.3
Rajasthan	342.24	15058.7	Gujarat	196.02	22708.3
Meghalaya	22.43	16035.0	Kerala	38.86	22824.0
Arunchal Pradesh	83.74	16579.0	Himachal Pradesh	55.67	24762.0
Uttaranchal	53.48	16998.7	Haryana	44.21	26255.7
Manipur	22.33	17263.7	Maharashtra	307.71	26994.3
West Bengal	88.75	17376.7	Punjab	50.36	28030.0
Jammu & Kashmir	222.24	18132.3	Goa	3.70	56589.3
Source (Basic Data): Census and CSO					

Table 1.3: Comparing States: Basic Size Indicators

	Population	Area	Per capita GSDP(Average 1999- 00 to 2001-02)
	2001(lakhs)	('000sq kms.)	Rs.
Maximum	1662.0	342.2	56589.3
Minimum	5.4	3.7	6539.3
Max/Min	307.3	92.5	8.7
	UP/Sikkim	Rajasthan/Goa	Goa/Bihar
Source: CSO and Registrar General			

**Table 2 States with Highest Rural Poverty Ratios
1999-2000 (30-day Recall period)**

General Category States and Assam			
No.	States/U.T.'s	No. of persons	% of persons
		(Lakhs)	
States arranged in descending order of Head-Count ratio			
First six states			
1	Orissa	143.69	48.01
2	Bihar	376.51	44.30
3	Assam	92.17	40.04
4	Madhya Pradesh	217.32	37.06
5	West Bengal	180.11	31.85
6	Uttar Pradesh	412.01	31.22
Total number of poor		1421.81	
Share of first six states in total rural poor(%)			73.6

**Source(Basic Data):Government of India, Press Information Bureau,
Poverty Estimates, Press Releases, Dated March 11, 1997
and February 22, 2001**

**Table 3: States with Highest Urban Poverty Ratios
1999-2000 (30-day Recall period)**

No.	States/U.T.'s	No. of persons	% of persons
		(Lakhs)	
First eight States in descending order of HCR			
1	Orissa	25.40	42.83
2	Madhya Pradesh	81.22	38.44
3	Bihar	49.13	32.91
4	Uttar Pradesh	117.88	30.89
5	Maharashtra	102.87	26.81
6	Andhra Pradesh	60.88	26.63
7	Karnataka	44.49	25.25
8	Tamil Nadu	49.97	22.11
Total number of poor		531.84	
Share of first 8 in total urban poor(%)			79.37

Source(Basic Data):Government of India, Press Information Bureau,
Poverty Estimates, Press Releases, Dated March 11, 1997 and February
22, 2001

Number of Local Bodies in India			
Rural		Urban	
Gram Panchayat	236350	Municipal Corporation	109
Panchayat Samiti	6795	Municipalities	1432
Zila Parishad	531	Nagar Panchayats	2182
Autonomous District Council	9		
	243685		3723

Institutions

- Finance Commission
- Planning Commission
- Inter-State Council
- National Development Council
- State Finance Commissions

Finance Commission

- Constitutionally provided for
- Set up every five years under normal circumstances
- 12 Finance Commissions have given recommendations so far
- Core duties defined constitutionally but additional tasks and ‘considerations’ given in the Presidential terms of reference

Planning Commission

- Created by an administrative order
- A permanent body
- Main task originally envisaged development and planning
- 10 Five Year Plans have so far been prepared: 10th Plan to continue until 2006-07
- The 5-year periods for FC and the Plans remain unsynchronised

Inter-State Council

- Established in 1990 under article 263 of the constitution
- Prime Minister, Chief Ministers of states, Chief Ministers of UTs with legislatures, Administrators of other UTs, Six Ministers of Union Cabinet nominated by the PM, two Ministers of the Union cabinet nominated as permanent invitees

Inter-state council

- Basic mandate: to deal with all centre-state and inter-state matters (administrative, political, judicial, financial)
- Meets infrequently
- Standing committee deals with for continuous consultations and processing of matters

