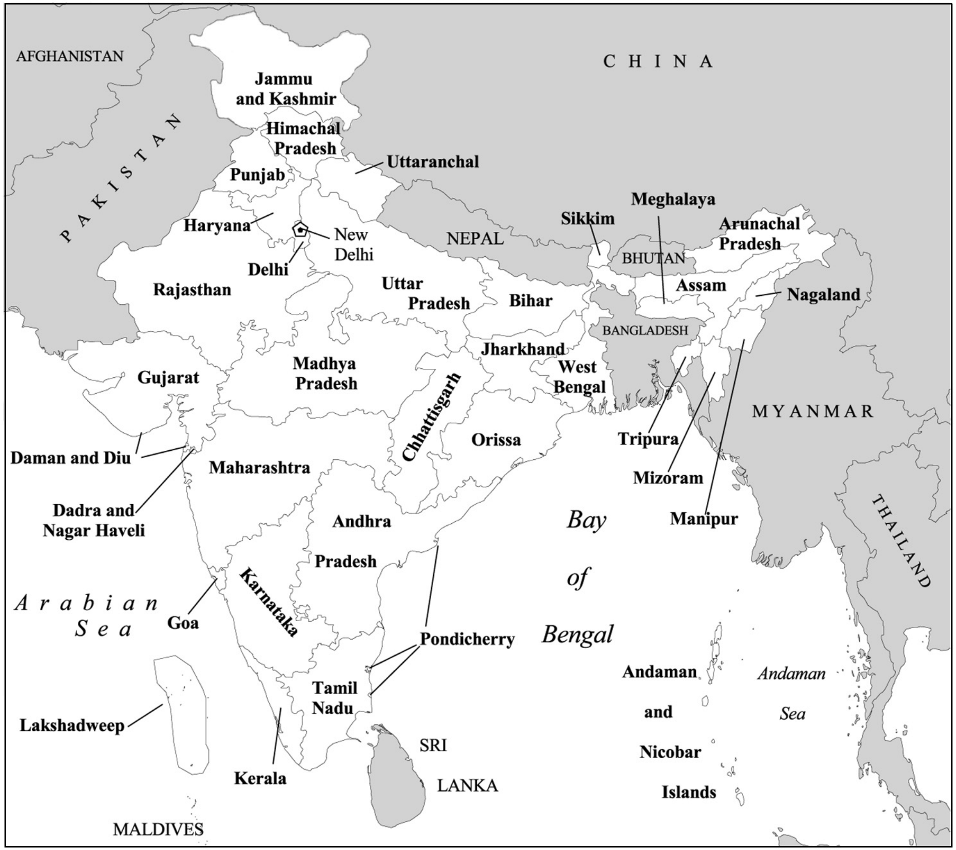
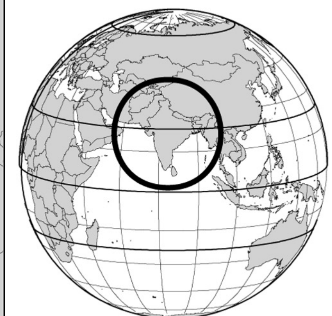
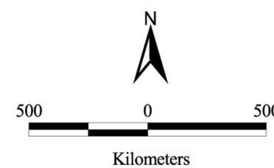


India

Capital: New Delhi
Population: 1 Billion
(2002)

Boundaries and place names are representative only and do not imply any official endorsement.





Sources: Times Atlas of the World; ESRI Ltd.; CIA World Factbook

Republic of India

M. GOVINDA RAO

This chapter deals with the evolution and working of Indian fiscal federalism.[1] Many observers characterize India as a "quasi federal" country due to its heavy centripetal bias.[2] The political environment at the time of Independence and the adoption of a public-sector strategy dominated by planned development led to the creation of a multilevel fiscal system with a high degree of centralization. The adoption of market-oriented reforms in 1991 brought out the contradictions between the functioning of markets and the centralized fiscal system. It also underlined the difficulties of subnational governments financing the basic social services and physical infrastructure assigned to them. The growing inequalities in the provision of public services in a market-based environment, leading to sharply widening regional disparities, have also necessitated reforms in intergovernmental transfer systems.

Indian fiscal federalism faces formidable challenges due to economic liberalization and globalization. Creating a competitive environment by providing efficient infrastructure is a major challenge, especially in light of the severe fiscal stress faced by the states. The problem is particularly severe for poorer states. Finding appropriate substitutes for declining customs revenue, reforming the tax systems to enhance revenue productivity while minimizing distortions, and ensuring a common market in the country are important challenges. Designing the transfer system to arrest sharply increasing inequalities in service standards also needs to be addressed sooner rather than later. The emergence of coalition governments at the centre and regional parties in the states, the latter becoming pivotal members of the coalition, and the declining time horizon of political parties and politicians also present serious issues for the functioning of Indian fiscal federalism.

EVOLUTION OF INDIAN FEDERALISM

The Constitution describes India as a "Union of States" and a "Sovereign, Secular, Socialist, Democratic Republic" established to secure justice, liberty, and equality. It is the largest democratic federal republic, inhabited by more than a billion people over an area of 3.29 million square kilometres. Although India attained Independence in 1947, the Constitution was adopted in 1950. The country evolved as a two-tier federation during the first forty years of Independence. In 1992, with Amendments 73 and 74 to the Constitution, the third tier of government – urban and rural local bodies – was given constitutional status.

India is a developing country that, in 2003, had an average per capita income of US$2,890 in purchasing power parity. It ranks 127 among the 177 countries listed in the *Human Development Report 2005* and is nine places lower in per capita GDP (PPP) rank. However, since 1991–92, with economic liberalization, the economy has been growing at 5.5 percent as compared with the 3.5 percent seen in the previous three decades. During 2003–06, India's economy has registered a growth rate of about 8 percent.

An important feature of the Indian economy is its marked diversity. Peoples of several races and religions and speaking 114 languages, eighteen of which are included in the schedule, coexist peacefully with a strong bond of history and culture. Hindi is the official language, but as people in large parts of southern and eastern India do not speak this language, English continues to be a major language. State legislatures may adopt additional languages for official business. The country is predominantly rural, according to the 2001 census, 72 percent of the population live in rural areas.

The country has a three-tier federal structure with governments at the central, regional, and local levels. At the regional level there are twenty-eight states and seven centrally administered territories – two of which have legislatures. Below the state governments, in urban areas there are 96 municipal corporations, 1,494 municipalities, and 2,092 smaller municipalities (called *Nagar Panchayats*). There are 247,033 rural local bodies, of which 515 are at the district level, 5,930 at the block level, and 240,588 at the village level.

