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FISCAL FEDERALISM IN INDIA: THEORY AND PRACTICE

M. GOVINDA RAO
TAPAS K. SEN

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National Institute of Public Finance and Policy
18/2, Special Institutional Area, New Delhi 110 067

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CHAPTER I

INTRODUCTION

a. Analytical Setting

There has been a resurgence of interest on fiscal federalism virtually in every part of the world in recent years. The renewal of interest is observed in the constitutionally declared federations as well as unitary countries spanning across both advanced and developing countries. It extends to the transitional economies and even the few countries that still have socialistic regime. The demonstrated merits of decentralisation has provided enough incentives to diffuse power among sub-Central governmental units. The emergence of the European Economic Union has clearly demonstrated the advantages of having a large common market while preserving the distinct regional identities. The international experience also shows that overcentralisation was one of the important reasons for the collapse of the erstwhile Soviet Union. The directed resource allocation could not build a strong economy and the concentration of power did not entertain regional autonomy or identity.

The analytical literature on fiscal federalism, right from the seminal paper by Charles Tiebout (1959) has emphasised the gains from fiscal decentralisation. Like the political concept of democracy, fiscal federalism is considered to be an optimal institutional arrangement for the provision of public services. It combines the advantages of decentralisation with the benefits from economies of scale. In addition, inter-jurisdictional competition provides incentive for innovation and increase in productivity in the provision of public services. Further, the nation-wide market for factors and products helps in the determination of a set of efficient prices and thereby ensures more efficient resource allocation than a balkanised economy.

The welfare gains from fiscal federalism accrue due to several reasons. As the decentralisation theorem demonstrates, fiscal federalism ensures that public services are provided corresponding to the diversified demand conditions in a federation (Oates, 1972). The matching of preference with the supply of public services is enabled by the existence of a large number of jurisdictions with different mixes of public services and tax rates. The consumer-voters exercise their preferences either by voting on foot (Tiebout, 1959) or by influencing public policies through a political mechanism. The larger the number of jurisdictions, the wider is the consumer choice. Also, the more diverse the demand for public services in different jurisdictions, the greater are the welfare gains from fiscal decentralisation[1]. Welfare gains accrue from decentralised provision of public services not only due to the existence of a wider choice but also because the welfare costs arising from the 'bundling' of public services provided as a package on a 'take it or leave it' basis would be lower. In addition, as already mentioned, efficiency gains accrue also from inter-jurisdictional competition and the existence of a nation-wide market for factors and products.

Fiscal federalism, however, represents the polar case where federal fiscal arrangements are decided purely on economic principles. The existence or otherwise of a federal constitution is not a consideration, and the principles of fiscal federalism apply to both unitary and federal countries[2]. What is relevant is the degree of decentralisation and not whether a country is unitary or federal. Under fiscal federalism, everything - boundaries, tax and expenditure assignments, intergovernmental and interjurisdictional interactions and intergovernmental transfer systems is determined purely on economic considerations. While such an analysis is clearly removed from reality, it certainly shows economic solutions to federal fiscal problems in a multi-jurisdictional community and helps us to set benchmark or ideal economic solutions to the problems of federal finance.

In shaping intergovernmental relationships in actual practice, historical, social, linguistic and political factors have often played a far more important role than the considerations of economic efficiency (Bird, 1986 p.206). In fact, the influence of non-economic factors on federal fiscal arrangements places a constraint on the efficacy of pure economic solutions in solving federal fiscal problems[3]. Although such a paradigm has obvious limitations, it is still helpful to understand and identify the sources of inefficiency and inequity. At the same time, it is necessary to be cautious about qualified application of economic solutions to the problems of different federations without considering the political and institutional constraints.

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1 Tiebout's paper demonstrated that when the number of jurisdictions are large, under some restrictive assumptions of footloose mobility and consumer voters deriving only dividend incomes, the mobility solution will lead to an efficient outcome. Subsequently, a number of scholars have examined the efficiency properties of the Tiebout model when the assumptions are relaxed. For a detailed review of these studies, see Oates (1993). Another set of studies on fiscal federalism have argued that efficiency gains arise from the ability of the consumers to influence the policies through the political mechanism. It has been demonstrated that in a parliamentary democracy, majority voting will yield median voter equilibrium. See, Mueller (1990) and also Oates (1977).

2 As stated by Livingstone (1952 p.52), "The essence of federalism lies not in the institutional or constitutional structure, but in the society itself". Even in unitary systems there is a considerable degree of hierarchial ordering of governments. As noted by Breton (1989, p.1), in many unitary countries including France and Italy, there are as many as four levels of elected governments.

3 As stated by Breton (1981, p.253), "...Political scientists, who know better, have in their more generous moments treated economists as poor souls with a model in need of application".

The influence of non-economic factors in shaping federal fiscal relationships necessitates the consideration of the practices and experiences of different federations in finding solutions to real world federal fiscal problems. Such experiences are useful in identifying the feasible options in any restructuring of federal fiscal arrangements. For this reason, comparative analysis of different federations can provide a useful guidance. At the same time, the practices and experiences are particular to each country - the products of its own historical evolution and the stage of political development, and therefore, it may not be possible to replicate them generally. Nevertheless, these, along with the principles of fiscal federalism, provide a useful analytical backdrop or framework against which the actual federal fiscal arrangements in a country can be analysed.

The relationship between governmental units, be it vertical (inter-governmental) or horizontal (inter-jurisdictional) is a complex phenomenon. Although much of the literature on federal finance emphasises the advantages of 'co-operative' federalism[4], it is necessary to note that the relationship between governmental units is essentially competitive. Cooperation, in the extreme could mean conformity to a centralised policy regime and this could imply negation of the concept of federalism altogether. Nor is competition among governmental units necessarily undesirable. Competitive relationship among governmental units can be welfare improving, if it is harnessed and monitored properly. Like in the case of firms in the market, governmental units compete with one another to provide bundles of public services at varying tax rates according to the preferences of consumer-voters. At the same time, like in the market, it is necessary to satisfy certain pre-conditions to ensure that competition among the jurisdictions leads to welfare gains. *Inter alia*, ensuring competitive equality among governmental units (like the prevalence of a large number of small firms in competitive equilibrium), and cost-benefit appropriability in each of the jurisdictions are the two important necessary conditions. (Breton, 1987).

In this study, we have taken the view that governmental relationships are essentially competitive. The efficient organisation or a federation will depend upon the way the competitive relationships are harnessed productively. This, however, does not mean that there is no room for inter-governmental or inter-jurisdictional cooperation. Of course, fiscal policy can be effective only when the policies of different levels of government are coordinated. Similarly, satisfactory resolution of tax and expenditure overlapping and conflicts between different levels of government and jurisdictions within each of the levels can be achieved only when there is a certain degree of coordinated behaviour

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4 For a review of the literature on federal finance, see Scott (1964). A useful analysis of cooperative federalism can be found in Hicks (1955).

among these governmental units. Also, the Coasian solution may not always be forthcoming; it may not always be possible to resolve the problems arising from concurrency and overlapping functions between different jurisdictions, much less different levels of government through voluntary actions even when the functions of the governmental units are clearly specified. Therefore, it is important to have an implementing agency or a monitor to oversee intergovernmental competition.

Thus, competitive federalism, to be successful should have, (i) clearly enforceable property rights or the assignment of functions and sources of finance; (ii) adherence to the set rules by each of the governmental units and effective machanisms to foster interactions based on mutual trust and understanding; and (iii) an independent and a just mechanism to conduct and monitor inter-governmental relationships (Breton, 1987). The mechanism should ensure that no governmental unit is able to exploit, free ride and dominate other units so as to ensure competitive equality and cost-benefit appropriability among governmental units.

b. Changing Role of the State and Reassessment of Federal Fiscal Arrangements

In this study, we reexamine federal fiscal arrangements in India in the light of the economic liberalisation strategy initiated since 1991. The analytical backdrop for the study is given by the principles of fiscal federalism, but we also consider the experiences of other federations in dealing with issues of federal fiscal relationships. The principles of fiscal federalism, as mentioned earlier, help us to understand welfare maximising organisation of governmental systems. It helps us to identify the sources of ineffiency and inequity in the federal fiscal arrangements in Indian federation and to get an idea of the extent to which the actual deviates from the ideal.

The analysis of federal fiscal arrangements in India assumes particular importance in the wake of the economic liberalisation process initiated since 1991. With the reassessment of the role of the State, a review of federal fiscal arrangements has in fact become necessary. Among other factors, the intergovernmental fiscal arrangements in India and institutional framework to conduct and monitor them have evolved to suit the requirements of the public sector dominated, heavy industry based, import substituting development planning strategy adopted in the four and a half decades since independence. As the planning agency passes on the allocational role to the market, and as the economy is opened up to face international competition, intergovernmental fiscal arrangements and the institutional framework to conduct them will have to adapt to the new role of the State. At the political level too, as the ruling party at the Centre loses control over the States, it has become necessary to place intergovernmental fiscal relations on a clearer and firmer footing[5].

In India, the adoption of economic planning strategy to accelerate economic growth necessitated the concentration of economic power in the hands of the Central government. As stated by Chelliah (1991, p.7) "...Comprehensive central planning, involving as it does, centralised decision making in relation to production activities and disposal of resources in the 'national interest' .... is the negation of the principle of true federalism". In the Indian context, even though planning was carried out in the 'mixed' economy framework, it necessitated a high degree of centralisation. The emphasis on investment in heavy industries particularly in the public sector signalled significant transfer of household sector savings for public investment; this necessitated centralised control of financial and banking sectors. In order to channelise private sector investment according to plan priorities the government had to resort to industrial licensing. To ensure that the market imperfection thus created did not cause oligopolistic trade practices, a number of other regulatory instruments had to be introduced. The scarcity of foreign exchange on the one hand, and a feeling of export pessimism on the other, led to the rationing of the foreign exchange earnings through measures like the issue of import licences and exchange control, and in general, led to greater emphasis on import substitution. These, besides requiring a plethora of centralised regulation and controls also led to altering the inter-sectoral terms of trade, which in turn had a centralising tendency.[6] Although many of these regulations and controls eventually did not serve the purpose for which they were introduced in the first instance, they certainly contributed to the concentration of economic and political power with the Central government.

There were other economic reasons for centralisation as well. The general scarcity conditions that prevailed immediately after independence, particularly the inadequacy of foodgrains output in relation to the population, led to centralised food management. The national effort at augmenting the output of foodgrains led to Central intervention in an activity which essentially belonged to the domain of the State governments. Similarly, the feeling that the State governments did not assign priority to

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5 The national government (as opposed to regional governments) has different nomenclatures in different federations. In Canada and U.S.A. it is called 'federal'; in Australia, it is called Commonwealth government. We have generally followed the Indian nomenclature - 'Central' government, but on occasions used these terms interchangeably. Similarly, the regional governments are termed as 'States', though, sometimes, they are also called 'provinces' as in Canada.

6 Altering the terms of trade in favour of industry against agriculture to achieve speedy industrialisation, for example, reduced the role of the State governments, as agriculture falls in their domain.

certain nationally important activities like family planning and poverty alleviation in their expenditure allocations led to the encroachment of the Central government in these activities. The economic rationale underlying Central intervention in the agricultural sector is the belief that these investments had benefit spillovers spanning more than a State (and hence, national benefits are greater than an individual State's benefits), or they required large scale investments beyond the States' reach. Of course, both the reasons are questionable and even if the argument is valid, centralisation of the activity is not necessarily the appropriate solution.

Economic liberalisation measures introduced since 1991, however, have necessitated restructuring of intergovernmental fiscal relationships. Assigning greater role to the market in determining prices and resource allocation and opening up the markets to domestic and foreign competition calls for redefining the governmental role. In the new situation, the governmental units will have to be reoriented to provide public services to cater to the diversified demand conditions prevailing in different regions and to regulate and monitor the functioning of the market. This has shifted the focus of governmental role from direct participation in production and distribution activities to one of strengthening the regulatory setup and of protecting the property rights. Assigning greater role to the market in economic activity, therefore, has necessitated diffusion of economic power of the Central government and has necessitated relatively more active participation of the sub-Central governments in the regulatory setup.

In the liberalised environment, although the governmental role in resource allocation in general would be smaller than in the past, the relative role of the sub-Central governments is likely to increase rather than decline. As the emphasis shifts from direct participation of the government in production and distribution to regulation, the State and local governments will be required to play more important roles than in the past, since market regulation is more effective when implemented at decentralised levels. At the same time, the sub-Central governments will have to continue to provide quasi-public goods. Accent on alleviating poverty will necessitate continued State government intervention in agricultural extension, investments in irrigation and direct poverty alleviation through government spending on self employment and wage employment projects. As economic restructuring proceeds, the frictional unemployment created by the closure of unviable firms in the public and private sectors may necessitate the introduction of a proper social security system, which is likely to enhance the responsibility of the State governments. Although this task belongs to both Central and State governments, the latter being closer to the people will have to shoulder a greater part of the responsibility than the former. Similarly, emphasis for poverty alleviation will also shift towards human resource development. In the past, as much of the resources were preempted by material sectors, the level of investments in human capital were below international standards.[7] Significant increases in the outlay on human resource development will enhance the relative role of the State governments as well. Increased outlay on 'quasi-public' goods at the State level may become necessary simply because of 'competitive populism'[8].