National Development Council

- Apex body for all development related policies and issues
- Prime Minister, Deputy Chairman, Planning Commission, Selected cabinet ministers, all chief ministers
- The body that finally approves the Five year Plans

State Finance Commission

- Provided for in the constitutional amendments (73rd and 74th) dealing with rural and urban local bodies
- Each state has to appoint and give terms of reference once in 5 years
- Two rounds of Such SFCs have been appointed
- Deal with revenue sharing and grants from states to local bodies

Main Issues

- Vertical Imbalance: relative claims of the centre and states
- Horizontal imbalance: increasing disparities
- Gap-filling approach and the alternative of equalization transfers
- Fiscal needs of the special category states
- Multiplicity of channels of transfers

Main Issues (continued)

- The challenge of Information lags
- The challenge of hidden transfers
- Pace and content of decentralization

Vertical Imbalance

- Vertical imbalance by design
- Vertical imbalance is the outcome of revenue centralization and expenditure decentralization
- This is common in all federal arrangements but degrees differ
- Large vertical imbalance is needed when there are large horizontal inequalities

Share of States in Combined Revenue Receipts and Expenditure			
			(per cent)
Average	Revenue Receipts Before and After Transfers		
(FC period)	Before	After	Revenue Expenditures
Seventh (1979-80 to 1983-84)	35.3	61.4	58.0
Eighth (1984-85 to 1988-89)	34.6	62.0	55.7
Ninth (1989-90 to 1994-95)	37.5	64.7	56.9
Tenth (1995-96 to 1999-00)	38.6	63.0	56.8
Eleventh (Avg 2 years: 2000-01 and 2001-02)	39.0	63.9	57.1
Source: Report of the Twelfth Finance Commission, 2005			

**Table 1:Share of Centre and States in Combined
Revenue Receipts Before Transfers**

	Rev rec of the centre	Own rev. rec of the states
First	58.8	41.2
Second	62.9	37.1
Third	66.5	33.5
Fourth	65.1	34.9
Fifth	64.4	35.6
Sixth	66.0	34.0
Seventh	64.9	35.1
Eighth	65.4	34.6
Ninth	62.9	37.1
Tenth	61.6	38.4
Eleventh*	58.2	41.8

Source(Basic Data):Indian Public Finance Statistics

Table 2: Revenue Receipts of Centre and States After Transfers(%)

	Share in Total Rev. Rec.		As % of GDPmp	
	Centre	States	Centre	States
First	43.8	56.2	3.7	4.7
Second	41.6	58.4	4.1	5.8
Third	48.9	51.1	6.1	6.4
Fourth	44.7	55.3	5.5	6.8
Fifth	39.5	60.5	5.1	7.9
Sixth	44.2	55.8	7.1	9.0
Seventh	39.0	61.0	6.6	10.4
Eighth	38.5	61.5	7.1	11.3
Ninth	36.0	64.0	6.5	11.5
Tenth	37.5	62.5	6.3	10.5
Eleventh*	33.9	66.1	5.9	11.5

Source(Basic Data): Indian Public Finance Statistics

* First two years of award period

Transfers as Percentgae of Centre's Gross Revenue Receipts: Different Channels

				(per cent)
Finance Commission Periods	Finance Commission	Planning Commission	Other Non- plan grants	Total
Seventh	24.35	12.11	1.66	38.11
Eighth	22.77	13.56	1.54	37.87
Ninth	24.79	14.48	1.06	40.33
Tenth	24.56	10.57	0.67	35.79
Eleventh(2 yrs.)	25.99	10.39	0.82	37.20

Source (Basic data): Union Finance Accounts and Budget Documents

Finance Commission: Approach to Determining Transfers

- Three main channels of transfers
- Criteria-based sharing of central tax revenues
- General Purpose Grants: Determined on the basis of assessment of needs and resources
- Conditional specific-purpose grants

Finance Commission: Tax Revenue Sharing

- Evolution of criteria
- Population
- Distance
- Inverse income
- Tax effort
- Fiscal discipline
- Area
- Index of Infrastructure

