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A Synoptic Look on Central-State Financial Relationship in India

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KEYWORDS :

Introduction

The present federal fiscal system has not evolved in aday or two but over a long period of time starting from the lage eighteenth centure. Though the Government of India Act-1919 was a major breakthrough in the history of evolution of fiscal federalism in India, the Government of India Act-1935 established a clear-cut demarcation of subjects coming under the Centre, States and, both Centre of the country, the federal status of India underwent a fundamental change with clear division of fnancial powers and expenditure responsibilities between Central and State governments in the Seventh Schedule of the Indian constitution.

The most important aspect of fscal federalism is the division of resources and functions between different levels of governments. The existence of fscal imbalances is inherent in most of the federations since the division of resources goes in favour of the central government to achieve the objectives of stabilization and distribution. Similar is the case of Indian federalism where there is a mismatch of resources and expenditure responsibilities at different layers of government. Though inter-governmental transfers take place to reduce fscal imbalances and provide average level of public services across the sub-national governments, there exist fscal imbalances and regional disparities across the states even after 60 years of independence. The transfers from Centre to States take place through three channels, namely, Union Finance Commission (UFC), Planning Commission (PC) and Central Ministries, of which the transfers from FC are predominant. Gross devolution and transfers (GDT) comprises of States' share in central taxes (SCT), grants-in-aid and gross loans from centre. Gross Transfers to the states have been rising over past decades except for a dip in 2011-12.

The UFC and PC take equalization as the most important general objective while making federal fscal transfers. Therefore as required from time to time, different UFCs and PCs keep changing the method of federal fiscal transfers to ensure the objective of equalization. Different approaches by different UFCs have differential impact on the resource transfers to the states. The tax sharing is based on the general criteria like population, geography, backwardness, poverty ratio, inverse per capita income, distance formula, revenue gap etc. After the seventh FC, the high (almost 90%) weightage given to population has been gradually lowered and alternative measures such as inverse formula and distant formula have been given more importance in sharing both income and union excise duties. However, these criteria have been multiplied by the scale factor population thereby giving more importance to population.

The dependence of states on Central transfers varies depending on the capacity of the states to generate own resources. For high income states it varies from one-fourth to one-sixth of their revenues, for middle-income states between one-third to one-fifth (except for Chhattisgarh and West Bengal where dependency is much higher, almost 40-50%) and for low-income states it is quiet high ranging from 42-80%. In case of Special Category States, these Central transfers are very high varying from 64.98% to almost 93% of their revenue receipts. Haryana is the least dependent State on central transfers, followed by Punjab, Maharashtra, Gujarat and Goa. Given the need of the states, FC has been trying to transfer more resources to the States. For example, the share of the States in the net proceeds of central taxes and duties have increased from 29.5% in 11th FC to 32% in 13th FC.

With the inception of economic reforms in 1991, the responsibility of the States has gone up substantially in meeting the increasing need of the basic services of the people. Over the years, the centre has become stronger in terms of higher revenue potential while states got burdened with greater functional responsibilities in the areas of education, health, economic and social infrastructure, social security and welfare. This has increased vertical fscal imbalance and also horizontal fiscal imbalances due to differential performance of the states during post-reforms period. As a result inequality across the states and within the states has increased with respect to providing public services. Further, the enactment of Fiscal Responsibility and Budget Management Act (FRBMA) by the Centre which directs States to bring in discipline in the management of public finances has added pressure, particularly in improving productive assets of the poorer States. The fscal discipline, though necessary, has resulted in decline in the share of capital expenditures in most of the states, particularly backward states. As States are depending more and more on market borrowing on the face of declining central loans to states that has led to reductions of the tenure but increased the cost of borrowing and worsening state debt burdens.

In central government transfers/assistance, over the years, a substantial amount of resources has been transferred by the Planning Commission and other ministries in which an element of discretion exists. It has been observed that there has been increase in discretionary plan grants in plan transfers through Central Plan Schemes (CPS) and Centrally Sponsored Schemes (CSS) instead of increase in State Plan Schemes (SPS). But more plan grants under the state plan schemes would ease the burden on the states resources and at the same time enable them to have more of free outlay to allocate resources according to States priorities.

The UFCs' schemes of fscal transfers over the years, held to serve the dual objectives of equity and effciency within the framework of fscal consolidation, have been unable to ensure a fair distribution of resources between Centre and States and among the States leading to increasing regional disparities. This regional disparity has been the basis of formulating the horizontal devolution (across states). The intra-state disparity on the other hand has been an area which lacks in-depth research and opinion is divided on whether FC should consider this dimension of disparity while designing the Centre-state transfers. Given the varying taxable capacity across states and high revenue expenditure (almost 80% of total expenditure) with rigid components like subsidies, pensions, salaries, wages, interest payments, UFCs keep a portion of the revenues from union excise duties to distribute exclusively to the net defcit states even after devolution of taxes and grants-in-aid which is an encouraging step, particularly for backward states.