The structure of intergovernmental relationship and the various institutions to conduct and monitor them have evolved over the years in the framework of a planned economy. Of course, unlike the comprehensive central planning followed in socialist economies, Indian planning did give a substantial role to the private sector as well as sub-Central levels of government. Nevertheless, to direct resource allocation to the desired activities and regions, it was necessary to secure the resources required by the public sector investments and to ensure that the system did not create an inegalitarian society, centralisation of economic power was inevitable. When greater role is assigned to the market in resource allocation, substantial restructuring of intergovernmental fiscal relationships becomes necessary in order to provide public services to cater to diverse preferences. The reorganisation assumes particular relevance as fiscal compression for stabilisation initiated at the Centre has constrained the resources available for transferring to the States and to be cost efficient, the transfer system will have to be better targeted. A detailed analysis of the prevailing federal fiscal arrangements from an economic perspective, identifying weaknesses in them and indicating directions for reform is a pre-requisite to evolving such a system.

c. Plan of the Study

The natural starting point for the review of federal fiscal arrangements is the assignment question. The assignment of taxes and expenditures between the Central and State governments should not only be in accordance with the principle of comparative advantage but also should establish a clear linkage between revenue and expenditure decisions at the margin to ensure accountability and the 'right' incentives at all levels of government. However, theoretical considerations can guide the actual assignment of tax and expenditure powers only upto a point. The actual assignments are shaped by historical and political considerations. Nevertheless, it is important to examine the problems in the

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7 For example, in 1987-88, government spending on education in India was just about 3.6 per cent of GDP, whereas it averaged 4.1 per cent for the developing countries taken together. See. Rao and Sen (1993).

8 Tamil Nadu is a good example of a State where elections are often fought on such issues. More recent examples are those of Andhra Pradesh and Bihar.

existing assignments in order to identify the sources of inefficiency. Of course, efficient assignment provides only an enabling condition; even under the most efficient assignments, imperfections and inefficiencies in inter-governmental relationships is possible. The critical questions that need to be addressed in this context are: (i) What should be the broad principles of tax and expenditure assignment in a federal system and to what extent assignments in India conform to these principles? (ii) Should the tax assignment follow the principle of separation as in the past or will concurrency in the power to levy important broad-based taxes respond to the requirements better? (iii) How can the assignments be done to enhance accountability, provide incentive for better fiscal management, but, at the same time ensure equity? Such theoretical and empirical questions pertaining to assignments are discussed in chapter II.

In actual practice, the assignments do not conform to the theoretical principles, for, political and historical factors too play as important a role, if not more, than economic considerations. More importantly, even the most efficient assignments cannot avoid inter-governmental and inter-jurisdictional concurrency and overlapping in tax and expenditure policies. This results in competitive relationship between different levels of government and between different units within each of the levels. Of course, competition among governmental units by itself need not be undesirable and the theoretical literature brings out the conditions under which this can be welfare improving. However, when the competitive power of the governments is unequal and when they indulge in 'free-riding' behaviour, Centre-State and inter-State fiscal disharmonies are inevitable. The problem becomes serious if the assignments are inefficient. In the Indian context, allocative and distributional consequences arising from overlapping tax bases, and disharmony in the levy of domestic trade taxes and, in particular, taxes on the inter-State sale of goods and intra-State movement of goods can be serious. The nature and consequences of vertical and horizontal fiscal overlapping and fiscal disharmony are discussed in chapter III.

In an open economy, to be competitive, it is necessary that the tax system is efficient. However, as mentioned earlier overlapping taxes may rob the system of simplicity and transparency, alter relative prices and cause allocative distortions. At the same time, if the tax system in the entire country is made uniform, this will nullify the advantage of fiscal federalism of enabling the consumer-voters to choose their preferred bundle of public services and tax rates. Thus, in a federation, the reform of the tax system should combine the principles of tax policy with those of fiscal decentralisation. Thus, a measure of coordination and harmonisation in tax and expenditure policies between governmental units is needed to minimise the distortionary effects of the overlapping tax systems. In the Indian context, the issue is one of reforming the existing domestic trade taxes and introducing an appropriate form of value added tax which would broaden the base, minimise the distortions, encourage better tax compliance, ensure fiscal accountability of different governmental units and at the same time, safeguard fiscal independence of the State governments. In chapter IV, the issue of harmonisation of the tax system in India is discussed in some detail.

Another consequence of the assignments in a federation is the mismatch between the ability to raise revenues and the expenditure needs of different governmental units. Perfect correspondence between revenue capacities and expenditure needs is impossible to achieve even under the most efficient assignments. This is because, an efficient tax assignment need not match an efficient expenditure assignment. Such fiscal imbalance may be vertical - between different levels of government, or horizontal - among different jurisdictions within a level. Vertical fiscal imbalance arises becuase the Central government has certain inherent advantages in raising revenues and the State governments, in spending. However, centralising revenues and decentralising expenditure could have adverse effects on incentives, accountability and sub-Central fiscal autonomy. The prevailing vertical fiscal imbalance essentially represents the trade-off between the gains from efficient assignment of revenues and expenditures (which necessarily results in the imbalances) and losses from delinking revenue and expenditure decisions. Horizontal imbalances occur when the ability to raise revenues or the unit cost of providing public services vary widely among different jurisdictions. This can cause significant differences in the standard of public services provided unless those with lower ability to raise revenue or higher unit cost of public services levy taxes at higher rates. The persistence of horizontal fiscal imbalance can result in unequal spread of physical and social infrastructure and thereby accentuate inter-State inequalities. The nature and extent of vertical and horizontal fiscal imbalances in the Indian federation are analysed in chapter V.

Inter-governmental transfers is one of the most visible and widely discussed aspects of federal finance. The design of inter-governmental transfers depends on the objectives they are required to subserve. The Central transfers given to close the fiscal gap and ensure fiscal equity among the States or 'equalising' transfers should enable every State to provide a given normative level of public services at a given tax rate. These transfers have to be necessarily block or general purpose transfers. On the other hand, the transfers given to offset inter-State spillovers or to ensure minimum levels of merit goods have to be purpose specific and, to be cost effective, should have matching requirements. Transfers may also be given to carry out some agency functions of the donor. Keeping the economic rationale of transfers in the background, the design and equalising impact of the transfer system and the institutional mechanism to determine the transfers in India are analysed in chapter VI.

The analysis of the assignments, tax and expenditure spillovers, fiscal imbalances and intergovernmental transfers will enable us to identify the major weaknesses of the federal fiscal arrangements in India and the reform measures needed to restructure federal fiscal relations to meet the challenges of the changing situation. The suggested changes in the assignment should not only minimise economic distortions but also provide incentives and promote accountability. Some of the changes may be effected within the existing Constitional framework, and others may require amendments to the Constitution. Similarly, maximum gains from fiscal decentralisation can be reaped only when there is fiscal coordination and harmonisation between different governmental units. In a federal system even the process of harmonisation is important.[9] Even more important are the reforms in the inter-governmental transfer systems. Constraints on the Centre's own resources makes it necessary to design the transfer system to be purposive and targeted. The reduced role of public investments in resource allocation will reduce Centre's flexibility to establish inter-regional equity through regional policies. The private sector investments will simply follow the availability of production and marketing infrastructure and therefore, cannot be expected to ensure regional equity. In the event, the transfer system will have to be targeted to offset the fiscal disabilities of the poorer States not only to reap the gains from competitive federalism, but also to ensure a stable polity. The reforms in the policy measures and institutional arrangements to conduct and monitor inter-governmental fiscal relationship will be outlined in chapter VII.

Coordination and harmonisation ordered from above cannot be a federal solution. See, Bird (1984).

CHAPTER II

FISCAL DECENTRALISATION: TAX AND EXPENDITURE ASSIGNMENTS

a. Fiscal Decentralisation: Some Theoretical Considerations:

Fiscal federalism is an area of study in which the principles of economics are applied to the functioning of the public sector in a multi-level decision making framework. The basic issues of fiscal federalism are (i) assignment of functions and sources of finance between different governmental levels, (ii) evolving mechanisms and policy instruments to resolve fiscal imbalances, arbitrate intergovernmental spillovers and foster harmonious and yet, competitive intergovernmental relationships. Such an arrangement will ensure cost efficient provision of public services corresponding to the preferences of people residing in different jurisdictions.

Efficiency in the provision of public services within a fiscal federalism can be brought about by making adjustments in jurisdictional boundaries, revenue and expenditure assignments and through intergovernmental fiscal arrangements including fiscal transfers. Defining the competent authority for each jurisdiction through the assignment of tax powers and expenditure functions to different levels of government provides a broad framework on which intergovernmental interactions can be built. The mechanism established to resolve fiscal imbalances and to correct spillovers helps in ensuring 'competitive equality' and in minimising the tendency to pass on the burden of providing public services to the non-residents (free-riding) and thus, can help in 'cost-benefit appropriability' among different jurisdictions (Breton, 1987). But this can be developed only when there is mutual trust among the governmental units which can be fostered through frequent consultation processes and interaction and by imparting transparency to the relationships. Effective monitoring mechanism ensures that all the governmental units follow the set rules to bring about efficient and equitable provision of public services in a federation.

This chapter is concerned with the "assignment" issue, which is the basis of intergovernmental relationships and, therefore, is of overriding importance. The assignment of functions demarcates the spheres of responsibility of different governmental units. The demarcation of the sources of finance endows the ability and flexibility to different governmental units to undertake the functions assigned to them. Efficient assignment should provide sufficient flexibility to all governmental units to vary the levels of public service-tax mix at the margin to cater to the diversified preferences of the consumers (voters), minimise inter-jurisdictional tax and benefit (expenditure) spillovers and provide adequate finances to the Central government to undertake regional equalisation so that 'competitive equality' of the jurisdictions or 'horizontal equity' of individuals across the federation is established.[1]

Proper assignment of functions and finances is possible only when the comparative advantage or cost-effectiveness of different levels of government in undertaking different functions is taken account of. In the "layer-cake" perspective of governmental functions, primary responsibility for macroeconomic stabilisation and redistribution of income and wealth rests with the Central government (Oates, 1972, 1977). It is difficult for the local governments with small, open economies to pursue independent stabilisation policies. They cannot be given the power to vary money supply and the effectiveness of fiscal policy for stabilisation at the sub-Central levels is limited by the spillover of effective demand to areas outside their jurisdictions. Similarly, potential mobility of economic agents places limits on the ability of sub-Central governments to pursue serious redistributive policies. Vigorous redistribution by a sub-Central authority can result in driving out the rich from and inviting the poor into its jurisdiction which would be self-defeating.

In undertaking the allocative functions, however, decentralised provision promises the greatest gains. The decentralisation theorem demonstrates that provision of public services by sub-Central governments, in the absence of scale economies, can result in significant welfare gains as compared to the centralised solution of uniform supply.[2] The more varied is the demand for public services across different jurisdictions, the larger are the

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1 In the traditional literature on fiscal federalism, intergovernmental transfers have been justified mainly to ensure equal treatment of equals (or horizontal equity) with regard to their private and public consumption levels (Buchanan, 1950, Boadway and Flatters, 1983). The competitive federalism literature, however, justifies such transfers as an instrument to bring about 'competitive equality' among the jurisdictions (Breton and Fraschini, 1992).

2 On the attempt to measure welfare gains, see Bradford and Oates (1974). The price elasticity of demand for local public services is estimated by Bergstrom and Goodman (1973).

welfare gains from fiscal decentralisation. Decentralised provision of local public goods can cater to the varying preferences of people better and thus enhance social welfare. It is also demonstrated that the welfare gains from decentralisation are inversely related to the price elasticity of demand for public services (Oates, 1977). Welfare gains can also accrue from the wider choice implicit in the different tax-benefit packages offered by different jurisdictions. When the choice set is wider, individuals can vote on their feet for the preferred communities. Further, the wider choice reduces the welfare cost implicit in the bundling (provided on take it or leave it basis) of public services. However, when there are significant scale economies or when sub-Central provision of public services involves transaction and organisational costs,[3] the assignments should be done so as to maximise the net welfare gains.

This implies that, on the spatial scale, assignment of various public goods should be done to different hierarchical governmental units depending upon their benefit span. Public goods having nationwide benefit span, like the national defence and foreign policy should be provided by the Central government. However, most of the public goods are of local concern and the provision of these should be decentralised. Thus, we have local, municipal, metropolitan, regional, provincial and national goods depending on their benefit spread (Breton, 1965, Olson, 1969, Oates, 1972). Of course, the mapping of benefits of different public services over various governmental jurisdictions is seldom perfect but the efficient assignment would minimise benefit and cost spillovers. Further, the externalities arising from imperfect mapping has to be resolved through the Pigovian transfers in order to ensure optimal provision of these public services.[4] However, exact calculation of spillovers requires an omniscient Central government, and if the Central government has so much information as to correctly estimate spillovers and make transfers, then there is no supply side reasons for decentralisation as the Central government itself can provide public services in a cost-effective manner. Of course, the basic argument for decentralisation - to provide public services to correspond to the diversified preferences is still valid. In advancing arguments for

3 Breton and Scott (1978) identify four kinds of transaction costs namely, mobility, signalling, administration and coordination.

