

## **CHANGING CONTOURS IN FEDERAL FISCAL ARRANGEMENTS IN INDIA**

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India is the largest democracy with federal form of government. The fiscal arrangements in India have evolved in a quasi-federal system to meet the requirements of centralized planning in a mixed economy framework. The time is opportune to restructure the multilevel fiscal system to meet the challenges of transition to the market and opening up of the economy. The inefficiencies in the economy and the inherent contradictions arising from the inefficient economic process comes into open as the economy is opened up. The paper attempts to bring out the major shortcomings impinging on the efficiency and equity in the federal fiscal system in India and addresses the issues of reform in fiscal arrangements in the changed context.

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## I. Introduction

India is a classical federation with a constitutional division of functions between the Union and States in terms of the Union<sup>1</sup>, State and Concurrent lists. Although the country has the federal system with separate legislative, executive and judicial wings at both central and State levels, in its functioning it is considered to be a quasi-federal system because of the very high concentration of powers with the central government. Besides, the residuary powers have been assigned to the central government; the center also has over-riding powers in respect of the items placed in the concurrent list. Above all, the Center, has powers even to alter the boundaries of a State and create new States by dividing the existing ones by informing the State government. The concentration of powers got further strengthened with the adoption of centralized planning in a mixed economy framework with the implementation of an item placed in the concurrent list ‘economic and social planning’ after 1951.

The objective of this paper is to analyze the trends and major challenges faced by Indian fiscal federalism in the context of a liberal and open economy environment. The analysis is important for a number of reasons. First, India is the most populated federation and resolution of intergovernmental and governance issues offer valuable lessons for other large multilevel fiscal systems. Second, the transition from to more liberalized and a more open economy involves many difficult issues of designing the reforms, their co-ordination and sequencing. Third, Indian experience shows how apparently contradictory features like developmental planning, market economy and fiscal decentralisation can be combined and with what consequences. Finally, experience with asymmetrical federalism - of accommodating diverse social, religious, linguistic and ethnic groups, protecting the interest of minorities and catering to the needs of people in atypical regions can provide useful lessons in accommodating diversities. The important issues of democratic federal polity including the politics of the coalition government, different political party rule at the center and states and emergence of regional parties in power some of the other developments warranting detailed analysis.

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<sup>1</sup> The terms “Union” and “Center” and used interchangeably in the paper.

The paper is organized in five sections. Section II gives a brief account of the evolution and structure of Indian federalism. Tax and expenditure assignments and their implications on vertical and horizontal fiscal imbalances are analyzed in Section III. Fiscal imbalances in Indian federalism are analyzed in Section IV. The design of general purpose and specific purpose transfers from the Center to the states are analyzed in Section V. The salient features of intergovernmental transfer systems in India are summarized in the last section.

## **II. Evolution of Indian Federalism:**

India is the largest democratic federal polity inhabited by a billion people spread over 28 States and 7 Centrally administered territories. A Separate legislative, executive and judicial arms of government are constituted at both Central and State levels. The upper house or *Rajya Sabha* in the Parliament is the Council of States. The seventh schedule to the Constitution specifies the legislative domains of the Central and State governments in terms of Union, State and Concurrent lists. The Constitution also requires the President of India to appoint a Finance Commission every five years to review the finances of the Center and the States and recommend devolution of taxes and grant in aid for the ensuing five years.

Historical factors have played an important role in the adoption of a federal constitution with strong unitary features in India. The centralized governance under the colonial rule was combined with the bias towards a unitary framework in the constitution. There was also considerable fear that in the oligarchic power structure prevailing in rural areas at the time of independence, significant decentralization could entail elite capture public services.

The centralization inherent in the constitutional assignments was accentuated by the adoption of a planned development strategy. Centralized planning strategy required the Planning Commission to allocate resources according to the envisaged priorities. The most important centralization process was done when the major commercial banks were nationalized in 1969 and along with the nationalization of financial institutions, the Central government virtually acquired complete control over the financial system..

Recent economic and political events, however, have paved the way for a greater degree of decentralisation. In the economic sphere, the transition to a market oriented liberalization and more open economic environment has necessitated a greater degree of fiscal decentralisation. On the political front, factors such as the end to single party rule, the

emergence of coalition of parties in power at the center and increasing importance of regional parties in the political affairs of the country have provided a favorable environment for decentralized governance.

## II.2 Sub-State decentralization:

Although Indian federation was evolved as a two-tier structure until 1992, local government units functioned both in urban and rural areas, but as agencies of the State governments. The statutory recognition to rural and urban local governments was accorded with the 73<sup>rd</sup> and 74<sup>th</sup> Constitutional amendments in 1992. With this, each of the State governments was required to pass legislation appointing Panchayat Raj institutions and urban local bodies. It was stipulated that election to these local bodies should be held within the stipulated period. If the elected governments at local levels are superseded, elections should be held within the six months. A separate list of 29 functions for rural local bodies and 18 items for urban local bodies were placed in schedules and are assigned to local governments to implement concurrently with the states. The sources of finance were also identified for the local bodies. Each State government was required to appoint a State Finance Commission to recommend tax devolution and grants to the local governments.

## II.3 The System:

Federalism in India is characterized by constitutional demarcation of revenue and expenditure powers among the three levels of government. The institutional structure of multilevel provision of public services is shown in Figure 1. Thus, one billion people in the country are spread over twenty eight States and seven centrally administered territories. The Seventh schedule to the Constitution specifies the legislative, executive, judicial and fiscal domains of Union and State governments in terms of Union, State and concurrent lists. The Constitution also requires the President to appoint a Finance Commission every five years or earlier to review the finances of the Union and States and recommend devolution of taxes and grants-in aid of revenues to them for the ensuing five years. In addition, the Planning Commission also gives assistance to the States based on a formula determined by the National Development Council<sup>2</sup> and different central ministries give specific purpose transfers to States.