Fiscal Transfers: Constitutional Provisions

- Finance Commission
- Article 280
 - a. Distribution of shareable taxes
 - b. Principles for determination of grants-in-aid
 - c. local bodies: rural, urban: augmentation of the consolidated fund of the state
 - d. Any other matter in the interest of sound finance

Evolution of Revenue Sharing Formulae

- Three Phases
- First Phase up to VII FC separate treatment of income tax and union excise duties
- Second Phase: VIII to X FC: Partial Convergence
- Third Phase XI FC Full Convergence

Role of Grants in Fiscal Transfers

- Assessment of resource gap
- Assessment of expenditures
- Assessment of revenues
- Application of normative approach
- Integrating tax devolution with grants
- Grants other than gap grants
- Local body grants

Determining Grants: Gap-filling Approach

- Adverse incentives since higher the historical levels of expenditures, and lower the historical levels of revenues, the larger the projected gap
- hence, it is in the interest of the states to spend as much as possible and raise as little as possible

Gap-filling approach (continued)

- States cannot create a history of expenditure unless they finance additional expenditure by borrowing: in other words, the presence of a hard budget constraint is critical to minimize the adverse impact of gap-filling

Equalization Approach

- Basic Principle
- Fiscal capacity equalization
- Capacity equalization with allowance for cost differentials

Equalization in Canada

- Provided for in the constitution
- “...principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation”

Equalization in Australia

- CGC: “State governments should receive funding ...such that, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency, each would have the capacity to provide services at the same standard.”

Defining selected criteria

- Let population of states be
- N_1, N_2, \dots, N_n
- Let incomes(per capita GSDP) be
- Y_1, y_2, \dots, y_n
- Let states be arranged in ascending order of per capita GSDP(Bihar first, Goa Last)

Criteria (Continued)

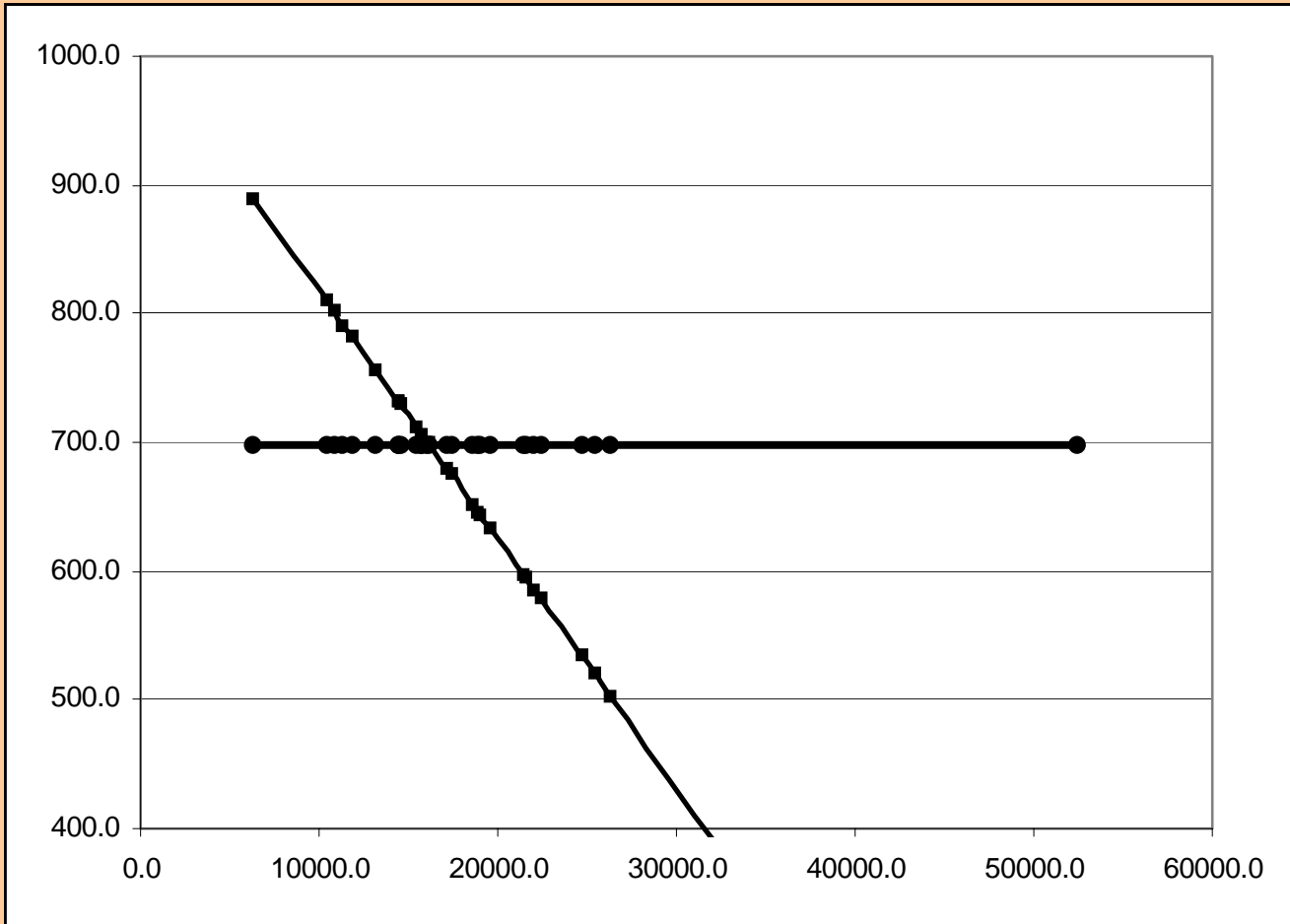
- Population criterion: Share of a state be denoted by q_i
- Then $q_i = N_i / S N_i$
- Per capita share is given by $q^* i = i / S N_i$
- This is a straight line in income-per capita share space