There are wide variations in size and economic structure among the states. In 2002, Uttar Pradesh, at 172 million population, was the largest state, and Sikkim, with 0.6 million, was the smallest. The average per capita gross state domestic product (GSDP) for 1999–2002, at Rs 56,599, was the highest in Goa, a small state on the western coast. It was lowest in Bihar, at Rs 6,531, the second largest state in the Gangetic plains in northern India. Due to their small size, low economic base, and strategic location, the eleven small, mountainous states are categorized as "special-category states."

India is a parliamentary democracy with a bicameral legislature. The Seventh Schedule to the Constitution divides legislative, executive, and judicial functions in terms of Union,[3] state, and concurrent lists. The members of Parliament at the centre and the legislatures in the states are directly elected. The upper house of the Parliament – *Rajya Sabha* – is the Council of States, and the members are elected through the electoral

Table 1
Geographical and demographic information

	Variable	*Value*
1	Official name	India
2	Population (2004–05)-millions	1090
3	Area 1000 sq. km	3287
4	GDP per capita (US$) 2003	2892 (PPP) / Rs. 23222 (NNP) or US$540 Rs. 28636 (GDP) or US$666 (Exchange rate 1 US$ = Rs.43)
5	Constitution: Year and form	1950, Parliamentary democracy, republic
6	Orders of government	Union; State; Local: Urban – municipal Local: Rural – Panchayats (at district, block, and village levels)
7	Constitutional status of local government	Independent, constitutional, recognized local governments after the 73rd and 74th amendment in 1992
8	Official languages	National languages: Hindi and English Official regional languages: 18
9	Number and types of constituent units	28 States; 3682 urban local governments 247,033 rural local governments, of which 515 are at district level, 5,930 at block level, and 240,588 at village level.
10	Population, area, and per capita GDP in US$ of largest unit	Uttar Pradesh Population: 166 million 241,000 sq. km. 10,817 rupees or US$252 Exchange rate: US$1 = Rs. 45.
11	Population, area, and per capita GDP of smallest unit	Sikkim Population: 54,0000 7,000 sq. km. 21,586 rupees or US$502
12	Per capita GSDP (highest)	Goa 55,000 rupees or US$1,279
13	Per capita GSDP (LOWEST)	Bihar 5780 rupees or US$134

college from each of the states. The Constitution also requires the president of India to appoint a finance commission every five years to review the finances of the centre and the states and to recommend devolution of divisible central taxes and grants to be given to the states for the ensuing five years.

Historical factors have played an important role in the adoption of a centralized federal Constitution in India. There was considerable demand for decentralization at the time of Independence. However, the country needed to hold together in the wake of Muslim majority areas' breaking away to form a new country (Pakistan), and the fissiparous tendency on the part of a number of small principalities contributed to the adoption of a highly centralized and yet federal Constitution. The centralization inherent in the constitutional assignments was strengthened with the adoption of a planned development strategy.

Recent economic and political events, however, have paved the way for a greater degree of decentralization. In the economic sphere, market-based reforms and the more open economic environment have necessitated a greater degree of fiscal decentralization. On the political front, factors such as the end of one-party rule, the emergence of coalition governments at the centre, and the increasing importance of regional parties in the political affairs of the country have resulted in greater decentralization. Furthermore, the amendment of the Constitution in 1992 to give constitutional status to local bodies below the state level has furthered the process.

The first twenty-five years after Independence, the Congress Party, which was at the forefront of the Independence movement, dominated the political architecture of both central and state governments. Leaders of undisputed stature and their commitment to the development and concerns of the people created a dominant one-party rule at both levels. Although this had several positive features, an important consequence was that formal systems of bargaining and conflict resolution did not develop to the desired extent.

The political architecture of the country has undergone four important changes, with significant implications for fiscal federalism. The first is the replacement of the dominance of one-party rule with coalition governments at the centre and in some states. Second, the emergence of regional parties in power in many of the states has led to the focus on a state-centric policy agenda and greater interstate frictions. Third, even as the regional parties dominate the political landscape in some states, their strategic alliance as pivotal members of the coalition at the centre has led to asymmetric arrangements in the functioning of fiscal federalism. Finally, the declining time horizon of political parties and politicians has led to the adoption of populist policies for short-term political gains – "competitive populism" – to the detriment of the medium- and longer-term developmental agenda.

THE STRUCTURE OF GOVERNMENT AND THE DIVISION OF FISCAL POWERS

The Seventh Schedule to the Constitution specifies the legislative, executive, and fiscal domains of the Union and state governments in terms of Union, state, and concurrent lists. There are 97 items in the Union list, 67 items under the state list, and 47 items under the concurrent list. The residual powers are assigned to the centre. The assignment of tax powers follows the principle of separation: they are assigned either to the Union or to the state governments.

In 1992, after the seventy-third and seventy-fourth constitutional amendments, separate schedules (eleventh and twelfth) were created, with twenty-nine items for rural and eighteen items for urban local bodies. The state legislatures are required to devolve functions listed in the schedules to rural and urban local bodies at their discretion. Each of the state governments has devolved powers to levy certain taxes and fees to the local bodies. The states have also instituted a system of sharing their revenues and giving grants to urban and rural local bodies. In addition, a number of central schemes are implemented by the local bodies, and the funds earmarked for this purpose are passed on to them either directly or through the state governments.

The functions required for maintaining macroeconomic stability, international relations, and activities having significant scale economies and, with spillovers, spanning multiple states are assigned exclusively to the centre. Thus, the Union list includes defence, external relations, international trade and commerce, national highways, post and telecommunications, broadcasting, railways and air travel, space, atomic energy, interstate matters, and external borrowing. The functions assigned to the state governments include maintenance of law and order, agriculture, animal husbandry, fisheries, irrigation, urban development, health, water supply and sanitation, intrastate trade, and local self-government. The concurrent subjects include education, health care, the environment (including forestry), electricity, economic and social planning, and all residual matters not included in either the Union or the state lists.

In terms of expenditure implementation, the central government defrays spending on defence; provision and regulation of large infrastructure such as railways, postal service, and telecommunications; and space and atomic energy research. The states have a high share of expenditures on internal security; social and economic services, such as agriculture, animal husbandry, forestry, fisheries, irrigation, and power; and public works. The states' share in expenditure on administrative services is about 68 percent; on social services, 83 percent; and on economic services, about two-thirds. Their role in providing education, public health, and family welfare is close to 90 percent.

