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A CASE STUDY

Fiscal federalism in India: An appraisal

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ABSTRACT

India pursues a federal form of government with strong unitary features. Institutions of federalism have helped the country to reach great heights in socio-economic development. Notwithstanding those achievements, disparities have been increasing across the States. Hence the study attempted to explore the inherent problems of Indian federal fiscal set up. Constitutionally, the States are left in a disadvantaged position in exercising their borrowing powers. Decreasing budgetary support and increasing discretionary transfers from Centre have severely constrained them in drawing and implementing schemes of their priorities. Moreover, the compliance and enforcement cost of central legislations are largely borne by the States. Low tax buoyancies and exclusion of certain taxes from the divisible pool further exaggerates their miseries. Such disproportional assignments of resources and responsibilities have caused a high degree of vertical imbalance against the States; even as they struggle to meet their expenditures with transferred revenue. To rectify such imbalances, successive Finance Commissions thrive to achieve maximum equalization among the States through efficient horizontal transfers.

KEY WORDS : Fiscal federalism, Regional imbalances, Fiscal deficit, Vertical imbalance, Horizontal imbalance

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Federalism refers to a system of government in which powers and responsibilities are constitutionally divided between Centre and States. Influenced by the experiences of colonial history, India adopted a federal form of government with strong unitary features. The 7th schedule of our constitution specifies the legislative, executive, judicial and fiscal domain of central and state governments in terms of Union, States and Concurrent lists. Further, Article 280 of the constitution mandates the President of India to appoint a Finance Commission every five years to review the finances of Centre and States, and recommend transfer of taxes and grants from Centre to States. Through 73rd and 74th constitutional amendments in 1992, constitutional status was accorded to rural and urban local governments, which necessitates the States to appoint a State Finance Commission to recommend tax and grant transfers to them. Following these developments, Article 280 was also amended mandating the Finance Commission to make its recommendations to augment the consolidated fund of States to supplement the resources of local bodies. Since 1951, 13 Finance Commissions have been constituted. In December 2009, the Thirteenth Finance Commission submitted its report and its recommendations will be applicable for the period 2010-15.

In addition to such constitutional devolution, The Planning Commission, which is a non-constitutional and non-statutory body, also provides assistance to States based on a formula determined by the National Development Council. Further, different Central Ministries also provide grants to States for implementing their schemes like Sarva Siksha Abhiyan, MGNREGS *etc*. Among these, three routes of resource devolution, transfers through Finance Commissions are predominant and increasing over the years with 68 per cent contribution.

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Performance of Indian economy:

The performance of a country is influenced by many factors among which, government policies and institutions play a crucial role. In this way, institutions of federalism along with other institutions of governance like the legal system and the civil services have a bearing on the efficiency of government in performing its fiscal tasks in a variety of ways (Bagchi, 2003).

From a nascent state, India's economy has evolved dramatically during the past sixty years of planning period (Appendix 1). The Gross Domestic Product (GDP) has increased from 2 lakh crore to 49 lakh crore. The annual GDP growth rate which was hovering around 3 per cent during the decades of 1950s and 1960s has increased to 5 per cent during 1980s and 1990s. Incidentally, the first decade of this millennium witnessed our economy achieving more than 9 per cent growth per annum. Similarly, the per capita income which was Rs.6,000 has increased to Rs.36,000. To augment production, the rate of saving and capital formation have increased from around 10 per cent to 35 per cent of GDP during this period. In the trade front, our exports and imports have increased tremendously from $1 billion to $ 180 billion