4 In addition, block transfers become necessary due to the difficulties in determining Samuelsonian prices. Inability to charge benefit taxes creates a wedge between marginal utility of public goods and marginal disutility of forgone private consumption due to taxes. For details, see, Breton (1965).

decentralisation of allocative functions, the cost savings from possible economies of scale have been assumed away. Similarly, the additional transaction costs involved in decentralisation have not been considered. Transaction costs consists of not only administrative cost of decentralisation but also include signalling and mobility costs. The decision on decentralising particular functions should depend upon the net welfare gains after taking into account the cost disabilities from uneconomic scale of providing the service and the transaction costs. The ideal assignment is the one where the benefit spread of public services will map perfectly with the jurisdictional boundaries. In the limit, this may call for a separate governmental units to provide each public service and therefore to minimise administrative costs, it may be preferable to match the functions where benefit spread approximately coincides with the jurisdictional boundaries (Olson, 1969), and this minimise inter-jurisdictional tax and benefit spillovers. Thus, spillovers do exist and there are no reasons to believe that cost and benefit spillovers cancel each other in all jurisdictions. Nor can this be solved through, the coasian solution of voluntary action among different jurisdictions (Coase, 1960). This gives rise to the problem of matching resources with responsibilities and can be solved by the intervention of the Central government through appropriate intergovernmental transfer mechanism.

The layer-cake framework of assignments has some problems, however. First, it is unrealistic to presume that the three governmental functions allocation, distribution and stabilization are independent of each other. Therefore, even in allocational decisions, distributional considerations do play some role. Similarly, both stabilization and distribution functions have allocational impact at sub-Central levels, as well.

Second, it has been argued that sub-Central governments do have specific spheres of responsibility even in redistribution and macroeconomics stabilization. Pauly [1973] and Tresch [1981] have argued that redistribution may be considered a local public good and when population is not mobile across jurisdictions, local initiative in redistribution may be desirable. In contrast, Ladd and Doolittle [1982] and Brown and Oates [1987] emphasise the national value of redistribution besides mobility arguments for Central predominance in undertaking this function. Thus, the critical question is first, whether redistribution is considered a national goal or simply, of local concern and second, whether and to what extent the poor are mobile across jurisdictions. Clearly, there is greater concern in a locality for the local poor than for the poor elsewhere and some useful role for decentralised poor relief cannot be denied. Similarly, in a country like India, there are historical, social and more importantly linguistic factors which impede mobility of the poor. Even when they are mobile at the margin, the costs of mobility can be prohibitive. What is more, sub-national governments, being closer to the people, can identify the poor easily and design and implement appropriate policies on poverty alleviation. Thus, active local participation in the administration of poverty alleviation policies may impart greater efficacy to these programmes. Therefore, King [1984, p.36] argues that there should be 'a basic national redistribution policy, and that sub-Central authorities should be allowed to alter the degree of distribution in their areas within specified limits.' Similarly, sub-Central fiscal policies can and do play a role, *albeit* limited, in managing local unemployment and hence, stabilization [Inman and Rubinfeld, 1992 and Gramlich, 1987]. All the same, Central predominance in macroeconomics stabilisation is inevitable.

The above discussion on fiscal decentralisation on the basis of tripartite division of governmental functions makes an implicit assumption of a market determined allocational process where the governmental interference is confined to the cases of market failure. However, when the government itself directs the allocation of resources, as it happens in a centrally planned or a public sector dominated economy, the issue of decentralisation is pushed to the background. The social engineering of allocating resources according to the priorities laid down by the planning agency does not recognise consumer choice and fiscal decentralisation implicit in the market economy. However, this is not to mean that fiscal decentralisation has no role in planned economy whatsoever. Surely, decentralisation in a planned economy can be useful in providing informational input and thus economise on informational costs as also in implementing the programmes efficiently (Bagchi and Sen, 1991). In other words, the degree of decentralisation desired in an economy and the assignment of tax, expenditure and regulatory powers following from it depend upon the envisaged role of the government vis-a-vis the market in allocating resources.

A planned economy directing economic activity by government fiat, as mentioned above, would have a greater degree of centralisation than a country where allocation of resources is market determined. By itself, planning calls for centralised decision making. Further, when the government adopts heavy industry based import-substituting industrialisation strategy, an even greater degree of concentration of economic power in the hands of the Central government is inevitable. The vast resources needed to make large investments in the public sector, and the execution of various physical controls, the most important of them being exchange control, industrial licensing and import restrictions and expanding the ownership of means of production and exchange including that of the banking and financial sectors, cannot but result in very high degree of concentration of power in the hands of the Centre.

Further, the production pattern with public investment on heavy and basic industries taking the lead in the transformation of a low productivity agrarian economy to a highly productive industrial economy, cannot have the flexibility to meet varying preferences of consumers in a diverse society. The basic assumption in such a system is either that the population is homogeneous or that catering to the diversified preferences of population is not an objective to be pursued. In such a set up, although sub-central units are assigned independent powers in several areas, the attempt is to streamline the overall economic activity including those of the sub-central governments on the lines determined by plan targets. The sub-Central units are merely the agencies of the Central planning authority. In short, as stated by Chelliah (1991, p.6), ".....centralised decision making in relation to production activities and dispersal of resources ..... is the negation of the principle of true federalism". This is because, public services are not provided to meet the diversified demand conditions in different jurisdictions, but according to the priorities determined by the planning agency. Again, setting of the plan targets and priorities are not done by summing up local preferences; planning is simply taken as a 'merit' goods.

Thus, considerations of local choice, economies of scale and transaction costs determine the functional assignments among hierarchical governmental units. However, public service levels can be varied and local preferences can be more effectively met by the sub-Central governments only when the revenue handles to finance these services are also assigned to them. Linking revenue raising to expenditure decisions at the margin is critical to provide the necessary incentives and to ensure accountability in the provision of public services at decentralized levels.

Economic considerations even in a predominantly market economy call for greater taxing powers to higher level governments. In fact, the levy of various taxes by different levels of government has different allocational consequences and assigning suitable tax handles to enable the sub-Central units to carry out their functions is an important issue. According to the general guidelines on tax assignment detailed in Musgrave [1983], highly progressive and mobile tax bases should be assigned to the Centre. Similarly, unequally distributed tax bases (like natural resources), must be centralised for both stabilisation and distributional purposes. User charges and fees are found to be the appropriate revenue sources at all levels, and are particularly suited to sub-Central governments. Thus, decentralised (local) levels of government should rely mainly on taxes on immobile bases like the property tax, user charges and fees. Middle level governments (states or provinces) can make use of taxes on incomes and sales to a limited extent [Oates, 1991], but in a harmonised manner.

The inherent advantage of the Central government in revenue raising powers becomes clear when we consider the determination of money supply and borrowing powers. For stabilisation reasons, these have to be concentrated at the Centre. Of course, in many countries, sub-national governments have the power to raise resources from capital markets. However, borrowing requirements in an economy where the governments play the traditional role of providing chiefly public services are lower than in a planned economy where the governmental units participate in the general production process as well. Secondly, in advanced economies, the capital market is usually well developed and the market itself provides a regulatory mechanism. Nevertheless, to the extent sub-national governments are allowed to borrow in the market, central control over the stabilisation function is rendered less effective.

Thus, even in an economy where the resource allocation is predominantly determined by the price mechanism, vertical fiscal imbalance is inevitable. In an economy where the resource allocation is predominantly determined according to social priorities as determined by the planning body, the degree of centralisation and the extent of fiscal imbalance is higher. Though overall resource allocation is done according to social priorities, a large number of functions are devolved to sub-central governments. Centre gets overwhelming taxation and borrowing powers, as a greater volume of private savings has to be channelised to meet public consumption and investment needs. The volume of government borrowing is larger and the extent of Central control over the resources of banking and financial institutions greater in a planned economy than in an economy driven by the market forces.

b. Tax and Expenditure Assignments in India : Important Issues

The general principles of assignment discussed above provide a useful backdrop for analysing the tax and expenditure assignments in the Indian federation. This provides a broad framework to examine the allocative implications of assignment and helps to suggest reassignment of functions and finances to different levels of government on more efficient lines.

Attempts at defining the relative roles of Central and State governments was date as far back as 1918, when the Montague-Chelmsford reforms were implemented. However, it is the Government of India Act, 1935, which clearly demarcated the roles of the two levels of government and in fact, the present constitutional assignment closely follows this in many respects. The Constitution, in its seventh schedule assigns the powers and functions of the Centre and the States. It specifies the exclusive powers of the Centre in the Union list; exclusive powers of the States are specified in the State list; and those falling under the joint jurisdiction of both the levels are placed in the Concurrent list. All the residuary powers vest with the Centre.

The functions undertaken by the Central government can be classified as those required to maintain macroeconomic stability, and those assigned for reasons of economies of scale and cost efficient provision of public services. Issuing currency and coinage, dealing in foreign exchange, foreign loans, the operation of the Central Bank of the country (Reserve Bank of India or RBI), international trade, banking, insurance and operation of stock exchanges are some of the major functions assigned to the Central government to maintain macroeconomic stability. The functions like the operation of railways, posts and telegraphs, national highways, shipping and navigation on inland waterways, air transport, atomic energy, space, regulation and development of oilfields and major minerals, inter-State trade and commerce and regulation and development of inter-State rivers are the major functions assigned to the Centre for reasons of scale economies (national coverage).

The power of the Centre has been further augmented by placing a number of additional items in the concurrent list and vesting it with overriding powers in regard to these subjects. The important items included in the concurrent list are: economic and social planning (which embraces virtually all items under economic and social services), commercial and industrial monopolies, trade unions, social security, employment and unemployment, welfare of labour, price control and trade and commerce in and production of certain basic goods such as foodstuff, cotton and any other goods if the Parliament decides to bring it into this category.

The major subjects assigned to the States comprise public order, police, public health, agriculture, irrigation, land rights, fisheries and industries and minerals other than those specified in the Union list. As mentioned earlier, the States do have jurisdiction over concurrent items and can take initiative with regard to these subjects. However, in the event of conflict, the Centre has overriding powers. Areas like public health, agriculture and irrigation involve considerable governmental intervention and expenditures. Even in regard to the subjects in the concurrent list like education and transport, social security and social insurance, the States are compelled to assume a significant role being proximate to the people within a democratic polity.

The assignment of tax powers, however, is based on the principle of 'separation', and the tax handles are exclusively assigned either to the Centre or to the States. Most of the broad-based and productive tax handles have been assigned to the Centre, perhaps for reasons of stabilization and redistribution stated earlier. These include taxes on income and wealth from non-agricultural sources, corporation tax, excise duty on manufactures (excluding those on alcoholic liquors, opium, hemp and other narcotics) and customs duty. A number of tax handles have been assigned to the States as well, but, from the point of view of revenue productivity, only the tax on the sale and purchase of goods is broad-based. What is more, the Centre also has the power to levy taxes on items not specifically mentioned in either the Union or the State list.

Recognising that the Constitutional assignment would result in imbalances between revenue capacities and expenditure needs at the State level, and that the extent of imbalances would vary widely among the States because of variations in their capacities and needs, the Constitution provides for the compulsory sharing of the net proceeds from non-corporate income tax (Article 270) and optional sharing of the proceeds of Union excise duty (Article 272). In addition, the States in need of further assistance can be given grants-in-aid (article 275). The quantum of shared taxes, their distribution among the States and the amount of grants to be given to the States are determined by an independent quasi-judicial body, the Finance Commission, appointed by the President of India every five years (or earlier).

The actual role of the Central and State governments in executing revenue raising and expenditure decisions are summarised in tables 2.1 and 2.2. It is seen that in the aggregate, the States raise about 43 per cent of total revenues, but incur about 54 per cent of total expenditures. The revenues derived from exclusive Central taxes constitute about 32 per cent; those from exclusive State taxes 35 per cent and the remaining 33 per cent of revenues are from shareable sources. The major taxes levied exclusively by the Centre consist of customs duty (22 per cent of total tax revenue) and corporation tax (7.8 per cent). Among the State taxes, the revenue from sales tax constitutes almost 20 per cent. Other State taxes individually contribute less than 6 per cent of total tax revenue. Although on an average, the States incur 54 per cent of total expenditures, their control over spending authority is much lower than the States' share in total expenditures, since almost 4 percentage points are incurred on Central sector and Centrally sponsored schemes and the outlay on individual schemes as also the the matching requirements are decided entirely by the Centre.

The relative roles of Central and State governments in the provision of public services is brought out in Table 2.2. The Central government plays a major role in providing defence, meeting interest payments and industrial promotion. The States on the other hand, have a predominant share of total expenditures on internal security, law and order, social services like education, health, family welfare, housing and social security and on economic services like agriculture, animal husbandry, forestry, fisheries, irrigation and power and public works. The States' share in expenditure on administrative services is about two-thirds; on social services they spend over 86 per cent and on economic services their expenditure share is almost 60 per cent.

The analysis of Constitutional assignment in India brings out the following features:

(i) The delegation of responsibilities between the Centre and the States shows an inherent 'centripetal' bias. As mentioned above, the constitutional assignment closely follows the demarcation made in the Government of India Act, 1935, which was designed to keep firm administrative control of the country in New Delhi. Thus, like in administrative and political spheres,[5] the constitutional assignment of economic functions vests the Centre with powers to impose its will on the States if such an action, in its view, is warranted in "national interest". Therefore, the Indian Constitution has been characterised as 'quasi-federal'.