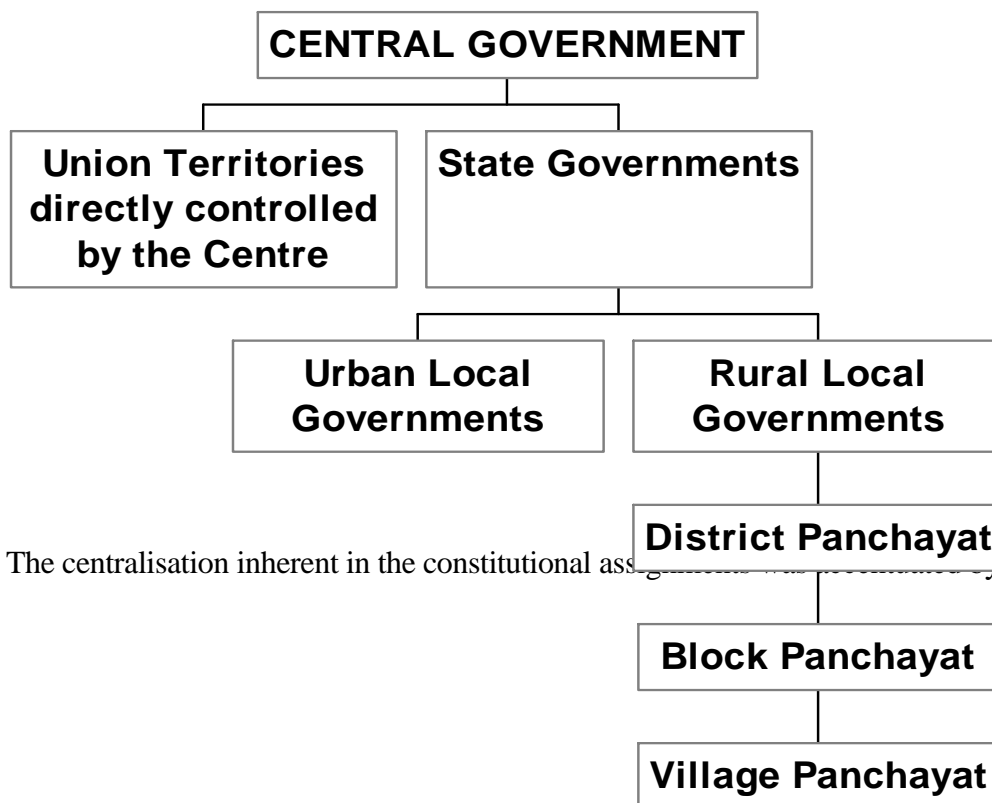
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<sup>2</sup> This is called the 'Gadgil' formula after the name of the Deputy Chair man of the Planning Commission (Prof. D. R. Gadgil) who introduced the formula for the first time in 1969.

Below the States, there are over a quarter million local governments. Of this about 3000 are in urban areas and the remaining in rural areas. Rural local governments again are at three levels - district, Taluk (block) and village levels. The urban local governments consist of municipal corporations in large cities, municipalities in smaller cities and towns and in notified area committees in smaller towns. Each of the State governments has devolved powers to levy certain taxes and fees to village panchayats and urban local bodies. The States have also instituted a system of sharing of States' revenues and giving grants to urban and rural local bodies. In addition, a number of Central sector and centrally sponsored schemes are implemented by the local governments and the funds earmarked for the purpose are passed on to them from the State governments for implementation.

**Figure 1**

**Organization of Multilevel Fiscal System in India**



### III. The Assignment Question

a. **Tax and Expenditure Assignments in India:** The functions required for maintaining macroeconomic stability, international relations and activities having significant scale economies have been assigned exclusively to the Center or have to be carried out concurrently with the States. The functions which have a State-wide jurisdiction are assigned to the States. Most broad-based and progressive tax handles have been assigned to the Center. The Center also has residual tax powers. A number of tax handles have been assigned to the States as well, but from the viewpoint of revenue productivity, only the sales tax is important. The States can borrow from the Central government. They have the powers to borrow from the market as well, but if a State is indebted to the Central government, the borrowing has to be approved by the Center.

The tax powers are assigned on the basis of the principle of separation, exclusively either to the Center or to the States. However, exclusivity is only in the legal sense and this gives rise to anomalous situations. Thus, the Center can levy taxes on production (excise duty) but the tax on the sale of goods is leviable by the States. Similarly, taxes on agricultural incomes and wealth are in States' domain whereas those on non-agricultural incomes and wealth are a Central prerogative. The States find taxing agricultural incomes politically infeasible besides being administratively difficult. In the event, this has provided an easy means to evade the income tax levied by the Center.

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 enactment of the Constitution (Eightieth Amendment) Act 2000, taxes on incomes other than non-agricultural incomes and union excise duty were shared with the States. Considering the potential adverse incentives of sharing of taxes from individual sources for the Central government, based on the recommendations of the Tenth Finance Commission, the Constitution was amended to include proceeds from all central taxes in the divisible pool. 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, an independent body appointed by the President every five years (Article 280).

The shares of Central and State governments in revenues and expenditures summarized in Tables 1 and 2 bring out their respective roles. The States, on an average, raise about 34 per cent of revenues and incur 57 per cent of expenditures. However, their maneuverability in implementing expenditures is lower; about 15 per cent of total expenditures is incurred on items requiring matching requirements from the States. In fact, States' expenditures on these schemes increased from 7 per cent of the total in 1985-86 to about 20 per cent in 2000-01.

The pattern of expenditures shown in Table 2 indicates that the Central government plays a major role in defense and provision of large physical infrastructure facilities. On the other hand, the States have a high share of expenditures on internal security, law and order, and social services and economic services like agriculture, animal husbandry, forestry, fisheries, irrigation and power and public works. The States' share in expenditure on administrative services is about 68 per cent; on social services they spend about 83 per cent and on economic services their share is about two-thirds. Their role in providing social services like education, public health and family is particularly predominant, close to 90 per cent.

### III.3 Assignment between State and local governments:

With the constitutional amendments in 1992, roles and responsibilities of rural and urban local governments have been specified. Accordingly, in separate schedules, a list of 29 functions to rural local bodies and another list of 18 functions to urban local bodies have been specified. However, these functions are concurrent with the States and the actual assignment of specific revenue sources and expenditures depends on the extent to which the State is willing to devolve. Each state is required to appoint the state Finance commission every five years to recommend the devolution of resources for carrying out the functions assigned.

In addition to State transfers, the local governments received funds for the implementation of various central schemes. The most important of them is for poverty alleviation, but there are also other schemes on social and community services in which, the local governments have a comparative advantage in implementation. Analysis shows that local governments have very little flexibility in the use of funds (Rao, Amar Nath and Vani, 2003). After deductions of charges for electricity by the State government in the general purpose transfers, very little is left. A bulk of what is available is needed for administration and the local governments are hardly in a position to execute any developmental schemes.