Appendix 1: Key socio-economic indicators

Indicator	1950-51	1990-91	2010-11
GDP at constant prices (Rs. lakh crore)	2	11	49
GDP Growth at constant prices (%)	2.4	5.3	8.4
Per capita income at constant prices (Rs.)	6,000	11,500	36,000
Saving (% of GDP)	9	23	32
Capital formation (% of GDP)	8	26	35
Exports ($ billion)	1	18	180
Imports ($ billion)	1	24	288
Forex reserve ($ billion)	2	2	255
Foodgrain production (Mt)	51	176	242
Gross cultivated area (Mha)	141	166	173
Irrigation potential (Mha)	23	81	108
Finished steel (Mt)	1	14	76
Cement (Mt)	3	49	216
Coal (Mt)	32	226	571
Crude oil (Mt)	0	33	38
Electricity generated (BKWH)	5	264	796
Agriculture contribution to GDP at factor cost (%)	55	31	15
Industry contribution to GDP at factor cost (%)	15	26	28
Services contribution to GDP at factor cost (%)	30	43	57
Agriculture contribution to exports (%)	44*	19	10
Ores and minerals contribution to exports (%)	8*	5	4
Manufactured goods contribution to exports (%)	45*	73	68
Crude and petroleum contribution to exports (%)	1*	3	17
Proportion of direct tax in total tax (%)	21#	16	60
Proportion of indirect tax to total tax (%)	79#	84	40
Population growth (% per annum)	1.25	2.2	1.6
Birth rate (per 1000)	40	30	22
Death rate (per 1000)	27	10	7
Life expectancy (years)	32	59	64
Literacy rate (%)	18	52	74
Infant mortality rate (per 1000 births)	-	80	50
Human development index	-	0.39	0.55

Note: * Figures pertain to 1960-61, # Figures pertain to 1970-71, **Source:** Economic survey, 2011-12.

and $ 288 billion, respectively. The forex reserve of our country had also crossed the $ 300 billion mark in 2007-08 before declining to $ 255 billion in 2010-11.

The foodgrain production which was only 51 Mt has increased to 242 Mt. This tremendous achievement may be attributed partly to increase in the gross cultivated area from 141 M ha to 173 M ha and expansion of irrigation potential from 23 M ha to 108 M ha. In the industrial sector, the production of finished steel, cement, coal, crude oil and electricity have also increased manifold. As a country develops, the share of primary sector in its growth declines while that of industry and services increases. India has also experienced this paradigm shift, as the contribution of agriculture to GDP has been declining from 55 per cent to 15 per cent while that of industry and services sectors has almost doubled to 28 per cent and 57 per cent, respectively. Similarly, the contribution of agriculture in exports has declined over the years, while that of manufactured and petroleum products has shown a constant rise. As an indicator of a country's progress, the share of direct taxes to total tax revenue has increased from 21 per cent to 60 per cent.

In concurrence with economic development, the welfare of people has also increased. Last two censuses have found that the annual growth rate of India's population is declining during the past two decades. Thus, with declining birth and death rates, our country is moving into the progressive third stage of demographic transition. Life expectancy at birth has doubled from 32 years to 64 years and literacy rate has increased from 18 per cent to 74 per cent. On the other hand, the infant mortality rate has declined to 50 per 1000 birth. Due to all round improvement in welfare indicators, our country is climbing up in the Human Development Index (HDI).

Regional imbalances in development:

In spite of all the above discussed achievements and other accomplishments at an aggregate level, disparities in development across the states have been steadily increasing over the planning period (Agarwalla and Pangotra, 2011). Particularly since the initiation of economic reforms in the country, private investment had gone mostly to southern and western states because of proximity of ports, better infrastructure and perception regarding better governance (Ahuluwalia, 2000). This has led to widening income differentials between more developed and relatively poorer states (Table 1). The proportion of per capita Net State Domestic Product (NSDP) of Bihar was 39 per cent that of Punjab in 1980-81, which has not changed much till 1990-91. Since then, the proportion has drastically decreased to 21 per cent in 2000-01 and continued to remain at the same level.