Table 2
Indicative legislative responsibility and actual provision of services by different orders of government

Legislative responsibility (de jure)	*Public service*	*Actual allocation of function (de facto)*
Union	International trade and commerce	Union
Union	Major minerals	Union
Union	Banking, insurance, and currency	Union
Union	Railways	Union
Union	Postal service	Union
Union	Census	Union
Union	Defence and foreign affairs	Union
Union	Shipping and offshore exploration	Union
Union	Airways	Union
Union		Union
Union	Patents, copyrights	Union
Union	Citizenship	Union
Union	Interstate trade and commerce	Union
Union	Interstate rivers	Union
Union	Banking	Union
Union	Emigration	Union
Union and states	Criminal law and procedures	Union and states
Union and states	Civil procedure	Union and states
Union and states	Marriage and divorce	Union and states
Union and states	Bankruptcy and insolvency	Union and states
Union and states	Education	Union and states
Union and states	Healthcare	Union and states
Union and states	Contracts	Union and states
Union and states	Environment and forests	Union and states
Union and states	Economic and social planning	Union and states

Table 2
Indicative legislative responsibility and actual provision of services by different orders of government (*Continued*)

Legislative responsibility (de jure)	*Public service*	*Actual allocation of function (de facto)*
Union and states	Social security and insurance	Union and states
Union and states	Charities and charitable institutions	Union and states
Union and states	Electricity	Union and states
State	Police and public order	State
State	Administration of justice	State
State	Prisons, reformatories etc.	State
State	Public health and sanitation	State and local
State	Agriculture and animal husbandry	State and local
State	Water	States and local
State	Forests	State and local
State	Fisheries	State and local
State	Minor minerals	State
State	Administration of justice, jails, and police	State
State	Civil and property rights	State
State	Public lands and natural resources	State and local
State	Local body institutions (municipal institutions in urban areas and Panchayati Raj Institutions in rural areas)	State and local
State	Water supply and sanitation	State and local
State	Incorporation of companies	State
State	Local services	Local
State	Education	State and local
State	Social welfare	State and local

Table 3
Shares of different levels of government in total expenditures*

Item of expenditure	*Centre (%)*	*States (%)*	*Total (%)*	*Percentage of total expenditure*
A. Interest payment	53.8	46.2	100	22.7
B. Defence	100	0.0	100	8.0
C. Administrative service	51.6	48.4	100	29.0
D. Social and community cervices	17.3	82.7	100	20.0
i. Education	13.0	87.0	100	10.8
ii. Medical and health	11.2	88.8	100	4.2
iii. Family welfare	20.9	79.1	100	0.6
iv. Others	33.3	66.7	100	4.4
E. Economic services	42.6	57.4	100	23.2
i. Agri. and allied services	38.8	61.2	100	6.6
ii. Industry and minerals	77.9	22.1	100	2.4
iii. Power, irri. flood control	12.6	87.4	100	6.1
iv. Tpt. and communication	47.4	52.6	100	4.4
v. Others	69.5	30.5	100	3.8
F. Others	41.7	58.3	100	5.2
G. Loans and advances	2.1	97.9	100	2.0
Total	42.6	57.4	100	100.0

* There are no reliable estimates of expenditures at local levels. The available information shows that local government expenditure in 2002–03 constitutes less than 10 percent of the total expenditures, or about 2 percent of GDP.

The centralization inherent in the assignments is seen in several ways. The residual powers not listed in the schedule are assigned to the centre. It has overriding powers on items listed in the concurrent list. The centre can change the boundaries of the states or carve out new states from the existing ones (Article 2). In fact, over the years the 14 states and 6 Union territories (in 1947) increased to 28 states and 7 Union territories. The centre can dismiss a state government and impose the president's rule if, in the opinion of the governor of the state, it cannot carry on in accordance with the provisions of the Constitution. The public sector dominated planning strategy, adopted in the initial years of Independence, and central control over major financial institutions have further centralized the functioning of the economic system.

Article 301 stipulates that, "Subject to the other provisions of this part, trade, commerce and intercourse throughout the territory of India shall be free," although Parliament may impose restrictions on this freedom in the "public interest." Thus, the centre is empowered to levy a tax on the interstate sale and purchase of goods. The central government has authorized the states to levy an interstate sales tax subject to a ceiling rate (4 percent), and this is a major impediment to interstate trade. It is proposed that, under the recently initiated value-added tax (VAT) reform, this tax will be abolished to evolve a destination-based VAT. It is to be hoped that this reform will ensure a customs union in the country.

FISCAL FEDERALISM AND MACROECONOMIC MANAGEMENT

Macroeconomic management of the economy belongs primarily to the central government, and external borrowing is entirely a central prerogative. The states can borrow domestically, but if they are indebted to the central government, the latter's permission is required. All states are indebted to the central government; as part of the central plan, assistance is given as a loan. This has meant that, each year, states' borrowings are determined by the Union Finance Ministry in consultation with the Planning Commission and the Reserve Bank of India.

There has been steady deterioration in both central and state finances since the latter half of 1990s. Stagnant revenues on the one hand, and increasing expenditures on account of pay revision, subsidies, and interest payments on the other, have resulted in bulging current budgetary deficits and fiscal deficits, with the latter contributing to an increase in the debt burden. The aggregate public debt in the country steadily increased from 63.7 percent in 1991 to 82 percent in 2004–05. In its review of central and state finances, the Twelfth Finance Commission (TFC) recommended a fiscal restructuring plan that entailed passing legislation to eliminate current deficits by 2008–09 from about 5 percent in 2003–04. It also mandated that the aggregate fiscal deficit of the centre and states should be brought down from 8 percent in 2004–05 to 6 percent in 2008–09. The centre has passed the Fiscal Responsibility and Budget Management Act (FRBMA), and most of the states have also passed fiscal responsibility acts (FRAS).

ASSIGNMENT OF REVENUES

Responsibility for most broad-based and progressive tax handles has been assigned to the centre. The centre also has residual tax powers. Responsibility for some taxes has been assigned to the states as well, but from the viewpoint of revenue productivity, only the sales tax is important. The states collect revenue from excise taxes on alcoholic products, stamps and registration, and taxes on motor vehicles and road transportation.

Table 4
Tax assignment to various orders of Government*

	Determination of			Share in revenue (%)		
Federal	*Base*	*Rate*	*Collection and administration*	*Federal*	*State*	*All orders*
Personal income tax (non-agricultural)	Union	Union	Union	6.5	2.7	100
Corporation income tax	Union	Union	Union	7.8	3.3	100
Union excise duties	Union	Union	Union	18.5	7.8	100
Customs	Union	Union	Union	7.9	3.3	100
Taxes on services	Union	Union	Union	0.87	0.4	100
Total central				41.6	17.4	100
Fees, fines, and charges						
State or Provincial					–	
Tax and land and agricultural incomes	State	State	State		0.6	100
Stamp duties and registration fees	State	State	State		3.3	100
Sales tax	State	State	State		21.5	100
State excise duties	State	State	State		4.8	100
Taxes on transport	State	State	State		3.1	100
Electricity duty					1.3	100
Entertainment tax	State	State	State		0.2	100
Others	State	State	State		1.5	100
Fees, fines and charges					2.0	100
Total					41.0	100
*Local**						
Property tax	Provincial	Local	Provincial	n	n	100
User fees on water supply	Local	Local	Local			

* There are no reliable estimates of revenue collected by local governments. The available estimates show that the revenue collected from local governments is not significant. In 2002–03, it constituted about 3 percent of total revenue, or about 0.6 percent of GDP.

