

India's System of Intergovernmental Fiscal Relations

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1. Origins and Context

Historical Development

- Origins of present system in colonial-era legislation and administrative structures
- British period one of decentralization in concept but centralization in practice
- Current assignments and revenue-sharing arrangements based on 1935 (pre-independence) legislation
- Circumstances at independence (1947) led to centralizing features of India's Constitution (1950)
- Considerable financial powers, and residual as well as overriding political powers, lie with Center vis-à-vis States

India



Political and Administrative Structures

- 28 States, 1 NCT, 6 Union Territories
- Parliamentary system, bicameral national legislature, first-past-the-post elections
- States have elected legislatures and Chief Ministers in executive role
- Indian states have populations comparable to European countries
- Regional political parties more prominent over time
- Explicit and implicit political bargaining among parties, and among their leaders (Inter-State Council, National Development Council)
- Bureaucracy, judiciary have layers, but relatively centralized

2. IGFR Features

Expenditure and Tax Assignments

- **Expenditures**

- Union, State, and Concurrent Lists, with residuary powers to Center
- Much ‘social spending’ assigned to States

- **Taxes**

- Principle of separation (but overlapping bases), residuary authority to Center
- Center: main income taxes, States: sales taxes

- **Transfers**

- Tax and expenditure assignments create ‘vertical fiscal imbalance’
- Transfer mechanisms are provided for in Constitution

Expenditure Assignments

| Union List | State List | Concurrent List |
|---------------------------------|---------------------------------|----------------------------------|
| National highways | Agriculture | Economic and social planning |
| Major ports and shipping | Public health and sanitation | Social security and insurance |
| Railways | Intra-state communications | Education |
| Air traffic and airports | Relief of disabled | Electricity |
| International trade | Local government | Population control |
| Inter-State commerce | Land | Forests |
| Inter-State river waters | Intra-State water | |
| Petroleum and major minerals | Intra-State trade | |
| Telecommunications | | |

Tax Assignments

| Union | States |
|--|--|
| Income taxes (non-agricultural) | Land revenue |
| Capital taxes (non-agricultural) | Taxes on agricultural income |
| Inheritance taxes (non-agricultural) | Taxes on land, buildings, mineral rights, agricultural inheritance |
| Customs duties | Excise duties on alcohol |
| Excise duties (not alcohol) | Sales taxes on goods |
| Inter-State sales and consignment taxes on goods | State and local entry taxes, tolls |
| | Electricity taxes |
| | Entertainment taxes |
| | Stamp duties |
| | Taxes on professions |

Center-State Transfers

- **Finance Commission**
 - Constitutional authority to ‘decide’ center-state transfers, mainly tax-sharing
- **Planning Commission**
 - Makes grants and loans for ‘development’ purposes
- **Central Ministries**
 - Project-based, specific purpose grants to states
- **Loans and Guarantees**

Central Transfers to States

| Years | Per Capita Transfers (1993-94 Rupees) | Percentage of transfers to GDP | Percentage of transfers to Central Revenues | Percentage of transfers to State Revenues | Percentage of transfers to State Expenditure |
|----------|---------------------------------------|--------------------------------|---|---|--|
| 1975-76 | 198.2 | 3.67 | 31.80 | 38.64 | 44.80 |
| 1980-81 | 272.2 | 4.84 | 34.80 | 43.81 | 47.50 |
| 1985-86 | 381.0 | 5.55 | 40.98 | 45.62 | 46.42 |
| 1990-91 | 449.9 | 4.66 | 39.06 | 38.37 | 30.85 |
| 1995-96 | 450.8 | 4.28 | 36.53 | 38.61 | 31.07 |
| 1996-97 | 487.0 | 4.28 | 36.35 | 39.97 | 31.83 |
| 1997-98 | 578.0 | 4.86 | 43.66 | 44.91 | 35.33 |
| 1998-99 | 469.9 | 3.73 | 34.46 | 37.69 | 26.29 |
| 1999-00 | 504.1 | 3.80 | 32.62 | 36.46 | 25.05 |
| 2000-01 | 580.1 | 4.41 | 35.38 | 37.41 | 26.92 |
| 2001-02* | 633.1 | 4.49 | 35.80 | 38.02 | 28.30 |