Table 1: Inter-state disparity in per capita NSDP

Year	State with lowest per capita NSDP	State with highest per capita NSDP	Proportion of minimum to maximum per capita NSDP (%)
1980-81	Bihar	Punjab	39
1990-91	Bihar	Punjab	36
2000-01	Bihar	Punjab	21
2001-02	Bihar	Punjab	20
2002-03	Bihar	Haryana	21
2003-04	Bihar	Haryana	22
2004-05	Bihar	Haryana	21
2005-06	Bihar	Haryana	20
2006-07	Bihar	Haryana	21
2007-08	Bihar	Haryana	20
2008-09	Bihar	Haryana	22
2009-10	Bihar	Haryana	21
2010-11	Bihar	Haryana	22

Source: Various issues of economic survey

A glance at the welfare indicators across states shows that, although there has been a decline in the incidence of poverty in all the States, there are marked variations between them. In Bihar and Orissa, the proportion of people living below poverty line (BPL) is 43 per cent and 47 per cent,

Table 2: Inter-state disparity in welfare indicators

State	Percentage of population below poverty line (1999-00)	Per capita electricity consumptio n (kWh) (2009-10)	Female literacy rate (per cent) (2011)	Infant mortality rate (per 1000 births) (2010)
Bihar	43	112	53	48
Uttar Pradesh	31	348	59	61
West Bengal	27	550	71	31
Madhya Pradesh	37	602	60	62
Jharkhand	-	880	56	42
Rajasthan	15	736	53	55
Orissa	47	874	64	61
Chattisgarh	-	1547	61	51
North East	32	421	75	34
Uttarakhand	-	1112	71	38
Karala	13	525	92	13
Karnataka	20	903	68	38
Jammu and Kashmir	4	952	58	43
Andhra Pradesh	16	967	60	46
Maharashtra	25	1028	76	28
Himachal Pradesh	8	1380	77	44
Tamil Nadu	21	1132	74	24
Haryana	9	1222	67	48
Gujarat	14	1615	71	44
Punjab	6	1527	71	34
INDIA	26	734	66	47

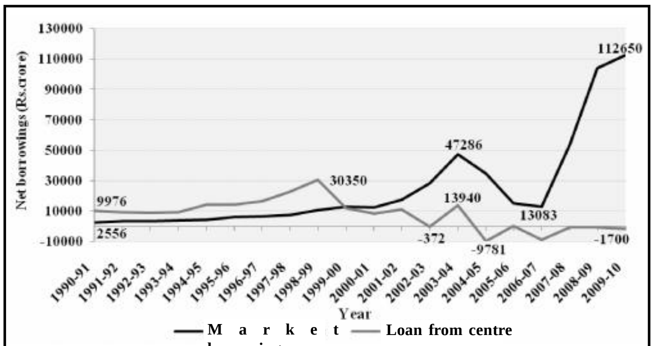
Source: Planning Commission,Economic Survey 2011-12 and Census 2011 respectively. For Madhya Pradesh and Uttar Pradesh, the proportion is over 30 per cent and so is the case in the majority of North Eastern states. Against this shoddy status, in states like Punjab and Haryana, the BPL population has come down to less than 10 per cent (Table 2).

Another indicator of living standards and level of economic activity *viz*., electricity consumption per capita also points to sharp and persistent regional inequalities. In 2009-10 electricity consumption per capita in Bihar was 112 kWh against 1615 kWh in Gujarat. Even now the average female literacy rate is only 56 per cent in BIMARU (Bihar, Madhya Pradesh, Rajasthan and Uttar Pradesh) states as compared to 92 per cent in Kerala and over 70 per cent in Himachal Pradesh, Punjab, West Bengal, Gujarat, Maharashtra and Tamil Nadu. The average infant mortality rate per 1000 live births is as high as 57 in BIMARU states as compared to 13 in Kerala, 28 in Maharashtra and 31 in West Bengal.

