India – An Overview of Fiscal Arrangements

by Roger Wilkins

India consists of 28 states and seven "Union Territories". Of these seven territories, two have their own elected legislatures (Delhi and Pondicherry) while the remaining five are governed directly by appointees of the centre. The national parliament consists of an upper and lower house. The States likewise have two elected legislatures, with Chief Ministers in the executive role. The States are assigned certain statutory powers, although devolution of power to both the States and local government bodies is quite weak. At various local levels, there are a quarter of a million recently formed directly elected government bodies. In urban areas, there are two tiers of local government: *panchayats* and municipalities. In rural areas, there are three tiers of local government: the village, block and district. The three tiers of government have 2.5 million directly elected representatives, one-third of whom are women. The presidentially-appointed Justices of the Indian Supreme Court have the right to rule on the constitutionality of laws passed by Parliament.

The functions and powers assigned to the States and central government are set out in the Indian Constitution. Central government's functions include those required to maintain macroeconomic stability, international trade and relations, and interstate affairs, such as money supply and external borrowing, defense, atomic energy, and transport and water infrastructure. The States' functions include public order, public health and welfare, agriculture, irrigation, land rights, fisheries and industries and "minor" minerals. They also have a significant role in education, transport, social security and social insurance.

Taxation

Assignment of tax powers in India is based on the principle of separation, meaning that tax categories are the exclusive province of the States or central government. Most broad-based taxes are collected by the Centre, including (non-agricultural) income tax, corporate tax, production taxes and customs duty. The largest revenue raising taxes assigned to the States are sales and purchase taxes on goods, but they also draw revenue from land tax, agricultural income and wealth taxes, stamp duties and registration fees, alcohol excises and motor vehicle and transport taxes. Local governments raise very little of their own revenue (3% of total revenues), and are largely dependent on transfers from the State governments.

The current system has led to tax avoidance with respect to personal income tax, and complicated, cascading and opaque taxes on the sale and purchase of goods. It has also resulted in a substantial vertical fiscal imbalance.

In 1997-8, the States on average raised about 31% of their total revenues from their own-source taxes, but incurred 57% of total expenditures. The balance was provided by statutory and discretionary transfers from the Centre. There has been a slow decline in the ability of the States to finance their current expenditures from own-source taxes, from 69% in 1955-56 to around 55% in the 1990s. Over the same period, there has been an increase in the discretionary element of transfers, while the proportion of tax devolution within statutory transfers has steadily increased and that of grants has decreased.

The major component of tax transfers to the States has traditionally been personal income tax. Until recently, the States received 87.5% of such tax revenues, whereas they received no share of income tax surcharges. Within the last few years, it has been agreed between the two tiers of government to allocate a proportion of overall central tax revenues to the States.

Equalization

The Constitution provides for the assignment of revenues, sharing of the proceeds of certain centrally-levied taxes with the States, and making grants to the States from the Consolidated Fund of India. It also provides for the compulsory sharing of the net revenue from non-corporate income tax, and optional sharing of the proceeds of Union excise duty. The allocation of shares of these taxes between the Centre and the States is determined by the Finance Commission appointed by the President of India every five years (or earlier if required). The Finance Commission is also responsible for recommending grants to the States in need of assistance.

The Planning Commission is responsible for making grants and loans for the implementation of development plans. These are five-year plans for each sector of the economy and each state. The distribution of funds by the Planning Commission is based on a consensus formula decided by the National Development Council. The Council's members are all of the central government Cabinet Ministers, Chief Ministers of the States and members of the Planning Commission. It is chaired by the Prime Minister.

Various ministries provide grants to their counterparts in the States for specific projects that are either wholly funded by the Centre (central sector projects) or jointly funded by the States and Centre (centrally sponsored schemes). The role of the States in central sector projects is solely one of implementation. Centrally sponsored projects are either inter-state in scope, or are aimed at achieving national outcomes, such as poverty alleviation or family planning. Over 100 specific purpose payments, with or without matching requirements, are provided by the various central ministries and monitored by the Planning Commission. These payments constitute between 15-20% of total transfers and are wholly discretionary.

It is generally recognised that the current system is too complex, and lacks transparency, focus and any clear articulation of its overall objectives. It is not adequately dealing with interstate inequalities, and provides insufficient incentives to the States to improve efficiency or fiscal prudence. While some reforms of the transfer system have been made in recent years, there is considerable scope for further improvement.

Sources

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