A Tract on Reform of Federal Fiscal Relations in India

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1. Introduction

Designing and operationalising a structure of federal fiscal relations is among the most complex areas of economic policy. This is because a number of criteria that conflict to some extent have to be satisfied simultaneously and this requires weighing consequences and balancing the weights given to the different criteria. The most important criteria that must be satisfied by a sound system of inter-governmental fiscal relations are: autonomy (of the sub-national governments), adequacy, equity, efficiency, and fiscal discipline.

If one takes into account only autonomy and efficiency in the provision of services, then one would advocate a fairly large number of public authorities with jurisdictions of different sizes, each corresponding to the area of benefit incidence of a service (or a group of services) provided. The citizens of each jurisdiction will enjoy the respective services and pay for them fully. There will be efficiency in the provision of services because each service will be provided according to local preferences and the group of people who enjoy a service will also pay for it. The link between the decision to spend and the decision to raise resources would ensure fiscal discipline.

However, many overlapping jurisdictions will create severe administrative complications. Apart from that, one fact that lies at the root of the basic problems of federal or multi-level finance is that it is difficult to provide to the sub-national governments tax handles with sufficient revenue potential that would satisfy economic criteria and that can also be efficiently administered. In practice, therefore, only a limited number (up to 4 or 5) levels of jurisdictions are generally created within a nation[1].

[1] Also, political and cultural considerations often determine the boundaries of the constituent units.

Even then, the principle of the residents of each jurisdiction paying for the services provided by the government of their jurisdiction cannot be implemented even to a reasonable extent for well-known reasons. Extensive expenditure decentralisation is desirable (and also politically demanded) but there has to be considerable centralisation of revenue raising powers[2].

Constitutions of most federal countries provide for considerable tax power centralisation combined with public expenditure decentralisation[3]. The resulting vertical fiscal imbalance necessitates transfers of resources from the central or federal government to the sub-national governments[4]. Thus, the major components of federal fiscal relations that have to be carefully designed are:

a. public expenditure assignment;

b. assignment of taxing powers and other resource raising powers;

c. the kinds and amounts of federal transfers to rectify veridical fiscal imbalance; and

d. additional federal transfers to sub-national governments with deficiency in fiscal capacity.

[2] It is better that taxes with nation-wide bases and mobile bases are raised by the central government; sub-national governments cannot be allowed to levy taxes that will lead to distortion in the allocation of resources or to tax exportation; and administrative costs will be much lower with central administration in the case of some major taxes.

[3] In the three older federations of United State of America, Canada and Switzerland, the principle of autonomy was given great weight and important tax powers were made concurrent. In the light of the problems created by concurrent tax powers, in the later federations considerable centralisation of tax powers has been provided for.

[4] In this paper, only two levels of government are assumed.

The last-mentioned transfers are needed in order to *enable* all the sub-national governments to provide the same standard of basic services at the average tax price. Some governments may not be able to provide the average standard of services even if they exploit their relative taxable capacity to the average extent. In the absence of compensating transfers from the central government, the residents of the concerned states will be at a comparative disadvantage: either they would have to bear burdens of a higher than average tax price or they have to be content with less than the average standard of basic services[5]. This is an important aspect of the criterion of equity that must be satisfied by a federal fiscal system. Other aspects of equity will be dealt with later in the paper.

Autonomy is the most basic value of the federal system. As was pointed out earlier, subject to the imposition of reasonable restrictions in the national interest, autonomy can be enjoyed by the constituent governments to a considerable extent, if all or most of the resources needed by them to fulfil their expenditure responsibilities can be raised by themselves. Then they can spend more or less as their residents desire and at the same time, there will be a link between the decision to spend and the decision to tax, leading to fiscal discipline at both levels, the centre and state, and what is equally important, the governments will be spending only to the extent that the citizens are willing to pay for, i.e., the central government will spend only up to the extent that the citizens of the country are willing to pay and each sub-national government up to what its residents are willing to finance *so that the size of the government sector will be in accordance with the citizens' desire or willingness to pay tax*.

[5] The case for specific transfers and the issues related to them are not discussed in this paper.

Although with the creation of vertical fiscal imbalance, in the real world, the link between the decision to spend and the decision to tax is snapped, in the system as a whole every attempt must be made to maintain it at the margin. This requirement must be kept in mind while designing the system of central transfers. In the same way, the criterion of autonomy should be violated by the transfer system to the least possible extent. Subject to these constraints, a transfer system should be devised to close the estimated fiscal gap. As will be easily seen, estimating the fiscal gap is among the most difficult tasks in this context. Given the assignment of taxes and keeping in mind the total tax burden that the country is willing to bear at a given time, one has to make a judgement as to the relative amounts of resources the two levels of government can be reasonably expected to raise and juxtaposing the responsibilities required to be fulfilled by the central government and the states[6], fix the amount of central transfers needed to close the estimated vertical fiscal gap. Formulae for transfers to bring about a transfer of the required amount have to be worked out, but with the passage of time, the formulae would need to be changed with changes in the levels of respective responsibilities. However, frequent changes to the rules in order to alter the proportion of the central taxes to be transferred should be avoided. At each level, expenditures and own tax policies can be properly planned only if there is some stability in the proportion of central taxes to be mandatorily transferred.

Central transfers can be effected in three major ways: a. tax sharing, b. tax-base sharing and c. grants. Since the vertical fiscal gap is created by the high degree of centralisation of taxing powers, tax sharing is the preferred method of transferring central resources to "fill" the vertical fiscal gap in federations where concurrency of tax powers is not provided for in the Constitution. Tax-base sharing in the

[6] From now on the two levels of governments are referred to as the central government and the states.

form of the states piggybacking their supplementary levies on the base of the central tax determined by the central government is another possible way of "transfer". But this method can be applied more easily in the case of direct taxes such as personal income and wealth taxes. However, even in these cases there will be additional administrative costs and also every state will have to keep its supplementary levy fairly low, for fear of 'driving' out the mobile bases. If taxes are shifted, then distortion in resource allocation results (Boadway, 1982)[7]. Tax-base sharing cannot be implemented in respect of domestic trade and consumption taxes since it would be very difficult to ensure that a piggyback on a central excise or VAT is ultimately borne on a destination basis. For these reasons tax sharing has been assigned a significant or main role in the central transfer system in a number of the modern federations such as Germany, Austria, Australia, Russia, India, Pakistan and many of the former Soviet Republics.

Tax sharing raises three important and complex issues. First, how is the proportion of central tax revenue (or the proportion of revenue from designated central taxes) to be shared be determined? Second, with the passage of time and with change of circumstances, how should the share going to the states be changed? Third, what should be the factors on the basis of which the "divisible pool" should be distributed among the constituent states?

While political bargaining will play a part in deciding such questions, the basic principles that guide the solving of the issues in tax sharing should be those of adequacy, autonomy, fiscal discipline and equity, referred to earlier. That is to say, the manner of closing the fiscal gap should not give the wrong incentives or entail injustice between residents of different states or erode autonomy.

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[7] In the case of corporate profits tax, there arises the problem of allocation of the base (profits) among the concerned states.

For these criteria to be satisfied, the vertical fiscal gap should be normatively estimated without any reference to the actual gaps of the states, except perhaps at the very beginning when the sharing system is inaugurated. As stated earlier, the authority that is designing the system should form a broad judgment about the requirements of resources of the central government and of the states, given their Constitutional responsibilities, and, taking into account the resources that these two levels of government could reasonably be expected to raise on their own, then arrive at the proportion of central tax revenues to be shared such that the states as a whole will have more or less adequate resources. If at the time of the original determination of the proportion, the state budgets already exist (as has generally happened at the time of the framing of a new Constitution), the actual revenue expenditures of the states (or the existing provinces) could be taken, if they are higher than the normative estimates.

The percentage share of the central tax revenues to be passed on to the states, once fixed, should remain constant for a reasonable period of time. Then the states would autonomously frame their budgets and each state would raise more or less resources from its own sources of revenue to finance its desired level of expenditure, given the share of central tax revenue to which it is entitled. Thus the link between the decision to spend and the decision to raise resources (pay taxes) will exist at the margin, ensuring autonomy and fiscal discipline.

Stability in the ratio of central tax revenues shared with the states will enable the central government and the states to frame their budgets based on reasonable forecasts of revenues. Frequent upward or downward revision in the ratio will cause imbalances in the budgets of the central government or the states. Such revisions will also raise anticipations of larger transfers and act as damper on tax effort.

