Fiscal Federalism in India: Emerging Challenges

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The system of intergovernmental fiscal arrangements in India has served it well for over 50 years. It has achieved a significant equalization of services, instituted a workable system of resolving the outstanding issues between the national government – called the "Centre" in India – and the states, adjusted to changing requirements, and thus has contributed to achieving a degree of cohesiveness in a large and diverse country. While reflection brings up several areas in need of reform, the most enduring point is that such reform is eminently possible.

The tax powers and expenditure responsibilities of the Centre and states are specified in the Constitution in terms of Centre, state, and concurrent lists. With the amendment to the Constitution in 1992, the local governments in rural and urban areas too have been accorded constitutional recognition. Besides ensuring law and order, the states have a predominant role in the provision of social services such as education, health, housing, and family welfare. They have an equal role with the Centre in the provision of economic services. In particular, their roles in agricultural development, irrigation, industrial promotion, and transport infrastructure are important. At the same time, most broad-based and progressive tax powers are assigned to the Centre. The important central taxes are customs, excise duties on manufactured goods, personal income tax, and corporate income tax. The states also have a few tax bases assigned to them, but from the viewpoint of revenues, the power to levy retail sales tax is the most important. The states can borrow from the central government. They can also borrow from the market, but if a state is indebted to the central government, continued borrowing must be approved by the Centre.

Indian fiscal federalism is marked by high degree of vertical and horizontal fiscal imbalance. In 2003-04, the state governments collected nearly 39 percent of total revenues, but their share in expenditures was 57 percent. Over 55 percent of states' total expenditures were financed from central transfers and borrowed funds. On the horizontal imbalance front, the most disadvantaged are the 11 small, mountainous states which are classified as "special category" states with very little production activity or capacity to raise revenues from the sources assigned to them. But even the remaining 17 "general category" states have significant differences in size, revenue raising capacities, efforts, expenditure levels, and fiscal dependence. The average annual per capita income for 1999-2002 in the highest income state of Goa (Rs. 56,599) was 8.7 times that of the lowest per capita income state of Bihar (Rs. 6,539). **The Constitution recognizes that the states' tax powers are inadequate to meet their expenditure needs and therefore provides for the sharing of central tax revenues.**

A notable feature of transfers in India is the existence of multiple channels with which to transfer funds. One such channel, the Planning Commission, set up by a Resolution of the Government of India in March 1950, provides assistance by way of grants and loans to the states to meet their plan requirements. Until 1969, the plan assistance to states was given for specific ventures and the degree of assistance, as well as grant-loan components, was decided on the basis of the nature of the venture chosen. Since 1969, however, the plan assistance to the states is given by way of both grants and loans on the basis of a formula approved by the National Development Council (NDC). The NDC is chaired by the Prime Minister and is composed of cabinet ministers, members of Planning Commission, and Chief Ministers of the states. The grants given by the Planning Commission constitute between 16 and 20 percent of the total central transfers.

The Constitution requires the President of India to appoint a Finance Commission every five years to review the finances of the Centre and the states and recommend both devolution of taxes and grant-in-aid for the ensuing five years. When the aforementioned Planning Commission joined the Finance Commission in giving grants, the scope of the Finance Commission became confined to recommending transfers to meet non-plan requirements of the states. To date, 12 Finance Commissions have been constituted and have submitted their reports. Presently, Finance Commission transfers constitute about 60 percent of the total transfers and those by the Planning Commission constitute about 20 percent. In addition to the above two channels, various central ministries give specific-purpose transfers to states with or without matching requirements. There are over 200 such ventures, though from a financial viewpoint only a few are important.

The transfer system is beset with many problems. Multiple transfer channels sometimes work at cross purposes, creating serious problems of focusing the transfers on fiscally disadvantaged states. The methodology adopted by the Finance Commission transfers – that of filling the gaps between projected revenues and expenditures – has not only created serious disincentives, but also results in inequity. The system does not attempt significant equalization, as projections of expenditures for poorer states are made from a low base. As the projected gaps are filled through transfers, disincentives are created for tax effort and expenditure economy. The distinction made between plan and non-plan transfers also has segmented the budget with adverse consequences on fiscal management. Furthermore, the proliferation of specific purpose transfers has led to inefficiency in expenditure management. These problems have significantly politicized the transfer system

The intergovernmental policies and institutions in India evolved in the context of a public sector dominated, heavy industry based industrialization that was implicit in the planned development strategy. With economic liberalization and the opening up of the economy, significant changes in fiscal federalism have become imperative. Replacing public enterprise revenues with taxes, compensating revenue loss from customs, and evolving a destination-based, value-added tax are some of the challenges. Given the increasingly globalized economy, the state governments are required to be efficient in their predominant role of providing social services and their equal role of providing physical infrastructure. In addition, the fiscal system has to deal with the issue of ensuring fiscal discipline at subnational orders to arrest the deteriorating situation of higher state deficits and debt accumulation. The emergence of a coalition government at the Centre and at the state order has led to competitive populism, or adopting policies popular with voters while disregarding the fiscal consequences. Regional parties in power at the state order, in becoming pivotal members of the central coalition, have led to several asymmetric arrangements. These factors have all had an adverse impact on fiscal management.