Hence, the system of intergovernmental fiscal transfers as it has evolved in India over the years has come under severe attack on the ground that it has created perverse incentives by putting a premium on equity to the neglect of efficiency and led to fiscal profligacy at lower levels of government. Such an inefficient devolution of resources is blamed to have caused sharp regional disparities which have grown sharper, particularly, in recent years. In this milieu, an attempt has been made to explore the inherent problems of our federal fiscal setup so that corrective measures can be taken to improve the efficiency of fiscal federalism in India.

Dichotomy in the borrowing powers of centre and states:

Under Article 292 of our constitution, centre can borrow even from abroad upon the security of the Consolidated Fund of India. But, under Article 293, States can borrow only within the territory of India upon the security of Consolidated Fund of the State. Moreover, a State cannot raise any loan without the consent of Central government so long as it is indebted to it. Following the recommendations of Twelfth Finance Commission, Centre terminated lending to States from 2005-06 on Centre Plan Assistance account. Subsequently, the offer of Debt Consolidation and Relief Facility (DCRF) by Centre compelled the States to repay their outstanding loans with the Centre in order to avail the benefits of debt write-off and interest relief. All these compulsions have cast a burden on the States as they have to fall back on short term loans from market (Fig.1).

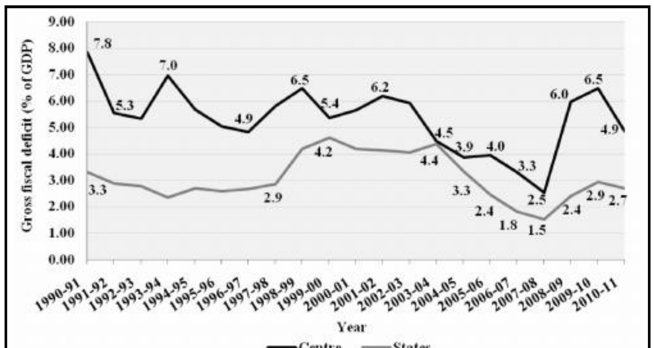


Source: State Finances- A study of budgets of 2010- 11 in *www.rbi.org.in*

Fig. 1: Borrowing pattern of states

Fiscal responsibility:

Since late 1980s, the finances of Centre and the States witnessed an alarming deterioration. The fiscal deficit which was 6.4 per cent of GDP in 1981-82 had increased to 9.3 per cent in 2001-02. Moreover, the revenue situation which was surplus had deteriorated to 6.9 per cent deficit during the same period. Worried by the situation, the Centre had enacted the Fiscal Responsibility and Budget Management (FR and BM) Act in 2003. Its stipulated targets of consolidating the fiscal disorder were very well achieved by both Centre and the States till 2007-08. But, since 2008-09, there was slippage in meeting the targets because of fall in revenue due to global downturn which necessitated three fiscal stimulus packages and increased food and fertilizer subsidies. Expenditure also increased due to farm loan waiver and pay revision following the 6th Pay Commission recommendations (Fig. 2).



Source: Database on Indian Economy in *www.rbi.org.in*

Fig. 2: Gross fiscal deficits of centre and states as percentage

Vertical imbalance:

Vertical imbalance refers to the unbalanced allocation of revenue powers and spending responsibilities between Centre and the States. Vertical transfer is essential - to make up for the extent of asymmetric decentralization of expenditure responsibility and revenue raising authority, to equalize the fiscal capacity of different regions to avoid inefficient migration of persons and businesses and to achieve national standards in social programmes. Constitution has assigned 13 taxes to Centre and 19 taxes to the States to augment their revenue. Among the central taxes, income tax other than agriculture, custom duty, excise duty other than liquor, corporation tax, estate duty other than agricultural land are important taxes. Among the state taxes, land revenue, mineral rights, excise on liquor and profession and entertainment taxes are important taxes.