In developed countries such as Germany and Australia, the ratio of central tax revenues to be shared with the sub-national governments is fixed on a long-term basis: either mandated by the Constitution or arrived at through agreement between the two levels of government or decided by the central government. In these cases the relative shares of the central government and the states are not changed frequently; nor are the budget projections of the states used to estimate what would be the level of own resources, expenditures and deficits in order to get an idea of the "needs" of the states. This ensures that states can function with autonomy and there is greater chance of fiscal discipline. And there cannot be expenditure exportation in the sense of one state government's incremental expenditure leading to higher central taxes on the residents of the other states. In Austria, however, the Revenue Sharing Act is re-enacted every four years, along with the Domestic Stability Pact which fixes the levels of deficits (See Appendix).

In a number of the so-called transitional economies, the arrangement of tax sharing exists. Such sharing is found in all the former Soviet Republics, besides Hungary, Poland, Ukraine and Russia itself (Rao, M.G., forthcoming). In these countries, the magnitudes of the shares of central taxes going to the sub-national governments are unilaterally fixed by the federal or central government and also changed (rather frequently) to accommodate the fiscal needs of the central governments, i.e. the shares of the sub-national governments are often reduced. For instance, Hungary reduced the share of personal income tax to be given to the local governments from 100 per cent in 1991 to 31 per cent in 1994 (Bird, Ebel, and Wallich, 1995 – Quoted in Rao, M.G., forthcoming). Such changes in the shares in the downward direction throw the budgets of the lower level governments into disarray, increasing their deficits to the benefit of the central government. Thus, frequently changing the shares of the central taxes going to the sub-national governments, in order to accommodate the deficits of the centre or the states is undesirable. It is also not desirable to increase

the ratio of central taxes shared frequently, in accordance with the trends in states budget expenditures. Such a practice gives the wrong incentives and destroys or weakens the link between the decision to spend the decision to tax. If the actual trends are moderated, a lot of arbitrariness would be introduced and the criterion of autonomy would be violated. We shall discuss the flaws of this method of continually adjusting the tax shares in detail in evaluating the Indian system.

The next major issue in tax sharing is the determination of the formula for the distribution of the divisible pool among the states. If it is assumed that the sharing of the central tax revenue is mainly to close the vertical fiscal gap (i.e. an antidote to the centralisation of the taxing powers), the distribution of the shared taxes should be on the basis of origin or the relative shares of those taxes paid by the residents of the various states. However, collection figures which are readily available do not properly reflect the amounts paid by the residents of the respective states, except perhaps in respect of the personal income tax[8]. Nevertheless, central tax shares are distributed on the basis of origin or derivation in a number of countries. Distribution of the central tax shares among the states on the basis of origin is, however, counter-equalising.

In a typical federation, there exist considerable economic disparities among the states. As pointed out, one important aspect of the principle of equity to be fulfilled in a federal system is that despite varying fiscal capacities, all the constituent states should be able to provide to their respective residents the average standard of basic services *at the average tax price*. To make this possible, the central government would have to compensate for the relative fiscal deficiency of particular states through grants. In order not to generate the wrong incentives, the measurement of deficiency in fiscal capacity should be

[8] And that too, only on the premise that the tax on a resident's income should go only to the state of his residence, even if derived from other states.

based on some objective criteria, and to preserve the autonomy of the states, the grants should be untied (i.e. they should be general, block grants). Canada is a prominent example of a country where such equalizing grants are mandatorily given. In determining equalizing transfers, while in Canada only relative deficiency in fiscal capacity is taken into account, in Australia comparative cost disadvantages in performing services are also taken into account.

Regional autonomy is the essence of federalism. Decentralisation of expenditure responsibilities is desired for efficient satisfaction of public wants and, equally important, because the constituent units which agree to federate wish to retain autonomy of choice subject to limitations that might have to be imposed in the national interest. At the same time, they need central transfers. The design of central transfers must satisfy a few fundamental principles. First, the system should preserve the principle of autonomy. That is to say, each state should be free within its allotted jurisdiction to spend more or less raising the required sources[9]. Second, the link between the decision to spend and the decision to raise resources must be kept intact at least at the margin. Third, in order not to generate the wrong incentives and avoid interference with the states' autonomy, the volume of transfers should not be determined on the basis of actual "gaps" or "moderated" gaps[10]. Fourth, the formulae for transfers should remain stable for a reasonable period of time so that budgets can be planned and the decisions of the states would not be influenced for the wrong reasons (in anticipation of changes). And, fifth, in addition to transfers "to close" the vertical fiscal gap, there should be transfers to weaker states to equalize fiscal capacity.

[9] Only then the rulers will be under the control of the voters in each state.

[10] Moderation by the grant giver inevitably involves the imposition of others' preferences on the states.

2. An Evaluation of the Arrangements for Central Transfers to the States in the Indian Federation

The makers of the Indian Constitution adopted the principle of separation in the assignment of tax powers to the central government and the states. One motive for this was possibly to make the central government relatively strong. Also, the leaders had probably taken into account the complications that had arisen in federations that had adopted the principle of concurrency. Since most of the taxes with nationwide bases and high revenue potential, such as the personal income tax on non-agricultural income, excise duties and taxes on corporate profits and imports were assigned to the central government, it was recognized that there would arise a vertical fiscal gap and that central transfers would be necessary to cover it. The Constitution made specific provisions for such payments in the form of tax sharing and grants.

The mandatory transfers were to consist of sharing of specified central taxes[11] and grants-in-aid to states 'in need of assistance'. The President would ultimately take the decisions in these matters, but the Constitution requires the President to appoint a Finance Commission every five years or earlier to make recommendations to him[12].

Thus the Constitutional stipulations in this regard provided for flexibility in the system of central transfers. The Constitution makers had anticipated that the expenditures at the level of the states would

[11] Initially, it was stipulated that the net proceeds of the central income tax were to be shared and the net proceeds of the Union excise duties may be shared, but now through a Constitutional amendment all central taxes have been made shareable.

[12] The President is to take decisions on the formula for determining the sharing of taxes and the distribution of the divisible pool among the states, but before taking any decisions on these matters, he has to consider the recommendations of the Finance Commission.

have to grow relatively fast and hence had provided for the optional sharing of another important central tax. Transfers had been provided for dealing with the vertical fiscal gap and also for helping the states in need of assistance. All important concerns had been attended to by the above-mentioned provisions. However, the basic principles on which rules or formulae for the volume and distribution of transfers were to be determined were left unspecified and, as it turned out, too much was left to the discretion of the Finance Commissions whose membership changed every five years. Differing principles of distribution could be laid down by successive Commissions since no guiding principles had been laid down. To some extent this gap was filled by "the terms of reference" that came to be given to the Finance Commissions (after the First Commission) in the Presidential order. As will be seen, the Presidential terms of reference did not give weight to states' autonomy and were influenced much by what were considered the requirements of the planning process.

Presidential Terms of Reference to the Finance Commissions

As regards the First Commission, the Presidential order constituting it merely listed the functions of the Commission under Article 280 of the Constitution, namely, (a) determining "the distribution between the Union and the States of the net proceeds of the taxes which are to be or may be divided between them....", "and the allocation between the states of the respective shares of the proceeds", and (b) the principles which should govern the grants-in-aid of the revenues of the states out of the Consolidated Fund of India.

The terms of reference of all the twelve Commissions (appointed so far) of course required the Commission to make recommendations regarding the shareable taxes, but other terms of reference were introduced and gradually changed or enlarged. Although Article 280 clause 3(b) of the Constitution requires the Finance Commission to

make recommendations on "the principles which should govern the grants-in-aid of the revenues of the States," from the Second Commission onwards the terms of reference only required the Commission to indicate the States which are in need of assistance by way of grants-in-aid under Article 275 and the sums to be paid to those states. Besides, the Commissions were asked to keep in mind certain factors in determining the amounts of grants-in-aid. The Second and the Third Finance Commissions were asked to keep in mind the requirements of the Five Year Plan that was to follow and the efforts made by the states to raise additional revenue.

It is to be presumed that the considerations to which the Commissions were asked to have regard were for making the recommendation on the sharing of taxes as well as for making recommendations regarding grants-in-aid.