<b>Table 2</b>									
<b>Revenue Receipts of the Central and States Governments: 1985-2001</b>									
Items of Revenue	Revenue Share 1985-86		Revenue Share 1990-91		Revenue Share 1999-00		Revenue Share 2000-01 (RE)		Per cent of total revenue 2000-01
	Center	States	Center	States	Center	States	Center	States	
<b>A. Tax Revenue (a+b)</b>	49.0	51.0	48.1	51.9	46.7	53.3	45.2	54.8	76.1
<b>a. Central Taxes</b>	100.0	-	100.0	-	74.7	25.3	72.8	27.2	47.2
1. Corporation Tax	100.0	-	100.0	-	100.0	-	72.8	27.2	9.2
2. Personal Income Tax	100.0	-	100.0	-	35.6	64.4	72.8	27.2	8.4
3. Custom duties	100.0	-	100.0	-	100.0	-	72.8	27.2	11.9
4. Union Excise Duty	100.0	-	100.0	-	56.5	43.5	72.8	27.2	16.8
5. Others#	100.0	-	100.0	-	100.0	-	72.8	27.2	0.9
<b>b. Exclusive States Taxes</b>	-	100.0	-	100.0	-	100.0	-	100.0	28.9
1. State Excise Duties	-	100.0	-	100.0	-	100.0	-	100.0	3.9
2. Sales Taxes	-	100.0	-	100.0	-	100.0	-	100.0	16.6
3. Taxes on Transports	-	100.0	-	100.0	-	100.0	-	100.0	2.2
4. Other	-	100.0	-	100.0	-	100.0	-	100.0	6.3
<b>B. Non-tax Revenue</b>	62.1	37.9	55.1	44.9	62.4	37.6	58.2	41.8	12.5
1. Net contribution from Public Enterprises	-868.7	968.7	-288.7	388.7	128.8	-28.8	118.3	-18.3	3.1
2. Administrative Receipts	59.2	40.8	36.5	63.5	27.5	72.5	26.1	73.9	1.9
3. Interest Receipts	66.6	33.4	59.6	40.4	47.6	52.4	39.5	60.5	4.0
4. External Grants	100.0	-	100.0	-	100.0	-	100.0	-	0.2
<b>C. Grants to States</b>	-	100.0	-	100.0	-	100.0	-	100.0	11.4
<b>D. Total Revenue Accrual</b>	45.2	54.8	43.5	56.5	44.6	55.4	41.6	58.4	100.0
<b>E. Total Revenue collections</b>	69.5	30.5	67.8	32.2	65.9	34.1	65.9	34.1	100.0

\* Revised Estimates. \*\* Netted for the interest paid to the Central government.

Source: Public Finance Statistics, Ministry of Finance, Government of India, 1993.



**Table 2:  
Share of State Governments in Total Expenditures\***

Expenditure Item	1985-86			1990-91			1999-00			2000-01 (RE)			Percentage of Total Expenditure
	Current	Capital	Total	Current	Capital	Total	Current	Capital	Total	Current	Capital	Total	
A. Interest Payment	34.6	0	34.6	35.5	0	35.5	41.1	0.0	41.1	44.0	0.0	44.0	21.41
B. Defence	0	0	0	0	0	0	0.0	0.0	0.0	0.0	0.0	0.0	9.46
C. Administrative Service	85.2	0.8	78	76.4	1.8	73.4	64.2	13.3	62.5	64.9	17.5	63.8	15.98
D. Social and Community Services	94.8	67	92.7	78.9	74.1	78.7	83.8	73.4	83.2	83.4	83.1	83.4	21.56
of which:													
i. Education	84.8	79.5	84.7	84.5	61.7	83.9	89.4	90.9	89.4	89.6	93.1	89.6	11.94
ii. Medical and Health	92.5	94.8	92.8	90.3	95.3	90.7	88.3	95.5	89.2	87.5	98.2	89.3	4.57
iii. Family Welfare	93.4	90.4	93.1	92.2	100	92.7	80.2	100.0	80.4	78.4	100.0	78.8	0.60
iv. Others	98.1	40.7	88.2	61.1	64	61.4	59.6	49.3	58.2	61.0	61.6	61.1	4.46
E. Economic Services,	78.1	46.3	62.9	50.2	53.1	51.1	59.5	68.5	62.0	60.2	76.6	65.0	22.99
of which:													
i. Agriculture and Allied Services	99.9	52.1	96.7	77.8	94.8	78.6	65.1	91.0	67.0	68.7	98.4	71.7	6.88
ii. Industry and Minerals	36.7	9.8	18.1	40.7	44.1	41.9	14.0	42.7	16.2	16.7	56.4	20.6	2.99
iii. Power, Irrigation and Flood Control	94.7	65.4	73.9	86.2	62.9	69.1	88.8	83.0	86.0	90.4	86.8	88.8	6.58
iv. Transport and Communication	68.3	68.3	68.3	70.4	32.1	47.3	55.7	60.6	57.9	44.3	71.5	55.8	4.10
v. Others	24.9	18	23.9	16.6	51.3	19.7	79.2	36.6	59.8	56.2	46.6	52.2	2.45
F. Others	80	14.7	33.2	57.2	0	57.2	55.1	0	55.1	61.7	0	61.7	6.90
G. Loans and Advances	0	51.7	51.7	0	51.1	51.1	0	79.5	79.5	0	73.2	73.2	1.70
H. Total @	55.2	43	52.1	55	44.5	52.9	56.4	56.7	56.5	57.8	59.7	58.0	100.00

\* Revised Estimates.

\*\* Includes food and fertilizer subsidies.

@ Excludes appropriation for reduction and avoidance of debt.

Source: Public Finance Statistics, Ministry of Finance, Government of India.

#### IV. Fiscal Imbalances: Trends and Issues.

a. **Vertical Fiscal Imbalance in India:** The constitutional assignment and developments over the years have caused a high degree vertical fiscal imbalance. As shown in Table 4, the State governments in 2000-01 collected only 38 per cent of total current revenues (column 2), but their share in total current expenditure was 57 per cent (column 3). From the revenue sources assigned to them, they could finance only 48 per cent of their current expenditures (column 4) and 43 per cent of their total expenditures (column 6). Thus, from the own sources assigned to them, the States raise only about 44 per cent of expenditure requirements. Over 55 per cent of States' total expenditures are financed from transfers from the Center and loans.

Interestingly, even when the States' revenues grew at a rate faster than that of the Center, their fiscal dependence on the latter increased. Although the States' share in raising revenue has marginally increased since mid 1980s, as their expenditure share increased at a faster rate (Table 4, column 5), causing increase in fiscal dependence. Thus, the proportion of States' current expenditures financed from own revenues declined from 59 per cent in 1995-96 to 49 per cent in 1998-99. The States' share in total expenditures too increased from 53 per cent in 1990-91 to 57 per cent in 2000-01. However, this does not signify increase in decentralization for, the spending financed by specific purpose transfer on which the states' have little maneuverability have shown a sharp increase in recent years.

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 States' own current revenues to States' current expenditure	Per cent of States' expenditure* to total expenditure*
1955-56	41.2	59.0	68.9	61.7
1960-61	36.6	59.9	63.9	56.8
1965-66	32.6	55.6	63.5	53.3
1970-71	35.5	60.2	60.6	53.9
1975-76	33.5	55.1	70.4	47.6
1980-81	35.6	59.6	60.1	56.0
1985-86	35.5	56.0	57.7	52.6
1990-91	35.2	54.6	53.1	51.7
1995-96	39.2	57.0	58.6	55.8
1999-00	38.6	56.4	49.8	56.0
2000-01 RE	38.1	57.8	48.7	57.1

\* Current + capital expenditures. RE: Revised Estimates

Source: Public Finance Statistics, Ministry of Finance, Government of India (relevant years).