Centralisation of economic power can be clearly seen when we analyse the Constitutional assignments. In the Constitution, as already pointed out, the Central government enjoys both overwhelming and overriding powers. Assignment of major broad-based taxes to the Centre (except the sales tax), vesting the residuary powers with the Centre, prevalence of Central authority over that of the States in the event of a conflict of jurisdiction over any item in the concurrent list, and the restrictions on the States' power to borrow are some of the examples of this bias. Further, although the States can levy a broad-based sales tax, the Centre has the power to levy Union excise duty virtually on the same base and thus can preempt the States' levy to some extent.

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5 The concentration of power in political and administrative spheres has been a subject matter of a number of scholarly works on Indian federation. Article 2 of the constitution, which assigns the Centre with powers to redefine State boundaries, negates the very concept of federalism. More importantly, there has been considerable discussion on the legitimacy of the use of Article 256 by the Centre. Large number of instances can be cited where the Centre has used the powers to dismiss the elected State governments to meet the partisan ends of the political party in power at the Centre (Guhan, 1993). In fact, the entire constitutional machinery in the country was trampled on and the federal principle in the policy was brought to nought when the then Prime Minister Mrs. Indira Gandhi acquired emergency powers for the Central government, merely to keep herself in power in the wake of the Allahabad High Court judgement setting aside her election. Also, the role of All India services and the absence of federal features in the national political parties seem to have contributed to the unitary bias in the Indian political federalism (Chelliah, 1991).

Table 2.1

Revenue Receipts of the Centre and States: 1991-92

	Revenue in Rs. Billion			Revenue Share (Per cent)		
	Centre	States	Total	Centre	States	Total
A. Tax Revenue (a+b)	501.6	526.9	1028.5	48.8	51.2	100
a. Exclusive Central Taxes	325.2	-	325.2	100	-	100
1. Corporation tax	78.5	-	78.5	100	-	100
2. Customs	222.6	-	222.6	100	-	100
3. Others	24.1	-	24.1	100	-	100
b. Exclusive State Taxes	-	354.9	354.9	-	100	100
1. State excise duties	-	54.7	54.7	-	100	100
2. Sales tax	-	198.2	198.2	-	100	100
3. Taxes on vehicles, goods and passengers	-	29.8	29.8	-	100	100
4. Others	-	72.3	72.3	-	100	100
c. Taxes Shared	176.5	172.0	348.4	50.6	49.4	100
1. Taxes on income	16.3	51.0	67.3	24.2	75.8	100
2. Union excise duty	160.2	120.9	281.1	57.0	43.0	100
B. Non-Tax Revenue	158.7	91.5	250.2	63.4	36.6	100
1. Net contribution of public undertakings	24.1	11.1	13.0	184.9	-84.9	100
2. Interest receipts	109.3	53.2	162.5	67.3	32.7	100
3. External grants	9.5	-	9.5	100.0	-	100
4. Others	15.8	49.4	65.1	24.2	75.8	100
C. Total Revenue Receipts (A+B)	660.3	618.4	1278.7	51.6	48.4	100

Source: Indian Economic Statistics: Public Finance, Ministry of Finance, Government of India

Article 293 of the Constitution does allow the States to borrow from the market. However, it is stipulated that when a State is indebted to the Centre, it has to seek and obtain Centre's permission for exercising its borrowing powers. As all the State governments are indebted to the Centre, States have little leeway in determining their market borrowing. Actually, the Planning Commission in consultation with the Union Finance Ministry and the Reserve Bank of India (RBI), simply determines the total quantum of States' borrowing and allocates the shares of each of the States.

Table 2.2

Expenditure (Current + Capital) of the Centre and State Governments: 1991-92

Budgetary Heads	Expenditure (Rs Billion)			Share of Expenditure (Per cent)		
	Centre	States	Total	Centre	States	Total
A. Interest payments	200.3	109.6	309.9	64.6	35.4	100
B. Defence	164.5	-	164.3	100	-	100
C. General Administrative Services of which -	100.2	167.4	267.6	37.4	62.6	100
1. Administrative Services of which-	31.2	75.5	106.7	29.2	70.8	100
a. Police	20.7	44.9	65.6	31.6	68.4	100
2. Compensation and assignment of local bodies	0.9	9.9	10.8	8.7	91.3	100
3. Others	3.9	17.4	21.2	18.2	81.8	100
D. Natural Calamity Relief	-	10.6	10.6	-	100.0	100
E. Social and Community Services	49.3	312.8	362.1	13.6	86.4	100
1. Education, art, culture and scientific services of which-	32.8	174.3	207.1	15.8	84.2	100
education	22.2	169.9	192.0	11.5	88.5	100
2. Medical and public health	6.2	67.1	73.4	8.5	91.5	100
3. Family welfare	0.8	9.9	10.7	7.4	92.6	100
4. Housing and urban development	3.6	15.2	18.9	19.3	80.7	100
5. Social security and welfare	3.4	41.7	45.2	7.6	92.4	100
6. Others	2.4	4.5	7.0	35.1	64.9	100
F. Economic Services	219.8	318.5	538.3	40.8	59.2	100
1. Agriculture and allied services (incl. food subsidy)	54.4	100.6	154.9	35.1	64.9	100
2. Industry and minerals (incl. subsidy on fertiliser and cloth)	67.3	18.1	85.4	78.8	21.2	100
3. Power, irrigation and flood control	24.9	128.6	153.4	16.2	83.8	100
4. Transport and communication	34.3	38.8	73.0	46.9	53.1	100
5. Public works	3.8	10.0	13.8	27.8	72.2	100
6. Others	35.1	22.6	57.7	60.9	39.1	100
G. Loans and Advances	88.2	31.6	119.7	73.6	26.4	100
H. Total (excluding appropriation for reduction or avoidance of debt)	822.3	950.6	1772.8	46.4	53.6	100

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

Note: Expenditures of the two levels of government in each of the items represents the actual expenditure incurred by them. Central transfers to States are not considered Central expenditures and thus, double counting has been avoided. Therefore, Central grants are not shown as an expenditure item of the Central government.

In effect, unless additional Central transfers are given, the States' ability to increase their expenditures depends merely on their capacity and willingness to enhance revenues from the tax and non-tax sources assigned to them. Although in each of the States the overall transaction in a year should match revenues and expenditures, there would be variations in daily and monthly positions. The cash balance position or the 'ways and means' position of the States is maintained by the Central Accounts Section of the RBI. The cash balances of the States are invested by the RBI as per States' instructions and the States can also take overdrafts upto the limits stipulated by the RBI, by agreement with the State government. Any borrowing beyond this limit is called ' unauthorised overdraft'. Until 1985, the States could resort to this source rather liberally. To that extent, the Central control over macroeconomic policy was less effective. Further, when the overdraft position reached very high levels, from time to time, the Centre simply cleared the overdrafts by converting them into medium term loans. In January, 1985, however, the overdraft regulation scheme was introduced which stipulated that if the States continue to have the overdrafts with the RBI for more than seven continuous working days, the RBI is not obliged to honour the cheques of such States.[6] While this measure has vested the Centre with more effective control of money supply and borrowing powers (and therefore, macroeconomic management of the economy), it has restricted the States' manoeuvrability with respect to their expenditures.

The centralisation of economic power in India is not merely an outcome of Constitutional assignments. The public sector was expected to reach the commanding heights of the economy in the developmental strategy adopted after independence and (directing the) resource allocation according to social priorities as determined by the planning agency had the inevitable consequence of centralisation. The heavy industry based import substituting industrialisation strategy with a dominant public sector necessarily augmented the economic power of the Centre. Entry 20 in the concurrent list ("Economic and Social Planning") enabled the Centre to direct resource allocation, and by virtue of the powers conferred by Entry 52 in the Union list, the Industrial Development and Regulation Act was passed to give

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6 The States have reacted to this measure by taking resort to short term borrowing from the private sector or from their own enterprises. The West Bengal government, for example, took short term loans from Peerless Insurance Company, a private sector financial firm.

control over almost all important industries to the Centre. The Planning Commission became a pivotal agency to determine resource allocation. While the investment pattern and its regional distribution in the private sector was sought to be influenced through industrial licensing and other policy measures, the public sector allocation was determined by the Planning Commission. Of course, the States were allowed to prepare their plans but this was judged and appraised in terms of the national objectives and norms. In addition, the States' priorities were also influenced through a multitude of Centrally sponsored schemes - shared cost programmes which presently number as many as 264.

Determining the resource allocation in a mixed economy through governmental fiat necessitated the introduction of a variety of physical controls over economic activities. The feeling of export pessimism and the emphasis on import substitution (euphemistically labelled as self-reliance) called for rationing of foreign exchange and protecting the domestic industry from foreign competition through exchange rate regulations and physical controls on imports. Determining investments according to social priorities necessitated influencing the sectoral investment pattern and its regional distribution through industrial licensing policy and exchange controls; concentration in economic power in the private sector was sought to be checked through a number of other policy measures such as Monopoly and Restrictive Trade Practices Act. Allocation of resources according to 'social' priorities was also to be achieved through credit policy and policy towards social control of the financial sector which eventually resulted in governmental ownership of all major banking and financial institutions. All these factors resulted in tremendous concentration of power. In the words of Chelliah, (1991, p. 8) "......there are few parallels of such tremendous concentration of power in a few hands. This economic power consists of not only the rights conferred by ownership, but also the right to control every major aspect of economic activity in the country. The feeling of helplessness and near subjugation experienced by the States, especially those at the periphery of power, arises from the spectre of overwhelming economic power wielded by the Centre."

(ii) The Constitutional assignment of tax powers follows the principle of 'separation' in contrast to that of 'concurrence' followed in federations like the U.S.A. and Canada. The clear demarcation of the tax handles of the Central and State governments has been prescribed to avoid tax overlapping and concurrency. However, tax separation in a system where the tax bases overlap can only be done in a *de jure* sense, and *de facto,* overlapping can not be avoided. This has not only created some problems of tax enforcement, but also led to adverse economic consequences. First, the splitting of the power to levy taxes on incomes and capital between the Centre and the States on the basis of whether they are derived from agricultural or non-agricultural sources has led to distortions, tax evasion and avoidance besides violating the principle of horizontal equity [Chelliah,1991]. Second, although in a legal sense the Central and State levies are separate, they levy taxes on virtually the same base. Consequently, the problem of vertical tax overlapping has continued to plague the Indian tax system. The Central government is empowered to levy manufacturing excises. The States levy sales taxes on the excise duty paid value of commodities. In addition, the tax on the entry of goods into a local area for consumption, use or sale or 'octroi' (contained in the State list and delegated to the local bodies) too falls on the same tax base. This is a clear example of vertical tax overlapping. Such a levy of tax on tax and margins on taxes in a mark up pricing situation creates divergence between the producer and consumer prices, of more than the tax element.[7] Although the extension of tax credit to virtually all inputs and capital goods in the case of Central excises limits cascading, sales tax is levied on the excise paid value. Further, sales tax and octroi are levied on inputs and capital goods as well. In the event, the degree of cascading remains unknown, the tax system becomes non-transparent and detailed exercises are required to estimate the effective tax rates. The extent of distortions caused and the welfare cost of this overlapping tax system remains unknown.

The Indian experience with separation of tax powers clearly contrasts with the assignments prevailing in a number of federations, where the Constitution itself assigns concurrent powers of taxation in respect of some broad-based taxes. In Australia, the problem arising from such concurrency has been minimised as all major taxes are assigned to the Commonwealth government. Further, even though the States have concurrent powers to levy indirect taxes except customs duty and sumptuary excises, the courts' ruling that sales taxes fall into the excepted category virtually rules out concurrency (ACIR,1981). In the U.S.A.

7 In an economy where the producers are protected from both domestic and foreign competition, mark-up pricing may be an appropriate characterisation. Of course, this general characterisation may not be applicable to particular industries.

and Canada, the Federal and State (provincial) governments have concurrent powers to levy income taxes, but cooperation and coordination among the two levels of government have ensured that the tax base adopted by the States and Federal government, by and large, is uniform. In Canada, the arrangement essentially is one of piggybacking. In the U.S.A., although in a majority of the States the tax bases are not identical to that of the Federal government in respect of both individual and corporate income taxes, the differences are not significant enough to cause major distortions. In the levy of taxes on goods and services, considerable degree of vertical coordination between the Federal and State (provincial) levels has been achieved to make the tax system simple and transparent. In the United States, the Federal government does not levy any broad-based internal indirect tax and the States have the exclusive rights to levy the sales tax. In Canada, both Federal and Provincial governments can levy consumption taxes.[8] Thus, while the Federal government levies a value added tax (goods and services tax or GST), the Provinces levy a retail sales tax (RST). The nature of RST, however, varies among the Provinces. The eastern provinces levy RST on the GST inclusive value of goods sold to consumers. Ontario levies the tax on the value excluding the GST. Alberta does not levy RST at all. Quebec, however, has harmonised its tax fully with the GST and it collects the tax for the Federal government as well. Of course, the GST in Quebec has significant differences with the GST levied by the Federal government in other parts of the country. There is thus, some degree of vertical overlapping of indirect taxes. In Switzerland, the Constitution allows for a significant degree of tax overlapping between the Federal and the Cantonal governments, but, historical developments have ensured that the Federal government collects most of the indirect taxes and direct taxes are collected mostly at the Cantonal level (ACIR,1981). In Germany too, income taxes, customs and excises and important business taxes including the value added tax are leviable by the Federal government, but the elaborate system of legislated sharing of taxes has ensured adequate resource flow to the States while achieving a high degree of vertical harmonization (ACIR,1981).