Beginning with the Fifth Finance commission, the Presidential terms of reference clearly indicated that the Commission's recommendations on transfers should be based on the estimated revenues of the states for the recommendation period (at base years levels of taxation) and requirements on revenue account of the states during that period under various heads. Thus it was that the "gap filling" approach was formally introduced. In making these projections of revenues and expenditures, the Finance Commission was asked to have in mind "the scope for better fiscal management as also for economy consistent with efficiency which may be effected by the states in their administrative, maintenance, development and other expenditures[13] (Terms of Reference, Fifth Finance Commission - 4 (b) iii), and also take into account "the scope for raising additional resources

[13] Other considerations were added in the terms of reference of subsequent Commissions, e.g., "the need for ensuring reasonable returns on investment by the states in irrigation projects, power projects, state transport undertakings, and departmental commercial undertakings.

by the various Sate Governments from the sources of revenue available to them" (Term of Reference 4 i). That is to say, the projections of revenues and expenditures as given by the states should not be taken as they were given. They should be modified to try to ensure that each state observed economy in expenditure and made "adequate"[14] effort to raise own resources.

The logic of the approach was that the entire budget was built around the National Development Plan and that each state should be enabled to achieve balance on non-plan revenue account as the basis of embarking on and financing an adequate plan. At the same time, if the transfers are to be geared to the 'needs' of the states, it was proper to expect them to raise sufficient resources and not incur expenditures more than what was laid down in the guidelines or principles to be propounded by the Commissions. Autonomy of action by the states and each state raising more or less resources, but balancing its budget on its own with whatever basic fixed support it gets, were/are ideas alien to the planning approach. The federal principle, giving space to autonomy of action by the states, finds no place in the Terms of Reference given to the Finance Commissions. Even if one did not give weight to the criterion of autonomy and wished the states to work under central guidance, as everyone would readily realize, it is almost impossible to evolve, in an objective manner, rules of prudence and measures of tax effort.

The Approach of the Finance Commissions

The very first Commission expressed the view that "the budgetary needs of the states should be the starting point for determining the assistance required by the states". However, due

[14] The Commission was to decide on the basis of some measure or measures what was adequate. But as we know, it is impossible to work out measures of absolute tax effort.

allowance should be made for clear cases of failure of states to "maximize tax effort". Further, in order not to place a premium upon extravagance, the states' endeavour to secure reasonable economies of expenditure should be taken into account[15] (para 62 of the *Report of the Second Finance Commission*).

Thus from the early stages of the functioning of the Finance Commissions, an approach was developed to determining the volume of assistance on the basis of budgetary needs which were to be derived from the proposed or projected budgets. This seemed proper at that time, as economic planning had been launched. The concerned Commissions realized that the expenditures at the level of the states would have to increase by a fairly large percentage and they had to bring about a larger transfer of central resources to the states. Hence the Commissions decided to enable the states, through the transfer of enough additional central resources, to balance their revenue budgets outside the plan, using budget projections based on the base year figures, but subject to ensuring that sufficient effort was made to raise own resources and due economy was observed. However, in practice not much could be done to encourage or reward economy and efficiency in administration or tax efforts of the states. There were conceptual problems about tax effort and the required data were not available. Thus the Third Finance Commission confessed: "We have, therefore, been, compelled, like our predecessors, to cover the assessed budgetary gaps of all the states, whether caused by normal growth of expenditure, the maintenance cost of completed schemes and mounting interest charges or even by a measure of improvidence" (para 88 of the *Report of the Third Finance Commission*).

[15] These cannot be unambiguously defined or quantified. And why should a state "maximize" tax effort if it does not want to?

The Third Finance Commission went on to say: "Secure in the knowledge that the annual budgetary gap would be fully covered by devolution of Union resources and grants-in-aid, the States are tending to develop an allergy to tap resources in the rural sector on many considerations and also a disinclination to make up the leeway in others. They do not also attach the same importance to a proper and adequate control on expenditure in the matter of services and supplies as before" (para 89, *Report of the Third Finance Commission*).

The Finance Commissions did make adjustments to the states' forecasts of the budgets for the concerned years. But these adjustments could be mainly such as assuming certain rates of return from public enterprises and irrigation works and freezing salaries as of a given date etc. Apart from conceptual problems and data problems that made it difficult to judge tax effort on a comparable basis and get a measure of the efficiency of expenditure, there was a basic political problem with substantially re-drawing a state's budget for the base year.

As the Fifth finance Commission pointed out: "Under a federal Constitution, the States have plenary powers within their own sphere in deciding on their policies of taxation, expenditure and investment. It is difficult for a Commission or any outside authority to judge the propriety of these policies. It is not, therefore, possible to regulate the grants to States on the basis of any judgement regarding the particular policies adopted by individual States. Our terms of reference, however, require us to have regard to the scope for economy consistent with efficiency and to the scope for better fiscal management.

All that can be done is to keep in view broad considerations which can be applied to all the States as regards their total tax effort, overall expenditure levels, and returns from investment".

It is clear that the budget projections by the states given to the Finance Commissions could not be modified much. The Twelfth Finance Commission did disallow many items and assumed its own rates of growth of revenue and expenditure. But cutting down the states' figures or assuming higher rates of growth of revenue, and thus re-drawing the states' budgets amount to imposing basically the decisions of the Commission on the states.

Generally, in the very next year after a Commission's reporting, the actual revenues and expenditures started diverging from the Finance Commission's projections. In its report, the Fifth Finance Commission drew attention to the developments in the field of state finances since the implementation of the recommendations of the Fourth Finance Commission. "These recommendations were expected to leave ten states with no deficit on non-plan revenue account and six States with surpluses on such account. However, in a brief interval of less than three years a large number of States showed substantial revenue and capital deficits and several States ran into unauthorized over drafts" (para 2.12). During these years the economy was going through a difficult phase and the finances of the state governments were adversely affected. But even in other periods, one has seen the state budgets running into deficits after the Finance Commission had recommended transfers to cover the assessed deficits. Thus, there was a spurt in the post-devolution deficits in all states in 1997-98 and 1998-99. "Although few among the States ever showed a surplus in the budget without the Central transfers, with tax devolution there was at least some whose revenue budgets yielded a surplus even though small. In 1998-99, none but one (Karnataka) had a post-devolution non-plan revenue surplus" (*Report of the Eleventh Finance Commission*, para 2.10)[16]

[16] This describes the situation after the implementation of the recommendations of Tenth Finance Commission.

The states could argue that the deficits arose since their liabilities were higher than estimated by the Finance Commission. Naturally, they (the states) ran into deficits contrary to the expectations of the Finance Commission. However that may be, the fact is that the deficit ratios at the state level remained substantial even until the appointment of the Twelfth Finance Commission in 2002 (Table 3). The Twelfth Finance Commission has pointed out that the ratio of revenue to total fiscal deficit, which was about 34 per cent at the end of eighties increased to 68 per cent on average during 1999-2002 (*Report,* p.62).

Two important conclusions may be drawn: 1. Since every five years a new base year is chosen, finally actuals will get incorporated except to the minor extent that base year estimates themselves (actuals) are modified by the Finance Commission. They are, and can be only marginally modified. This is the most critical fact to be kept in mind in evaluating the system. 2. Substantial increases in transfers by way of devolution, combined with the Finance Commissions moderating the state budgets have not led to even near sustainability of state finances. Have the commissions not been making transfers in a manner *not leading to some tangible long-term of objectives?*

Implications and Economic Consequences of the Finance Commissions' General Approach[17]

a. Tax sharing and grants-in-aid have been treated as though they were both just two ways of transfers. In federations, where the principle of separation of tax powers has been adopted, tax sharing stands on a separate footing from grants-in-aid. The central government has its own claim on the share of taxes with the states and any adjudicatory authority must carefully consider the rightful claims of both the central government and the states on a broad judgement of their respective responsibilities. By treating tax sharing and grants-in-aid meant for only the weaker states as though they were both just simple transfers to the states, the Finance Commissions have not only made grants-in-aid to weaker states residuary grants, but also not paid enough attention to their function as adjudicating authority between the central government and the states on the sharing of taxes, a function specifically given to them under Article 280 of the Constitution.

b. The approach of the Finance Commissions gives the wrong incentives to the state governments in relation to the management of their finances. Let us assume that the state governments make the five-year "projections" of their budgets realistically. But over the years when they make their decisions on expenditure and taxes, the fact that gaps (even though modified gaps) will be filled would necessarily be kept in mind by the decision makers. In some cases, this might not be a significant factor; in other cases the possibility of shifting the burden of expenditure to the Central Exchequer (that is, the country as a whole) might motivate the policy makers. Thus, the citizens in different states end up financing services, subsidies and transfer payments which they would not have wanted to be given, if they had known that they would have to pay the bill. This represents a clear distortion of resource allocation.

c. Given the inevitability of starting the five-year projections of revenues and expenditures with more or less the base year actuals[18] the states "recover lost ground" when the actuals (or

[17] We call it the Finance Commissions' general approach though the origins are to be found in the Presidential Terms of References because no Finance Commission intellectually challenged them or sought to modify them.

