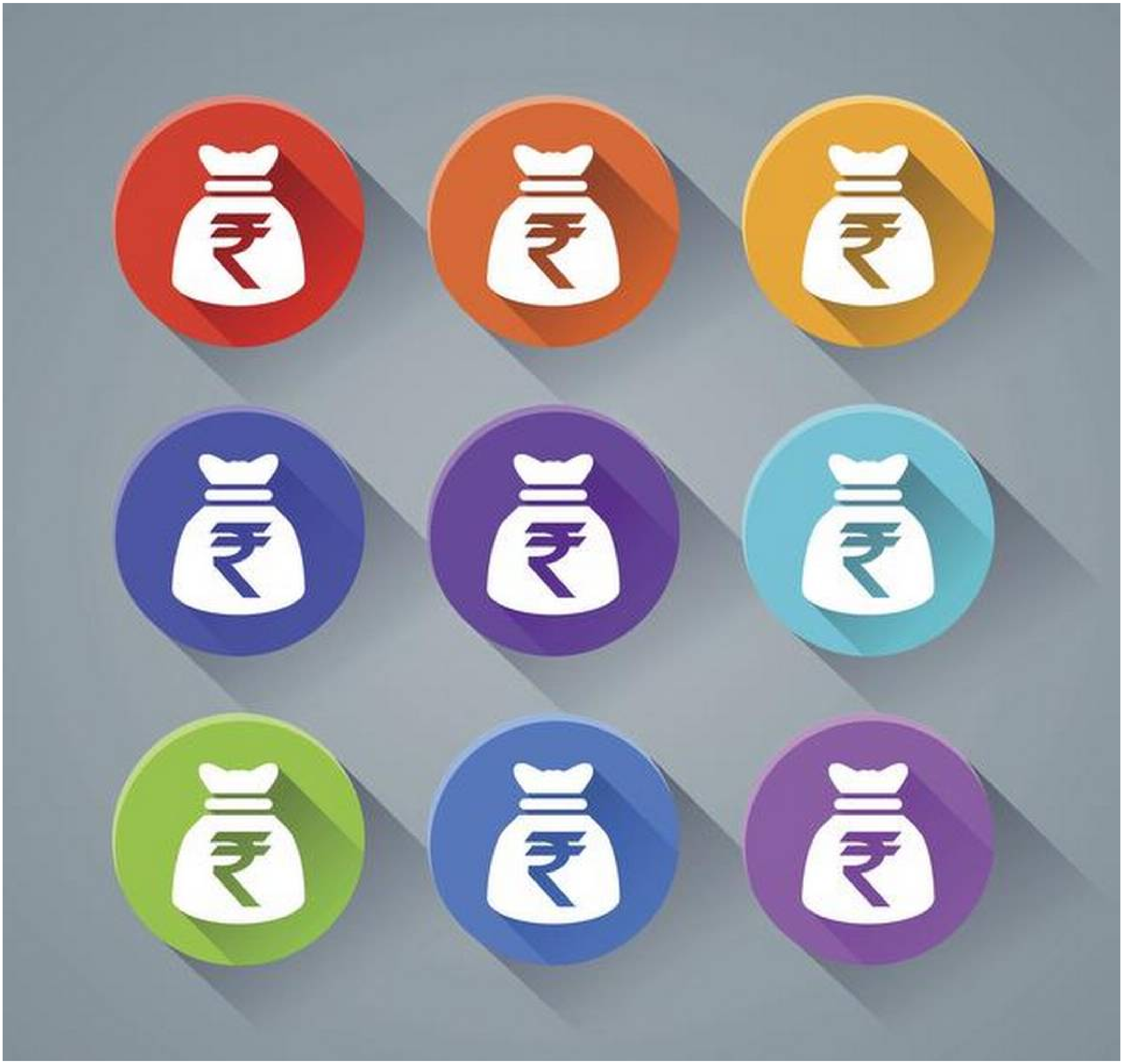
LEAD

Another look at fiscal transfers



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The time has come to amend the Constitution to fix the proportion of shareable taxes for the States

Federalism is an old concept. Its origin is mainly political. It is well known that the efficiency of a government depends on, among other factors, its structure. In large countries, it has been felt that only a federal structure can efficiently meet the requirements of people from different regions. Underlying this proposition is the premise that preferences vary across regions.

In our country during the independence struggle, provincial autonomy was regarded as an integral part of the freedom movement. However, after Independence, several compulsions, which included defence and internal security, led to a scheme of federalism in which the Centre assumed greater importance. Also in the immediate period following Independence, when the Centre and all States were ruled by the same party and when many of the powerful provincial leaders migrated to the Centre, the process of centralisation gathered further momentum. Economic planning at a nation-wide level helped this centralising process.