Causes of vertical imbalance:

Difference in tax buoyancies:

The issue of vertical imbalance has its roots right from the difference in the buoyancy of Centre and State taxes. Inherently, Centre's taxes have a higher buoyancy of 1.6 while that of state taxes is 1.2. To rectify this deficiency, successive Finance Commissions have increased the States' share in net revenues.

Exclusion of certain taxes from divisible pool:

The next problem with vertical transfer is the number of taxes shared. Till the year 2000, the constitution provided for mandatory sharing of only income tax and excise duty. Following the recommendations of Tenth Finance Commission, Article 270 was amended in 2000 to provide for the sharing of all Union taxes. But cess and surcharges are still kept out of the purview of sharing. Though these taxes should be levied for specific purposes, for a limited period, they are being continued on a permanent basis. The share of cess and surcharges in the gross tax revenue of the Centre has been increasing over the years from 5 per cent during the Eighth Finance Commission period to 11 per cent during the Twelfth Finance Commission period. Due to this and other non-divisible pool taxes, the share of States in Central gross tax revenues persistently remains low at around 25 per cent over the years (Table 3).

Impact of vertical imbalance:

The disproportional assignments of resources and responsibilities have caused a high degree of vertical fiscal imbalance between Centre and the States (Table 4). While the share of states in total revenue is only 37 per cent, they have to bear 56 per cent share of total expenditure. Due to such a disproportionate allocation, States struggle to meet out their expenditures. They could meet out only 43 per cent of revenue expenditure and 48 per cent of total expenditure out of their own revenue.

Horizontal imbalance:

Horizontal imbalance emerges when different state governments have different abilities to raise funds from their tax bases and to provide services to their citizens. While determining horizontal devolution across the States, differences in fiscal need, fiscal capacity to raise revenue, cost of providing similar levels of public goods and services, the need to improve efficiency in public management are taken into consideration. Over the years, the Finance Commissions have used two guiding principles while recommending *inter se* shares of states in tax devolution:

The principle of equity:

This principle addresses the problem of differences in revenue raising capacity and cost disabilities across the States. But this principle has the risk of moral hazard in making the States lax in terms of improving their revenue effort and managing their finances prudently.

Table 3: Impact of cess and surcharges on the states' share of revenue **(Rs. Crore)**

Finance commission	Gross tax revenue of the centre	Cess and surcharges	Actual tax devolution
Eighth	1,67,119	8,225 (5)	42,009 (25)
Nineth	4,19,250	1,6642 (4)	1,12,569 (27)
Tenth	6,94,756	21,474 (3)	1,82,925 (26)
Eleventh	11,48,007	68,203 (6)	3,05,013 (27)
Twelfth	26,63,337	3,01,944 (11)	6,91,056 (26)

Note: Figures in the parentheses indicate percentage share, **Source:** Finance Accounts and Budget Documents of Union Government

Table 4 : Share of states in revenue and expenditure **(per cent)**

Year	Share of states in total revenue	Share of states in total expenditure	Current expenditure met out by own revenue	Total expenditure met out by own revenue
1960-61	37	60	64	43
1970-71	36	60	61	46
1980-81	36	60	60	44
1990-91	35	55	53	48
2000-01	38	58	49	43
2007-08	37	56	48	43

Source: Commission on Centre-State Relations Report, 2010

The principle of efficiency:

This principle rectifies the above drawback and motivates the states to exploit their resource base and manage their fiscal operation in a cost effective manner.

Utilizing these two principles, the Thirteenth Finance Commission while recommending the distribution of total vertical transfer among the States, has assigned 25 per cent weight to population at 1971 level, 10 per cent weight to area, 47.5 per cent weight to fiscal capacity distance which is the extent of difference between the richest State and others in providing comparable levels of public services to their residents at reasonably comparable levels of taxation and 17.5 per cent weight to the fiscal discipline which is referred to as the proportion of revenue expenditure met out by own revenue receipts.