**b. Horizontal Fiscal Imbalance:** An important feature of Indian fiscal federalism is the wide inter-State differences in revenue capacity and consequently, per capita expenditures. 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 Center. In addition, in terms of economic characteristics the 11 mountainous States of the north and the Northeast differ markedly from the rest and therefore are considered 'special category' States. Of the 28, three States have been carved out from three large States.<sup>3</sup>

Differences in per capita revenues and expenditures among the States shown in Table 5 bring out several important features. First, there are wide inter-State variations in revenues in both per capita terms and as a ratio of Gross State Domestic Product (GSDP). Second, these variations indicate differences in revenue capacity, and partly, differences in revenue efforts. Third, the tax-GSDP ratios in the special category States are lower than in the general category States even when their per capita GSDP is higher. This is partly because, in these States there is not much production activity and the government administration is the major determinant of the GSDP. Further, size of their tax base is smaller than what is indicated by the GSDP, because a significant proportion of government spending spills over the jurisdictions. Fourth, although the revenue bases in the special category States are low, their average per capita current expenditure are higher than not only the all-State average but also the average of high income States<sup>4</sup>. Fifth, in the case of general category States, the fiscal dependence on the Center is not only high but also varies inversely with per capita income. It is seen that per capita expenditures in high income States was higher than the all State average by 44 per cent and that of the low income States is lower by 36 per cent. Nevertheless, there has been significant equalization; while the per capita revenues from own sources in low income States were about 29 per cent of those in high income States, per capita expenditure in the former was close to 63 per cent.

The inter-State disparities in India even among the general category States are not only high, but also have shown an increasing trend. In 1980-81, the per capita SDP in the richest State, Punjab (Rs 2674) was about 2.9 times that of the poorest, Bihar (Rs 919). In 1998-99, this difference increased to 4.8 times with per capita SDPs of the two States respectively at Rs 23254 and Rs 4813. It is also seen that per capita income levels have tended to diverge sharply after market based reforms

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<sup>3</sup> The three now States are Jharkhand (carved out of Bihar), Chattisgarh (carved out of Madhya Pradesh) and Uttarakhand (carved out of Uttar Pradesh). While the first two states have continued as general category states, the last one is considered to be a special category state.

<sup>4</sup> Of course, the higher than average per capita expenditures in special category States cannot be entirely attributed to their inherent cost disability. This may also be due to bad fiscal management.

were initiated. (Rao et.al, 1999). As inter-State differences in the ability to raise revenues increased over the years, and as federal transfers did not entirely offset the fiscal disabilities of the poorer states, the coefficient of variation in expenditures also increased over the time period (Rao, 1998).

## **VI. Intergovernmental Transfers**

**a. Economic Rationale for Transfers:** Intergovernmental transfers have been employed to fulfil a variety of objectives and the design of the transfer scheme depends on the purpose for which it is given. In the literature, federal transfers are recommended for (i) closing the fiscal gap, (ii) equalization, (iii) spillovers and merit good reasons.

The argument for equalisation on horizontal equity grounds is advanced initially by Buchanan (1950) and later developed by Boadway and Flatters (1982). Taking comprehensive income as the index of well-being, it is argued that the federal income tax as is presently structured cannot ensure horizontal equity for, its base does not take into account the redistributive effect of States' fiscal operations. States' fiscal operations cannot be distributionally neutral except in the unlikely case of benefit taxes. When the States' quasi-public services are financed by resource rents or source-based taxes as against residence-based taxes, the net fiscal benefits (NFBs) will systematically vary. The residents in the resource rich (high income) regions will have higher NFBs and their higher public consumption will not be included in determining the tax base of the Central government.

Boadway and Flatters define horizontal equity in two alternative ways. According to the broad view, the fiscal system should be equitable nation-wide vis-à-vis the actions of all governments. Two persons equally well off before Central and State actions must also be so afterwards. To fulfil this concept of horizontal equity, it is necessary to give transfers so that each province is enabled to provide the same level of public services at a given tax rate (like in a unitary State). In contrast, the narrow view of horizontal equity takes the level of real incomes attained by the individuals after a State's budgetary operation as the starting point and the Central fiscal action will be directed to ensure horizontal equity after the State's fiscal system has been established. The Central budget need not offset the inequalities introduced by the operation of the State budgets *per se*, but takes the income distribution effects of the States' fiscal operations as a given datum.

States	Per capita SDP (Rupees)	Poverty ratio (percent) 1999-00	Per capita own revenue (Rupees)	Own Revenue as percentage of SDP	Per capita Transfers	Per capita current spending (Rupees)	Per cent of own revenue to current spending
<b>High Income States</b>	<b>22461</b>	<b>17.83</b>	<b>2931.6</b>	<b>13.1</b>	500	<b>4386.6</b>	<b>66.8</b>
Gujarat	18685	14.07	2684.6	13.2	863	5167.6	52.0
Goa	44613	4.4	14310.3	15.8	588	11904.8	120.2
Haryana	21551	8.74	3209.7	12.1	502	4107.9	78.1
Maharashtra	22604	25.02	2741.3	11.1	448	3852.6	71.2
Punjab	23254	6.16	3333.2	10.2	494	4712.7	70.7
<b>Middle Income States</b>	<b>17635</b>	<b>20.3</b>	<b>1868.8</b>	<b>10.6</b>	<b>658</b>	<b>3400.4</b>	<b>55.0</b>
Andhra Pradesh	14878	15.77	1930.2	10.7	713	3320.2	58.1
Karnataka	16654	20.44	2148.1	11.3	686	3580.9	60.0
Kerala	17709	12.72	2295.8	10.2	690	3689.4	62.2
Tamil Nadu	18623	21.12	2342.5	11.3	658	3594.3	65.2
West Bengal	14874	27.02	1091.0	5.5	576	3092.7	35.3
<b>Low Income States</b>	<b>9182</b>	<b>34.28</b>	<b>858.5</b>	<b>9.3</b>	<b>673</b>	<b>2261.3</b>	<b>38.8</b>
Bihar	4813	42.6	338.2	8.9	724	1515.5	22.3
Chattisgarh	10405	NA	1264.0	4.9	NA	2455.2	51.5
Jharkhand	9223	NA	1128.0	9.0	NA	2229.4	50.6
Madhya Pradesh	11626	37.43	1061.9	11.5	624	2695.5	39.4
Orissa	8733	47.15	900.5	9.3	969	2785.3	32.3
Rajasthan	13046	15.28	1297.2	10.4	693	2864.2	45.3
Uttaranchal	NA	NA	1295.5	NA	NA	4912.7	26.4
Uttar Pradesh	9323	31.15	791.2	8.1	598	2135.6	37.0
<b>General Cat. States</b>	<b>14605</b>	<b>25.97</b>	<b>1606.3</b>	<b>11.0</b>	<b>660</b>	<b>3060.9</b>	<b>52.5</b>
<b>Special cat. States</b>	<b>10695</b>		<b>1032.2</b>	<b>9.7</b>	<b>2896</b>	<b>5126.7</b>	<b>20.1</b>
Arunachal Pradesh	13352	33.47	1067.8	5.3	7985	9992.3	10.7
Assam	9720	36.09	798.7	7.2	1216	3317.0	24.1
Himachal Pradesh	17786	7.63	1660.5	7.8	3070	7420.6	22.4
Jammu & Kashmir	12373	3.48	1150.4	7.9	4602	6080.0	18.9
Manipur	12721	28.54	406.0	3.1	3971	6032.3	6.7
Meghalaya	12063	33.87	1066.8	6.3	3149	5878.4	18.1
Mizoram	14909	19.47	679.0	3.8	9602	12845.6	5.3
Nagaland	12594	32.67	506.8	3.7	6332	7291.0	7.0
Sikkim	14751	36.55	5998.1	15.9	7945	12200.6	49.2
Tripura	13195	34.44	729.6	4.8	3376	5838.9	12.5
Uttaranchal	na		1295.5		na	4912.7	26.4
<b>All States</b>	<b>14359</b>	<b>26.1</b>	<b>1570.1</b>	<b>10.9</b>	<b>768</b>	<b>3191.1</b>	<b>49.2</b>

Note: Revenues and Expenditures are net of Lotteries; GSDP – Gross State Domestic Product.