The essence of the above discussion is that many of the developed federations have, to a large extent, resolved the problem of vertical tax overlapping either through tax assignment or through coordination. Of course, this is not to say that there is perfect harmony

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8 The Constitution allows the levy of all direct taxes by both Federal and Provincial governments, and the Courts have interpreted retail sales tax to be a direct tax.

between different levels of government in these federations in the levy of taxes. But surely, the degree of disharmony is nowhere as much as it is seen in India. In India, the tax assignments have resulted in a large area of concurrency in indirect taxes, mutual understanding and trust between the Centre and States is inadequate and therefore, attempts at coordination have not been serious enough to minimise distortions in the tax system.[9]

The Indian experience brings out three important lessons. First, tax assignment should not be done merely on legal considerations; economic consequences of such assignments must be taken account of. Second, avoidance of concurrency in a *de jure* sense does not prevent *de facto* overlapping. While overlapping exists in all federations, often in the assignment of the tax itself, like in the U.S.A. and Canada, the success of the federation lies in how effectively the adverse effects of tax overlapping are resolved through tax coordination and harmonization. Unfortunately, the attempts at tax coordination in India have not been successful enough to minimise distortions in the tax system.

(iii) A major advantage of a federation over the balkanised system is the existence of a unified market not encumbered by any form of impediments to the free movement of and trading in factors of production as well as products. The Constitution recognises this in Article 301, which reads, "Subject to other provisions of this part, trade, commerce and intercourse throughout the territory of India shall be free". However, article 302 states, "Parliament may by law impose such restrictions on the freedom of trade, commerce or intercourse between one State and another or within any part of the territory of India as may be required in the public interest". What is more, Entry 92A (inserted by the Constitutional amendment in 1956) in the Union list allows the Centre to levy ' Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce'. Under this provision, the Centre has allowed the States to levy the tax on inter-State sale subject to the specified ceiling rate. Similarly, Entry 52 in the State list allows the

9 Some degree of coordination was achieved in 1956 when the States surrendered the right to levy sales tax on sugar, textiles and tobacco in lieu of which, the Central government agreed to levy additional excise duties on the three groups of commodities, the proceeds of which were to be assigned to the States. However, over the years, the States have been dissatisfied with this arrangement and the recommendations of the Committee extending the arrangement to five more groups of commodities were unanimously rejected by the States [India,1983]. Again, the decision taken in at the National Development Council to levy the sales tax at uniform rates on 29 groups of commodities as a measure to contain tax competition has not been acted upon. The attempt has now been renewed with a Committee of State Finance Ministers grappling with the issue of coordination of sales taxation by States.

States to levy a tax on the entry of goods into a local area for consumption, use or sale. Both these levies violate the principle of free internal trade and a unified common market. In fact, these taxes have tended to create several tariff zones within the country leading to severe resource distortions, which cannot be easily quantified (Rao, 1993).

(iv) As already mentioned, a desirable principle of tax assignment is to entrust relatively less mobile tax bases to States and local governments so that they do not indulge in 'free-riding' by exporting the tax burden to non-residents and thereby distort the tax system. The motivation behind the Constitutional amendment to allow taxation of inter-State trade was to provide a safeguard against the evasion of sales tax by camouflaging local sales as inter-State sales. The Taxation Enquiry Committee (India, 1953), therefore, recommended an inter-State sales tax at a low rate of one per cent. However, this was used as a revenue raising measure to finance developmental plans and over the years the rate was increased to four per cent.[10] The tax is collected by the exporting State and although the rate cannot exceed 4 per cent, actual rate of tax exportation can be much higher, for, the cascading taxes on inputs and capital goods too may be shifted forward to the consumers. This has distorted relative prices, created impediments to the free movement of goods across the nation and caused inequitable resource transfers from poorer consuming States to the richer producing States [Rao and Vaillancourt, 1994]. These will be discussed in detail in the next chapter.

(v) The Constitution recognises that assignment of tax powers and expenditure functions would create an imbalance between expenditure needs and abilities to raise revenue. The imbalances could be both vertical among different levels of government and horizontal among different units within a sub-Central level. Therefore, it provides for the assignment of revenues (as contrasted to assignment of tax powers), sharing of the proceeds of certain Centrally levied taxes with the States and making grants to the States from the 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. Estate duty on non-agricultural property, terminal taxes on passengers and goods carried by railway, sea or air;

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10 The CST is levied at 4 per cent or at the tax rate prevailing in the exporting State whichever is lower, when the inter-State sale is made to a registered dealer. If the goods are sold to an unregistered dealer, the lower of 10 per cent or the local sales tax rate in the importing State will apply.

taxes on railway fares and freights, taxes on transactions in stock exchanges and futures markets, taxes on the sale and purchase of newspapers and on advertisements published therein and taxes on sale and purchase in the course of inter-State trade fall into this category. All of them except the last one are to be levied and collected by the Centre and proceeds are to be assigned to the States entirely. In the case of the last one, the States have been allowed to collect the tax subject to the ceiling rate specified by the Centre, as mentioned earlier. The Constitution also provides for the compulsory sharing of the net revenue from non-corporate income tax (Article 270), and optional sharing of the proceeds of Union excise duty (Article 272). The shares of the Centre and the States and their allocation among different States of both the taxes are to be determined by the Finance Commission appointed by the President of India every five years or earlier as needed. In addition to tax devolution, the Finance Commission is also required to recommend grants to the States in need of assistance under Article 275.

While the Constitutional assignment itself has a number of shortcomings as pointed out above, the developments over the years and the working of various institutions have tended to aggravate them. We have already pointed out the consequences arising from the addition of an entry in the Union list allowing the levy of tax on inter-State sale in goods. There have been other similar developments causing tax and benefit spillovers, accentuating fiscal imbalances and contributing to inter-jurisdictional tax and expenditure disharmony. In particular, the focus on development planning and the establishment of the Planning Commission have brought in additional complications. The pursuit of centralised planning in a decentralised institutional setup too has contributed to problems and contradictions.

With the increasing role of the Planning Commission in resource allocation and intergovernmental transfers, the role of constitutionally provided Finance Commission has been considerably reduced. Further attempts by various Central ministries to influence States' expenditure allocations have led them to introduce several specific purpose transfer schemes (called the Centrally sponsored schemes) with matching provisions. With this, the discretionary component in the total transfers has shown a steady increase as also the degree of Central control over the spending decisions of the States. Further, the emphasis on large plans has led to resource mobilisation in convenient and easy ways without due regard to their adverse economic consequences. The proliferation of cascading type commodity taxes at every level of government and extensive recourse to inter-State tax exportation referred to above are examples of this.

c. Economic Liberalisation and Fiscal Decentralisation

The sustained and growing fiscal imbalances through the decade of the eighties caused macroeconomic imbalances and eventually led to balance of payments disequilibrium. The problem reached crisis proportion when the oil prices showed a steep increase during the middle east conflict in 1991. Deposits from Non-resident Indians fell steeply and foreign-exchange reserves were sufficient to service barely three weeks' imports. The government had to seek structural adjustment loans from the International Monetary Fund (IMF) and undertake to liberalise the economy and integrate it with the world market. Since June, 1991, considerable progress has been achieved in dismantling state control and in giving a greater role to market forces in economic activity. Attempts have been made to phase out fiscal imbalances; industrial licensing requirements have been dispensed with in respect of all but seven industries; export orientation to the economy has been given by liberalising the foreign trade regime, determination of exchange rate broadly on the basis of market forces, reduction in protective duties and by making the rupee convertible in the current account.

Of course, dismantling the state controlled regime with widespread regulations and controls built over 40 years of planning cannot be achieved in a short time. Much remains to be done in terms of privatising public enterprises and in making a transition from all-pervasive government production and sale of goods and services in the economy, to confining it to the traditional function of providing public and merit goods. This would reduce the concentration of power with the government and restore the role of the market in resource allocation. The governmental role itself will be reduced to the provision of only the basic infrastructure. Withdrawal from non-essential activities would considerably reduce the role of the Central government and the Planning Commission's role will be primarily to undertake indicative (policy) planning for the medium and long term in relation to macroeconomic stability, inter-personal and inter-regional distribution, strategic sectors and international trade. It would also be an advisory body both to the various Central government departments and State governments.

However, in the new environment, the State governments would have a very important role to perform. Of course, like the Central government, they too would have to eventually withdraw from production and trading activities. But human resource development will be a major thrust area and the State governments have a predominant role in providing social services like education, health and family welfare, water supply and sanitation, urban development and social security. We may actually see an increase, rather than decline in their activities. They along with other levels of government would have to regulate and assist the orderly development of the markets. Certain expenditures (like consumer subsidy on foodgrains) may have to be willy-nilly taken up at the State level in the interest of political and social stability. Also, the Centrally sponsored schemes transferred to the States will have the immediate effect of creating resource problems, although these are likely to be eventually phased out or integrated with State schemes. This implies that they would have to spend larger amounts on these functions and therefore, should have access to larger sources of revenue. A part of this can be secured from reducing budgetary support to public enterprises, withdrawal from non-core areas, charging user charges on a more rational basis, better collection from existing taxes by rationalising the tax structure and improving administration and enforcement of the taxes.

The foregoing discussion brings out the major issues arising from the assignment of tax powers and expenditure functions in the Indian Constitution, which have important consequences on inter-regional equity and resource allocation in the Indian federation. As mentioned earlier, assignment of tax powers and expenditure functions have allocative consequences. On the tax side, the assignment determines the extent of vertical and horizontal overlapping of taxes, inter-State tax competition and inter-State tax exportation. The problems of subnational tax disharmony, impediments to internal trade arising from tax measures are also partly attributable to the assignments necessitating the introduction of measures aimed at tax harmonisation and coordination. On the expenditure side, concurrency in assignment calls for coordination of policies among different levels of government. Issues arising from Centre's attempt to influence the States' policies in various ways, encroachment of the functions of one level of government by the other and inter-State benefit spillovers are some of the issues of interest. Further, the magnitude of vertical and horizontal fiscal imbalances, particularly during a period of economic liberalisation and their implications on the inter-regional investment pattern - both public and private, call for a more detailed analysis. The fiscal imbalances can be resolved either through appropriate regional policies or through a well designed system of intergovernmental transfer mechanism. The efficacy of the planning mechanism in reducing regional disparities in the provision of social and economic infrastructure, the Constitutional mechanism to resolve fiscal imbalances and the working of various institutions are also of immense significance for the future of Indian federation. These issues will be discussed in the ensuing chapters.

Annexure I

TAXATION HEADS ASSIGNED TO THE UNION AND THE STATES IN THE CONSTITUTION

(AS LISTED IN THE SEVENTH SCHEDULE OF THE CONSTITUTION)

Union		States	
Entry in List I of the Seventh Schedule	Head	Entry in List II of the Seventh Schedule	Head
82	Taxes on income other than agricultural income	45	Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes.
83	Duties of customs including export duties	46	Taxes on agricultural income
84	Duties of excise on tobacco and other goods manufactured or produced in India except- a. alcoholic liquors for human consumption; b. opium, Indian hemp and other narcotic drugs and narcotics; but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.	47	Duties in respect of succession of agricultural land
85	Corporation tax	48	Estate duty in respect of agricultural land
86	Taxes on the capital value of the assets, exclusive of agricultural land of individuals and companies; taxes on the capital of companies	49	Taxes on lands and buildings
87	Estate duty in respect of property other than agricultural land.	50	Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development
88	Duties in respect of succession to property other than agricultural land	51	Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: a. alcohol liquors for human consumption; b. opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
89	Terminal taxes on goods or passengers carried by railway, sea or air: taxes on railway fares and freights.	52	Taxes on the entry of goods into a local area for consumption, use or sale therein.

90	Taxes other than stamp duties on transactions in stock exchanges and future markets	53	Taxes on the consumption or sale of electricity
91	Rates of stamp duty in respect of bills of exchange cheques promisory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.	@54	Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I.
92	Taxes on the sale or purchase of newspapers and on advertisements published therein.	55	Taxes on advertisements other than advertisements published in the newspaper @@ and advertisements broadcast by radio or television.
*92A	Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.	56	Taxes on goods and passengers carried by road or on inland waterways.
**92B	Taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.	57	Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads including tramcars, subject to the provision of entry 35 of List III.
97	Any other matter not enumerated in List II or List III including any tax not mentioned in either or both the Lists.	58	Taxes on animals and boats
		59	Tolls
		60	Taxes on professions, trades, callings and employments
		61	Capitation taxes
		62	Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.
		63	Rates of stamp duty in respect of documents other than those specified in the provision of List I with regard to rates of stamp duty.

