Fiscal Imbalances in India: Recent Trends

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Abstract

Fiscal federation is concerned with the design of fiscal arrangements when decision – making is among various orders of governments. The design of fiscal arrangements entails the division of powers for taxing, spending and regulatory functions. Fiscal federalism relates to the division of government functions and finance in a logical way among multiple layers of government. Traditional theory of fiscal federalism lays out general framework for the assignment of functions to different levels of government and appropriate financial powers for carrying out these functions. Fiscal federalism in addition to being economically efficient in providing and financing government services, can more effectively promote democratic and participatory forms of government. This paper presents an overview of imbalances in Indian fiscal federalism and its recent trends. The rest of the paper provides the role of Finance Commission, especially Thirteenth Finance Commission, in terms of intergovernmental Transfers.

Keywords: imbalances, intergovernmental transfers, fiscal federalism

Introduction

Fiscal federation is concerned with the design of fiscal arrangements when decision – making is among various orders of governments. The design of fiscal arrangements entails the division of powers for taxing, spending and regulatory functions. Fiscal federalism relates to the division of government functions and finance in a logical way among multiple layers of government. Traditional theory of fiscal federalism lays out general framework for the assignment of functions to different levels of government and appropriate financial powers for carrying out these functions. Fiscal federalism in addition to being economically efficient in providing and financing government services, can more effectively promote democratic and participatory forms of government.

Fiscal Federalism in India

The Federal System in India consists of a Central Government, twenty eight States, seven Union Territories. Some of the important institutions that oversee centre-state financial relations and intermediate between the central, state and local governments are the Finance Commission, Planning Commission, the Inter-State Council and National Development Council. Attempts at defining the relative roles of Central and State governments dates to as for back as 1918, when the Montague Chelmsford reforms were implemented. However, it was the Government of India Act, 1935, which clearly demarcated the roles of the two levels of government and infact, the present constitutional assignments closely follows it in many respects. The Constitution, in its 7th Schedule, assigns the powers and functions (Union List, State List and Concurrent List)of the Centre and States. The most common phenomena is imbalances in the fiscal structure. Usually, two types of fiscal imbalances are discussed. The imbalances at different levels of the government (inter-governmental) are known as vertical fiscal imbalance, while those at different units of the same level of government (inter-jurisdictional) are known as horizontal fiscal imbalance.

In India, the constitutional assignment would result in imbalances between revenue capacities and expenditure needs at the state level. Constitution provides for the assignment of revenues, sharing of the proceeds of certain centrally levied taxes with the States and making grants to States from consolidated fund of India. Articles 268 and 269 provide for the levy and collection of certain taxes by the Centre, but the revenues are to be entirely assigned to the States.

The Constitution also recognizes that the States' tax powers are inadequate to meet their expenditure needs and therefore, provides for the sharing of revenues from Central taxes, prior to the 80th amendment to the Constitution, revenue from taxes on non-agricultural incomes and union excise duties were shared with the States. Following the above amendment of constitution, based on the recommendations of the 10th Finance Commission all central taxes have been brought into a divisible pool and it is mandatory to assign a share from each central tax to the states. In addition to tax devolution, the Constitution provides for making grants in aid to the States as well (article 275). Both tax devolution and Grants in Aid have to be determined by the Finance Commission. It was for the first time that the 11th Finance Commission set out an indicative ceiling of total revenue transfers taking into account tax devolution, grants recommended by the Commission, plan grants and other grants. Like the 11th Finance Commission, 12th Finance Commission has also been asked to review the state of finances of the Union and the States and suggest a plan for restructuring public finances with a view to restoring budgetary balance, maintaining macro-economic stability and bringing about debt reduction along with equitable growth.