Source: 1. Reserve Bank of India Bulletin, December 2000

2. Public Finance Statistics, Ministry of Finance, Government of India, 1994-95.

The rationale for specific purpose transfer is routed in offsetting spillovers. In the absence of perfect 'mapping', the public services by sub-Central governments may spill over the jurisdictions and such externalities result in the non-optimal provision of public services. A Pigovian subsidy is required to 'set the prices right'. To be cost-effective, specific purpose transfers made to the States to ensure optimal provision of public services require matching contributions from them.

**b. The Design of Intergovernmental Transfers:** General-purpose transfers, as mentioned earlier, are given to offset fiscal disabilities. Thus, the objective of these transfers is to offset the fiscal disadvantages arising from lower revenue capacity and higher unit cost of providing public services. This is achieved by unconditional grants equivalent to the 'need-revenue' gap (Bradbury, et al., 1984). The 'need-revenue' gap measures the difference between what a State ought to spend to provide specified levels of public services and the revenue it can raise at a given standard level of tax effort.

Specific purpose transfers on the other hand, are intended to compensate the spillovers or are given for merit good reasons or for reasons of "categorical equity". The transfer system, therefore, should be specific purpose and open ended with matching ratios varying with the size of spillovers. As the responsiveness of the States to a given matching rate could vary with their level of its incomes, equalizing matching ratios are also recommended (Feldstein, 1975).

Thus, in an ideal system, there should be an optimal combination of general and specific purpose transfers. General-purpose transfers would *enable* all the States to provide a given normative standard of public services at a given tax effort. The specific purpose transfers would *ensure* a given standard of outlay on the aided services.

#### © Intergovernmental Transfers in India:

A notable feature of transfer system in India is the existence of multiple channels. The Constitution provides for the appointment of the Finance Commission by the President of India every five years to make an assessment of the fiscal resources and needs of the Center and individual States. Based on these, the Commission is required to recommend the shares of personal income tax and union excise duty and grants-in-aid to the States. However, with development planning gaining emphasis, the scope of the Finance Commissions was restricted to cover the States' non-plan requirements in the current account. The Planning Commission became a major dispenser of funds to the States by way of both grants and loans. In addition to these two channels, various Central ministries give specific purpose transfers with or without matching requirements.

The trends in the relative shares of the three channels of Central transfers<sup>5</sup> to States since the fourth five-year plan, as shown in Table 5, bring out some interesting features. First, the share of

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<sup>5</sup> There is a considerable amount of confusion in the term 'transfers'. In Indian fiscal literature, Central loans to States are also characterized as transfers. Such transactions involve transfers only to the extent of any interest subsidy or write off of loans. Sometimes, on the recommendation of the Finance Commissions, the loans to States are rescheduled,

statutory transfers in the total declined from 65 per cent during the fourth plan (1969-74) to a little over 60 per cent during the seventh plan. Although it increased to 65 per cent in 1997-98, declined subsequently to less than 62 per cent in 2000-01. Second, the proportion of formula based transfers given by the Finance Commission and the Planning Commission has declined and that of discretionary transfers has increased in recent years. Third, within the Finance Commission, the proportion of tax devolution is overwhelming though in recent years, this has tended to decline.

**(i) Finance Commission Transfers:** Under Article 280 of the Constitution, President of India appoints the Finance Commission every five years or earlier as deemed necessary. The Commission is required to make recommendations on the following:

- (a) The distribution between the Union and the States of the net proceeds of shareable taxes and allocation between the States of the States' share of divisible taxes;
- (b) The principles that should govern grants in aid of revenues of the states out of the consolidated fund of India and the amount to be paid to the States in need of assistance;
- (c) the measures needed to augment the Consolidated Fund of a State to supplement the resources of Panchayats (rural local governments) in the State on the basis of recommendations made by the State Finance Commissions;
- (d) the measures needed to augment the Consolidated Fund of a State to supplement the resources of municipalities on the basis of a recommendations by the State Finance commissions;
- (e) any other matter referred to the Commission in the interest of sound finance.

With the emergence of Planning Commission as a major dispenser of financial assistance to States for plan purposes, the scope of the Finance Commission has been restricted to meeting the non-plan current expenditure requirements of the States. The approach of the Finance Commissions' to transfers consists of (i) assessment of overall budgetary requirements of the Center and States to determine the volume of resources that can be transferred during the period of their recommendation; (ii) forecasting States' own current revenues and non-plan current expenditures;(iii) determining the States' share in Central tax revenues and distributing between the States of these shareable proceeds; (iv) filling the post-devolution projected gaps between non-plan

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the rate of interest reduced and even a portion of the loan itself is written off. Here, we have taken only tax devolution

current expenditures and revenues with the grants in aid. This is known as the "gap-filling" approach. The latest Finance Commission (Eleventh) has made the recommendations for the five years beginning April 2000.

<b>Table 9.2 : Composition of Central Transfers to States</b>								
Plan Periods / Years	Finance commission Transfers			Plan Grants			Other Grants	Total
	Tax Devolution	Grants	Total	State Plan Scheme	Central Scheme	Total		
	Forth Plan (1969-74)	45.60 (54.35)	8.60 (10.25)	54.20 (64.60)	10.80 (12.87)	9.70 (11.56)		
Fifth Plan (1974-79)	82.70 (50.21)	28.20 (17.12)	110.90 (67.33)	29.10 (17.67)	19.30 (11.72)	48.40 (29.39)	5.40 (3.28)	164.70 (100.00)
Sixth Plan (1980-85)	237.30 (56.97)	21.40 (5.14)	258.70 (62.11)	73.80 (17.72)	69.00 (16.57)	142.80 (34.29)	15.10 (3.63)	416.50 (100.00)
Seventh Plan (1985-90)	494.60 (54.17)	62.70 (6.87)	557.40 (61.04)	155.20 (17.00)	165.10 (18.08)	320.30 (35.08)	35.20 (3.85)	913.10 (100.00)
Annual Plan 1991-92	172.00 (52.22)	34.50 (10.47)	206.40 (62.66)	57.20 (17.36)	55.40 (16.82)	112.50 (34.15)	10.20 (3.10)	329.40 (100.00)
Eighth Plan (1992-97)	1318.50 (55.56)	147.20 (6.20)	1465.70 (61.76)	483.40 (20.37)	364.70 (15.37)	848.40 (35.75)	58.40 (2.46)	2373.10 (100.00)
1997-98	404.11 (62.52)	16.80 (2.60)	420.91 (65.12)	120.08 (18.58)	67.56 (10.45)	187.64 (29.03)	37.80 (5.85)	646.35 (100.00)
1998-99	394.20 (62.29)	14.20 (2.24)	408.40 (64.54)	132.70 (20.97)	71.10 (11.24)	203.80 (32.21)	20.60 (3.26)	632.80 (100.00)
1999-00	441.21 (59.03)	19.88 (2.66)	461.09 (61.69)	163.16 (21.83)	82.03 (10.98)	245.19 (32.80)	41.14 (5.50)	747.42 (100.00)
2000-01RE	518.27 (52.28)	121.69 (12.28)	639.96 (64.56)	157.59 (15.90)	136.76 (13.80)	294.35 (29.69)	56.99 (5.75)	991.30 (100.00)
2001-02 BE	603.5 (55.41)	95.34 (8.75)	698.84 (64.17)	190.67 (17.51)	152.52 (14.00)	343.19 (31.51)	47.04 (4.32)	1089.07 (100.00)