* Ins. by the Constitution (Sixth Amendment) Act, 1956 s.2
** Ins. by the Constitution (Forty-sixth Amendment) Act, 1982, s.5
@ Sub. by the Constitution (sixth Amendment) Act 1956, s.2 for entry 54
@@ Ins. by the Constitution (Forth-second Amendment) Act, 1975, s.57 (w.e.f. 31.1.1977)

Annexure II

ILLUSTRATIVE LIST OF DEVELOPMENTAL SUBJECTS (OTHER THAN FINANCIAL SUBJECTS) INCLUDED IN UNION LIST, STATE LIST AND CONCURRENT LIST AS PER SEVENTH SCHEDULE OF THE CONSTITUTION

(A) Union List

S. No.	Entry No.	Subject
1	6	Atomic energy and mineral resources necessary for its production
2	22	Railways
3.	23	Highways declared by or under law made by Parliament to be national highways
4.	24	Shipping and navigation on inland waterways, declared by Parliament by law to be national waterways, as regards mechanically propelled vessels the rule of the road on such waterways.
5.	25	Maritime shipping and navigation including shipping and navigation on tidal waters provision of education and training for the mercantile marine and regulation of such education and training provided by States and other agencies.
6.	26	Lighthouses, including lightships, beacons and other provision for the safety of shipping and aircraft
7.	27	Ports declared by or under law made by Parliament or existing law to be major ports, including the delimitation and the constitution and powers of port authorities therein.
8.	28	Port quarantine, including hospitals connected therewith seamen's and marine hospitals.
9.	29	Airways aircraft and air-navigation provision of aerodromes; regulation and organisation of air traffic and of aerodromes; provision for aeronautical education and training and regulation of such education and training provided by States and other agencies.
10.	30	Carriage of passengers and goods by railways, sea or air, or by national waterways in mechanically propelled vessels.
11.	31	Posts and telegraph: telephones, wireless, broadcasting and other like forms of communication.
12.	41	Trade and commerce with foreign countries; import and export across customs frontiers; definition of customs frontiers.
13.	42	Inter-State trade and commerce.
14.	52	Industries, the control of which by the Union is declared by parliament by law to be expedient in the public interest.
15.	53	Regulation and development of oilfields and mineral oil resources; petroleum and petroleum products; other liquids and substances declared by Parliament by law to be dangerously inflammable
16.	54	Regulation of mines and mineral development to the extent which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest.
17.	56	Regulation and development of inter-State rivers and river valleys to the extent to which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest.
18.	57	Fishing and fisheries beyond territorial waters.
19.	65	Union agenda and institutions for - a. professional, vocational or technical training including the training of police officers: or b. the promotion of special studies or research; or c. scientific or technical assistance in the investigation or detection of crime.
20.	66	Coordination and determination of standards in institutions for higher education or research and scientific and technical institutions.
21.	68	Survey of India, the geological, botanical, zoological and anthropological surveys of India, meterological organisations.

B. State List

1	5	Local government, that is to say, the constitution and powers of municipal corporations, improvements trusts, district boards, mining settlement authorities and other local authorities for the purpose of local self-Government or village administration.
2	6	Public health and sanitation; hospitals and dispensaries
3.	9	Relief of the disabled and unemployable.
4.	13	Communications, that is to say, roads, bridges, ferries, and other means of communication not specified in List I: municipal tramways; ropeways; inland waterways and traffic thereon subject to the provisions of List I and List II with regard to such waterways; vehicles other than mechanically propelled vehicles.
5.	14	Agriculture, including agricultural education and research, protection against pests and prevention of plant diseases.
6.	15	Preservation, protection and improvement of stock and prevention of animal diseases; veterinary training and practice.
7.	17	Water, that is to say, water supplies, irrigation and canals, drainage, embankments, water storage and water power subject to the provisions of entry 56 of List I.
8.	18	Land, that is to say, rights in or over land, land tenures including the relations of landlord and tenant, and the collection of rents; transfer and alienation of agricultural land; land improvement and agricultural loans; colonisation.
9.	21	Fisheries
10.	23	Regulation of mines and mineral development subject to the provisions of List I with respect to regulation and development under the control of the Union.
11.	24	Industries subject to the provisions of entries 7 and 52 of List I.
12.	25	Gas and gas-works
13.	26	Trade and commerce within the State subjects to the provisions of entry 33 of List III.
14.	27	Production, supply and distribution of goods subject to the provisions of entry 33 of List III
15.	32	Cooperative societies
16.	35	Works, lands and buildings vested in or in the possession of the State.

(C)	Concurrent List	
1	17A	Forests
2.	20	Economic and social planning
3.	20A	Population control and family planning
4.	23	Social security and social insurance; employment and unemployment
5.	25	Education, including technical education, medical education and universities, subject to the provisions of entries 63, 64, 65 and 66 of List I; vocational and technical training of labour.
6.	27	Relief and rehabilitation of persons displaced from their original place of residence by reasons of the setting up of the Dominions of India and Pakistan.
7.	31	Ports other than those declared by or under law made by Parliament or existing law to be major ports.
8.	32	Shipping and navigation and inland waterways as regards mechanically propelled vessels, and the rule of the road on such waterways, and the carriage of passengers and goods on inland waterways subject to the provisions of List I with regard to national waterways.
9.	33	Trade and commerce in, and the production supply and distribution of -
		a. the products of any industry where the control of such industry by the Union is declared by Parliament by law to be expedient in the public interest and imported goods on inland waterways subject to the provisions of List I with regard to national waterways.
		b. foodstuffs, including edible oilseeds and oils;
		c. cattle fodder, including oilseeds and other concentrates;
		d. raw cotton, where ginned or unginned and cotton seed; and
		e. raw jute.
10.	36	Factories
11.	37	Boilers
12.	38	Electricity

CHAPTER III

FISCAL OVERLAPPING IN INDIAN FEDERALISM

a. Introduction

Concurrency in tax, expenditure and regulatory functions cannot be entirely avoided in any federation despite the most judiciously prescribed assignments. A number of functions are of common concern between different governmental units and proper execution of policies in respect of these functions necessitates concurrent jurisdiction. Thus, overlapping can be the result of even the most efficient Constitutional assignment itself. But, more often, even when there is no need for a joint jurisdiction and Constitutional assignments clearly demarcate the functions, ther may still be serious overlapping due to economic interdependence between vertical and horizontal governmental units.

As mentioned in Chapter I, Governmental units essentially enjoy a competitive relationship. The essence of fiscal federalism, however, is to coordinate the policies of different levels of governments and different units within each of the levels to foster welfare improving competition. Not all competition is socially beneficial and coordination is essential to avoid such wasteful competition. Thus, it is obvious that no governmental unit should be able to exploit others and if it does, there should be an effective mechanism to counter it. Exploitation can be minimised when there is 'competitive equality' or equality of the power of the competing entities. It is also important to ensure that no jurisdiction is able to 'free-ride' on others or provide public services to its residents by passing on the burden of finacing them to non-residents. For this to come about, there must be an effective agency to monitor intergovernmental competition and to enforce the rules of the game. This also calls for a certain degee of coordination in the policies of governmental units, both vertically between hierarchical layers and horizontally among fraternal units, so that they do not work at cross purposes.

Overlapping can occur among different jurisdictions in tax, expenditure as well as regulatory functions. Fiscal overlapping can be vertical - between different levels of government, or horizontal - among different units within a level. The analysis of vertical and horizontal spillovers and their satisfactory resolution itself can be an important subject of study. We, in this chapter, examine the issues arising from concurrency and overlapping only to the extent that they result in allocative distortions. Further, our emphasis is to highlight the problems arising from overlapping taxes.

b. Vertical Fiscal Disharmony: Major Issues

The sources of overlapping and disharmony in the functioning of vertical intergovernmental units can be found in Constitutional assignments itself. No matter how carefully the assignments are worked out, concurrency in the functioning of different units/levels of government is unavoidable. This is partly because efficient allocation of resources (comparative advantage) itself requires that certain functions are undertaken by more than one layer of government. Further, even when assignments are made to minimise conflicts, the interdependence in the fiscal and regulatory operations among the hierarchical units makes it impossible to avoid a certain degree of disharmony and conflict in their functioning.

In the Indian context, in carrying out the regulatory and expenditure functions, disharmony between the Centre and States arises due to a variety of reasons. To some extent, this conflict is inherent in the Constitutional arrangement itself, but the more important cause is to be found in the interdependence (complementarity and substitutability) in the fiscal operations of between the Central and the State governments. Fiscal policy pursued by the Central government has its impact on the budgetary positions of the States. For instance, expansionary fiscal operations financed by large deficits can create an inflationary situation. In addition, when the ever expanding expenditures on wages and salaries, interest payments, subsidies and other transfers crowd out capital and maintenance expenditures, particularly on infrastructural facilities, the supply bottlenecks create a stagflationary situation [Rao and Sen, 1993, 1994]. This constrains the ability of the States to raise revenues and at the same time inflates their expenditures, forcing them to cut down their own spending on social and economic infrastructures.

Externalities arising from Central policies on the States' functioning is also seen in the pressure for revising the pay scales of the State government employees as a consequence of the Centre's decision to implement the recommendations of the Fourth Pay Commission. Fiscal problems of the States assumed serious proportions as the Centre's fiscal compression was attempted to a large extent by reducing transfers to States. The increase in the administered prices of goods and services produced by Central governmental enterprises, particularly those of the basic inputs and capital goods such as petroleum products, coal, steel, machine tools, electric transmission equipments, rail transport and telecommunications can significantly add to the cost of providing services at the State level and thereby, increase their current expenditures. Externalities on States' fiscal operations can also be caused when the Central government simply withdraws its operations in a concurrent activity; being proximate to the electorate, the States may be forced to continue spending on the activity. Thus, when the Central government raises issue prices (selling prices) on foodgrains and reduces foodgrain subsidy, the States may step in to protect the consumers' interest. There are also instances of the States providing additional subsidy to the farmers on the foodgrains procured when they perceive that Centrally determined procurement prices were too low. The interdependence was also seen when the rationalisation of incentives given under the Income Tax Act to small savings in 1991 reduced the amout of small saving collections itself and thereby, the resources available to the States. It may be noted that 75 per cent of net collections from small savings schemes is given to the States as non-plan loan. As a matter of fact, interdependence in fiscal operations of Central and State governments is seen virtually in every sphere of activity. Unless properly coordinated, the overlapping functions of the two levels of government can lead to conflicts and undermine the effectiveness of governmental activity as a whole.

The most uncoordinated functioning of the Centre and the States is seen in the structural reforms undertaken since the middle of 1991. Even when not much has been achieved in terms of fiscal compression at the Central level after four years of fiscal reform, the transfers to States has shown a decline. During the four reform years, the fiscal deficit as a ratio of GDP at the Central level was reduced merely by 1.1 percentage points from 8.4

per cent in 1990-91 to 7.3 per cent in 1993-94 (revised estimates)[1] and the reduction in gross transfers to the States as a proportion of GDP was by about 0.6 points or over 50 per cent. Similarly, significant increases in the administered prices of basic inputs and capital goods, and dearness allowace payments given to government employees to neutralise increases in general price level have constrained the ablity of the States to provide the social and economic infrastructure necessary to attract private investments, both domestic and foreign.

Just as Central policies affect States' functions, the policies pursued by the latter may affect the provision of public services by the former. The perception that the States are unable to competently discharge the functions assigned to them has led the Central government to bring a number of subjects into the concurrent list and alter the allocations to such items through direct Central spending or shared cost programmes. The expansion of the role of the Central government in several activities like population control and family planning, forests, education, and trade and commerce in several essential items is a case in point. These items were originally placed in the State list but were brought into the concurrent list through constitutional amendments. Similarly, the Central government has significantly expanded its involvement in agriculture, rural development, education and health sectors though these were originally conceived as subjects legitimately belonging to the States. [Gulati and George, 1985]. The Central 'intrusion' in allocational decisions on subjects falling in the State list has also taken the form of introducing several Central sector and Centrally sponsored schemes. Through the Central sector schemes, the Central government spends the moneys using the States essentially as spending agencies.[2] The Centrally sponsored schemes are in the nature of shared cost programmes or specific purpose transfer schemes wherein the Centre influences States' allocation to the aided functions by making matching contributions. Just as Central policies affect the States' fisc, the pricing and tax policies of the State governments too have their impact on Centre's expenditures. State sales

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1 A large proportion of this reduction was achieved by the sale of public sector equity and appropriating the profits of Reserve Bank of India. If the adjustments are made on these items to compare like with the like, there has hardly been any reduction in fiscal deficit. See, Sen, Rao and Ghosh (1994).

2 The States may be used as spending agencies also because of their comparative advantage in implementing the function. In poverty alleviation schemes, for example, the States are better placed to implement policies as they can identify the poor, and initiate policies suited to the prevailing conditions which vary from region to region. On this, see, Rao and Das-Gupta (1994).

taxation of works contracts carried out for the Central agencies, for example, raises their costs and affects the Centre's expenditures. Indian Railways, a departmental undertaking of the Central government, sometimes buys power from the State Electricity Boards, and the latter's tariff policies naturally affect the former.

One of the areas where the interdependence in the fiscal operations has led to severe problems is in the exercising of the borrowing powers. Unable to meet the growing expenditure commitments, the States have been utilising their borrowed funds not only to finance their capital expenditures, but to meet current budgetary deficits as well. Even what is spent on capital projects by the States have not generated the desired returns due to low productivity caused by both long gestation in completing the projects and the inability or unwillingness to levy user charges at economic rates (Rao, 1992; Rao and Mundle, 1992). Increasing difficulty in debt-servicing by the States over the years forced the Centre to periodically reshedule or write off the Central loans given to the States which, in effect, meant transferring the burden from the State taxpayers to the national taxpayers (or free riding). The periodic adjustment of loans over time itself has had its adverse effects on fiscal management of the States.