On the basis of the principle of separation, tax powers are assigned exclusively either to the centre or to the states. However, exclusivity is only in the legal sense, and this has given rise to anomalous situations. Thus, the centre can levy taxes on production (excise duties), but states can levy taxes on the sale of goods. Similarly, taxes on agricultural income and wealth are in the states' domain, whereas the tax on non-agricultural income is a central prerogative. The states find that taxing agricultural income is not politically feasible. In the event, this has provided an easy means to evade and avoid the personal income tax.

The assignment of taxes on production to the centre and sales tax power to the states has led to the uncoordinated evolution of domestic trade taxes in Indian fiscal federalism. Thus, there is a parallel and uncoordinated domestic trade tax system: the centre levies taxes on production of all manufactured items and the states levy sales taxes. Reform at the central level has transformed manufacturing excise taxes into a VAT on goods at the manufacturing stage. Reform at the state level started only in 2005–06, and cascading sales taxes are being converted into a VAT. This reform will take another few years to complete in order to deal with the complications of interstate transactions. The Union finance minister, in the budget speech for 2006–07, has stated that the country will switch to a coordinated goods and services tax in 2009–10.

The Constitution also recognizes that the states' tax powers are inadequate to meet their expenditure needs; it therefore provides for the sharing of revenues from central taxes. Until 1999–2000, the Constitution provided only for the sharing of personal income tax and Union excise duties; thereafter, all central taxes were included in the divisible pool. In addition to tax devolution, the Constitution provides for grants to aid the states (Article 275). Both tax devolution and grants have to be determined by the Finance Commission (Article 280).

FISCAL IMBALANCES: TRENDS AND ISSUES

Vertical Fiscal Imbalance in India

The constitutional assignment and developments over the years have caused a high degree of vertical fiscal imbalance. The state governments in 2002–03 collected only 41 percent of total current revenues, but their share in total current expenditure was 57 percent. From the revenue sources assigned to them, they could finance only 54 percent of their current expenditures. In other words, the states depend on central transfers to finance about 46 percent of their current expenditures.

Notably, even as the states' revenues have grown faster than have those of the centre, their fiscal dependence on the latter has increased. Although the states' share in raising revenues has increased since the mid-1980s, their expenditure share has increased at an even faster rate. Thus, the states' share in total expenditures increased from 52 percent in 1990–91 to 57.5 percent in 2002–03. However, this does not signify an increase in decentralization because much of the increase was in specific-purpose transfers for which the states functioned merely as implementing agencies of the centre.

Table 5
Vertical fiscal gaps in 2002–03

	Total revenue collected (in million rupees)	*Total revenue available, including net transfers for that level of government (in current US$ million, 2005)*	*Expenditures (in current US$ million, 2005)*
National	2,602,080	1,894,782	2,997,842
Subnational			
State/provincial	1,540,040	2,247,338	4,051,943
Local	Na	Na	
All orders	4,142,120	4,145,120	7,049,785

1USD = Rs. 40 (approximate)

Horizontal Fiscal Imbalance

There are seventeen relatively homogenous general-category states, but even these have wide differences in size, revenue-raising capacities and efforts, expenditure levels, and fiscal dependence on the centre. In addition, in terms of economic characteristics, the eleven mountainous states in the north and northeast differ markedly from the rest and, therefore, are designated as "special-category" states. Of the twenty-eight, three states have recently been carved out of three large states.[4]

Analysis of the fiscal indicators of the states brings out important features. First, there are wide interstate variations in revenues in both per capita terms and as a ratio of gross state domestic product. Second, these variations indicate differences in revenue capacity as well as differences in effort. Third, the tax-GSDP ratios in the special-category states are lower in the general-category states, even when their per capita GSDP is higher. This is because, in these states, there is not much economic activity other than that derived from the government. Fourth, although the revenue bases in the special-category states are low, their average per capita current expenditure in 2002–03 was much higher (Rs 5,605) than not only the all-state average (Rs 3,509) but also the average of high-income states (Rs 4,380). Fifth, in the case of general-category states, the fiscal dependence on the centre is high and varies inversely with per capita income. The per capita total (Rs 4,380) as well as development (Rs 2,705) expenditures in above-average per capita GSDP states were higher than were those of the below average-income states (at Rs 1,511 and Rs 2,577) by

45 percent and 42 percent, respectively. Thus, large differences in per capita expenditures have persisted despite equalization.

Interstate disparities in India, even among the general-category states, are not only high but are also increasing. In 1980–81, the per capita GSDP of the richest state, Punjab (Rs 2,674), was about 2.9 times that of the poorest, Bihar (Rs 919). During 1999–2002, the difference increased to 4.3 times with the per capita GSDPs of the richest and poorest states, at Rs 28,039 and Rs 6,539, respectively. Furthermore, per capita income levels tended to diverge sharply after market-based reforms were initiated. An important reason for this has to be found in the inability of the transfer system to offset the fiscal disabilities of poorer states.

INTERGOVERNMENTAL TRANSFERS: EQUITY AND INCENTIVES

Intergovernmental Transfers in India

A notable feature of India's transfer system is the existence of multiple channels. First, there are statutory transfers comprised of tax devolution and grants made on the recommendation of the Finance Commission. Second, the Planning Commission gives plan assistance comprised of grants and loans. However, since 2005–06, only grants are given and the loan component has been discontinued. In addition, various central ministries give specific-purpose transfers for various central schemes with or without matching requirements.

The trends in the relative shares of the three channels of central transfers to states since the fourth five-year plan bring out some interesting features. First, the share of statutory transfers in the total increased to 67 percent during the Fifth Plan but declined thereafter to 62 percent during the Eighth Plan (1992–97). In 2003–04, it was about 59 percent. Second, the proportion of formula-based transfers given by the Finance Commission and the Planning Commission has declined and that of discretionary transfers has increased in recent years. Third, within the Finance Commission transfers, the proportion of tax devolution has been predominant.