Note: Figures in parenthesis are percentages to total transfers.

Source: **State Finances – A Study of Budgets (various years), Reserve Bank of India Bulletin**

Prior to the Constitutional amendment in which devolution of selective central taxes was replaced by general tax sharing, the Finance Commissions were required to recommend the transfer of additional excise duties in respect of sales taxes on sugar, textiles and tobacco. In respect of these three groups of articles, the States had voluntarily surrendered their right to levy sales taxes and the Center has been levying additional excise duties, which was passed on to them on the basis of origin as recommended by the Commission. With the substitution of general tax sharing to sharing of individual taxes, separate assignment of additional excise duties has been discontinued. Thus the Eleventh Finance Commission has recommended the distribution of 29.5 per cent of net proceeds of

and grants as transfers. Transfers arising from interest subsidy guarantees and loan write off are not taken account of.



Central taxes consisting of 28 per cent for general tax sharing and 1.5 per cent in lieu of additional excise duties. The entire 29.5 per cent is to be distributed according to a uniform formula given in Table 6.

Table 6: Criteria and relative Weights for tax Devolution	
Criterion	Weight (Per cent)
1. Population	10
2. Income (Distance Method)*	62.5
3. Area	7.5
4. Index of Infrastructure	7.5
5. Tax Effort**	5.0
6. Fiscal Discipline***	7.5

Note: \*The distance method is given by:  $(Y_h - Y_i)P_i / S(Y_h - Y_i)P_i$  where,  $Y_i$  and  $Y_h$  represent per capita SDP of the  $i^{th}$  and the highest income State respectively and  $P_i$  is the population of the  $i^{th}$  State .

\*\* Tax Effort ( $\eta$ ) is estimated as  $(\eta) = (T_i / Y_i) / (0.5 T_h / Y_h)$  where,  $T_i$  is the per capita tax revenue collected by the  $i^{th}$  State and  $Y_i$  is the per capita State domestic product of the  $i^{th}$  State.

\*\*\* estimated as the improvement in the ratio of own revenue of a state to its revenue expenditures divided by a similar ratio for all States averaged for the period 1966-99 over 1991-1993.

An important feature of tax devolution recommended by the Finance Commissions is that, while the criteria adopted for distribution are different from the principles of grants-in-aid, nowhere is it made clear that the economic objectives of the two instruments are different (Rao and Sen, 1996, Ch.6). The tax devolution is recommended mainly on the basis of general economic indicators (Table 6) and grants are given to offset the residuary fiscal disadvantages of the States as quantified by the Commissions. Further, assigning weights to contradictory factors like 'backwardness' and 'contribution' in the same formula has rendered the achievement of the overall objective of offsetting revenue and cost disabilities difficult.

Over the years, attempts have been made to improve degree of equalization in the transfer scheme by assigning higher weight to per capita SDP either in the "inverse" or "distance" form by the successive Commissions. Yet, population has continued to receive the largest implicit and explicit weight, though the last Commission has significantly reduced explicit weight to this factor. Equally important is the unreliability of tax effort and index of fiscal discipline. In a tax system, which is predominantly origin based, there can be significant inter-state tax exportation and the tax effort indicator ignores this phenomenon. Besides, there are a number of other factors in addition to per capita SDP that determines taxable capacity of a State. The changes in the ratios of own revenues to revenue expenditures relative to all-State average and their changes over time can occur due to factors

totally extraneous to States own efforts at fiscal discipline. Equalization has been further blunted by the terms of reference, which require the Commissions to use the 1971 population figures wherever it is used in the transfer formula. The purpose of this is to penalize the States with higher population growth rates. The important questions are first, whether, the federal transfer mechanism should be employed as an instrument of population policy and second, even if it is, why should those States with high population growth due to migration be penalized.

The 'gap-filling' approach outlined above has been subjected to criticisms. First, none of the Finance Commissions assessed the overall resource position and requirements of the Center on any objective basis. Second, the transfers made by the Finance Commissions were not designed specifically to offset fiscal disadvantages of the States arising from lower revenue raising capacity and the higher unit cost of public services. While the tax devolution is determined on the basis of general economic indicators, grants are given on the basis of projected post-devolution budgetary gaps. Third, the design of the grants has serious disincentive effects on fiscal management of the States. Nor are the fiscally disadvantaged enabled to provide a given level of public service at a given tax-price.

There has been a considerable concern at the Finance Commissions following the "gap-filling" approach and its possible disincentives on fiscal management in States. This was the reason for modifying the terms of reference of the Ninth Finance Commission to follow a "normative approach". The Commission did develop methodology for the purpose. However, the subsequent Commissions simply abandoned the approach. The 11th Finance Commission in the additional terms of reference given to it just before the finalization of its recommendations was asked to "...draw a monitorable fiscal reforms program aimed at reduction of revenue deficit of the state and recommended the manner in which the grants to the States to cover the assessed deficit in their non-plan revenue account may be linked to progress in implementing the program."

The Commission worked out a scheme by pooling 15 per cent of revenue deficit grants and adding an equal amount to it to create an incentive fund to be allocated among the based on fulfillment targets of growth of tax and non-tax revenues and expenditures on salaries, interest payments and subsidies set in the fiscal restructuring plan detailed by the Commission. It gave equal weight to monitorable measures on the revenue and expenditure sides and specified weights to each of the monitorable measures. The incentive fund has been allocated to the States according to their population shares. A State will get the full amount if it fulfils the targets and the amount will vary depending on the degree of achievement of monitorable targets. If a State does not get the full amount

during the first four years it will continue to be available in subsequent years, but if by the fifth year the targets are not achieved, the funds will lapse. To implement the scheme a monitoring agency should be set up by the Government of India consisting of representatives of the Planning Commission, Finance Ministry of Government of India and representatives of State governments.