Generally, population and geography are considered as the most important criteria for tax devolution as it is perceived to be the most important indicator of the general need of a state. This approach is justifed when there are very insignifcant differences in area, distribution of population and per capita income among states. But, there are signifcant differences in these indicators among the States in India. Keeping this problem in view, more weightage has been given to distance and inverse formula in last few UFCs but population has been used as the scale factor. This high weightage given to population may not result in more transfers to states which are underdeveloped and having low population. The central plan assistance is being given on the basis of Gadgil formula (changes have been made since nineties), which takes population, per capita income, tax efforts and special problems into account. The criteria such as fiscal performance, tax efforts, prudent fscal management, and elimination of illiteracy and successful implementation of land reforms etc over the time have not helped states with differential fscal and administrative capabilities.

Following the 73rd and 74th Amendments to the constitution, India has become a three-tier multi-level federalism. Along with Central and State Governments, India has 2.5 lakh local governments, comprising over three million elected representatives which makes India the largest democratic and federal country. The signifcance of the local bodies is measured in terms of the percentage of local governments to total public sector expenditure and share of local government expenditure to GDP. Compared to other countries in the world, India stands at the lower end of the spectrum with a share of local governments at only 5.1% of total public sector expenditure (Brazil-15%; OECD-20 to 30%). In fact this share has declined by over 20% in last fve years (from 6.4% in 1998-99). The constitution spells out the task to the State Fiscal Commission (SFCs) to provide recommendations for the PRI institutions, both urban and rural, so that the consolidated fund can be augmented accordingly. However, it appears that most SFCs do not take their instrumental role seriously in helping to provide the said services and in laying the foundations for participatory democracy in the country.

All UFCs have indicated several shortcomings and omission and commission of the SFCs. The main reasons are non-synchronization of the period of recommendation of SFCs and UFCs; lack of clarity in respect of the assignment of powers, authority and responsibilities of the local government; absence of time limit to take appropriate action; etc. The 13th UFC has made a signifcant change in the devolution of resources to the third tier by assigning a share of the divisible tax revenue. This share is on an average 1.93% of the divisible pool of taxes for the period 2010-15. However, this devolution is a weak surrogate to cover up the failure of 13th UFC to employ a comprehensive measure of decentralisation. The criticism of THFC is the use of Census 2001 numbers for calculating population shares of local grants-in-aid.

Though there is no substantial information available about the administrative and financial effciency of the PRIs in the state to carry out the responsibilities, it is generally believed that PRIs cannot function on their own due to lack of administrative and infrastructural facilities. Given the expenditure decentralization ratio and revenue mobilization by PRIs in the state, local bodies are not in a position to carry out the assigned expenditure responsibilities. Since the amount of grants and share in the taxes given through SFCs is very low, central government needs to transfer more funds to the consolidated fund of the State to fulfill the needs of PRIs. At the same time, as more and more of the states' expenditure of the rural/urban local government is met by transfers from central government the autonomy of the states diminish likewise showing clear signs of the dependency syndrome. The magnitude and trend of the percentage of the central transfers to expenditure of the local bodies in 2007-08 for a few of the states are as follows : Andhra Pradesh – 51.8%; Assam-87%; Bihar – 90.7%; MP-65%; Orissa-71.6%; Tamil Nadu- 39.4% and West Bengal – 47.8%.

There is wide variance in the provision of basic services like education, medical and other infrastructural facilities leading to discrepancies in major socio-economic indicators like literacy rate, infant mortality rate, poverty ratio, and life expectancy etc. For example the highest IMR (per 1000 births) can be seen in lower income states such as Madhya Pradesh (2009) 67, Orissa (65), UP (63), Assam (61), Rajasthan (59) respectively where as it is much better in middle income and higher income states. Similar is the case of life expectancy and maternal mortality rate. A few states were able to attract investment (both domestic and foreign) and do better due to market reforms as well as their fiscal abilities to provide incentives and other utilities during post reforms period. Moreover, substantial changes in sectoral origin of income without appropriate re-distribution of population has created inequality both across the states and also within the states. Infact, India is currently in the first phase, the phase of increasing income inequality, of the inverted 'U' of Kuznets' curve. Therefore the role of central transfers to states is very important for ensuring provision of public services at a similar rate of taxation. It seems that the central transfers or centre-states financial relations has not been very successful in fulflling the the main objective .i.e. to ensure equal provision of public services across sub-national government by reducing fscal imbalances.