[18] Even the Twelfth Finance Commission which made substantial modifications to the states' projections, could not/did not alter the base year's figures much.

close to actuals) are adopted by the next Finance Commission. Thus "moderations" of the states' projections of budgetary figures are not of much avail over the medium term.

d. The link between the decision to spend and the decision to raise resources is not retained even at the margin.

e. The transfers recommended by the Finance Commissions are no doubt weighted in favour of the backward states because of the large weight given to low per capita income in the tax sharing formula. But for the reasons mentioned earlier, the states that spend more in relation to their tax effort also get relatively more transfers.

f. The First Commission said: "We should like to emphasise here that it is not the purpose of any system of grants-in-aid to diminish the responsibility of the State Governments to balance their own budgets. The method of extending financial assistance should be such as to avoid any suggestion that the Central Government have taken upon themselves the responsibility for helping the States to balance their budgets from year to year" (*Report of the First Finance Commission*, p.97). This prescription laid down by the First Finance Commission has not been accepted in practice.

g. None of the Finance Commissions except the First, stressed, or even referred to, the criterion of autonomy and the desirability of sub-national governments managing their own affairs within the framework of broad national policy. In fact, autonomy of action by the sub-national governments will not have a significant role if someone else is going to balance the budget.

h. On capital account, the states have had access to funds (loans) from mainly three sources: i. Plan loans ii. market borrowing and iii. share of small savings based on collections within each state. None of them was to be obtained from the market on the basis of bidding. They were made available as entitlements based on non-monetary criteria. Even the share of market borrowing for a state was allocated and RBI helped the states, if necessary, to obtain the allotted amount. The share of a state in none of these was determined on the basis of performance, the nature of use, or capacity to repay. The loans were intended to be used mostly for capital formation. However, the states began incurring revenue deficits from the middle of the 1980's, which became substantial in the nineties. Their capital investments did not yield adequate returns. Hence dead weight debt was built up. As was to be expected, the states found it difficult to repay on schedule their loans from the central government. So, from the Sixth Finance Commission (1974-79) onwards, the Finance Commissions were asked to suggest debt relief for the states. The Sixth Commission suggested mainly some debt repayment rescheduling; but later Commissions recommended partial debt write off, interest write off or reduction and other relief measures that shifted the burden to the central government. The Eleventh and Twelfth Commissions linked relief on capital account to some indicators of performance. That was not going to make much difference to the basic situation. Given the debt overhang at the state level, if the same or similar approach is adopted by the future Finance Commissions, nudged by Presidential Terms of Reference, debt relief will have to continue. In the context of the moderated gap-filling approach, debt relief serves to confirm the "soft budget constraint" at the state level – of course, at the cost of the states losing their autonomy to manage their finances and of considerable inefficiency characterizing the system.

As indicated earlier, in the early years of the Indian Republic the state governments were required to undertake development functions which they had not undertaken before and the transfers they were then getting from the central government were clearly insufficient to enable them to undertake their new functions. Hence, central transfers through devolution had to increase substantially. That increase was brought about: The proportion of devolution in gross central tax revenue went up from about 12 per cent in 1950-51 to nearly 29 per cent in 1980-81 (Table 4). But then no consideration has been given in the deliberations of the Commissions as to how far this proportion could be allowed to rise taking all economic and political considerations into account. And also an appropriate methodology for determining the change in the proportion of devolution based on balancing criteria such as autonomy and fiscal discipline as well as the relative responsibilities of the states and the central government was not evolved. The central government's responsibility for maintaining macro economic stability has not been specifically taken into account as one of the determining factors. With the Finance Commissions adopting the 'gap filling' approach, the ratio of devolution to central tax revenue would have the tendency to keep rising. There was a slight dip in the proportion between 1980-81 and 1990-91 because the central government then raised additional revenues mainly through non-shareable taxes[19]. Then all central taxes were made shareable. Since with the given methodology the successive Finance Commissions are led to raise the percentage of devolution, the states' share is bound to go up. As has been pointed out in the literature, "The vertical fiscal gap is generated by the expenditure and revenue assignments. However, individual policy choices also play a significant role in determining the resulting ex post vertical gap. If a lower level of government chooses to increase spending or not raise assigned taxes, the vertical gap would increase. Thus, if transfers were designed solely to close the vertical gap, there would be little incentive for the lower levels of government to raise own account revenues or restrict or manage expenditures efficiently. Unless there are objective criteria for the determination of transfers, "gap filling" to finance sub-national deficits is likely to lead to macroeconomic difficulties as well as indeterminate "bargaining" between the centre and lower levels", (Ehtisham Ahmad and Jon Craig, 1997, p.74).

[19] As a counter-strategy to the Finance Commissions raising the proportion of devolution!

In the Reports of none of the Finance commissions is there any discussion of the impact of raising the volume of devolution and of the percentage of devolution on the ability of the central government to maintain macroeconomic stability, even after a substantial revenue deficit had arisen in the central budget. While the Finance Commissions could point out many serious instances of improvidence on the part of the central government, they cannot omit from consideration the adverse effect of the indefinite raising of the percentage of devolution on the maintenance of macroeconomic stability. And the raising of the central tax ratio involves many considerations that should be given sufficient weight. If, as one suspects, state budget gaps tend to be higher as they are expected to be filled, then raising the central tax ratio to finance the filling of the gaps would be a totally wrong policy.

3. An Outline of Proposal for Reform

We conclude that a re-look must be given to the methodology employed for determining Finance Commissions' recommendations on sharing of taxes and on determining grants-in-aid under Article 275 to "the states in-need-of assistance". A fresh approach should be formulated which would incorporate all the relevant principles – the right incentives (linking of decision to tax and to that to spend at least at the margin), equalization of fiscal capacity across states, adequacy and autonomy.

As the First Finance Commission pointed out, “it is not the purpose of any system of grants-in-aid to diminish the responsibility of the State Governments to balance their own budgets” (p.97). The states’ responsibility to balance their budgets is the fundamental basis of the federal fiscal system. For this the states must be able to plan their budgets in the short as well as in the medium term; and that requires stability in the assistance received by way of share of taxes. Hence, as has been prescribed in most federations, the formula of tax sharing should remain stable for longer than the medium term and the amount shared must be determined independently of the actual trends of the state budgets. Therefore, the first item in the reform of the present system of tax sharing must be to have the formula fixed for a period of 15 years. The Finance Commissions may be appointed every five years but their main job will be to deal with equalization grants, re-working the formula for this purpose and other matters related to public finance on which advice is needed. Secondly, grant-in-aid under Article 275 will be delinked from budgetary gaps. An attempt should be made to develop measures of deficiency in fiscal capacity which would be the bases for determining equalizing grants as in Canada.

Since tax sharing and equalizing grants-in-aid would be delinked from budget deficits or surpluses, the budgetary decisions of the states would not be influenced by the desire to influence the volume of central transfers. While fiscal responsibility will have to be assumed by the states, they would have full autonomy subject to observing common deficit rules which can be agreed upon through discussions at the Inter-State Council.

While the states will have autonomy in budget making, for promoting national priorities and to deal with the problem of spillover effects, special purpose grants may continue to be given by the central government within limits.

The relative shares of the central government and the states in central gross tax revenues will have to be decided upon a careful consideration of the responsibilities of the two levels of government. However, now that the share of the states has been fixed at 30.5 per cent and their expenditure levels have already been aligned to this percentage share, although the central government is incurring revenue deficits, it may be best to continue with the existing percentage share going to the states. In order to keep the devolution at the same level of 30.5 per cent of net divisible pool and to enable the governments to make the adjustments, advance notice about the change in the system has to be given within the next 12 months are so.[20]

A full discussion of the advantages of going to the new system in terms of gains in state autonomy, fiscal discipline (linking of decision to spend and decision to tax), equity, and minimum expenditure exportation, must be had among the central government and the states under some such body as the Inter-State Council. If a consensus could be evolved, the Constitution can be amended to the effect that the tax share of the states and the central government could be changed (up or down) once every fifteen years, *if need be* with an upper limit being fixed for the states’ share. The Constitutional amendment should lay down the considerations on which such a decision could be taken. But the actual or projected expenditures should not be one of the considerations. The change in percentage of devolution can be effected only through Parliamentary legislation with the approval of the Upper House. This means that there must be extensive discussion among the central and state governments.