There are a number of problems with the proposed scheme. Some of them have been pointed out in the Note of Dissent presented by one of the Members of the Commission (Government of India, 2000, pp. 9-13). The problems include both with the monitorable measures and implementation mechanism. The measures can vary not only due to factors within the States' control but also beyond. Again, while determining the grants these measures have been taken into account, but a portion of the grants thus determined is withheld for distribution according to the achievement of these measures. There are also problems of fiscal autonomy of the States when its actions are supervised by a monitoring agency. Finally, while the scheme tries to monitor the fiscal performance of the States, there is no mechanism to monitor the performance of the Center.

**ii. Plan transfers:** The assistance given by the Planning Commission comprises of both grants and loans. In earlier years, both the volume and the loan - grant component was project based, but since 1969 the assistance has been allocated on the basis of a formula (Gadgil formula)<sup>6</sup>. At present, 30 per cent of the funds is kept apart for the special category States and distributed among them on the basis of plan projects formulated by them, 90 per cent of the assistance given by way of grants and the remainder as loans. The 70 per cent of the funds available to the major States is distributed with 60 per cent weight assigned to population, 25 per cent to per capita SDP, 7.5 per cent to fiscal management and the remaining 7.5 per cent to special problems of these States (Table 7). 30 per cent of the resources is given by way of grants and the remainder as loans. Thus, plan transfers and their grant-loan components, are determined independently of the required plan investments, their sectoral composition, the resources available to the States or their fiscal performances.

**iii. Assistance to the Central Sector and Centrally Sponsored Schemes:** This is the third component of transfer and is given for specified purposes with or without matching provisions. Grants for the Central sector schemes are given to the States to execute Central projects and are entirely funded by it. Centrally sponsored schemes, on the other hand, are shared cost programs falling within the States' ambit with uniform matching ratios across the States, but, varying with the projects. There

were 262 such schemes in 1985, and some more have been added in subsequent years. These transfers have attracted the sharpest criticism due to their discretionary nature and conditionality attached to them. They accounted for about 40 per cent of the total plan assistance and about 14 per cent of total current transfers were given to these schemes in 2000-01 (Table 5).

#### iv. Financing infrastructure at the State level: The loans

Borrowing is an important source of financing infrastructure at the state level. Until 1987-88, the government savings at the State level did contribute to financing capital expenditures. Since then, however, with increasing dissavings at the state level, the borrowing is used not only to finance capital expenditures, but also a significant part of current expenditures of the States. In 1998-99 for example, almost one-half of the States' borrowing is used to finance capital expenditure.

The States' liabilities consist of Central government loans, market borrowings, share of small savings collections, and provident funds, deposit accounts etc. The Central loans constitute 60 per cent of the States' indebtedness. These loans are given mainly for financing the plans under the Gadgil formula. As already mentioned, the States receive 70 per cent of plan assistance in the form of loans. Other Central loans consist of ways and means advances and the share of small savings collections<sup>7</sup>.

Variable	Weight
Population (1971)	60.0
Per capita SDP, of which,	25.0
(i) Deviation from the average to the States below average per capita SDP	20.0
(ii) 'Distance ' from the highest per capita SDP for all the general category States.	5.0
Fiscal Performance, of which,	7.5
(i) Tax effort	2.5
(ii) Fiscal management	2.5
(iii) National objectives	2.5
(iv) Special problems	7.5
<b>Total</b>	<b>100.0</b>

<sup>6</sup> The formula and its modifications from time to time are evolved on the basis of consensus the National Development Council (NDC). The NDC is constituted by the cabinet ministers at the Center, chief ministers of the States and the members of the Planning Commission and is chaired by the Prime Minister.

<sup>7</sup> Small savings consist of post office savings in national saving certificates. The Center advances two-thirds of net collection of small savings to the states on the basis of origin

The States can also borrow from the market. However, if a State is indebted to the Center, it has to take central permission before borrowing. As all the States are indebted to the Center, the Ministry of Finance, Planning Commission and the Reserve Bank of India determine market borrowing of the States. In determining the volume of market borrowings, volume of repayments, the plan investments decided upon and the volume of indebtedness of each of the states is taken account of. In 1998-99, the market borrowings constituted 22 per cent of States' indebtedness.

Subscription to State government loans constitutes a part of the Statutory Liquidity Ratio (SLR), the commercial banks are required to maintain 35 per cent of their lendable resources in stipulated assets, which includes state government borrowings. Thus, the investible resources of the banking system is pre-empted for government consumption and investment.. The interest rates on government bonds were significantly below the market rates. However, financial sector reforms initiated since 1991 has gradually aligned the interest rates on government bonds with market rates.

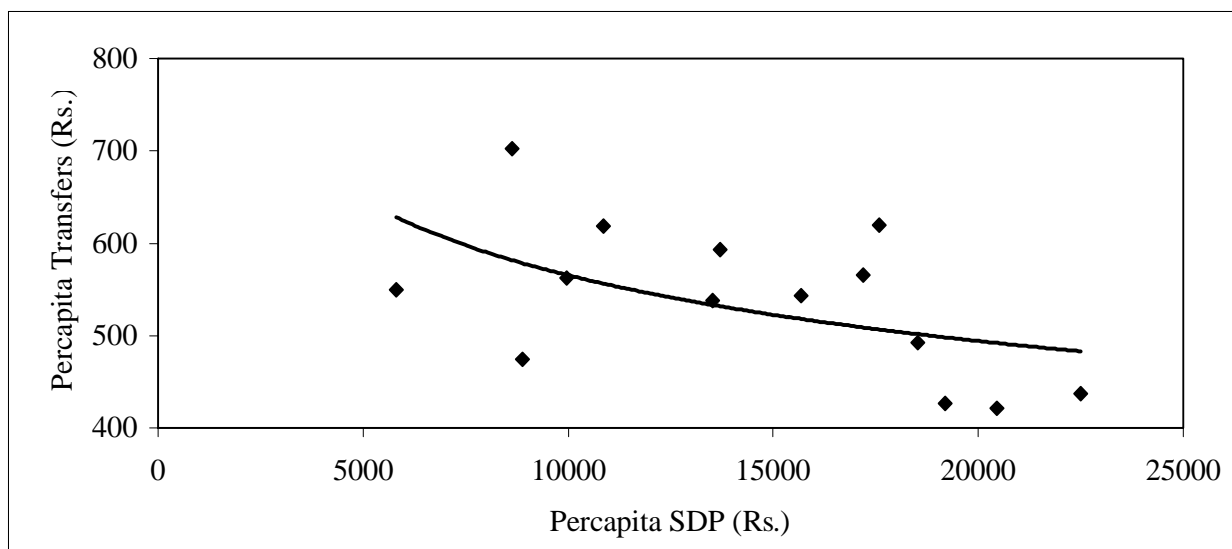
**v. Shortcomings of Intergovernmental Transfers Summarized:** The design and implementation of intergovernmental transfer schemes in India suffer from a number of shortcomings. First, multiple agencies with overlapping jurisdictions have blurred the overall objectives of transfers. Second, accommodating different interests has unduly complicated the transfer formula. Third, the design of the transfer system is not well targeted to achieve equalization and to ensure minimum service levels in the States. Fourth, they have disincentive effects on the fiscal management in the States. While there is certainly a role for specific purpose transfers in Indian federation, the design and implementation of the centrally sponsored schemes has not served the purpose. It has tended to multiply State level bureaucracy and distort States' own allocations in unintended ways.

