SPECIAL SECTION

Sharing the pie

How public planning and finance work in India

The states and the central government co-operate on a wide range of programs.

BY *TAPAS K. SEN*

Photo: REUTERS/Punit Parnjpe

Economic planning has been crucial for India since the early 1950s. Prime Minister Manmohan Singh (right), Chair of India's Planning Commission, joins Finance Minister P. Chidambaram at an Asia Development Bank meeting in Hyderabad in May 2006.

Three institutions play important roles in shaping how the system of fiscal federalism in India works in practice, given the constitutional distribution of powers and responsibilities.

The high-level Apex Finance Commission (AFC) and the State Finance Commissions (SFCs) are the agencies constitutionally entrusted with the role of supervising the system and periodically modifying the structure or the parameters as needed.

The third institution, the Planning Commission, despite losing some of its powers, continues to play a key role because of the grants it recommends; its stamp of approval on states' planning projects also allows the states to obtain loan financing for them more easily than would otherwise be the case. The third group includes the line ministries and the Ministry of Finance of the Government of India.

Transfer payments to the states

Significant transfers are made to states from the central government with regard to central plan schemes, and centrally-sponsored schemes, which are designed by the central authority and implemented by the states.

By convention, the AFC confines itself to the current account (exports minus imports, in goods and services) in general, and major public investments are left to the consideration of the Planning Commission. The usual methodology of the AFC is to project current receipts and current expenditures on the **non-plan** account for each state using a mix of normative and actual-based estimates.

This yields the surplus or deficit, without transfers, for each state. Simultaneously, it decides on the share of the total tax revenue of the central government (this used to be restricted to two taxes – personal income tax and excise duty) that can be passed on to the states, and then works out a formula for the distribution of the total states' share among individual states. For each of the states with deficits prior to transfers, such deficits are reduced by the amount of estimated tax transfers, and the remaining deficits are awarded to each of the states as grants-in-aid.

Apart from this basic exercise, the AFC also:

- awards some compensatory grants,
- awards grants for specific purposes at its discretion,
- advises on fiscal mechanisms for calamity relief and
- advises on necessary measures with regard to state indebtedness to the central authority.

Occasionally, other specific issues of central government-state fiscal relations are also referred to it for its opinion.

The Five Year Plans

Since 1951, the central government of India has set out Five Year Plans for the growth of the economy in specific sectors. The Planning Commission's basic mandate is to advise the states and the central government on the formulation and implementation of their Five Year Plans, and to approve these Plans. In the process, it also acts as a channel for central assistance to states for Plan purposes. Such assistance is largely formula-based, with a small amount of discretion available to the Planning Commission. However, it has an indirect role in certain other transfers from the central government to the states.

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Photo: Press Trust of India

Montek Singh Ahluwalia (right), Deputy Chairman of India's Planning Commission, is greeted by Virbhadra Singh, Chief Minister of the state of Himchal Pradesh.

Central Plan Schemes (fully centrally funded) and Centrally Sponsored Schemes (usually partly centrally funded) are also approved by the Planning Commission and administered by the concerned line departments of the central government. Some of the former and all of the latter programs are actually implemented by the states. While all expenses related to implementation of central plan schemes are payable to the implementing states, there is usually a matching grant system with respect to centrally sponsored schemes. There are at least two areas in which the latter have come to dominate – the poverty alleviation and employment generation programs and primary education.

Apart from the role of line ministries with respect to the central plan schemes and the centrally sponsored schemes, individual line ministries often have major interactions with the states, which get woven into the fabric of fiscal federalism in India. For example, the ministries of petroleum and mining play a key role in the division of public resources generated from these two sectors. The states are entitled to royalties, the rates of which are determined by the central government.

Making oil and gas royalties obsolete

However, recent changes in the system of exploration and exploitation of petroleum and mining fields have started the process of making royalties obsolete. This issue was studied by the AFC, which recommended sharing with the states the profit share that would flow to the central government as a result of the changes in the system. Similarly, the central Ministry of Food and Agriculture has a key role to play in the allocation of a large amount of food subsidies (actually a combination of subsidies to consumers, producers and the public sector).

As mentioned above, State Finance Commissions (SFCs) are the second type of agency constitutionally entrusted with the role of supervising the fiscal system. The SFC mechanism could be a powerful lever in improving state-local fiscal relations in India; however, the SFC has not yet made its presence felt.

The Ministry of Finance is a key institution in the practice of fiscal federalism in India because it has the responsibility for implementing all the recommended transfers and ensuring the actual flow of resources to the states. Besides, the finance ministry is often left with the job of filling in the details of recommendations made while implementing them; this, in fact, provides it with some discretion. A recent example illustrates this well. Following recommendations to pass on international assistance to states at the same terms and conditions as originally granted, the centre agreed to do so.

Foreign currency loans

But in the case of foreign currency loans, a mechanism was needed to take care of the exchange risk. It fell upon the Finance ministry to work out alternative ways to cover such risk, inform the states about the alternatives and persuade them to choose one. Its role in fostering discussion and debates on important issues, and its leadership role, are also crucial to the healthy functioning of the federal system, as was evident in the long drawn-out case of the introduction of VAT at the state level.

Another recent development needs mention as an illustration of the changing contours of fiscal federalism in India. After a long period of administered interest rates, they have been more market-oriented since the 1990s. Initially, this raised interest rates for everyone, and the states' interest burden shot up to unprecedented levels, creating serious fiscal problems. The central government came to the rescue by introducing a debt-swap program, whereby costly debt was replaced by cheaper debt. By the time this program wound up, interest rates had come down.

The lower level of interest rates made debt from the central government expensive in comparison. As the largest amount of debt owed by the states was to the central government, a reduction in interest liabilities was possible by substituting states' debt to the central government by states' market borrowings. This was achieved by discontinuing the practice of providing a part of the plan assistance to the states in the form of loans. Only the grant portion was transferred and the loan portion was substituted by market borrowings. For states that had problems raising loans from the market, the central government offered its assistance.

This overview of the practice of fiscal federalism in India is meant to highlight some of its more positive aspects. In a rapidly changing world, and even national background, comparatively fixed provisions, as found in the Constitution, need to be supplemented by a system that is responsive to changing needs. Basic changes can, of course, be achieved only through modifications in the Constitutional provisions; one illustration of this is provided by the 73rd and 74th amendments to the Constitution, according formal recognition to rural and urban local bodies.

But the institutions responsible for implementing the system at ground level have to be ready to adjust the system within their competencies to be in tune with the surrounding reality. The flexibility exhibited by the system of fiscal federalism in India bodes well for its future. The other positive aspect has been the willingness of the parties concerned to play according to the rules of the game. The best example of this is provided by the fact that neither the central government nor the states have ever seriously challenged the awards of the AFC, an absolute must for an effective arbitration process, as the Finance Commissions are, after all, arbitrators between the grantor and the grantee governments.