Four general principles require consideration in assigning taxing powers to various governments. First, the Economic Efficiency Criterion dictates that taxes on mobile factors and tradable goods that have a bearing on the efficiency of the internal common market should be assigned to the central government. Second, National Equity considerations warrant that progressive redistributive taxes should be assigned to the Central government, which limits the possibility of regional and local governments following perverse redistribution policies using both taxes & transfers to attract high-income people and repel low income ones. Third, the Administrative Feasibility Criterion (lowering administration costs) suggests that taxes should be assigned to the jurisdiction with the best ability to monitor relevant assessments. Fourth, the Fiscal Need or Revenue Adequacy Criterion suggests that to ensure accountability, revenue means should be matched as closely as possible with expenditure needs.

Several studies reveal that fiscal imbalances in India have shown an upward trend especially after the introduction of economic reforms in the country. In this context, it would be of interest to analyze the shares of Central and State governments in revenues and expenditures.

Welfare Gains from Fiscal Federalism

Fiscal federalism with its inherent structure of decentralization of spending and revenue sources promotes efficiency and welfare. The decentralization theorem propounded by Oates (1972) demonstrates fiscal federalism ensures that public services are provided corresponding to the diversified demand conditions in a federation. The provision of public services by a central government will be of uniform nature throughout the country. The State and local governments being much closer to their people and geography of their respective jurisdictions posses better knowledge of both local preferences and cost conditions unlike a Central government. The State and local governments will be more responsive to particular preferences of their constituencies and will be able to find new and better ways to provide these services.

The gains from decentralization, as propounded by Charles Tiebout (1956) were due to highly mobile households. They choose a jurisdiction as their residence based upon its fiscal package that suits their tastes. The larger the member of jurisdictions the wider is the consumer choice. Also, the more diverse the demand for public services in different jurisdictions, the greater is the welfare gains from fiscal decentralization.

Vertical Fiscal Imbalance

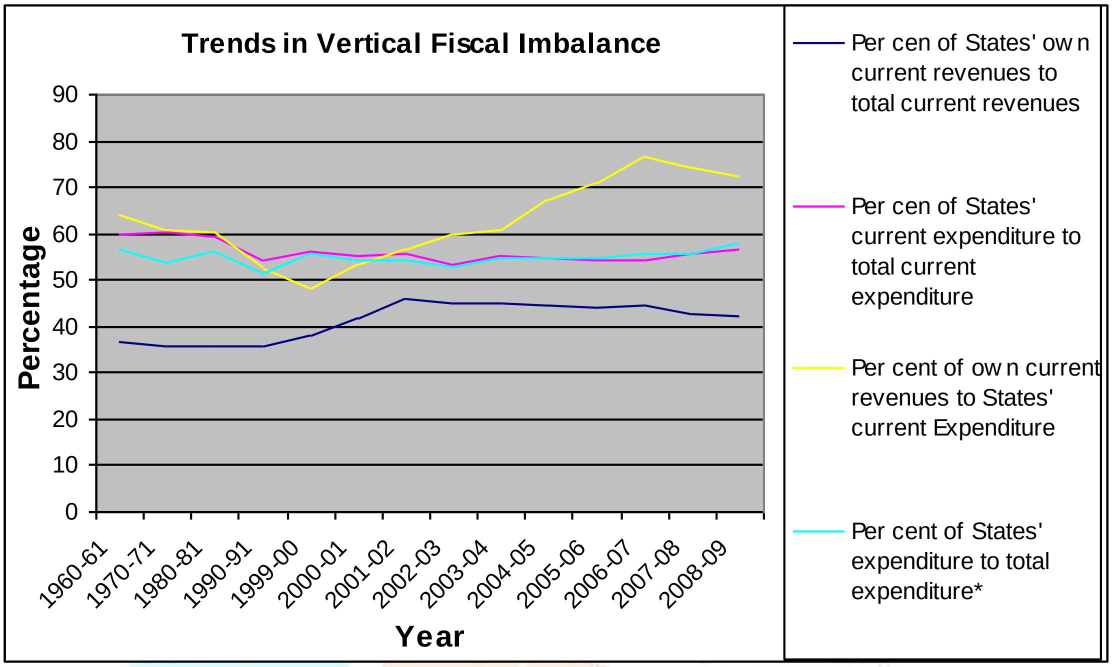
Constitutional assignments and developments over the years have contrived to create a high degree of fiscal centralization and vertical fiscal imbalances. Vertical fiscal imbalance is usually given primary importance in the discussions of fiscal imbalances; probably because it serves to focus on the most lively issue of federal finance that of mismatch in the assignment of taxing powers and expenditure responsibilities. Vertical imbalance is part of the system because the main tasks of assigning taxes, money supply and others remaining with centre only, whereas, wide public services like health, education, irrigation are left to sub national governments.