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[20] The next (13th) Finance Commission is due to be appointed by October 2007.

The model of a federal fiscal system suggested in these pages is similar, in essential features, to those found in several advanced federations, with and without tax sharing. Those systems embody the same well-accepted economic and political principles as underlie the system suggested here. Australia, Germany, and China are among the prominent federations, that have used the tax sharing method for dealing with the vertical fiscal gap. The ratios of tax sharing are fixed with no link to “assessed gaps” and there are no attempts to quantify the “needs” of the states given proper own “tax effort” and “economy consistent with efficiency”. Once fixed, the relative shares of the states and the federal government remain constant unless some important changes take place. In Germany, for example, VAT is now fixed to be shared between the central government and the states (Lander) in the ratio of 50.5 : 49.5 the basis of agreement. The ratio has been fixed by law after consultations, but with the approval of the Upper House (Bundersat) This will remain constant from 2005-2019. It could be changed by law after that date with the consent of the Upper House. The shares of income taxes of the three levels of governments are fixed in the Constitution itself. The points to note is that changes occur only after fairly long intervals and not as a matter of routine. In Australia, the entire proceeds of GST, levied by the federal government, are transferred to the states. This is the transfer intended to cover vertical fiscal gap, though distributed through an equalizing methodology.

It may be pointed out that in Germany tax sharing is used also partly for the purpose of horizontal equalization. 75 per cent of the states’ share of VAT revenues are distributed among the Lander governments according to population, but the rest of the 25 per cent is additionally distributed among “the financially weak states”.

Road map for change

It is time in India for a comprehensive change in the principles and practices of intergovernmental transfers and if need be in other related matters. We need to lay the basis for responsible and efficient political action under a federal set up. We cannot afford to continue with wrong incentives resulting in inefficiency and periodic ‘bailing’ out of governments getting into debt trap. Moreover, as India gets itself more and more closely tied to the world economy, the central government’s capacity to maintain macro-economic stability and its ability to take effective counter-cyclical action should not be unduly fettered as of now. While the special category states may be treated to some extent as units that need to be specially nurtured, the states as a whole must be encouraged and permitted to act as governments that can manage their affairs and fulfill their priorities subject to national goals. The states raise nearly forty per cent of the combined tax revenues but after devolution, have at their disposal 55 per cent of the total (Table 1). After devolution and grants, the states’ share of total combined revenues is 62 per cent. (Table 2) It cannot be argued that the states are comparatively deprived of revenues and that they do not have access to elastic source of revenue. If the states are restricted to around 62 per cent of the total revenues which in turn amount to about 16-17 per cent of GDP and which will at least rise proportionately with GDP, the states should be considered to have enough resources for discharging all their important responsibilities. The resources (on current account) available to them would be rising at 7-8 per cent in real terms.

There has to be wide-ranging discussion among the states and the central government on the lines of reform, as were held to evolve a consensus on the introduction of state level VAT. The major features of the new system should be:

a. The relative shares of the central government and the states in *central* gross tax revenues should remain fixed at least for 15 years.

b. Tax sharing should be used mainly for closing the vertical gap and the central government's claim on its own share must be considered and given weight. Also, tax sharing is in fact, though not in law, a response to tax centralisation. And in distributing the shared tax among the states, strictly speaking, each state's contribution should be given considerable weight. Since this factor cannot be measured in some cases and contribution as a base will be counter-equalising, the distribution could be according to population, which would reflect needs. But by law in India 1971 population figures have to be used. This must be changed. Population figures of the nearest Census should be used along with the respective GSDPs with the weights of 75 : 25.

c. On top of it, equalizing grants should be given on the basis of measures of relative deficiency in fiscal capacity that should be developed. There are different models to follow in doing this, such as the Canadian, the German and the Australian. As of now, the amounts of Article 275 grants to the states "in need of assistance" are determined almost fortuitously: The ratio of tax sharing is hiked up by each Commission to cover a high proportion of the total assessed non-plan resource gap. This would cover the gaps of most of the states. Then, grants are given to cover the uncovered gaps of some states. These residuary gaps cannot be said to measure, on any defined criteria, relative deficiency in fiscal capacity of different states. These gaps are the resultant of various moderations and the extent of hike in the tax sharing ratio.

d. As described earlier, the Finance Commissions supplemented their gap filling exercise by debt relief of various types. This has continued right up to the Twelfth Commission. An important part of the reform must be to put an end to this process of bailing out the states on capital account. The Twelfth Commission has started the process of change by recommending that the central government should not be extending loans to the states, but that the latter obtain the loans directly from the market. But the states now get loan funds from the central collection of small savings though these are not shown as loans in central budget. As part of the reform, the states' borrowing from Small Savings should be made into loans from an autonomous Small Savings Trust which will receive funds from the central government and give loans according to rules that would be linked to capacity to repay (among other factors).

In carrying out the reform on the capital side, three major problems have to be tackled: (a) the present large debt overhang has to be dealt with before denying further debt relief to the states; (b) rules for borrowing from the Small Savings Trust have to be formulated keeping in mind the present level of intake and the capacity of the states to repay; i.e., the borrowing from the small savings fund should be allowed to increase in the light of the capacity of a state to repay, given its budgetary conditions and (c) while within the overall ceiling of the borrowing fixed, the states will borrow from the market, some ways will have to be devised to help the financially weaker states to get at least a specified minimum level of funds without having to pay a much higher rate of interest. Some central help will be in order, but this must be only for a short period of ten or fifteen years.

A moment's reflection would show that repeated debt relief is a self-perpetuating process; on the top of the gap-filing, it well-nigh nullifies the budget constraint. The best way of dealing with the unsustainable level of debt that has been built up is to give a one-off big write off, along with the change in policy that would stipulate that post-write off each state will be responsible for managing its own debt and that there will be no more debt relief extended from the central government whether the debt is owed to the central government or to the market. I would suggest that 50 percent of the debt that the states owe to the central government should be written off simultaneously with the new system of states borrowing on market principles and cessation of "gap filling". This is necessary to enable them to adjust to a regime of hard budget constraint. At the same time, a Maastricht type of agreement should be entered into between the central government and the states that creation of credit for the benefit of the government sector would not exceed the norm derived from the rules of monetary prudence set by the RBI. (budget constraint for the central government).

In India, the devices for dealing with the vertical fiscal gap and the horizontal (fiscal) inequalities have been merged. The net result of the methods followed has been *a decline* in the relative shares in tax devolution over time of states with higher per capita income and better financially managed. Thus, as Table 5 shows, the shares of states like Maharashtra, Tamil Nadu, Punjab and Gujarat have declined between 1980-81 and 1999-2000, the period covered by the Sixth to the Tenth Finance Commissions. One of the reasons for this that from the Seventh Commission onwards lowness of per capita income has been given much weight in the distribution of tax share among the states. But the states that did not manage their finances well, relatively as well as absolutely

speaking, also gained because of the gap-filling methodology. How much did particular states gain from low per capita income or higher or wasteful expenditures or lower tax effort[21] is a question that has not been empirically determined. But by using tax sharing as the main equalizing instrument, the later Finance Commissions have unfairly treated some states that have done better economically and financially. In a federation, with centralisation of tax assignment, each state has a claim related to the amount of tax money its residents pay to the central government. The amount paid by the residents of a state should at least be given substantial weight, if not made the only base. This is clear from Article 270, clause 2 which states "Such percentage, as may be prescribed, of the net proceeds of any such tax or duty in any financial year shall not form part of the Consolidated Fund of India, *but shall be assigned to the states within which that tax or duty is leviable in that year,* and shall be distributed among those states….." (italics added).

One can understand the relative per capita devolution of a better off state being fixed lower than that of a poorer state. But it can be said to be against federation *dharma* that the relative share of devolution of a state that is contributing relatively more to the federation, whose proportionate contribution is perhaps rising and that is managing its affairs better, should continuously decline.