Expected share of the states in total vertical transfer:

Table 5 shows the expected *inter se* share of States in total vertical transfer as delegated through the above criteria. It has been observed from the table that backward states like Uttar Pradesh, Bihar, Madhya Pradesh, Rajasthan and Orissa are expected to garner a good share in the vertical transfer.

Table 5: *Inter se* shares of the states in total vertical transfer (per cent)

State	Share
Uttar Pradesh	20
Bihar	11
Andhra Pradesh, West Bengal and Madhya Pradesh	7
Rajasthan	6
Tamil Nadu, Maharashtra and Orissa	5
Assam and Karnataka	4
Chhattisgarh and Jharkhand	3
Jammu and Kashmir and Kerala	2
Haryana, Himachal Pradesh, Punjab and Uttarakhand	1
Goa and North- East (Average)	0.4

Source: Thirteenth Finance Commission Report

Efficiency of horizontal transfer:

To resolve the issues of vertical and horizontal imbalances, the fiscal transfer scheme needs to be analyzed in terms of the combined effect of three components of transfer *viz.*, the "vertical" component equal to the per capita transfer to the highest income state, an "equalizing" component due to deficiency in fiscal capacity and a residual, which reflects cost disabilities and other special need considerations. Thus, total transfers to a State can be derived as follows:

Total transfer,

$$\sum \mathbf{N_i t_i} = \sum \mathbf{N_i (a - eY^*)} + \{\sum \mathbf{B_i (aY^* - aY_i)} - \sum \mathbf{N_i def_i}\} + \sum \mathbf{N_i res_i}$$

where,

N_i = Population of the i[th] State

t_j = Per capita transfer to i[th] State

e = Per capita expenditure norm

a = Average tax effort

Y* = Per capita income of the richest State

Y_j = Per capita income of i[th] State

def_i = Per capita deficiency for incentives of i[th] State

Res_j = Per capita residual for incentives of i[th] State

Table 6 summarizes the relative shares of the three components in total transfers, as recommended by the last two Finance Commissions.

It is thus, clear from the table that 54 per cent of total transfers are used as vertical transfers, while 37 per cent are used as equalization transfers and 9 per cent for special needs and cost differentials. In spite of this large share for vertical transfers, 91 per cent of equalization across the states has been achieved through Thirteenth Finance Commission transfers, which is 3 per cent more than that achieved by the Twelfth Finance Commission transfers.

Changing pattern of plan assistance to states:

In this regard, two distinct changes have occurred during the past decade:

Table 6: Extent of equalization achieved by successive finance commissions (Rs.Crore)

Component	12^{th} FC	13^{th} FC
Total transfers per year	1,51,150	3,40,000
Amount used for vertical transfers	75,570	1,83,000
Share (%)	50	54
Amount for equalization transfers	58,738	1,25,000
Share (%)	39	37
Amount used for cost differentials and special needs	16,843	33,000
Share (%)	11	9
Amount needed for full equalization	66,740	1,39,000
Extent of equalization achieved (%)	88	91

Source: Rangarajan and Srivastava, 2008 and Srivastava, 2010

The reduced budgetary support to the state plan:

In the 10th Five Year Plan, Centre's budgetary support to the Plan was distributed between Central Plan and State Plan in the ratio 66:34. This was further reduced to 23 per cent for State plan in the 11th Five Year Plan.

Change in the composition of plan assistance:

Over the years, the share of normal Plan assistance to State Plan has come down drastically and that of Centrally Sponsored Schemes (CSS), additional central assistance and special plan assistance have gone up considerably.

Growth of such discretionary transfers from Centre had severely constrained the States in drawing and implementing schemes according to their priorities.

Compliance and enforcement cost of central legislations:

There are number of central legislations and administrative instructions to be carried out by the states *viz.*, Environment Protection Act, Wildlife Protection Act, Forest Conservation Act, Right to Education Act *etc.* and fulfillment of international treaty obligations entered into by the central government. Compliance and enforcement cost of these functions are largely or entirely borne by the States.