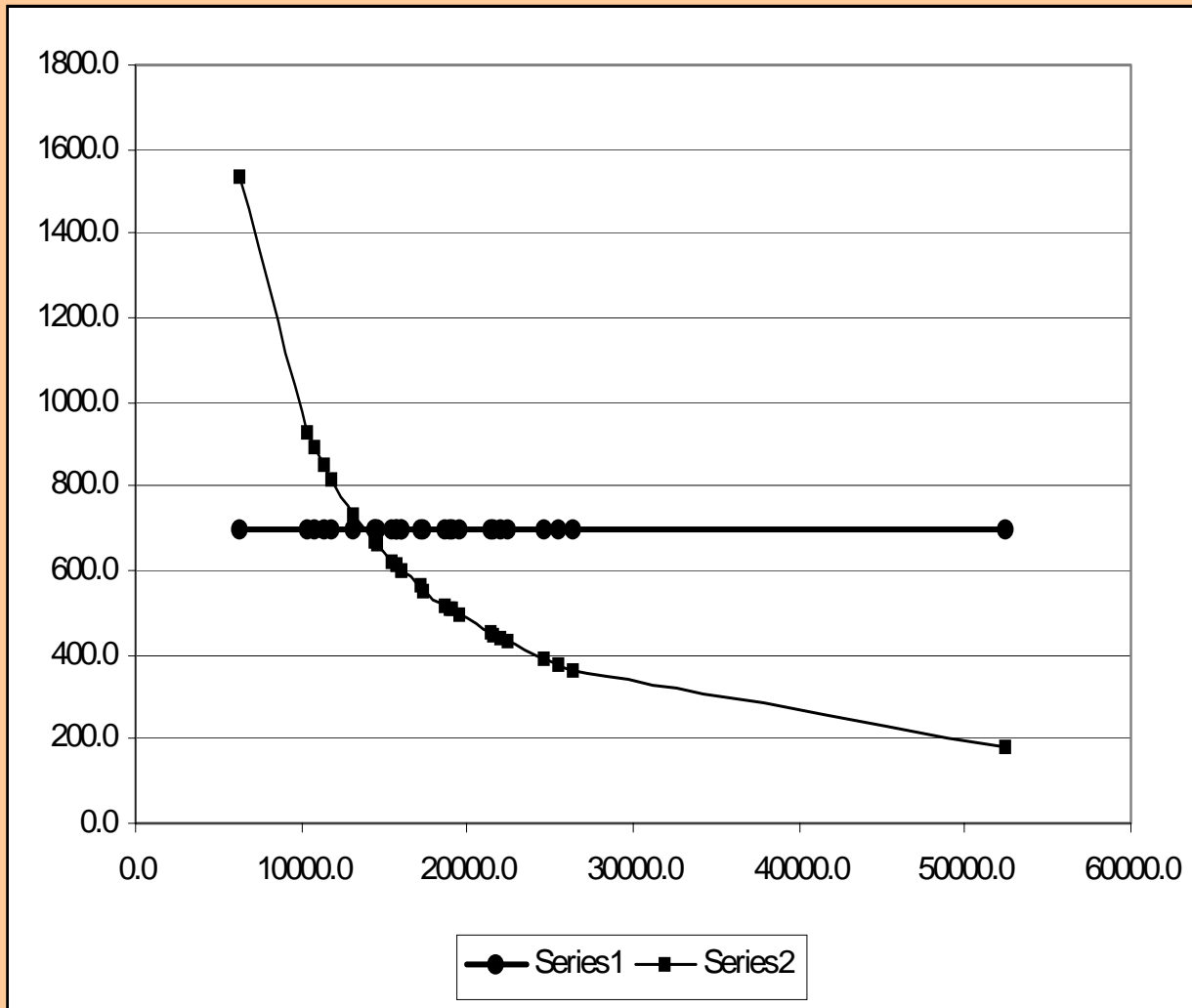
Criteria continued

- Distance criterion
- Let share of a state be a_i
- Then $a_i = N_i(y_n - y_i) / S N_i(y_n - y_i)$
- Per capita share by $a^*i = z y_n - z y_i$, where $z = 1 / S N_i(y_n - y_i)$
- This describes a straight line falling to the right in per capita share-income space

Inverse-income criterion

- Share of a state is given by
- $b_i = N_i \cdot (1/y_i) / [\sum N_i \cdot (1/y_i)]$
- $[\sum N_i \cdot (1/y_i)] = Z$ is constant for all states
- Per capita share of a state can be written as
- $b^*_i = Z/y_i$





Tax Devolution: Factors Determining Inter-se Shares

	Weights	
Factors	EFC	TFC
Population	10	25
Distance	62.5	50
Area	7.5	10
Infrastructure	7.5	0
Tax Effort	5	7.5
Fiscal Discipline	7.5	7.5
	100	100

Shares in Central taxes : Recommended by the EFC and TFC				
	Twelfth	Eleventh	TFC-EFC	