Note: * Revised estimates

Source: Indian Economic Statistics/ Public Finance Statistics. Ministry of Finance, Government of India

States' Revenues and Expenditures, 2000-

01

| States | P.C. SDP (Rupees) | Poverty ratio (%) 1999-00 | P.C. own revenue (Rupees) | Own Revenue % of SDP | P.C. Transfers | P.C. current spending (Rupees) | Own rev., % of current spending |
|----------------------------|----------------------|---------------------------------|---------------------------------|----------------------------|-------------------|---|--|
| High Income States | 22461 | 17.83 | 2931.6 | 13.1 | 500 | 4386.6 | 66.8 |
| Gujarat | 18685 | 14.07 | 2684.6 | 13.2 | 863 | 5167.6 | 52.0 |
| Goa | 44613 | 4.40 | 14310.3 | 15.8 | 588 | 11904.8 | 120.2 |
| Haryana | 21551 | 8.74 | 3209.7 | 12.1 | 502 | 4107.9 | 78.1 |
| Maharashtra | 22604 | 25.02 | 2741.3 | 11.1 | 448 | 3852.6 | 71.2 |
| Punjab | 23254 | 6.16 | 3333.2 | 10.2 | 494 | 4712.7 | 70.7 |
| Mid Income States | 17635 | 20.30 | 1868.8 | 10.6 | 658 | 3400.4 | 55.0 |
| Andhra Pradesh | 14878 | 15.77 | 1930.2 | 10.7 | 713 | 3320.2 | 58.1 |
| Karnataka | 16654 | 20.44 | 2148.1 | 11.3 | 686 | 3580.9 | 60.0 |
| Kerala | 17709 | 12.72 | 2295.8 | 10.2 | 690 | 3689.4 | 62.2 |
| Tamil Nadu | 18623 | 21.12 | 2342.5 | 11.3 | 658 | 3594.3 | 65.2 |
| West Bengal | 14874 | 27.02 | 1091.0 | 5.5 | 576 | 3092.7 | 35.3 |
| Low Income States | 9013 | 34.28 | 846.8 | 9.4 | 673 | 2243.4 | 37.7 |
| Bihar | 4813 | 42.60 | 338.2 | 8.9 | 724 | 1515.5 | 22.3 |
| Chattisgarh | 10405 | NA | 1264.0 | 4.9 | NA | 2455.2 | 51.5 |
| Jharkhand | 9223 | NA | 1128.0 | 9.0 | NA | 2229.4 | 50.6 |
| Madhya Pradesh | 11626 | 37.43 | 1061.9 | 11.5 | 624 | 2695.5 | 39.4 |
| Orissa | 8733 | 47.15 | 900.5 | 9.3 | 969 | 2785.3 | 32.3 |
| Rajasthan | 13046 | 15.28 | 1297.2 | 10.4 | 693 | 2864.2 | 45.3 |
| Uttaranchal | NA | NA | 1295.5 | NA | NA | 4912.7 | 26.4 |
| Uttar Pradesh | 9323 | 31.15 | 791.2 | 8.1 | 598 | 2135.6 | 37.0 |
| General Cat. States | 14476 | 25.97 | 1594.0 | 11.0 | 660 | 3045.3 | 52.3 |
| Special Cat. States | 12339 | | 1155.9 | 9.4 | 2896 | 5715.4 | 20.2 |
| All States | 14359 | 26.10 | 1570.1 | 10.9 | 768 | 3191.1 | 49.2 |

Finance Commission

- Constituted every five years, as mandated by the Constitution of India
- No permanent personnel or organization
- Role is technically advisory, but recommendations mostly followed
- Guidelines from government may vary
- Precedent is important, in decision-making as well as acceptance of recommendations
- Tax-sharing transfers are unconditional
- Formula is used for inter-state allocations of tax shares