Neglected fiscal domain of local bodies:

Following the 73rd and 74th constitutional amendments, many States have notified transfer of functions to local bodies. But there has been limited progress in the direction of transfer of funds and functionaries. The present system of almost total dependence of local bodies on state government does not promote accountability. Under Article 243, state legislatures are authorized to allow local bodies to levy and collect specified state taxes. While there has been some progress in transferring the functions to local bodies, States are by and large reluctant to part with financial powers.

Gap-filling approach of finance commission:

A fundamental shortcoming of Finance Commission transfer system pointed out by critics has been the 'gap filling' approach whereby Finance Commission recommends grant-in-aid for States which are found to be deficit in their revenue budget after taking account of their tax share. This creates a moral hazard problem and acts as an incentive for improvident budgeting. States sharing large deficits in their budget get rewarded while those that manage their finances better, suffer.

Remedial measures:

Neutralizing regional imbalances:

Since the problems faced by the backward regions are multi-dimensional, a multi-pronged strategy should be adopted comprising public investment in infrastructure development, pro-active policies to attract private investments and higher public expenditure on social sectors such as education, health etc. For this, the quality of governance and service delivery system in these States should be improved at the outset.

Streamlining market borrowings:

Time and again States have contended that their share in market borrowings be restored to the level of 50 per cent from 25 per cent of total borrowings. But, with the enactment of FR and BM legislation, overall borrowing limits for each year are fixed taking into account the fiscal deficit target and the fiscal correction path recommended by the Thirteenth Finance Commission. Hence, a prescribed share in market borrowings for states has lost much of its relevance in the post-FR and BM regime.

Fiscal consolidation:

Concerned about the fiscal expansion that took place since 2008, the Thirteenth Finance Commission recommended a revised road map for fiscal consolidation to eliminate the revenue deficit and bring down the fiscal deficit to 3 per cent of GDP, separately at both Centre and State levels by the end of 2014-15. New concepts like "Effective Revenue Deficit" and "Medium Term Expenditure Framework" are being introduced by amending the FR and BM Act.

Effective revenue deficit:

It is the revenue deficit remaining after excluding the grants provided for creation of capital assets. This identification helps in reducing the consumptive component on revenue deficit and creates space for increased capital spending.

Medium term expenditure framework:

It will set forth a 3-year rolling target for expenditure indicators.

Rectifying vertical imbalance:

Since, subjects like agriculture, education, skill development, health services and welfare of weaker sections, which contribute to a broad based growth, are in the dominion of States, there is a clear need to realign the resources in their favour.

Rectifying horizontal imbalance:

The Thirteenth Finance Commission transfer system, despite achieving higher levels of equalization and attempting to impart objectivity to the system, has left a lot of room for improvement in terms of both equity and incentives. Reform system will have to begin with redefining the scope of Planning Commission and Finance Commission to avoid the overlap in their roles.

Reorienting plan assistance:

The number of CSS should be restricted to flagship programmes of national and regional importance. There should also be flexibility in the guidelines governing the implementation of CSS to suit state-specific situations.

Delineating functional and financial responsibilities:

The Central enactments should clearly delineate the responsibilities of Centre and State governments in meeting the additional cost of implementing the provisions of the Acts. In this regard, the Right to Education Act has broken a new ground in clearly defining the functional and financial responsibilities of Centre and State governments.

Elevating local bodies:

Having constitutionally assigned a certain functional domain to local bodies, it is for the Union and State governments to help this process of decentralized planning and governance with funds, functionaries and technical support. In this regard, a scheme called Rajiv Gandhi Panchayat Sashaktikaran Abhiyan has been proposed in the budget 2012-13 to strengthen the panchayats.

Rationalizing gap-filling:

The grant component of transfer is being decided based on the projections of historical data. Some full-fledged normative approach should be designed for this purpose.

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