Recent trends in Vertical Fiscal Imbalance is shown in Table 1. States have 42.2 percent of total revenue and incur 58% of States total expenditure. Here States have maximum expenditure. The states own revenues in the total have shown increase upto 45.8% in 2001-02 from 36.6% in 1960-61 but declined to 42.2 percent in 2008-09. However their share in expenditure has increased about 56.4% in 2008-09.

Table 1: Trends in Vertical Fiscal Imbalance

Year	Per cent of States' own current revenues to total current revenues	Per cent of States' current expenditure to total current expenditure	Per cent of own current revenues to States' current Expenditure	Per cent of States' expenditure to total expenditure*
1960-61	36.6	59.9	63.9	56.8
1970-71	35.5	60.2	60.6	53.9
1980-81	35.6	59.6	60.1	56.0
1990-91	35.9	54.3	52.3	51.4
1999-00	38.0	56.2	48.3	55.7
2000-01	41.8	55.1	53.5	54.3
2001-02	45.8	55.9	56.8	54.2
2002-03	44.8	53.1	59.7	53.1
2003-04	44.8	55.1	60.7	54.8
2004-05	44.4	54.9	67.4	54.6
2005-06	44.1	54.2	70.8	54.7
2006-07	44.6	54.4	76.4	55.8
2007-08	42.8	55.6	74.1	55.7
2008-09(RE)	42.2	56.4	72.5	57.9

Source: Rao (2008) and Indian Public Finance Statistics (2008-09) and CSO



Horizontal Fiscal Imbalances

The horizontal imbalances have, intern, arisen mainly from inter-state disparities in revenue capacity and effort as well as in expenditure needs. There are 17 relatively more homogenous General Category states, but even these have wide differences in size, revenue raising capacities, efforts, expenditure levels and fiscal dependence on the centre. In addition, in terms of economic characteristics the 11 mountainous states of the north and the north-east differ markedly from the rest and therefore are considered Special Category States. Of the 28, Three States have been recently carved out from three large states.

Table 2: Selected fiscal Indicators of States 2008-09

State	Per Capita NSDP	Per capita Developmental Expenditure	Per capita Own Revenue	Per capita Transfers
I. Non-Special Category				
1. Andhra Pradesh	33842	7894	5325	2986
2. Bihar	12643	3394	719	3018
3. Chhattisgarh	29621	6387	3507	3547
4. Goa	102716	4071	3663	969
5. Gujarat	41142	14433	11414	4006
6. Haryana	67891	5973	5648	1063
7. Jharkhand	21465	5683	2945	3386
8. Karnataka	40309	6164	5295	1951
9. Kerala	41821	4787	5072	2377
10. Madhya Pradesh	18053	3987	2467	2581
11. Maharashtra	46426	6489	5557	2019