Finance Commission

Criteria and Relative Weights for Tax Devolution

| Criterion | Weight (Percent) |
|------------------------------|---------------------|
| 1. Population (1971 Census) | 10 |
| 2. Income (Distance Method)* | 62.5 |
| 3. Area | 7.5 |
| 4. Index of Infrastructure | 7.5 |
| 5. Tax Effort** | 5.0 |
| 6. Fiscal Discipline*** | 7.5 |

Notes: *The distance method is given by: $(Y_h - Y_i)P_i / \sum(Y_h - Y_i)P_i$ where Y_i and Y_h represent per capita GDP of the i^{th} and the highest income State respectively and P_i is the population of the i^{th} State .

** Tax Effort (η) is estimated as $(\eta) = (T_i / Y_i) / (1/Y_i)^{0.5}$ where, T_i is the per capita tax revenue collected by the i^{th} State and Y_i is the per capita State domestic product of the i^{th} State.

*** Estimated as the improvement in the ratio of own revenue of a state to its revenue expenditures divided by a similar ratio for all States averaged for the period 1966-99 over 1991-1993.

Finance Commission

- Formula is not well-grounded in economic principles, nor does it reflect clear objectives
- Some transfers are not formula-based, but are through ad hoc grants
- Grants are based on filling revenue-expenditure gaps at the margin, and therefore provide negative incentives for fiscal discipline
- Overall, Finance Commission transfers have increased horizontal equity, but fall well short of horizontal equalization

Planning Commission

- Formulates five-year plans and makes transfers in accordance with these plans
- Mix of grants and loans
- Constitutional underpinnings somewhat weak, under provision for miscellaneous transfers
- Permanent body with large staff, and more “political” than Finance Commission
- Political bargaining an important part of process of determination of transfers
- Formula is used for inter-state allocations

Planning Commission

Formulae for Distributing State Plan Assistance

| Criteria | Share in central plan assistance (%) | Share of grants and loans | Distribution criteria: general category states |
|--|--------------------------------------|---------------------------|--|
| A. Special category States | 30 | 90:10 | |
| B. Non-special category States | 70 | 30:70 | |
| (i) Population (1971) | | | 60.0 |
| (ii) Per capita income, of which | | | 25.0 |
| (a) According to the 'deviation' method covering only States with per capita income below the national average | | | 20.0 |
| (b) According to the 'distance' method covering all non-special category states | | | 5.0 |
| (iii) Fiscal performance, of which | | | 7.5 |
| (a) Tax effort | | | 2.5 |
| (b) Fiscal management | | | 2.5 |
| (c) National objectives | | | 2.5 |
| (iv) Special problems | | | 7.5 |
| Total | | | 100.0 |

Planning Commission

- Formula is not well-grounded in economic principles, nor does it reflect clear objectives
- Formula is not coordinated with Finance Commission formula
- But note that Planning Commission makes conditional or specific-purpose transfers
- Overall process not coordinated with that of Finance Commissions
- Lack of clear process for evaluating investment needs and priorities
- Planning Commission have little impact on horizontal equity

Central Ministry Transfers

- Central sector schemes
 - Project-based categorical transfers, included in planning process
- Centrally sponsored schemes
 - Categorical transfers with matching requirements
- Potentially important channel for addressing spillovers
- Highly discretionary, lacking transparency, poor selection and implementation, ineffective monitoring

Composition of Transfers (%)