**d. Equalizing Effect of Intergovernmental Transfers:**

Analysis of intergovernmental transfers shows a fair degree of inter-State redistribution. The transfers vary inversely with the level of per capita State domestic product. The cross-section income elasticity of aggregate transfers in 1998-99 was - 0.194. The progressively in the transfer system was entirely due to the redistribution achieved in Finance Commission transfers. The elasticity of Finance Commission transfers with respect to GSDP in 1997-98 was -0.26. In contrast, grants for State Plan schemes and centrally sponsored schemes were not significant. These transfers did not achieve significant equalization. Thus by and large, the transfer system may be considered equitable. Nevertheless, it should be noted that the absolute value of elasticity is low. On an average, per capita transfers were higher by 0.19 percent when the per capita SDP were

lower by one per cent. This shows that although the transfer system on the whole has an equalizing impact, it is not designed to offset shortfall in fiscal capacity and cost disabilities fully.

**Figure 2**  
Equalization in Intergovernmental Transfers



**Table 8**  
Equalization in Fiscal Transfer System in India - 1998-99

State	Finance Planning Commission			Total Current Transfers	
	Commission	State Plan Schemes	Centrally Sponsored	Total	
1. Major States					
Intercept	8.383	5.859	-2.819	3.848	8.124
T value	8.943	3.527	-0.760	2.011	9.180
Coefficient	-0.260	-0.171	0.736	0.115	-0.194
T value	-2.638	-0.978	1.891	0.573	-2.087
R 2	0.349	0.068	0.216	0.025	0.251

Note: Estimated by employing the functional form:  $\ln G = a + b \ln Y + e$

Where, G denotes different types of per capita transfers, Y represent per capita NSDP, a and b represent parameter estimates and e is the error term.

#### VI.4 Fiscal Transfers from the State to local governments:

As mentioned earlier, each State is required to appoint a State Finance Commission (SFC) every five years to make recommendations on the transfers to be made to urban and rural local bodies. They are required to make recommendations on the assignment of tax revenues to local bodies, sharing of tax revenues between the States and the local governments and their distribution among individual local bodies and grants to be made to them.

The experience of implementation of this by various States does not bring much cheer, however. Some States are yet to constitute a SFC even after a decade of giving constitutional recognition to local bodies. In some States, SFCs are yet to submit reports and in many where it has been submitted, the State governments have not accepted the recommendations. As regards revenue raising powers, very little has been done in terms of giving revenue raising powers. The volume of transfers made is inadequate mainly because the States themselves have been facing severe financial crunch and there is a general reluctance to pass on functions as well as funds. The distribution is not done in any scientific manner. Often, particularly to village panchayats, the distribution is done on a lump sum basis irrespective of their capacity or need. In fact, after deducting the cost of electricity at source by the State government, very little is available for actual spending by the local bodies. The rural local bodies hardly collect any revenues. The only major tax with the rural local bodies is the property tax, but its administration and enforcement is so poor that very little revenue is actually collected. Of course, these generalizations are simplistic and there are States where local bodies play more active roles than that has been portrayed here, but that is an exception rather than a rule.

State Category	Per cent of Own Revenues to NSDP	Per cent of Total Revenues to NSDP	Per cent of Total Expenditure to NSDP	Per cent of Own Revenues to Total Expenditure	Per cent of Local Revenue to Subnational Revenue
High Income States	1.60	3.64	35.37	43.91	10.42
Middle Income States	0.67	3.5	15.61	19.08	3.94
Low Income States	0.31	2.38	2.51	13.03	1.75
Special category States	0.16	0.88	1.12	18.52	0.38
All States	0.58	2.13	12.02	27.11	4.73

Note: Includes both urban and rural local governments.

Source: Rao, Amar Nath and Vani (2003) Annexure Table 4.

Table 6  
**State Transfers to Local Governments**

(Per Cent of NSDP)

Category of State	Rural Local Bodies	Urban Local Bodies	All Local Bodies
High Income states	1.73	0.3	2.04
Middle Income states	2.16	0.47	2.58
Low Income States	1.74	0.33	2.07
Special Category States	0.21	0.20	0.21
All States	1.3	0.25	1.55

## VI. Federal Fiscal Arrangements in India: Major Issues

The preceding analysis brings out the important features of federal fiscal arrangements in India. The analysis highlights a number of shortcomings, which are due not merely to Constitutional arrangements, but also to conventions, methods and working of institutions. The paper attempts to identify the reform areas, both in policies and institutions.

Like in most other federations, the system of assignments has resulted in a significant degree of vertical fiscal imbalance. The wide differences in per capita incomes among the states have also caused severe horizontal fiscal imbalances. The transfer system should offset the fiscal imbalances. However, the transfer system despite achieving as measure of equalization and attempts to impart objectivity to the system, has left a lot of room for improvement in terms of both equity and incentives. It is therefore necessary to redesign the transfer system to improve accountability, incentives and equity. In particular, there are serious disincentives involved in the 'gap-filling' approach the Commissions have adopted.

Reforms in the transfer system will have to begin with redefining the scope of Planning and Finance Commissions to avoid, overlap in their roles. Preferably, the entire transfers should be the responsibility of the Finance Commission and the Planning Commission should focus on physical infrastructure. Until the debt market for the States is fully developed, the Planning Commission could also administer loans to finance physical infrastructure. For poorer States and those located in border areas, they could even provide loans at concessional rate of interest. The Finance Commission should be made a permanent body with well qualified technical personnel providing information and research base. It could also be given the responsibility of administering and monitoring the specific purpose transfers.



On the general purpose transfers, the Finance Commissions should move away the gap filling role and adopt more scientific approach to the design of transfers. Transfers should be designed to offset fiscal disabilities. It should be formula based, simple and should not have disincentives. As regards specific purpose transfers are concerned, there is an urgent need to consolidate the prevailing schemes numbering more than 220 into just about 10-15, provide greater flexibility in their design and administration and if necessary have lower matching ratio requirement for poorer States. The States may even be allowed to choose from among a number of priority schemes instead of fixing conditionality for each scheme. Consolidation of the large number of centrally sponsored schemes could improve the flexibility to the States and reduce resource distortions.

Notwithstanding the weaknesses, it must be noted that the system of intergovernmental fiscal arrangements in India has served well for over 50 years. It has achieved a significant equalization over the years, instituted a workable system of resolving the outstanding issues between the Center and the States and among the States inter se, and adjusted to the changing requirements and thus has contributed to achieving a degree of cohesiveness in a large and diverse country. No doubt, the analysis brings out several areas of reform; what is however important, it is eminently possible to reform the system.

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