The allocative implications of vertical tax overlapping are equally, if not more, serious. On the one hand, sharing of certain taxes involves incentives for the collecting agency. On the other, there are issues arising from taxing the same base by different levels of government giving rise to the larger question of efficient means to pursue macroeconomic policies and the method of coordinating the Central and State tasks in this endeavour so that the action at one level of government does not nullify the objectives of the other.

While the Constitution of India has avoided concurrent tax jurisdiction, it has provided an arrangement to augment the revenues of the State governments through sharing of the proceeds of personal income tax and union excise duty. The net proceeds of personal income tax is compulsorily shareable whereas, the sharing of revenues from Union excise duty could be shared with the States if the Parliament so choose. The Parliament did decide to share the revenue from Union excise duty. The distribution between the Centre and the States and the shares of individual States in both the taxes are determined by the Finance

Commission appointed by the President of India every five years as per Constitutional provisions.

The States have, by and large, preferred tax sharing to grants because, the tax shares fixed in percentage terms have an inherent buoyancy and therefore, to a large extent, are hedged against inflation. On the contrary, unless indexed, the grants recommended once in five years can significantly erode in value at the end of the recommendation period, particularly when the inflation rate is high. However, in spite of the general preference for tax devolution, the States still cannot forget the fact that the Central government through a simple fiat seperated the company tax from personal income tax in 1956 prior to which the combined tax was shareable. Of course, an interim arrangement was worked out to compensate the States for the loss of revenues due to levying a seperate corporation tax and the next Finance Commission in any case made recommendations after taking account of narrower divisible pool. Yet, the States have continued to complain and have impressed upon every Finance Commission to include the tax in the divisible pool as this was found to be more bouyant than the personal income tax.[3]

Adverse incentive effects of tax sharing is, however, an important issue from the viewpoint of resource allocation. Over the years, successive Finance Commissions have increased the shares of income tax and excise duty going to the States. The eighth and the ninth Finance Commissions covering the last ten years recommended that 85 per cent of net collections of personal income tax and 45 per cent of union excise duty should be transferred to the States. Thus, any additional effort put in to collect to more revenues from these taxes by the Centre brings only a marginal gain to it. Therefore, it is pointed out that the Centre's incentive to raise more revenues from these taxes has been considerably reduced resulting in its concentrating its revenue effort on the non-shareable sources of revenue [Burgess and Stern,1993]. It is therefore not surprising that customs duty which ought to have been primarily used as a protective instrument has been used as a major revenue instrument resulting in its share in total Central tax revenue increasing from 11 per cent in 1970-71 to 17 per cent in 1980-81 and further to 22.3 per cent in 1991-92. It is also seen that the share

3 The events have however, disproved this. In the eighties, for example, at 15 per cent personal income tax grew faster than the corporation tax (13.2 per cent).

of personal income tax in Centre's tax revenue declined from 10 per cent in 1970-71 to 7.6 per cent in 1980-81 and further to 6.6 per cent in 1991-92, before increasing marginally in 1992-93 [Rao, 1993a]. Perhaps due to these perceived incentive problems, the tenth Finance Commission has recommended that a given percentage of gross tax revenue from all taxes levied by the Centre may form the States' share. A Constitutional amendment to this effect is under consideration at present.

It is also pointed out that the Centre prefers to increase the administered prices in respect of public monopolies instead of revising union excise duties to avoid sharing of the proceeds with the State. This can alter relative prices and effective protection rates of different commodities in unintended ways, thereby causing resource distortions.

c. Inter-jurisdictional Tax Competition and Allocative Efficiency

The provision of public services catering to diversified preferences of the people in different jurisdictions necessarily implies that the standards of public services and tax rates ought to be different in them, and in a representative democracy, as mentioned earlier, the choice of the tax-expenditure package reflects the median voter's preferences. However, the fact that there is no direct linkage between the taxpayers and the beneficiaries of public services causes the preferred outcomes on taxes to be different from that of expenditures. The economic agents within each jurisdiction indulge in "free-riding" in their attempt to minimise tax payments and maximise benefits from public services. Given that capital mobility is greater than labour mobility, it would be perfectly rational for the States to indulge in tax competition to attract trade and industry into their jurisdictions and to export the burden of financing their public services to the non-residents to the maximum extent possible. This, however, can alter relative prices in unintended ways and can bring in various types of barriers - fiscal as well as physical, on the free movement of factors and products, and thus distort the pattern of resource allocation. In addition, when the ability of a jurisdiction to 'free-ride' on others differs widely (when the jurisdictions are non-homogenous), this can give rise to the exploitation of the weak by the strong.

As pointed out in the previous section, there is very little systematic analysis of inter-jurisdictional tax competition and their efficiency implications and the conclusions reached by the few studies that exist have arrived at conflicting results.[4] Most striking is the result of Oates and Schwab (1988) who show that when communities are homogenous, where the costs and benefits are clearly perceived and where public decisions reflect the preferences of the residents of respective jurisdictions, inter-jurisdictional competition is efficiency enhancing. However, even in their model, if the jurisdictions are constrained to tax capital for want of more efficient tax instruments and/or if public decisions deviate from the will of the electorate,[5] tax competition will not lead to efficient outcomes. Another important precondition for efficiency enhancing intergovernmental competition as mentioned above is homogeneity of jurisdictions. In terms of competitive federalism, these preconditions can be stated as, "competitive equality" and "cost-benefit appropriability" (Breton, 1987). When these conditions are not satisfied, competition among sub-Central governments can cause inefficiencies.

In a developing country federation with acute inter-State inequalities in the levels of development, when there is a delinking of the tax and expenditure decisions wherein costs and benefits of public decisions are not clearly perceived and when the States attempt to pass the burden of financing public services to non-residents, the preconditions required to meet the efficiency enhancing properties of tax competition among the States cannot be met and tax competition would cause distortions and inequity. First, in most developing countries like India, consumption taxes as a source of revenue predominate (Burgess and Stern, 1992). Besides, the administrative apparatus in these countries is weak and often, "origin" based indirect taxes rather than "destination" based ones have been preferred. Second, for both administrative and political reasons, the States have found it useful to have a non-transparent and a cascading tax system wherein, taxes are collected from inputs and capital goods in addition to final consumer goods. Third, when the States' attempt to attract trade through cross-border purchases, items with relatively high price elasticity of demand tend to be taxed

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4 The important studies addressing this issue are, Mintz and Tulkens (1986), Oates and Schwab (1988) and Wilson (1986).

5 This can happen in the Niskanen model wherein, revenue maximising behaviour will cause excessive taxation of capital. See, Oates and Schwab (1988, pp 350-351).

at low rates. Similarly, tax on commodities which are predominantly exported to other States tend to be levied at the maximum rate permissible on inter-State trade (4 per cent) even if they consitute basic necessities like foodgrains. While this dovetails with the Ramsey rule for optimal taxation, these are also the items which constitute the largest proportion of the consumption of the poorest and therefore, for equity reasons, have been exempted or taxed at low rates if they are consumed mainly by the residents. Thus, the "free-riding" strategy adopted by the States influences the States' tax structures as well.

The implications of the above are not very difficult to see. First, the strategy of choosing different tax rates on items consumed by the residents and on those exported to non-residents increases rate differentiation within each of the States. Besides, the attempt to export the tax burden to the out-of-State consumers or to attract capital through various incentives and concessions in commodity taxes complicates the structure of taxes and makes it open to abuse. Second, inter-State tax competition combined with tax exportation can cause wide differences between the States' tax systems depending upon the structure of production, composition of consumption and the type of strategy followed to maximise revenue and to attract capital into the respective jurisdictions. Third, "origin" based consumption taxes with taxes levied on inputs and capital goods can result in cascading, and in heterogenous States with varying 'powers', this can cause significant inter-State tax exportation with unfavourable effects on both equity and efficiency. As the more developed States are usually net exporters of goods and the composition of their exports is heavily weighted in favour of final consumption goods as against raw materials, their 'ability' or 'power' to export the tax is higher than that of the less developed States. Generally, it is argued that inter-State tax competition results in the convergence of the tax systems. But when the States are heterogenous and their tax systems are non-transparent and complicated, when the structure of taxes is determined by the strategy to free-ride on other States and when capital and labour are not perfectly mobile, tax competition may, in fact, cause divergence in the States' tax systems and may actually result in welfare losses.

Thus, often, the gains from autonomy in choosing their preferred public service-tax rate combination can come into conflict with the welfare loss arising from inter-State tax competition. It is necessary to know the exact nature of resource distortion and inequity due to inter-State tax conflicts emerging from the States' 'free-riding' strategy to achieve the required degree of tax harmonisation. The optimal degree of tax harmonisation is achieved when the marginal welfare gains from the States' fiscal autonomy is equated with the marginal welfare loss from resource distortion and inequity arising from inter-State tax competition and tax exportation.

d. Inter-State Tax Disharmony in Indian Federation

In this section, we attempt to identify the sources of inter-State tax conflicts in India. For this purpose, we point out the salient features of the States' tax systems, analyse the intra-State and inter-State differences in the structure of commodity taxes which contribute a predominant proportion of States' tax revenues and infer the consequences of these factors on allocative efficiency and inter-regional equity.

i. Nature and Importance of States' Taxes in India: In India, the States collect about 30 per cent of aggregate total revenues of the Centre and the States taken together and incur about 55 per cent of total expenditures. Thus, the revenues raised by the State governments form quite a significant a proportion of total revenues and therefore, the method of raising these revenues and their consequences would have important allocative and equity implications. The percentages cited above imply that fiscal dependence of the States on the Centre in India was high as the States could generate only about 43 per cent of the revenues required to finance their expenditures from the own tax sources assigned to them and had to depend upon the Central transfers for the remaining 57 per cent.[6] What is more, as may be seen from Table 3.1, the share of States' own revenues in their current expenditures (or fiscal independence) has shown a steady decline from 53.5 per cent in 1975-76 to 45.3 per cent in 1990-91.

Another important development brought out in Table 3.1 is the trends in inter-State difference in fiscal dependence. Interestingly, the share of States' own tax revenues in

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6 These figures refer only to the 14 major States whose list is found in Table 3.4. When all the States are taken in the share of tax revenues in expenditures shows a marginal decline (40 per cent). It must also be pointed out, strictly speaking, the non-tax revenues also must be considered to analyse fiscal independence. However, the share of non-tax revenues in total States' revenues is not very significant.

State Domestic Product (SDP) has shown a steady increase on the average since 1975-76, but the States' fiscal dependence on the Centre has not shown a commensurate decline, as seen in the falling share of States' own tax revenue in their current expenditures. At the same time, the coefficient of variation in the shares of tax revenue in both SDP and current expenditure have increased, which implies that the performance of the States in raising revenues has become more uneven and inter-State variations in dependence has increased over time.

Table 3.1

Importance of States' Tax Revenue

Year	Share of States' own tax revenue in State domestic product (SDP)		Share of States' Tax Revenue in States' Current Expenditure	
	Mean	Coefficient of variation	Mean	Coefficient of variation
1975-76	6.3	19.7	53.5	20.8
1980-81	6.9	23.5	47.9	25.9
1985-86	8.2	26.8	47.8	24.6
1986-87	8.5	25.7	47.4	27.8
1987-88	8.7	23.5	45.8	25.1
1988-89	8.3	25.2	46.5	25.9
1989-90	8.4	25.2	47.4	25.0
1990-91	8.5	26.9	45.3	27.7

Note All estimates pertain to 14 major States. The less homogenous hill States and the small State of Goa are not considered. However, these 14 major States cover 93 per cent of total population in the country.

Sources:
1. Budget documents of the State governments.
2. Central Statistical Organisation, Ministry of Planning, Government of India.

The ratio of tax revenue to State domestic product (SDP) as may be seen from Table 3.1 actually increased from 6.3 per cent in 1975-76 to over 8.2 per cent in 1985-86 but stagnated at that level thereafter. The increase in the tax ratio, however, was accompanied by increase in inter-State variations in the tax ratios from 20 per cent in 1975-76 to 27 per cent in 1990-91 (column 3) indicating increasing inter-State disharmony in the levy of taxes.

A major characteristic of the State tax systems in India is the predominance of taxes on commodities and services. The share of three major indirect taxes - sales tax, taxes on transport and State excise duty constituted over 82 per cent of total State tax revenue (Table 3.2). Among the indirect taxes, sales taxes contributed over 56 per cent of total tax revenues. The pattern is broadly uniform across different States with the share of sales tax varying from 44 per cent in Punjab to over 70 per cent in Bihar. The other major State taxes are State excise duties on alcoholic beverages (16.5 per cent), stamp duties and registration fees (6.4 per cent), and taxes on vehicles, goods and passengers (9.7 per cent).

Given that revenue from sales taxes predominate in the States' fiscal operations, understanding the nature of disharmony in the levy of sales taxation is important. Specifically, such disharmony in India has taken two forms (i) large variations in nominal tax rates, and (ii) according sales tax incentives for new investments.