| Years | Finance Commission Transfers | | | Plan Grants | | | Other Grants | Total |
|---------|------------------------------|--------|-------|--------------------|-----------------|-------|--------------|-------|
| | Tax Devolution | Grants | Total | State Plan Schemes | Central Schemes | Total | | |
| 1969-74 | 54.35 | 10.25 | 64.60 | 12.87 | 11.56 | 24.43 | 11.08 | 100 |
| 1974-79 | 50.21 | 17.12 | 67.33 | 17.67 | 11.72 | 29.39 | 3.28 | 100 |
| 1980-85 | 56.97 | 5.14 | 62.11 | 17.72 | 16.57 | 34.29 | 3.63 | 100 |
| 1985-90 | 54.17 | 6.87 | 61.04 | 17.00 | 18.08 | 35.08 | 3.85 | 100 |
| 1991-92 | 52.22 | 10.47 | 62.66 | 17.36 | 16.82 | 34.15 | 3.10 | 100 |
| 1992-97 | 55.56 | 6.20 | 61.76 | 20.37 | 15.37 | 35.75 | 2.46 | 100 |
| 1997-98 | 62.52 | 2.60 | 65.12 | 18.58 | 10.45 | 29.03 | 5.85 | 100 |
| 1998-99 | 62.29 | 2.24 | 64.54 | 20.97 | 11.24 | 32.21 | 3.26 | 100 |
| 1999-00 | 59.03 | 2.66 | 61.69 | 21.83 | 10.98 | 32.80 | 5.50 | 100 |
| 2000-01 | 52.28 | 12.28 | 64.56 | 15.90 | 13.80 | 29.69 | 5.75 | 100 |
| RE | | | | | | | | |
| 2001-02 | 55.41 | 8.75 | 64.17 | 17.51 | 14.00 | 31.51 | 4.32 | 100 |
| BE | | | | | | | | |

Loans and Guarantees

- Interest on loans may be subsidized
- Loans may be rescheduled
- Principal may be written off
- Loan guarantees serve as a subsidy also
- Overall ‘soft-budget constraint’ as a result of these implicit transfers, plus high discretion
- High fiscal deficits of states have led to
 - More market-based and transparent borrowing mechanisms
 - Attempts to use transfers to incentivize fiscal discipline
 - Passage of fiscal responsibility laws

3. Institutional Developments and Policy Imperatives

Local Government and Decentralization

- Constitutional amendments, in 1993, strengthened local government
- Substitute ‘voice’ for hierarchical control – this will take time to develop fully
- Move regulation and monitoring of local governments from case-by-case discretion towards rules- and outcome-based approach
- Need further strengthening of assignment of revenue authority to local governments

Local Government and Decentralization

- Introduced State Finance Commissions (SFCs) for State-Local transfers
- Eventually will make state-local transfers more rule-based, predictable and transparent
- Early performance of SFCs uneven, and generally below par
- Capacity-building grants (for accounting and information systems) initially came from the center
- Further center-local transfers being discussed (and opposed by states)

Regional Inequalities and IGFR

- Empirical studies suggest that regional disparities, as measured by SDP per capita, already large, are growing
- May not be true when one looks at social indicators such as literacy and life expectancy
- Simple, clear rules and better targeting of poor states, with respect to explicit intergovernmental transfers, can help:
 - **NOT** any substantial reduction in inter-state inequality of SDP
 - **MAYBE** reduction in inequality of provision of public services
 - **PROBABLY** reduction in political tension

Internal Common Market and Tax Reform

- Inter-state sales taxation and state and local entry taxes impede creation of an internal common market
- Current indirect tax assignments and systems also a barrier to a comprehensive destination-based VAT
- Latter would reduce tax-exporting (which benefits higher income states) and potentially improve horizontal equity
- Tax reform a major item on policy agenda
 - Include services in states' indirect tax authority
 - Remove distinction between agricultural and non-agricultural income
 - Base-broadening
 - Improved administration and enforcement of income taxes

4. Conclusion: Lessons and Challenges

Lessons

- India's IGFR system has virtues of stability, history and precedent
- Along with these come complexity and inertia
- System can be simpler, more transparent and more effective
- Nature of institutional channels for transfers, as well as specific transfer formulae can be re-examined
- Reform of transfer system best part of an overall package of fiscal reform, including tax and expenditure assignments
- Need to harden budget constraints

Challenges

- Systemic reform is complex and difficult, even when done piecemeal
- Diversity and regional inequality create political hurdles and exacerbate internal political tensions
- Need to build new political coalitions for governmental reforms
- Several other simultaneous developments heighten the challenges:
 - Increasing fiscal deficits
 - Major local government reform
 - Liberalization and move away from government intervention, including re-evaluation of government economic planning

Thank You!