Andhra Pradesh	7.356	7.701	-0.345	
Arunachal Pradesh	0.288	0.244		0.044
Assam	3.235	3.285	-0.05	
Bihar	11.028	11.589	-0.561	
Chattisgarh	2.654	2.385		0.269
Goa	0.259	0.206		0.053
Gujarat	3.569	2.821		0.748
Haryana	1.075	0.944		0.131
Himachal Pradesh	0.522	0.683	-0.161	
Jammu and Kashmir	1.297	1.29		0.007
Jharkhand	3.361	3.008		0.353
Karnataka	4.459	4.93	-0.471	
Kerala	2.665	3.057	-0.392	
Madhya Pradesh	6.711	6.453		0.258
Maharashtra	4.997	4.632		0.365
Manipur	0.362	0.366	-0.004	
Meghalaya	0.371	0.342		0.029
Mizoram	0.239	0.198		0.041
Nagaland	0.263	0.22		0.043
Orissa	5.161	5.056		0.105
Punjab	1.299	1.147		0.152
Rajasthan	5.609	5.473		0.136
Sikkim	0.227	0.184		0.043
Tamil Nadu	5.305	5.385	-0.08	
Tripura	0.428	0.487	-0.059	
Uttar Pradesh	19.264	19.137		0.127
Uttaranchal	0.939	0.661		0.278
West Bengal	7.057	8.116	-1.059	
	100.000	100.000	-3.182	3.182