12. Orissa	26507	4865	2571	4047
13. Punjab	50558	5832	6545	1646
14. Rajasthan	25654	4247	2910	2277
15. Tamil Nadu	45058	6370	6050	2355
16. Uttar Pradesh	18214	3727	1951	2354
17. West Bengal	31474	4213	2457	1972
CV(%)	**56.4**	**43.9**	**56.7**	**36.2**
II. Special Category				
1. Arunachal Pradesh	28366	31401	3320	27336
2. Assam	23308	5570	2119	5596
3. Himachal Pradesh	41348	16031	7616	12657
4. Jammu and Kashmir	24975	17491	5591	17187
5. Manipur	19952	12181	1331	12316
6. Meghalaya	27618	11362	2283	12034
7. Mizoram	29576	21086	2378	22368
8. Nagaland	25822	9363	1107	10999
9. Sikkim	34114	30753	22285	26164
10. Tripura	31077	9124	1669	10133
11. Uttarakhand	31103	6933	3866	5217
CV(%)	**19.9**	**57.4**	**125.3**	**51.7**
All States	37490	5540	3705	5540
CV of All states	**51.0**	**78.4**	**91.7**	**105.1**
Memo item:				
1. NCT Delhi	77919	8984	8556	-697
2. Puducherry	64122	25327	11699	7868

Source: RBI, Study of State Finances and CSO

Per capita revenue & expenditure of the states for the year 2008-09 has shown in table -2. Here we can see wide disparity in revenue effort and expenditure. In terms of percapita Development expenditure Arunachal Pradesh & Sikkim are high as Rs. 31,401 & Rs. 30,375 respectively whereas Bihar has expenditure as very low as Rs. 3394 in 2008-09. In case of per capita own revenue Special Category States' co-efficient of variation is very high as 125.7%, whereas Non-Special Category States have only 45.7% coefficient of variation. Inter-state disparities is India even among the general category states are high at some extent.

As inter-state difference in the ability to raise revenue increased over the years, and as federal transfers did not entirely offset the fiscal disabilities of the poorer states, the coefficient of variation in per capita development expenditures also increased over the time period.

Intergovernmental Transfers: 13th F. C. Recommendations

There are economic, social, political and historical objectives. Here the focus is on economic objectives. Finance commissions have aim at achieving equity & efficiency interms of intergovernmental transfers. Efficiency refers to Allocation of resources, whereas equity with good taxation.

11th Finance Commission was asked to review the finances of the union & the states and suggest ways and means to restructure the public finance to restore budgetary balance & maintain macro economic stability and to reduce deficits. 12the Finance Commission was asked to recommend a fiscal restructuring plan by which both the union and state governments can phase out their revenue deficits and reduce fiscal deficits to a sustainable level.

13th Finance Commission has been asked to suggest measurer for maintaining a stable and sustainable fiscal environment consistent with equitable growth. 13th Finance Commission recommended for sharing of union tax revenues that the states' share in the net proceeds of shareable central taxes shall remain unchanged at 32 percent and the indicative ceiling on overall transfers to states on the revenue account may be set at 39.5% of gross revenue receipts of the centre. It made revised roadmap for fiscal consolidation by recommending that the revenue deficit of the centre needs to be progressively reduced and eliminated by 2014-15 and a target of 68 percent of GDP for the combined debt of the Centre and States should be achieved by 2014-15. Commission states that all States that attained a zero revenue deficit or a revenue surplus in 2007-08 should achieve a fiscal deficit of 3% of Gross State Domestic Product (GSDP) by 2011-12 and maintain such thereafter. Total grants in aid to states of Rs. 3,18,581 is awarded.

Conclusion

Fiscal federalism improves the responsiveness and accountability of policy makers and provision of services tends to respond to the preference of beneficiaries and taxpayers. It has the capacity to promote coincidence between the three circles of budgetary policy; those who decide, those who benefit and those who pay. Federal fiscal arrangements pay special attention to regional economic divisions in order to ensure level playing field to strengthen the economic union. This explains why federal countries generally do better than unitary countries on all aspects of public governance citizen participation, political freedom, political stability, rule of law, efficient and equitable service delivery, human development curtailing corruption and equitable and inclusive governance.

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