Finance Commission transfers Under Article 280 of the Constitution, the president of India appoints the Finance Commission every five years or earlier as deemed necessary. The commission is required to make recommendations on the following:

1 The distribution between the Union and the states of the net proceeds of shareable taxes and the allocation between the states

2 The principles that should govern the grants in aid of revenues of the states out of the consolidated fund of India and the amount to be paid to the states in need of assistance
3 The measures needed to augment the consolidated fund of a state to supplement the resources of rural and urban local governments in the state on the basis of recommendations made by the state finance commissions
4 Any other matter referred to the commission in the interest of sound finance.

With the emergence of the Planning Commission as a dispenser of assistance to meet plan requirements, the scope of the Finance Commission has been confined to meeting the non-plan current expenditure requirements of the states. The approach of the finance commissions to determining transfers consists of (1) assessing the overall budgetary requirements of the centre and states to determine the volume of resources that can be transferred during the period of their recommendation; (2) forecasting the states' own current revenues and non-plan current expenditures; (3) determining the states' shares in central tax revenues and distributing them among the states based on a formula; and (4) filling the post-devolution projected gaps between non-plan current expenditures and revenues with the grants in aid. This is known as the "gap-filling" approach. The latest Finance Commission (twelfth) has made recommendations for the five years beginning April 2005.

Until 1999–2000, proceeds from only two central taxes – the personal income tax and the Union excise duty – were shared with the states. The eightieth constitutional amendment replaced selective sharing with sharing of aggregate revenue from all central taxes. Thus, the Twelfth Finance Commission (TFC) (2005) has recommended the distribution of 30.5 percent of net proceeds of central taxes to be distributed according to the following approach.

Over the years, successive commissions have attempted to improve the degree of equalization in the tax devolution scheme by assigning higher weight to per capita GSDP. Yet population has continued to receive the largest implicit and explicit weight, although the last commission significantly reduced the explicit weight for this factor. Equally important are the unreliability of the tax effort and the index of fiscal discipline. In a tax system that is predominantly origin-based there can be significant interstate tax exportation, and the tax effort indicator ignores this phenomenon. Besides, there are a number of other factors in addition to per capita GSDP that determine the taxable capacity of a state. Equalization has been further blunted by the fact that the parliamentary resolution requires the commissions to use the 1971 population figures in the transfer formula whenever it is used for interstate distribution to provide an incentive for population control.

The approach outlined above has been subjected to some important criticisms. First, none of the finance commissions assessed the overall resource position and requirements of the centre on any objective basis. Second, the transfers made by the finance commissions were not designed specifically to offset the fiscal disadvantages of the states arising from their lower revenue-raising capacity and the higher unit cost of public services. While the tax devolution is determined on the basis of general economic indicators, grants are given on the basis of projected post-devolution budgetary gaps. The introduction of a backwardness factor in tax devolution has had the effect of equalization, but the transfer system is not specifically targeted to fiscally disadvantaged states. Finally, it is argued that the gap-filling methodology has led to both inequity and disincentives for fiscal management in the states.

The critical element in the finance commissions' methodology is the projections. These are calculated by taking the base year actual collections (or their estimates) of own-source revenues and the non-plan revenue expenditures of the states, standardizing them, and projecting them using normative growth rates determined according to the fiscal restructuring plan. The gap thus estimated between projected revenue receipts and non-plan expenditures was first filled by the tax devolution, and the remaining gap was filled by grants.

This gap-filling methodology has been criticized on two grounds. First, in taking the base-year expenditures, the methodology did not take note of the differences in the existing levels of services. The effect of the "tyranny of the base year" was to perpetuate the existing interstate differences in expenditures. The low-income states with a low resource base (even after the transfers) and, hence, low expenditures could not get transfers commensurate with their fiscal disability. In other words, the relevant base should have been fiscal capacity and expenditure needs, not actual revenues and non-plan revenue expenditures. Therefore, it is argued that the methodology has failed to offset the fiscal disabilities of poorer states.

The second important criticism concerns perverse incentives. The methodology is characterized as "fiscal dentistry." It is argued that the finance commissions' practice of filling projected budgetary cavities has adverse incentives for tax effort and expenditure economy. In fact, to a large extent, deterioration in state finances is attributed to the gap-filling approach followed by the finance commissions.

The criticism of the gap-filling approach has led to modifying the terms of reference of the Ninth Finance Commission so that it follows a "normative approach." The commission estimated cost functions in order to measure the expenditure needs of the states. However, the subsequent commissions thought that this approach was too difficult to adopt and continued with the gap-filling approach. The TFC has tried to impart incentives to some extent by linking debt write-off to states that have shown reductions in their revenue deficits. The equity element built into the tax-devolution formula, the assessment of revenues and expenditures, and upgraded grants for education and health care are supposed to take care of equity, although these factors may not entirely offset the fiscal disabilities of low-income states.

Plan transfers The assistance given by the Planning Commission is comprised of both grants and loans. In earlier years, both the volume and the loan-grant component were project-based; however, since 1969, the assistance has been allocated on the basis of a formula devised and occasionally modified by the National Development Council (NDC). The prime minister presides over the NDC, while central cabinet ministers, the deputy chairman and members of the Planning Commission, and the chief ministers of the states are represented on it. At present, 30 percent of the funds are kept apart for the special-category states and are distributed among them on the basis of plan projects, which it is up to them to formulate. Until 2004–05, assistance to these states was given in the form of 90 percent grants and 10 percent loans. The 70 percent of the funds available to the general-category states is distributed with 60 percent weight assigned to population, 25 percent to per capita GSDP, 7.5 percent to fiscal management, and the remaining 7.5 percent to special problems. In the case of these states, until 2004–05, the grant component of the assistance was 30 percent and the remainder was given as loans. However, the TFC recommended the discontinuation of central loans to states, and, from 2005 to 2007, central assistance for plans consisted only of grants, and the states were required to raise the balance of resources from the market.

Assistance to the central schemes The third component of transfers – assistance to the central schemes – is given for specified purposes with or without matching provisions. There are more than two hundred schemes at present, even after a number of schemes were consolidated in 2005–06. These transfers have attracted the sharpest criticism due to their discretionary nature and the conditionality attached to them. They accounted for about 40 percent of total plan assistance and for about 14 percent of total current transfers in 2000–01.

Equalizing Effect of Intergovernmental Transfers

Analysis of intergovernmental transfers shows a fair degree of interstate redistribution. Transfers vary inversely with the level of per capita state domestic product (SDP). The progressivity of the transfer system is mainly due to the equalizing element in Finance Commission transfers. The elasticity of Finance Commission transfers with respect to GSDP is –0.796. In contrast, equalization in the grants for state plan schemes and centrally sponsored schemes is not significant. Thus, while the transfer system as a whole has an equalizing impact, it does not fully offset the shortfall in fiscal capacity and cost disabilities.