With the increasing inequality and requirement for fiscal discipline and macroeconomic stability, the scope of the 13th UFC was much wider than any of the preceding UFCs. Besides the usual tax devolution and grants to fll the gaps in non-plan budgetary expenditure, it was expected to recommend several other grants for local bodies, grants dealing with environmental and non-environmental issues, and also design and implementation of the GST. It has placed the centre and more so, the states, in a multitude of conditions to micro-manage their fscal system. These include fscal consolidation, disaster relief, design and implementation of GST and specific problems accruing to specific states. If properly implemented, the conditionalities can be very effective in rationalizing the spending priorities of the States to ensure provision of minimum amount and standard of public services. However, complying and enforcing the conditions is a major challenge and some states have questioned the conditionalities in terms of their fscal autonomy. THFC has enhanced the vertical devolution from 30.5% to 32% of the divisible pool of taxes. The horizontal distribution of this transfer is categorized as area (10%), population(25%), fscal capacity(47.5%) and index of fscal discipline(17.5%). Even after attaching high weights to fscal capacity index, the horizontal formula has failed to increase aggregate share of devolution to low-income states, which remains stagnant at around 54% over the period of past three UFCs. This is while the shares of middle-income states have declined from 29.28% in 11th UFC to 25.8% in 13th UFC and share of high-income has increased from 9.75% to 11.19% during the same period.

With t he objective of maintaining long term stability in the relative share of centre and states in the total revenues, 13th UFC have set the target for transfers from all sources at 39.5%, marginally higher than the 12th FC (38%) which would be close to 4% of the estimated GDP. The centre is receiving huge revenues from sources such as telecom auctions of which the states get no share. There is also increase in the number of centrally sponsored schemes involving huge expenditure which exceeds the set limit. All this is going to reduce the relative share of the states sharply (Rao, 2010). The approach followed by 13th UFC is not very different from the past UFCs as the recommendations are made on the basis of projections made on actual revenues and non-plan revenue expenditures on a base year rather than estimating the fscal capacities and the needs of the state for determining the transfers, which is not right.

Deviating from past UFCs, 13th UFC estimate entitlements based on fscal capacity accords the factor a weight of 47.55 of the total estimation. This approach does not solve the issues regarding the earlier "gap-flling" approach and in fact has both conceptual and methodical glitches. The arguments given by 13th UFC in this regard are not convincing and it could have done well by using a better measure of fscal capacity than simply taking the average tax-GSDP ratio of the state as the norm (Rao, 2010).

The objective of the transfers is to enable the states to provide comparable levels of services at comparable tax rates. But the 13th UFC does not make enough efforts to fulfll this criteria and in fact continues with the gap-flling which has in the past always affected the equity and incentives of the states adversely. Unlike the recommendation of 12th UFC of debt write-offs and rescheduling linked to fscal adjustment, 13th UFC conditions on the states do not entail any incentive payments except in the case of those that did not pass fscal responsibility legislation as required by 12th FC. Thus there is a issue in design and implementation.

Further, the 13th UFC report and recommendations have been criticized on many grounds. 13th UFC has recommended different fscal adjustment path for Kerala, Punjab, and West Bengal which are states with high fscal defcits. Among the 11 special category states, different fscal adjustments have been suggested for Jammu & Kashmir, Manipur, Nagaland, Sikkim, Uttarakhand and Mizoram. The 13th UFC base year for estimating fscal discipline path is selective which is not fair and subjective in nature (Rao, 2010). On the other hand, existence of fiscal capacity distance and an index of fiscal discipline in the same horizontal distribution formula is a contradiction to achieving horizontal equity. This is because while the first tries to increase the fscal capacity of the states, the second limits their expenditure according to their revenue. 13th UFC prescribes a GST model for the country which does not fall in Finance Commission domain. Further, it assumes that GST would be revenue neutral to both centre and states, thereby ignoring to incorporate the impact of GST on the rest of its recommendations.

The role of 14th UFC is mandated with more burdensome responsibilities in fscal, economic and social areas. The 14th UFC has been asked even to suggest measures to raise tax ratios of both Centre and States, improve performance of public sector enterprises, tackle challenges in ecology, environment and climate change. Also it is supposed to suggest measures to amend the FRBMA keeping in view its shortcomings. It has to address the rising trend of widening inequality in government spending across states and take action towards fscal autonomy, which has been substantially eroded over the years by the implementation of fscal consolidation path since the 10th UFC. It has got the job to assess the impact of GST and device a compensation mechanism for both centre and states and take the states in confdence, so that it can have higher acceptability.

Overall, though efforts have been made towards a full-fledged federation, India continues to have greater vertical fscal imbalances at different levels of governments and horizontal fscal imbalance across the levels of governments. India has evolved a noble kind of federation which is completely different from the accepted notion of federation.

Conclusion

The evolved Indian federalism is very unique in character and the Union-state relationship has also become extremely complex over the years. The role of PC, constitutional mechanism and working of various institutions will determine the future of Indian federation. The rising inequality in an increasingly market economy demands scientifc approach for fscal transfers from Centre to states so that the objectives of fscal federalism of equality and the provision of providing public goods across states is ensured. There are few issues which remain in the domain of centre-states fnancial relations such as multiple channels of transfer; limited scope of UFC transfers; methodological weakness and too much reliance on the "gap-flling" approach, and multiplicity of objectives failing to focus on main objective of reducing disparities.