The initiative to ask for change has to be taken by fiscal economists and political scientists who are undoubtedly aware of the experiences of other federations. More importantly, those states that are being penalized and asked to accept a decreasing share of devolution over time should certainly ask for a change, while not hesitating to support equalization payments that are based on objective criteria (as

[21] Allowing for relative deficiency in taxable capacity

in Canada). Indeed, the states in general should welcome a change in the rules of the game which would be giving each state autonomy of choice and require it to balance its own budget given a fair share of central taxes and an equalization grant calculated on the basis of accepted and objective criteria. So it is to be hoped that the demand for change would be strong enough to get the central government to act.

Work on the lines of reform of the system of federal fiscal relations covering all the aspects dealt with above should be started immediately so that recommendations on reform to be taken up for discussion by the representatives of the states, the central government and the experts can be formulated soon. Consensus on reform will have to be reached well before the date of the appointment of the next (13th) Finance Commission. If that does not prove to be possible, the next Finance Commission may be asked to work out a scheme of reform and get it approved by the National Development Council.

The need for this substantial reform is a matter for serious national concern in the perspective of efficient growth and healthy political development. The basic rules of government must be such that voters will have the means of controlling those whom they vote to power (in each states and in the federation) and for this at the margin at least those who spend will also raise the resources. The present system is not only inefficient and inequitable, it is no longer sustainable with the ratio of tax devolution rising every five years, no end to deficits on revenue account and periodic debit write off. Each Finance Commission looks only at the succeeding five years, but political leadership and economic advisors should have a longer horizon.

Table 1: Tax Revenues of the Centre and the States: Raised and Accruals

(Percentages)

Year	Gross Tax Revenue of the Centre		Own Tax Revenue of the States		Taxes Accruing to the Centre		Taxes Accruing to the States		Total Taxes as % of GDP
	As % of GDP	As % of Total Taxes	As % of GDP	As % of Total Taxes	As % of GDP	As % of Total Taxes	As % of GDP	As % of Total Taxes	
1950-51	4.08	64.59	2.23	35.41	3.59	56.94	2.72	43.06	6.31
1955-56	4.46	63.15	2.60	36.85	3.78	53.52	3.28	46.48	7.06
1960-61	5.21	66.30	2.65	33.70	4.25	54.07	3.61	45.93	7.86
1965-66	7.45	70.53	3.11	29.47	6.45	61.09	4.11	38.91	10.56
1970-71	7.02	67.47	3.38	32.53	5.37	51.58	5.04	48.42	10.40
1975-76	9.14	68.05	4.29	31.95	7.22	53.75	6.21	46.25	13.43
1979-80	9.91	67.71	4.72	32.29	7.09	48.45	7.54	51.55	14.63
1980-81	9.17	66.41	4.64	33.59	6.53	47.31	7.27	52.69	13.80
1981-82	9.40	65.64	4.92	34.36	6.86	47.94	7.45	52.06	14.32
1982-83	9.40	64.96	5.07	35.04	6.94	47.93	7.54	52.07	14.47
1983-84	9.44	65.73	4.92	34.27	7.05	49.09	7.31	50.91	14.36
1984-85	9.56	65.54	5.03	34.46	7.21	49.41	7.38	50.59	14.59
1985-86	10.31	66.26	5.25	33.74	7.62	48.95	7.95	51.05	15.56
1986-87	10.55	66.29	5.37	33.71	7.83	49.18	8.09	50.82	15.92
1987-88	10.63	66.11	5.45	33.89	7.92	49.26	8.16	50.74	16.08
1988-89	10.55	66.45	5.33	33.55	8.02	50.51	7.86	49.49	15.88
1989-90	10.62	66.46	5.36	33.54	7.90	49.43	8.08	50.57	15.98
1990-91	10.12	65.64	5.30	34.36	7.57	49.07	7.86	50.93	15.43
1991-92	10.31	65.27	5.49	34.73	7.68	48.61	8.12	51.39	15.80
1992-93	9.97	65.37	5.28	34.63	7.23	47.40	8.02	52.60	15.26
1993-94	8.82	62.10	5.38	37.90	6.23	43.87	7.97	56.13	14.19
1994-95	9.11	62.43	5.49	37.57	6.66	45.62	7.94	54.38	14.60
1995-96	9.36	63.46	5.39	36.54	6.90	46.75	7.86	53.25	14.75
1996-97	9.48	64.54	5.21	35.46	6.92	47.10	7.77	52.90	14.69
1997-98	9.14	63.09	5.35	36.91	6.28	43.36	8.21	56.64	14.49
1998-99	8.26	61.71	5.12	38.29	6.01	44.91	7.37	55.09	13.38
1999-00	8.87	62.55	5.31	37.45	6.62	46.71	7.55	53.29	14.18
2000-01	9.03	61.77	5.59	38.23	6.54	44.76	8.07	55.24	14.61
2001-02	8.23	59.47	5.61	40.53	5.88	42.50	7.96	57.50	13.84
2002-03	8.76	60.60	5.70	39.40	6.49	44.85	7.98	55.15	14.46

Computed using GDP figures from the CSO (website) and data on Tax Revenues from *Indian Public Finance Statistics*, Ministry of Finance, Government of India (Various issues).

Table 2: Revenues of the Centre and the States: Raised and Accruals

(Percentages)

Year	Revenue Raised by the Centre		Revenue Raised by the States		Revenue Accruals of the Centre		Revenue Accruals of the States		Total Revenue (Centre & States) as % of GDP
	As % of GDP	As % of Total Revenue	As % of GDP	As % of Total Revenue	As % of GDP	As % of Total Revenue	As % of GDP	As % of Total Revenue	
1950-51	4.74	60.15	3.14	39.85	4.13	52.16	3.78	47.84	7.91
1955-56	5.67	61.27	3.59	38.73	4.21	44.60	5.23	55.40	9.45
1960-61	6.27	62.80	3.72	37.20	4.26	41.29	6.06	58.71	10.33
1965-66	8.35	65.01	4.49	34.99	6.64	49.60	6.75	50.40	13.39
1970-71	7.77	63.33	4.50	36.67	5.34	41.63	7.49	58.37	12.84
1975-76	10.38	65.33	5.51	34.67	7.46	45.39	8.98	54.61	16.44
1979-80	11.56	64.85	6.27	35.15	6.75	38.43	10.81	61.57	17.55
1980-81	10.70	64.09	6.00	35.91	6.12	36.92	10.46	63.08	16.58
1981-82	10.98	63.79	6.23	36.21	6.75	39.39	10.38	60.61	17.13
1982-83	11.22	63.34	6.49	36.66	6.82	38.82	10.75	61.18	17.57
1983-84	10.80	63.59	6.18	36.41	6.40	38.02	10.44	61.98	16.84
1984-85	11.29	63.86	6.39	36.14	6.83	39.01	10.68	60.99	17.51
1985-86	12.11	65.04	6.51	34.96	6.87	37.45	11.48	62.55	18.35
1986-87	12.43	65.33	6.59	34.67	7.22	38.42	11.56	61.58	18.78
1987-88	12.27	64.15	6.86	35.85	6.96	36.91	11.90	63.09	18.86
1988-89	11.98	64.79	6.51	35.21	7.06	38.37	11.33	61.63	18.39
1989-90	12.53	65.85	6.50	34.15	8.01	42.22	10.97	57.78	18.98
1990-91	11.32	64.40	6.26	35.60	6.42	36.79	11.04	63.21	17.46
1991-92	11.75	62.76	6.97	37.24	6.68	35.90	11.94	64.10	18.62
1992-93	11.60	64.01	6.52	35.99	6.46	35.69	11.64	64.31	18.10
1993-94	10.30	60.17	6.81	39.83	5.27	30.75	11.87	69.25	17.14
1994-95	10.37	58.88	7.24	41.12	5.91	33.61	11.67	66.39	17.58
1995-96	10.63	60.78	6.86	39.22	6.35	36.40	11.09	63.60	17.44
1996-97	10.75	62.46	6.46	37.54	6.39	37.36	10.72	62.64	17.11
1997-98	10.48	62.20	6.37	37.80	6.12	36.13	10.82	63.87	16.94
1998-99	9.61	60.47	6.28	39.53	5.88	37.25	9.90	62.75	15.78
1999-00	10.29	61.08	6.56	38.92	6.50	38.52	10.38	61.48	16.89
2000-01	10.43	62.27	6.32	37.73	6.13	36.63	10.61	63.37	16.75
2001-02	9.98	59.77	6.72	40.23	5.76	34.50	10.94	65.50	16.70
2002-03	10.50	61.17	6.67	38.83	6.47	37.69	10.70	62.31	17.17

Computed using GDP data from the CSO (website) and data on revenues and taxes are from *Indian Public Finance Statistics*, Ministry of Finance, Government of India (Various issues).