Fiscal Transfers from State to Local Governments

Fiscal transfers to local governments in urban and rural areas are comprised of (1) the grants recommended by the Central Finance Commission, which are given to states and passed on to local bodies; (2) state government grants to local bodies based on the recommendation of the state finance commissions; (3) grants for implementing some of the centrally sponsored schemes received either through the state governments or directly from the central government; and (4) funds that state departments give to the local bodies for implementing state schemes.

Each state is required to appoint the State Finance Commission (SFC) every five years to make recommendations on the transfers to be made to urban and rural local bodies. However, the experience of decentralization, which has been undergone by various states, does not bring much cheer. The states are reluctant to devolve revenue and expenditure powers. Some have devolved functions, functionaries, and finances, but the functions have been encapsulated in terms of schemes, and local bodies do not have flexibility or autonomy in expenditure implementation. Despite transferring the employees to local governments, the former are not accountable to the latter. Some states have yet to constitute SFCs; in some, SFCs are yet to submit reports; and in some of those in which reports have been submitted, the state governments have not accepted the recommendations. Furthermore, local bodies have very little enforcement capacity through which to raise revenues.

The volume of transfers is inadequate mainly because the states themselves have been facing a severe financial crunch, and there is a general reluctance to pass on functions as well as funds. The distribution is not conducted in any systematic, scientific manner. Often it is conducted on a lump-sum basis to local bodies at the village level irrespective of their capacity or need. In fact, after the state government has deducted the cost of electricity at the source, very little is available to local bodies for actual spending.

Rural local bodies collect hardly any revenues. The only important rural tax is the property tax, but its enforcement is so poor that very little revenue is actually collected. Of course, these generalizations are simplistic, and there are states where local bodies play more active roles than what has been portrayed here, but they are the exception rather than the rule.

Thus, despite creating an enabling environment more than fourteen years ago, fiscal decentralization below the state level has not brought much joy. Several reasons may be given for this. Forcing decentralization from a centralized situation cannot be carried out according to the implementable rules. It cannot be carried out de novo; rather, it has to be calibrated from the existing situation in a democratic polity. And that can only happen gradually. In the Indian case, employees cannot simply be transferred to implement the schemes. Then there are problems of capacity building at the local level, and the issue of elite capture is also important. All these factors need to be resolved. The issue of local government finance itself deserves a separate chapter.

FINANCING INFRASTRUCTURE AT THE STATE LEVEL: LOANS

For the states, borrowing is an important source of infrastructure financing. Until 1987–88, government savings on the part of the states contributed to financing capital expenditures. Since then, however, with increasing negative savings borrowing is used to finance not only capital expenditures but also a significant part of current state expenditures. In 1998–99, for example, only one-half of the states' borrowing was used to finance capital expenditure.

The states' liabilities consist of central government loans, market borrowings, a share of small savings collections, and provident funds and deposit accounts. Outstanding loans from the central government constitute 60 percent of the states' liabilities. These loans used to be given mainly for financing the plans. However, since 2005–06, on the recommendation of the TFC, the central government has ceased giving plan loans to states, and the latter are required to gain access to market loans.

Commercial banks are required to maintain 35 percent of their lendable resources in stipulated assets, and subscriptions to state government bonds constitute a part of the statutory liquidity ratio (SLR) requirement. Thus, the investible resources of the banking system are preempted for government consumption and investment. Interest rates on government bonds had been significantly below market rates; however, financial-sector reforms initiated since 1991 have gradually aligned interest rates on government bonds with market rates.

IMPORTANT CHALLENGES TO INDIAN FISCAL FEDERALISM

Indian fiscal federalism is faced with a number of important challenges. Some of these arise from inherent shortcomings in policies and institutions; others arise from the changing economic and political environment.[5] Any forward-looking reform agenda has to not only recognize the basic shortcomings in the system but also to examine and identify the challenges that are faced in the emerging political and economic situations. This section summarizes the various challenges confronting Indian fiscal federalism.

Deterioration in State Finances

As mentioned above, some of the challenges faced in Indian fiscal federalism arise from the inherent shortcomings of the system. One such problem arises from the steady deterioration in the fiscal health of the states. This has macroeconomic implications as the aggregate revenue deficits of the states during 2000–03 averaged more than 3 percent of GSDP, and aggregate fiscal deficits were estimated at more than 5 percent of GSDP. In addition, there are deficits in public enterprise accounts, and power-sector deficits alone amount to about 1.4 percent of GSDP. The severity of fiscal stress can have microeconomic implications as well. It can severely affect efficiency in resource allocation by under-providing for the creation and maintenance of physical infrastructure and social development.

Increasing fiscal imbalances in state budgets have been a matter of concern. Every finance commission subsequent to the ninth has been asked to draw up a fiscal restructuring plan to phase out the deficits, to create surpluses in the revenue account, and to contain the fiscal deficits. In fact, the TFC was asked to draw up a restructuring plan "by which the governments, collectively and severally, may bring about restructuring of public finances restoring budgetary balance, achieving macro-economic stability and debt reduction along with equitable growth" (Report of the Twelfth Finance Commission, p. 2). While the focus of all these attempts has been to reduce the deficits, fiscal stress manifests itself in different ways, depending on the response to the situations. This includes, besides reduction in deficits, compression in spending on basic public services.

Even considering deficit measures to infer the severity of fiscal imbalances in states, from the viewpoint of policy intervention, it is important to analyze revenue and fiscal deficits in individual states. Analysis shows three main factors. First, in varying magnitudes, there has been a sharp deterioration in fiscal deficits in every single state. Second, there has been a marked deterioration not only in the quantity of deficits but also in their quality. During 2000–03, current budgetary deficits accounted for almost two-thirds of the states' fiscal deficit, whereas in 1993–96, they accounted for less than one-fourth. Third, curiously, there is no association between the per capita income levels of the states and the severity of their fiscal problems as measured by revenue and fiscal deficits. Contrary to the general impression, the revenue and fiscal deficits are not higher in poorer states.

Thus, there is no significant correlation between revenue and fiscal deficits, on the one hand, and per capita GSDP, on the other. The poor fiscal performance in the two poorest states, Bihar and Uttar Pradesh, was not seen in terms of high deficits but, rather, in terms of low levels of spending on social and economic services. While the middle- and high-income states could finance higher expenditures by borrowing from avenues available to them, including borrowing from public enterprises and creating special-purpose vehicles to borrow additional resources, the poorer states simply compressed their expenditures.