Year wise Item wise Grants Recommended by TFC						
						(Rs.crore)
	2005-06	2006-07	2007-08	2008-09	2009-10	Total
Revenue Gap	15091.86	11315.21	10922.15	9998.51	9528.14	56855.87
Health	938	1044.71	1163.69	1296.37	1444.31	5887.08
Education	1686.23	1844.51	2017.84	2207.62	2415.45	10171.65
Roads and bridges	0	3750	3750	3750	3750	15000
Buildings	0	1250	1250	1250	1250	5000
Forests	200	200	200	200	200	1000
Heritage conservation	0	156.25	156.25	156.25	156.25	625
State specific needs	0	1775	1775	1775	1775	7100
Local bodies	5000	5000	5000	5000	5000	25000
Calamity relief	3200	3200	3200	3200	3200	16000
Total	26116.09	29535.68	29434.93	28833.75	28719.15	142639.6

Main Recommendations of TFC

- Over all transfers 38 per cent of centre's gross revenue receipts
- Complete overhaul of on-lending; states to borrow directly subject to limits imposed by a loan council
- Consolidation of outstanding loans at 7.5 per cent interest rate

TFC Recommendations (continued)

- FRBMA requirements for centre and states
- Outlook for reducing fiscal deficit and revenue deficit and improving sustained growth prospects
- New grants for maintenance of roads and bridges, government buildings, forests

TFC Recommendations (continued)

- Raising the share of states to 30.5 per cent
- Raising the share of grants in devolution
- Special equalizing grant for health and education
- CSSs to be devolved to the states
- Monitoring mechanism for all conditional grants

Challenges to Equalization

- Multiple Channels and Interface with Finance Commission
- Issues of Information Lag
- Disparities and Extent of Required Redistribution
- Claims of Special category states

Links between plan assistance and Finance Commission transfers

- Interest payments
- Committed liabilities of salary payments
- Committed liabilities of maintenance
- Plan Size and the case for borrowing to finance plan expenditures

Distribution of Plan Assistance

• States	Grants	Loans	Total
• Special	27	3	30
• General	21	49	70
• Total	48	52	100

Criteria		Modified Gadgil Formula (1980)	NDC Revised Formula (1990)	NDC Revised Formula (1991)
A.	Special Category States (10)	30% share of 10 States excluding North Eastern Council	30% share of 10 States including North Eastern Council	30% share of 10 States excluding North Eastern Council
B.	Non-Special Category States (15)			
	(i) Population (1971)	60.0	55.0	60.0
	(ii) Per Capita Income	20.0	25.0	25.0
	<i>Of which</i>			
	a. According to the 'deviation' method covering only the states with per capita income below the national average	20.0	20.0	20.0
	b. According to the 'distance' method covering all the fifteen states	-	5.0	5.0
	(iii) Performance	10.0	5.0	7.5
	<i>of which</i>			
	a. Tax effort	10.0	-	2.5
	b. Fiscal management	-	5.0	2.5
	c. National objectives	-	-	2.5
	d. Special problems	10.0	15.0	7.5
	Total	100.0	100.0	100.0

Reforming the Fiscal transfer System: The Way Forward

- Re-look at the Role of Planning
- Abolishing Plan-non-Plan distinctions in expenditure
- Focusing Governments' attention on public and merit goods
- Hard-budget constraint on centre and states through fiscal responsibility legislations

Reforming the Fiscal Transfer System: The Way Forward(continued)

- Controlling Revenue and Fiscal Deficit
- Effective Decentralization
- Encouraging migration to urban areas
- Norm-based equalization Approach to transfers
- Redesigning centrally sponsored schemes