Table 3 : Fiscal Deficit (FD) and Revenue Deficit (RD) of the Centre and States

(Rs. Crore)

Year	Centre		*States*		Combined	
	FD	RD	FD	RD	FD	RD
1980-81	8299 (5.77)	2037 (1.42)	3713 (2.58)	-1486 (-1.03)	10780 (7.50)	551 (0.38)
1981-82	8666 (5.14)	392 (0.23)	4063 (2.41)	-1379 (-0.82)	10608 (6.29)	-987 (-0.59)
1982-83	10627 (5.64)	1308 (0.69)	4986 (2.65)	-888 (-0.47)	11116 (5.90)	420 (0.22)
1983-84	13030 (5.94)	2540 (1.16)	6359 (2.90)	-210 (-0.10)	15971 (7.28)	2330 (1.06)
1984-85	17416 (7.09)	4225 (1.72)	8199 (3.34)	923 (0.38)	22013 (8.97)	5148 (2.10)
1985-86	21858 (7.86)	5889 (2.12)	7521 (2.71)	-654 (-0.24)	22174 (7.98)	5235 (1.88)
1986-87	26342 (8.47)	7777 (2.50)	9269 (2.98)	-170 (-0.05)	30789 (9.89)	7607 (2.44)
1987-88	27044 (7.63)	9137 (2.58)	11219 (3.17)	1088 (0.31)	32432 (9.15)	10225 (2.89)
1988-89	30923 (7.34)	10515 (2.49)	11672 (2.77)	1807 (0.43)	35887 (8.51)	12322 (2.92)
1989-90	35632 (7.33)	11914 (2.45)	15433 (3.17)	3682 (0.76)	43135 (8.87)	15596 (3.21)
1990-91	44632 (7.85)	18562 (3.26)	18787 (3.30)	5309 (0.93)	53580 (9.42)	23871 (4.20)
1991-92	36325 (5.56)	16261 (2.49)	18900 (2.89)	5651 (0.87)	45850 (7.02)	21912 (3.35)
1992-93	40173 (5.37)	18574 (2.48)	20891 (2.79)	5114 (0.68)	52404 (7.00)	23688 (3.17)
1993-94	60257 (7.01)	32716 (3.81)	20596 (2.40)	3813 (0.44)	70952 (8.26)	36529 (4.25)
1994-95	57703 (5.70)	31029 (3.06)	27697 (2.73)	6156 (0.61)	71639 (7.07)	37185 (3.67)
1995-96	60243 (5.07)	29731 (2.50)	31426 (2.65)	8201 (0.69)	77671 (6.54)	37932 (3.19)
1996-97	66733 (4.88)	32654 (2.39)	37251 (2.72)	16114 (1.18)	87244 (6.38)	48768 (3.56)
1997-98	88937 (5.84)	46449 (3.05)	44200 (2.90)	16333 (1.07)	110743 (7.27)	62782 (4.12)
1998-99	113349 (6.51)	66976 (3.85)	74254 (4.27)	43642 (2.51)	157053 (9.02)	110618 (6.35)
1999-00	104717 (5.41)	67596 (3.49)	91480 (4.72)	53797 (2.78)	184826 (9.54)	121393 (6.27)
2000-01	118816 (5.69)	85234 (4.08)	89532 (4.28)	53569 (2.56)	199852 (9.56)	138803 (6.64)
2001-02	140955 (6.20)	100162 (4.41)	95994 (4.23)	59188 (2.61)	226425 (9.97)	159350 (7.01)
2002-03	145072 (5.89)	107879 (4.38)	102123 (4.15)	55111 (2.24)	234987 (9.54)	162990 (6.62)
2003-04	123272 (4.47)	98262 (3.56)	121420 (4.40)	61238 (2.22)	232852 (8.44)	159500 (5.78)

Figures in parentheses are percentages of GDP

Source: CSO (website) for the GDP data and *Handbook of Statistics on the Indian Economy* (RBI) for the deficit figures.

Table 4: Proportion of Tax Devolution in Gross Taxes of the Centre and of Total Transfers in Gross Revenues of the Centre

Year	Tax Devolution as % of Gross Taxes of the Centre	Central Transfers as % of Revenue Raised by the Centre
1950-51	11.85	13.59
1960-61	18.44	37.42
1970-71	23.55	38.52
1980-81	28.77	42.82
1990-91	25.24	43.24
2001-02	28.55	42.29

Source: Computed using the data on GDP from CSO (website) and data on revenue and transfers from *Indian Public Finance Statistics*, Ministry of Finance, Government of India (Various issues).

Table 5 : Relative Shares of States in Devolution from the Central Government recommended by the Finance Commissions

Percentages

Sl. No.	States	Sixth Commission		Seventh Commission		Eighth Commission		Ninth Commission		Tenth Commission		Eleventh Commission
		Income Tax	Excise Duties	Income Tax	Excise Duties	Income Tax	Excise Duties	Income Tax	Excise Duties	Income Tax	Excise Duties	Total Devolution
1.	Andhra Pradesh	7.76	8.16	8.02	7.69	8.19	8.59	8.21	7.17	8.47	8.47	7.70
2.	Arunachal Pradesh	-	-	-	-	-	-	0.07	0.90	0.17	0.17	0.24
3.	Assam	2.54	2.71	2.52	2.79	2.79	2.98	2.63	3.81	2.78	2.78	3.29
4.	Bihar	9.61	11.47	9.54	13.02	12.08	13.20	12.42	11.03	12.86	12.86	14.60
5.	Goa	-	-	-	-	-	-	0.11	0.52	0.18	0.18	0.21
6.	Gujarat	5.55	4.57	5.96	4.10	4.41	3.51	4.55	3.18	4.05	4.05	2.82
7.	Haryana	1.77	1.53	1.82	1.18	1.07	1.02	1.24	1.10	1.24	1.24	0.94
8.	Himachal Pradesh	0.60	0.63	0.60	0.52	0.56	0.59	0.60	1.94	0.70	0.70	0.68
9.	Jammu & Kashmir	0.81	0.90	0.82	0.84	0.84	0.86	0.70	3.55	1.10	1.10	1.29
10.	Karnataka	5.33	5.45	5.44	4.88	4.98	5.08	4.93	4.10	5.34	5.34	4.93
11.	Kerala	3.92	3.86	3.95	4.04	3.76	3.80	3.73	3.09	3.88	3.88	3.06
12.	Madhya Pradesh	7.30	8.15	7.35	8.73	8.38	8.85	8.19	7.22	8.29	8.29	8.84
13.	Maharashtra	11.05	8.58	10.95	6.63	8.39	6.22	8.19	5.19	6.13	6.13	4.63
14.	Manipur	0.18	0.21	0.19	0.22	0.22	0.23	0.17	1.17	0.28	0.28	0.37
15.	Meghalaya	0.18	0.19	0.18	0.20	0.18	0.19	0.21	0.89	0.28	0.28	0.34
16.	Mizoram	-	-	-	-	-	-	0.07	1.11	0.15	0.15	0.20
17.	Nagaland	0.09	0.11	0.09	0.10	0.09	0.10	0.10	1.35	0.18	0.18	0.22
18.	Orissa	3.73	4.06	0.74	4.68	4.20	4.59	4.33	5.36	4.50	4.50	5.06
19.	Punjab	2.75	1.87	2.71	1.23	1.74	1.32	1.71	1.36	1.46	1.46	1.15
20.	Rajasthan	4.50	5.00	4.36	4.81	4.55	4.70	4.84	5.52	5.55	5.55	5.47
21.	Sikkim	-	-	0.04	0.03	0.04	0.04	0.03	0.26	0.13	0.13	0.18
22.	Tamil Nadu	7.94	7.43	8.05	7.64	7.57	7.32	7.93	6.38	6.64	6.64	5.39
23.	Tripura	0.27	0.30	0.26	0.37	0.27	0.29	0.30	1.56	0.38	0.38	0.49
24.	Uttar Pradesh	15.23	17.03	15.42	18.29	17.91	19.10	16.79	15.64	17.81	17.81	19.80
25.	West Bengal	8.89	7.79	8.02	8.03	7.80	7.45	7.98	6.60	7.47	7.47	8.12
	Total	**100.00**	**100.00**	-	-	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Source: Fifty Years of Fiscal Federalism, Finance Commissions of India, April (2003), Twelfth Finance Commission, Government of India