Increasing Inequalities in States

In the aftermath of economic reforms following the crisis in 1991, there has been a significant acceleration in the economic growth of the country; however, at the same time, there has been a significant increase in interstate inequalities. The correlation coefficient between the level of per capita incomes and their growth rates was 0.331 during 1991–2004. Economic liberalization and the opening up of the economy during the 1990s seem to have benefited the states with a stronger manufacturing base and better access to markets than they have those that are predominantly agricultural.

Another interesting feature of the pattern of growth is that the relative positions of the lowest and highest per capita income states have not changed. Bihar continues to be the lowest per capita income state, and Punjab has continued to hold the top spot among the non-special-category states (excluding the small state of Goa). The index of per capita NSDP (all India: 100), which was 60 in Bihar in 1980–81, declined to 35 in 2000–01, whereas the index in Punjab increased from 171 to 263 during the same period.

Transition from Plan to Market

Another set of challenges arises from the transition from plan to market. Market-based reform entails applying the market principles of resource allocation. These call for reforms in federal fiscal policies and institutions.[6]

Centralized planning involves controls on prices and outputs, which cause regional redistribution of resources in unintended ways. Besides, planning also involves allocation of resources according to plan priorities. As the economy is liberalized and resources are allocated according to market principles, such implicit transfers and distortions will be minimized. Nevertheless, the production structure and the stock of capital created by past investments will continue to affect resource allocations.

Restrictions on the free movement of goods and factors create resource distortions as well. In the past, these restrictions were a part of the centralized planning regime and partly the result of supply management in a scarcity hit economy. Ensuring a nationwide common market is an important objective. In India, violations of common market principles have also arisen from the physical barriers erected to administer taxes on the interstate sale of goods. The interstate sales tax is a tax on exports from one state to another. In addition, urban local bodies in some states are allowed to levy *Octroi* – a tax on the import of goods into the local area for consumption, use, or sale – so that resources get distorted in unintended ways. The consequence of all this is to segment the economy into several tariff zones.

Globalization and Fiscal Federalism

Closely related to the above is the challenge arising from globalization. Liberalization of international trade and the flow of international capital entail a number of important initiatives that adversely affect states' fiscal systems. Given the predominance of states in providing social services and their co-equal role in providing physical infrastructure, providing efficient infrastructure to ensure competitiveness for domestic manufacturers requires large investments. In the given environment, this is feasible only when the private sector is effectively involved. Enabling private-sector functioning in strategic areas requires significant changes not only in policies but also in setting up the edifice of the regulatory system.

Another aspect of the opening up of the economy is the loss of revenue from customs. This is a challenge faced all over the world, and, although not entirely adequate, the VAT has often been employed to substitute revenue loss from reducing import duties. In the Indian context, however, the power to levy VAT rests with the states. Not surprisingly, liberalization of imports and reduction in the customs tariff since 1991 resulted in the loss of revenue by more than 2 percentage points of GDP in 2001–02 compared with 1991–92. Further liberalization of imports will cause a further decline in the ratio. Given the need to provide efficient infrastructure, improving the revenue productivity of the domestic tax system in order to replace revenue loss from customs remains an important challenge.

Globalization brings with it greater international mobility of capital and skilled labour, and the challenges of taxing them can be daunting. The problems of transfer pricing and difficulties in taxing e-commerce are only two examples of this. The recent initiative of creating several special economic zones results in providing several tax shelters and further segmenting the economy. As it is, the tax system in India suffers from a narrow base, with several exemptions and tax preferences. Tax administration will have to gear up to meet greater complexities in taxing mobile capital and labour.

Challenges to Fiscal Federalism from the Changing Political Environment

The most important challenge to Indian fiscal federalism comes from the changing political environment. The one-party rule at the centre and in the states for over one-quarter of a century after Independence did not help to evolve the rules and conventions in conflicting situations. With the polarization of political parties and competitive relationships between the centre and many of the states, both vertical and horizontal conflicting relationships have emerged. The resolution of these conflicts will continue to be a major challenge in the years to come.

Another important political development is the emergence of coalition governments at the centre and regional parties in the states. The coalition of disparate parties with differing ideologies makes it difficult to forge consensus on major policy issues. When regional parties become "pivotal" members of the coalition, they tend to extract various concessions – political and economic – and this can result in a discretionary rather than in a rule-based intergovernmental system. The asymmetric treatment of various states could have long-term implications for the stability of Indian federalism.

The discussion on the political environment is not complete without referring to the declining time horizon of political parties and politicians. In the last parliamentary elections, only 32 percent of the candidates were re-elected. With a low probability of getting re-elected, the political parties prefer to pursue policies with short-term electoral gains over long-term developmental requirements. This has adverse effects on reforms in policies and institutions.

REFORMING FEDERAL FISCAL ARRANGEMENTS IN INDIA: THE WAY FORWARD

The preceding analysis brings out the important features of federal fiscal arrangements in India and highlights a number of shortcomings. It also attempts to identify important factors that, due to the changing economic-political environment, are affecting the functioning of the intergovernmental fiscal system. Reforms in fiscal federalism will continue to be a central theme in ensuring efficient public service provision and in creating an enabling business environment.

Reforms in fiscal federalism should encompass both policies and institutions. They have to deal not merely with the factors internal to the intergovernmental fiscal system but also with those that were created by the political and economic environment. Some of the reforms should be carried out in the short term, while others will have to be explored in the medium and long term.

Reforms in Tax Systems

The starting point of reform is the tax assignment system itself. For many reasons, it is preferable not to separate income tax powers on the basis of the origin of the income. At the same time, there are successful cases of states exercising concurrent personal income tax powers by allowing them to piggyback their tax on central levies. This will provide an important tax handle to the states. Of course, the transfer mechanism will have to provide a correction to the skewed resource distribution that could arise from this.

Coordination in the consumption tax system is equally important. From the viewpoint of tax harmonization, the goods and services tax (GST) at the central level, with separate central and state components, would be appropriate. However, this can be achieved only with the willing cooperation of the states, which does not seem feasible in the medium term. The feasible option in the medium term would be to allow separate central and state VATs. This would require reassigning the taxation of services – to enable the states to levy the destination-based retail GST. There are problems surrounding assigning services with interstate scope to states, but resolution of these may not be entirely satisfactory. Nevertheless, a compromise solution has to be found.

Equally if not more important is the issue of phasing out taxes on interstate sales. This is also important from the viewpoint of removing impediments to internal trade and establishing a common market in the country. On the same note, it is also possible to abolish *Octroi* and to empower the urban local governments to levy an additional rate on the VAT on purchases within municipal jurisdictions. This would further remove impediments and provide much needed resources to municipalities. Reforms are also necessary to remove restrictions on the movement of goods within the country under the Essential Commodities Act.

