

# **India's System of Intergovernmental Fiscal Relations**

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- Internal Common Market and Tax Reform

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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

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<b>Union List</b>	<b>State List</b>	<b>Concurrent List</b>
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		

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# Tax Assignments

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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

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# 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
<b>High Income States</b>	<b>22461</b>	<b>17.83</b>	<b>2931.6</b>	<b>13.1</b>	<b>500</b>	<b>4386.6</b>	<b>66.8</b>
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
<b>Mid Income States</b>	<b>17635</b>	<b>20.30</b>	<b>1868.8</b>	<b>10.6</b>	<b>658</b>	<b>3400.4</b>	<b>55.0</b>
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
<b>Low Income States</b>	<b>9013</b>	<b>34.28</b>	<b>846.8</b>	<b>9.4</b>	<b>673</b>	<b>2243.4</b>	<b>37.7</b>
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
<b>General Cat. States</b>	<b>14476</b>	<b>25.97</b>	<b>1594.0</b>	<b>11.0</b>	<b>660</b>	<b>3045.3</b>	<b>52.3</b>
<b>Special Cat. States</b>	<b>12339</b>		<b>1155.9</b>	<b>9.4</b>	<b>2896</b>	<b>5715.4</b>	<b>20.2</b>
<b>All States</b>	<b>14359</b>	<b>26.10</b>	<b>1570.1</b>	<b>10.9</b>	<b>768</b>	<b>3191.1</b>	<b>49.2</b>

# 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  $i^{\text{th}}$  and the highest income State respectively and  $P_i$  is the population of the  $i^{\text{th}}$  State .

\*\* Tax Effort ( $\eta$ ) 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  $i^{\text{th}}$  State and  $Y_i$  is the per capita State domestic product of the  $i^{\text{th}}$  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!**