Appendix

Arrangements for Tax Sharing and Inter-Governmental Transfers in Germany, Australia and Austria

Germany

The tax system is highly centralized. The personal income tax, the company profits tax and VAT are all legislated and levied by the federal government. But the states are responsible for all tasks that are not explicitly assigned to the federal government. The large vertical fiscal gap is sought to be closed by tax sharing. The revenue from personal income tax is shared between the federal government, the states (lander) and the municipalities in the ratio of 42.5 per cent, 42.5 per cent and 15 per cent, respectively. The yield of the corporate profits tax and the capital tax are equally shared between the federal government and the states. These ratios of shares of direct taxes are constitutionally fixed (not subject to frequent change)[22]. The horizontal apportionment of the shares follows the principle of derivation. However, the vertical splitting of the proceeds of Vat is fixed by a federal law, which requires the consent of the *Bundersat* (Upper House). At present the federal share of VAT is 50.5 per cent with the states getting the remaining 49.5 per cent. These features are not subject to frequent change, i.e., the vertical tax splitting is not changed from time to time.

However, there is an equalization law, which is re-enacted from time to time. The present law (which is also called the "Solidarity Pact") will hold good during 2005-2019. This law specifies the measures of horizontal re-distribution among the states and municipalities for the purpose of reducing inequalities. As part of that, it also lays down

[22] Sources: Spahn, P.B. and O. Franz, (2002); Rao, M.G. (forthcoming)

the manner of distribution of sates' share of Vat among them. Out of the total states' share of Vat, 75 per cent is distributed among them on the basis of population. The rest of the 25 per cent is reserved for the states considered 'financially weak'. They receive supplementary transfers from the VAT share in order to bring their fiscal potential up to at least 92 per cent of the average of total state taxes" (Spahn P.B. and Franz, G. 2002).

At the second level, there is a scheme of redistribution of resources among the states in which the richer states make payments to the weaker states. In addition to inter-state transfers, supplementary equalizing grants are given by the federal government to the states that are considered "weak in the provision of services". Some other grants are also given by the federal governments to help states with special problems. In principle, block grants from the central government are the best means of equalizing fiscal capacity. But the grants given by the federal government in Germany, unlike those by the Canadian government, tend to be gap filling because they are related to the actual revenues of the states. They are being criticized as tending to soften the budget constraint. The inter-state transfers also tend to penalize tax effort. Three states – the so-called paying states – recently challenged the Equalization Law before the Constitutional Court.

Australia

Australia started as a federal system with almost full concurrent tax powers, but over the hundred years of its existence, has become a federation with a highly centralized tax system. The power to levy the income tax was taken away from the states during the years of World War II. This loss of revenue raising power by the states was compensated by financial assistance grants. The relative volume of grants to a state was largely determined by the amount of wage payments. The grants were increased each year on the basis of a formula "stressing three factors for each state, viz. population changes, average wage increases and a so-called betterment factor designed to allow the states to expand their relative level of services" (C. Rangarajan and D.K. Sirvastava, 2004). Thus, payments or transfers to fill vertical fiscal gap had no equalizing element and were not linked to actual budgetary trends. This system of transfers was replaced in 1976 by tax sharing until 1986 when financial assistance grants were re-introduced.

Along with the system of financial assistance grants, there existed in Australia a unique system of equalization grants which were given to the states on the basis of the recommendations of the Commonwealth Grants Commission (CGC). These equalization grants were tailored to equalize fiscal capacity among the states such that if each state "made the same [average] effort to raise revenue from its sources and operated at the same level of efficiency each would have the capacity to provide services at the same standard" – (CGC – quoted in C.Rangarajan and D.K.Srivastava, 2004, p.34). In working out the amount of equalization grant to which a state is eligible both relative fiscal capacities and relative cost disadvantages are taken into account.

In 2000, the Federal transfer system in Australia was again changed. As a result of the introduction of a Goods and Service Tax (GST) at the central level (levied and administered by the Commonwealth Government), the states had to give up the minor domestic trade taxes they were levying. It was agreed that the entire proceeds of the GST would be distributed among the states. The distribution, it was decided, would be according to the "relativities" worked out by the CGC. The equalization and filling the vertical fiscal gap were merged – the same instrument was to accomplish both the tasks.

While the federal equalization attempts are much admired, not everyone is satisfied with the present system. First of all, the Australian tax system is over-centralised. About 76 per cent of the total tax revenue is now being collected by the central government. Second, the distribution of the proceeds of the GST according to CGC relativities means that in the tax sharing formula contribution or derivation has not been given any weight. There has been much controversy in Australia about the present grant system, particularly about the manner in which the principle of horizontal equalization is applied. It is reported that three richer states, viz. New South Wales, Victoria and Western Australia appointed a Review Committee consisting of experts to evaluate the system of transfers in terms of efficiency, equity and transparency.

What we may note for our purpose is that the Australian grant system has no link to actual or projected budget balances of the individual states. The total grants available increase along with GST revenue – basically. Wrong incentives are not generated by the manner of determining the grants. However, the merging of the revenue sharing and equalization grants seems undesirable because no weight at all is given to derivation in the transfer formula.

Austria

Austria also has a highly centralized tax system. The states and the municipalities have very limited taxing powers. As of 2005, 74.6 per cent of total taxes are shared federal taxes, 17.4 per cent exclusive federal taxes, 0.7 per cent exclusive state taxes and 7.3 per cent exclusive municipal taxes, (Margit Schratzenstaller, 2005, p.14]. Thus the authority of the sub-national governments to spend more or less by varying their own taxes is quite limited.

Tax sharing has an important role in the federal fiscal relations in Austria. A Tax Sharing Act is enacted every four years. The present Act, passed in 2004, will hold good during 2005- 2008. This lays down the federal taxes to be shared, the proportions of the taxes to be shared and the manner of distribution of the shares among the sub-national governments.

Along with the Revenue Sharing Act, a Stability Pact is enacted of equal duration; they are closely inter-related in the sense that the tax sharing is determined in the light of the tasks to be accomplished – the levels of deficits to be reached - by the end of the period by the various governments. “The 2005 Stability Pact fixes the yearly stability contributions the individual governmental levels have to make during the four-year period from 2005 to 2008 to ensure the realization of the consolidation path outlined in the Austrian stability programme”, (Margit Schratzenstaller 2005, pp.12-13) : According to this programme, the government sector’s Maastricht – relevant deficit is to be reduced from 1.9 per cent of GDP in 2005 to zero per cent in 2008. In so far as the tax share determination is partly linked to enabling governments to reduce their deficits to the specified levels, an element of inefficiency is introduced. As argued earlier, the tax shares should be determined on a broad judgement of the respective responsibilities and given tax entitlements, the governments concerned should strive to reach the stability level. However, since the levels of deficit are jointly determined the incentive to raise expenditures by individual government is limited.

The shared taxes are distributed among the sub-national governments on the basis of weighted population. The weighting is intended to take care of varying needs such as the extra demands for services created by large and congested municipalities. The weighted population as the basis of distribution suggests that the objective is to provide broadly according to needs.

Apart from tax sharing, the federal government gives various types of specific grants. (These are equalizing). Also, block grants are given by the federal government to municipalities “with below-average potential own resources”. Thus in Austria “equalization” in the sense of reducing regional inequalities is attempted through grants, the taxes being distributed on the basis of weighted population.

One of the important drawbacks of the Austrian federal fiscal system is the frequency with which the Revenue Sharing Act (or the Equalisation Law) is changed. “The more often revenue allocations are negotiated between the different administrations the higher the risks are that agreed-upon deficit caps are not considered effectively binding. Hence, relatively frequent re-negotiation of the Fiscal Equalisation Law .... is likely to weaken inter-temporal budget constraints to sub-national governments’ spending decisions, easing incentives for budgetary consolidation”, (Fuentes, A.E. Wurzel and A. Wörgötter, 2006, p.26).

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