Reforms in the Transfer System

The most important reform of the intergovernmental fiscal arrangement that is required would be in the transfer system. To begin, it is necessary to have clarity in the roles of the Finance Commission and the Planning Commission. This was the recommendation made by the Administrative Reforms Commission almost forty years ago. Given the constitutional position of the Finance Commission, the reform could involve converting it into a professional body with a qualified permanent secretariat and entrusting the grant-giving function entirely to it. It could even administer the specific-purpose transfers on the centrally sponsored schemes of the various ministries. The Planning Commission could be entrusted with the task of developing the physical infrastructure in the country and, until such time as the primary debt market develops, could provide concessional loans to poor and smaller states. This measure would help make it possible to view the budgets of the states in a holistic manner.[7]

The Finance Commission will also have to change its approach and methodology. It will have to evolve a formula-based transfer system that is simple, equitable, and that does not involve disincentives. One way to go about doing this would be to base tax devolution on disability in taxable capacity and provide a larger amount of grants to equalize standards in primary education and health care.

Indeed, the reforms in centrally sponsored schemes should focus on rationalizing them and consolidating them, reducing them from the current two hundred-plus schemes to just about a dozen. Rationalization of schemes would help to ensure minimum levels of these services in all the states.

Fiscal Consolidation

One of the important reasons for the fiscal stress at the state level during the 1990s was the decline in the ratio of central transfers to GDP. A large part of the decline of over 1 percent of GDP was in tax devolution, which was mainly due to declining customs. Although, every five years, the finance commissions will consider the sharing of taxes afresh, the difficult fiscal situation at the centre constrains any appreciable increase in transfers in the near future. The problem is compounded by the fact that there would be further decline in the revenue from important duties as the economy is opened up, and, more important, taxing mobile capital and skilled labour in a globalizing environment would pose difficulties.

The ultimate solution to the fiscal problems lies in fiscal consolidation at both the central and state levels. The TFC has worked out the magnitude of adjustment required to achieve a sustainable fiscal situation. This would require increasing the tax revenue-GDP ratio by about 2 percentage points, increasing non-tax revenues by about 1 percentage point, and reducing revenue expenditure by about 1.5 percentage points. This is a priority area, and, unless there is overall fiscal consolidation, reform of intergovernmental finance will not be meaningful and effective.

Local Government Reform

An important area that has concerned policy makers in India is the poor and declining standards of public service delivery. Constitutional amendments to empower local governments have failed to make them effective, and lack of participation in their functioning, particularly in rural areas, is a major concern. Empowerment of local government is meaningful only when people's stake in local government is enhanced. One important way to do this would be to make concerted efforts to reform local tax systems in order to raise larger amounts of local resources for development. Equally important is the need to consolidate the various schemes implemented by local governments to impart flexibility. And it is necessary to make employees accountable to the *panchayats*. Reform in this area is possible only if the information on revenues, expenditures, and other economic variables in different *panchayats* is collected and used for policy. This is also necessary in order to design an appropriate transfer system at the local level.

Making Intergovernmental Institutions Effective

One of the major problems confronted by Indian fiscal federalism is the absence of an effective mechanism for conflict resolution as conflicts are likely to intensify within an environment of intense intergovernmental competition. This has been amply demonstrated by the river water disputes. Conflicts can be vertical (between different levels of government) or horizontal (between different units within the same level). Indeed, it is necessary to make institutions such as the National Development Council (NDC) and the Inter-State Council more effective in order to ensure greater cooperation among governmental units. This issue has gained importance with the emergence of a coalition government at the centre, with regional parties in power in the states, and with regional parties becoming pivotal members of the coalition at the centre.

While both the NDC and the Inter-State Council have done commendable work in the past, it is necessary to bring them to centre stage in regulating intergovernmental competition. In fact, often the Inter-State Council, which is a constitutional institution, is not involved in tasks that it should legitimately be undertaking. The most important example is the inter-state tax harmonization and introduction of the VAT. The entire reform is calibrated by the Empowered Committee of State Finance Ministers, which is totally outside the Inter-State Council. The issue of resolving interstate conflicts will intensify with the phasing out of the interstate sales tax and with the introduction of a system to relieve the tax paid at the state of origin as goods are taken to the destination state.

Notwithstanding the weaknesses, it must be noted that the system of intergovernmental fiscal arrangements in India has served well for over fifty years. It has achieved significant equalization over the years, instituted a workable system of resolving the outstanding issues between the centre and the states and among the states, and adjusted to changing requirements. It has thus contributed to achieving a degree of cohesiveness in a large and diverse country. No doubt this analysis brings out several areas in need of reform; what is important, however, is that the system is eminently amenable to reform.

NOTES

1 Analyses of Indian federalism are available in the two volumes on Global Dialogue on Federalism brought out by the Forum of Federations. See Akhtar Majeed, "Republic of India," in *Constitutional Origins, Structure, and Change in Federal Countries*, ed. John Kinkaid and G. Alan Tarr, 180–208 (Montreal: McGill-Queen's University Press, 2005); and George Mathew, "Republic of India," in *Distribution of Powers and Responsibilities in Federal Countries*, ed. Akhtar Majeed, Ronald L. Watts, and Douglas M. Brown, 155–80 (Montreal: McGill-Queen's University Press, 2006).

2 For a detailed analysis of the circumstances leading to the centripetal bias in the Indian Constitution, see A.K. Chanda, *Federalism in India* (London: George Allen and Unwin Ltd., 1965).

3 I use the terms "Union" and "centre" interchangeably.

4 The three new states are Jharkhand (carved out of Bihar), Chattisgarh (carved out of Madhya Pradesh), and Uttarachal (carved out of Uttar Pradesh). While the first two states have continued as general-category states, the last one is considered to be a special-category state.

5 Reforms in federal fiscal policies and institutions in the context of the emerging economic environment are analyzed in M. Govinda Rao and Nirvikar Singh, *Political Economy of Federalism in India* (New Delhi: Oxford University Press, 2005).

6 For a detailed discussion on the changes in the framework of fiscal federalism required in developing and transitional economies, see M. Govinda Rao, "Fiscal Federalism in Planned Economies," in *Handbook in Fiscal Federalism*, ed. Etisham Ahmad and Georgio Brosio, 212–28 (Cheltenham, UK: Edward Elgar, 2006).

7 For a more detailed analysis of the role of finance and planning commissions, see M. Govinda Rao and Nirvikar Singh, *Political Economy of Federalism in India* (New Delhi: Oxford University Press, 2005); and Nirvikar Singh and T.N. Srinivasan, "Indian Federalism, Globalization and Economic reform," in *Federalism and Economic Reform in a Globalizing Environment*, ed. T.N. Srinivasan and Jessica Wallace, 258–82 (Cambridge, UK: Cambridge University Press, 2005).