Fiscal federalism

Fiscal federalism is the economic counterpart to political federalism. Fiscal federalism is concerned with the assignment on the one hand of functions to different levels of government, and with appropriate fiscal instruments for carrying out these functions on the other. It is generally believed that the Central government must provide national public goods that render services to the entire population. A typical example cited is defence. Sub-national governments are expected to provide goods and services whose consumption is limited to their own jurisdictions. An equally important question in fiscal federalism is the determination of the specific fiscal instruments that would enable the different levels of government to carry out their functions. This is the 'tax-assignment problem' which is much discussed in the literature on the subject. In determining the taxes that are best suited for use at different levels of government, one basic consideration is in relation to the mobility of economic agents, goods and resources. It is generally argued that the de-centralised levels of government should avoid non-benefit taxes and taxes on mobile units.

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This implies that the Central government should have the responsibility to levy non-benefit taxes and taxes on mobile units or resources. Building these principles into an actual scheme of assignment of taxes to different levels of government in a Constitution is indeed very difficult. Different Constitutions interpret differently what is mobile and what is purely a benefit tax. For example, in the United States and Canada, both Federal and State governments have concurrent powers to levy income tax. On the contrary, in India, income tax is levied only by the Central government though shared with the States. Recognising the possibility of imbalance between resources and responsibilities, many countries have a system of inter-governmental transfers.

The Indian Constitution lays down the functions as well as taxing powers of the Centre and States. It is against this background that the issues relating to the correction of vertical and horizontal imbalances have been addressed by every Finance Commission, taking into account the prevailing set of circumstances. However, Central transfers to States are not confined to the recommendations of the Finance Commissions. There are other channels such as those through the Planning Commission until recently as well the discretionary grants of the Central government.

In 2010-11, in the combined revenue receipts of the Centre and States, the share of the Centre was 64.68%. After transfer, the share came down to 40.20%. In the case of the States, their share before transfers was 35.32%. After the receipts of transfers the share of States went up to 59.80%. Thus the shares got reversed. In 2016-17, the share of the Centre after transfers was 33.37% and that of the States was 66.63%. In the case of total expenditures, the share of the Centre in 2014-15 was 41.14% and that of the States was 58.86%. The ultimate position appears reasonable. The question may be on the mode of transfers.

New developments

The Fourteenth Finance Commission has broken new ground in terms of allocation of resources. One of its major recommendations has been to increase the share of tax devolution to 42% of the divisible pool. This is a substantial increase by almost 10 percentage points. The commission has argued that this does not necessarily affect the overall transfers but only enhances the share of unconditional transfers. It is true that Centrally sponsored schemes, which have ballooned in recent years, may have 'encroached' on the territory of States. Over years, the performance of the Central government is judged not only on the basis of actions taken which fall strictly in its jurisdiction but also on initiatives undertaken in the areas which fall in the Concurrent and even State lists. Centralised planning has something to do with it. Today, the Central government is held responsible for everything that happens, including, for example, agrarian distress. In viewing the responsibilities of the Centre and States we must take a broader view than what is stipulated in the Constitution.

On the allocation of unconditional transfers, two questions arise. The first is to determine the total transfers that need to be made, while the second is whether all transfers must be done by the Finance Commission alone. Finance Commissions prior to the Fourteenth recognised that some transfers were being made by the Planning Commission; this was kept in mind while deciding on tax devolution. By the time the Fourteenth Finance Commission was required to submit its report, a fundamental change in the institutional framework had occurred.

The Planning Commission was replaced by the NITI Aayog, which was simply a think-tank with no powers of resource allocation. In this context perhaps what the Fourteenth Finance Commission did was justifiable. Of course, the Fourteenth Finance Commission did what it did because the terms of reference had not made any distinction between Plan and non-Plan revenue expenditures. The moot question is about what happens if any future government revives the Planning Commission with financial powers. This will put the Central government in a fix.

Some suggestions

Perhaps the time has come for the Constitution to be amended and the proportion of shareable taxes that should go to the States fixed at the desired level. The shareable tax pool must also include cesses and surcharges as these have sharply increased in recent years. Fixing the ratio at 42% of shareable taxes, including cesses and surcharges, seems appropriate. Another possible route is to follow the practice in the U.S. and Canada: of allowing the States to levy tax on personal income, with some limitations. Since one of the concerns is that resources do not match functions, this may be a way out. But, as in the U.S., the scheme should be simple and ride on federal income tax, that is, just a levy on the income assessed by federal authorities. The freedom given to the States must be limited. It is important to note that the levy by the Centre and States together should be reasonable.

Also once this power is given to the States, the transfers from the Centre need adjustment. As far as India is concerned, this is an area which needs a fuller study. Adoption of any one of these alternatives will avoid friction between the Centre and the States. Perhaps the first alternative of constitutionally fixing the ratio is the easiest.

There are issues relating to horizontal distribution. Equity considerations have dominated the allocations. This is as it should be. However, the ability of bringing about equalisation across States in India has limitations. Even the relatively richer States have their own problems and they feel ‘cheated’ because of the overuse of the equity criterion. An appropriate balancing of criteria is needed particularly in the context of the rise in unconditional transfers. Of course, appropriate balancing is what all Finance Commissions are concerned about.

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