Table 3.2

Share of Individual State Taxes - 1990-91

Taxes	As Percentage of SDP	As Percentage of Total Own Tax Revenue
Sales tax	4.11	56.1
Taxes on Vehicles, goods and passengers	0.71	9.7
State excise duty	1.21	16.5
Stamp duty and registration fees	0.47	6.4
Other taxes	0.83	11.3

Source: As in Table 3.1.

ii. Nature and Consequences of Sales Tax Competition and Tax Exportation: A major consequence of sales tax competition is the minute differentiation in the nominal rates. While initially the rate differentiation had been for reasons of administrative convenience, equity and economic efficiency (lower tax rates on inputs and capital goods), in recent years, tax competition among the States has contributed to this outcome in no small measure. Attempts to reduce the tax rates on commodities with high price elasticity of demand to enhance tax yield by encouraging cross-border purchases (tax competition) and to increase rates on price inelastic commodities which are predominantly exported out of the States (a ploy to export the tax burdens) often has resulted in irrational structure of tax rates. Thus, there are quite a few instances where motor cars and consumer electronics are taxed at the same or lower rates than foodgrains and edible oils neutralising the very objective of equity for which rate differentiation was introduced in the first place.[7]

The nature of irrationality in the sales tax structure arising from the levy of multiple tax rates which vary widely among the States is, to some extent, brought out in Table 3.3. Foodgrains, for example, are exempt in approximately half the number of States and taxed at 4 per cent in others; edible oil is taxed at 1.5 per cent in Maharashtra and at 9 per cent in Bihar. Bicycles are taxed at 2 per cent in Andhra Pradesh, but at 8 per cent in Haryana and Madhya Pradesh. There are other types of anomalies as well. Punjab levies a tax at 3.5 per cent on motor cars, but 4 per cent on foodgrains, a commodity the bulk of which is exported out of the State. Similarly, in Tamil Nadu, the tax rate on electronic items at 3 per cent is lower than that on foodgrains. Thus, we not only have wide inter-State differences in sales tax rates but even within the States, the tax rates levied do not appear to be rational. Needless to add, this has led to tax-induced relative price distortions.

Apart from differences in nominal rates, there are other reasons why effective tax rates vary across the States. First, the tax systems across the States themselves are not uniform - while most of the States have tended to move towards the levy of tax at the point of manufacture or import into the State for administrative reasons and to reduce the point of

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7 In Punjab, for example, the tax rate on motor cars is 3.5 per cent whereas foodgrains are taxed at 4 per cent and edible oils at 8 per cent. Of course, the equity objective in the design of tax rates itself has been taken account of on the basis of the judgements about income elasticity of demand for various commodities without considering the general equilibrium effects of such a tax design.

contact between the taxpayer and the tax collector, some States continue to levy the tax at the last stage of sale and some States continue to levy a multi-point tax on some commodities (Table 3.3). In addition, most States levy additional sales tax or a surcharge on sales tax over and above the general sales tax on sales tax dealers above a specified turnover limit. Further, the standards of tax administration and enforcement vary widely across States resulting in wide differences in the effective tax rates. A more important source of variation in effective rates of tax is the inter-State competition in providing sales tax concessions to attract new investments. This "beggar thy neighbour" policy, besides causing significant loss of revenue to the States' exchequor, has distorted the relative prices across both commodities and regions[8]. All these factors have tended to cause minute differentiation in effective tax rates on commodities within and between different States.

Equally worrisome are the consequences of attempts by the States to pass the tax burden to non-residents. As already mentioned, in India the States levy sales taxes predominantly on the basis of origin, at the stage of manufacture or import. Further, for revenue reasons, given their constraint on tax handles and narrow tax bases, the States have tended to tax raw materials, intermediate inputs as well as capital goods (see Table 3.3). What is more, as stated earlier, the States can levy the tax on inter-State sale subject to the ceiling on the tax rate (4 per cent)[9]. A high level of effective protection, industrial licencing, exchange control, import restrictions and such other policies followed as a corollary of the plan strategy, have eliminated both domestic and foreign competition resulting in 'mark-up' pricing situation in many of the sectors in the economy. Under this, there is full forward shifting of the tax; the cascaded taxes on inputs and capital goods add on to the inter-State sales tax and the effective tax rate on inter-State exports would be much higher than the four per cent nominally levied. The effective tax rate will depend upon the extent of input tax included in the traded commodity. It is generally seen that the exports of more developed States are larger than their imports and the proportion of final goods in their exports too is

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8 For an analysis of the cost and efficacy of sales tax incentives, see Tulasidhar and Rao (1986).

9 The ceiling rate is applicable only when the transaction takes place between the registered dealers. If the sale is from a registered dealer in the exporting State to a non-registered dealer in the importing State the ceiling rate applicable is 10 per cent.

Table 3.3

Sales Tax Rates on Selected Commodities as in March, 1991 (14 Major States)

Commodities	Andhra Pradesh	Bihar	Guja-rat	Haryana	Karnataka	Kerala	Madhya Pradesh	Maha-rashtra	Orissa	Pun-jab	Rajas-than	Tamil Nadu	Uttar Pra-desh	West Bengal	Mea n	C V
1. Cereals	4	4	E	4	2	4	2	E	4	4	4	E	4	1	2.6	6
2. Pulses	4	4	E	4	2	4	3	e	4	4	4	4	4	1	3.0	5
3. Hydrogenerated vegetable oil	6	9	10	8	5(c)	6(c)	12	8	4	8	8	5	8	8	7.5	2
4. Other edible oils	4	2	4	6	4/3(c)	6(c)	3	4	2	8	6	E	5	8	4.4	5
5. Kerosene	4	6	3	3	4	4	3	4	E	8	10	4	8	5	4.7	5
6. Cooking gas	10	9	14	14	15(c)	15(c)	16	4	5	8	10	8	8	15	10.8	3
7. Costmetics	10	12	12	10	15	15	16	15	16	8	12	12	12	15	12.9	1
8. Medicines	5	7	8	8	10	10	3	4/12	4	4	6	6	6	4	6.1	3
9. Stainless steel utensils	6(a)	8	6	3	7(a)	10	8	12	12	10	15	5	12	8/11	8.8	3
10. Wooden furnitures	5	12	12	8	8(c)	10(c)	14	8	16	10	12	8	12	8	10.2	2
11. Steel furnitures	10	13	12	10	15(c)	10(c)	14	15	16	10	15	8	12	15	12.5	1
12. Refrigerator/air-conditioners	10	16	12	10	15	15	16	15	12/16	10	12	15	12	11/15	13.1	1
13. Domestic electrical appliances	10	12	15	10	12+3(b)	10	12	15	12	10	12	12/8	12	8/11/15	12.0	1
14. Motor cars	4	9	12	8/10	6	4	10	15	8	4	6	5	10	6	8.1	3
15. All kinds of machinery	6	9	6	8	13	8	12	10	16	10	10	10	5	8	9.4	3
16. Fertilisers	3	6	4	E	3	2	3	E	2	E	6	3/5	5	4	3.0	6

17. Cement	9	11	12	12	15(c)	10	12	10	12	7	16	12	10	8	11.1	2
18. Motor spirit	18	9	20	8	20	20	16	12	12	E	18	18	E	10	12.9	5
19. High speed diesel	12	14	18	E	20	20	18	10	16	E	16	16	E	12	12.3	5
20. General rate	6(a)	8(c)	8+4(b)	8	7(a)	5(a)	8	10	12	7	10	8	8(c)	8(a)	7.9	2

Note: (a) Multi-point levy, (b) Double point levy (c) Single stage last-point (d) E - Exempted
All other commodities are subject to first point single stage levy.

Source: Sales Tax System in India: A Profile, NIPFP, 1991.

higher. Thus, the residents of poorer States end up paying taxes on larger volume of imports and at higher effective tax rates.

e. Inter-State Tax Exportation: A Speculative Estimate

The extent of inequitable resource transfers from the poorer to the richer States due to the prevailing tax system comes out clearly when we compare the actual share of each State in sales tax collections with the share that would accrue when the tax is levied according to the destination principle.

To arrive at an estimate of tax collections under the destination-type consumption tax, we have quantified the tax base consisting of the total value of consumption in the i^{th} State which includes household consumption (H_i) and State government's consumption of goods (G_i).[10]

$$H_i + G_i = C_i, \qquad i = 1 \ldots\ldots n \qquad (1)$$

If the effective tax rate is identical across the States (t_i = t for all i), then tax shares of the States will be equivalent to the consumption shares.

$$\frac{t_i C_i}{t_i \sum_{i=1}^{n} C_i} = \frac{t C_i}{t \sum_{i=1}^{n} C_i} = \frac{C_i}{\Sigma C_i}, \text{ if } t_i = t \text{ for all } i. \qquad \ldots\ldots(2)$$

However, even when tax rates are identical, when a non-destination type of tax is levied, the actual tax shares will be different from the consumption shares to the extent the tax is levied on the net exports to other States. If T_i denotes actual tax collection in the i^{th} State, then,

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10 This still leaves out Central government consumption of goods in various States. As the bulk of this accrues in Delhi, the non-inclusion of this would not significantly affect the relative shares. In any case, the information on the State-wise purchase of goods by the Central government is not available.

$$\frac{T_i}{\sum_{i=1}^{n} T_i} = \frac{t_i(C_i + e_i)}{\sum_{i=1}^{n} T_i} \qquad \text{..........(3)}$$

where e_i is the net exports to other States. Equation (3) can be alternatively written as

$$\frac{T_i}{\Sigma T_i} - t_i \frac{e_i}{\Sigma T_i} = \frac{C_i}{\Sigma C_i} \qquad \text{........(4)}$$

Thus,

$$\frac{T_i}{\Sigma T_i} \; >/< \; \frac{C_i}{\Sigma C_i} \; \textit{depending upon whether} \; \frac{t_i e_i}{\Sigma T_i} \; >/< \; 0$$

Thus, the sales tax shares of individual States will not be equivalent to their consumption shares if all the States do not levy the tax at identical effective tax rates (ETR) and/or the tax is not levied according to destination principle and hence, there can be net tax exports to out of State residents.

The estimates shown in table 3.4 clearly bring out the difference in the sales tax shares of the States from their consumption shares. Assuming no difference in ETR applicable to home consumption, the sales tax collections of high income States under the destination based taxation would be lower by 17.7 per cent of total sales tax collections and the low income States would gain as much. On an average, the destination based tax would have reduced the tax revenue of the high income States by 26.6 per cent and the collection of low income States would have been higher by 42.2 per cent. Of the seven above average income States, all except West Bengal were net tax exporters and among less than average income States, except Andhra Pradesh and Kerala, all were net tax importers. The extent of exportation as a percentage of their actual tax collections was high in Gujarat and Maharashtra (about 41 and 43 per cent respectively); in contrast, the residents of Bihar paid the highest percentage of their tax collection to other States (92 per cent).

Table 3.4

Consumption Shares, Tax Shares and Effective Tax Rates (1987-88)

States	House-hold con-sump-tion	State govern-ment pur-chase ofgoods	Total con-sump-tion	Percen-tage of total con-sump-tion	Sales tax collec-tions (Rs billion)	Percen-tage of total sales tax collec-tions	Diffe-rence bet-ween sales tax con-sump-tion shares	Effec-tive tax rates (per cent)	Tax expor-ted (Rs billion)	Tax expor-ted/sales tax collectio ns (per cent)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1. High Income States										
Gujarat	85.55	2.37	88.92	5.56	10.20	9.39	3.83	11.47	4.16	40.78
Haryana	41.38	1.21	42.59	2.66	3.15	3.32	0.66	7.39	0.72	22.86
Karnataka	87.14	0.99	88.14	5.51	7.76	7.15	1.64	8.81	1.78	22.94
Maharashtra	179.09	3.49	182.57	11.42	20.47	18.35	7.43	11.21	8.07	42.81
Punjab	57.25	1.65	58.90	3.68	4.31	4.53	0.85	7.31	0.92	20.31
Tamil Nadu	118.83	3.49	122.32	7.65	12.42	11.44	3.79	10.16	4.12	33.17
West Bengal	133.40	3.65	137.05	8.57	8.32	7.66	-0.91	6.07	-0.99	-11.90
Sub-Total 1	488.57	12.27	720.49	45.05	66.63	61.36	16.31	9.25	17.71	26.58
2. Low Income States										
Andhra Pradesh	131.92	3.54	135.46	8.47	9.71	8.94	0.47	7.16	0.51	5.25
Bihar	138.10	3.35	141.46	8.85	5.00	4.60	-4.25	3.54	-4.62	-92.40
Kerala	74.04	1.60	75.64	4.73	6.00	6.31	1.58	7.93	1.72	28.67
Madhya Pradesh	119.75	2.77	122.52	7.66	5.15	4.74	-2.92	4.20	-3.17	-61.55
Orissa	50.55	0.98	51.53	3.22	2.06	1.90	-1.32	4.00	-1.43	-69.41
Rajasthan	92.53	2.54	95.07	5.94	4.50	4.14	-1.80	4.74	-1.95	-43.33
Uttar Pradesh	251.44	5.69	257.12	16.08	9.54	8.79	-7.29	3.71	-7.92	-83.02
Sub-Total 2	858.33	20.47	878.80	54.95	41.96	38.64	-16.31	4.77	-17.71	-42.21
All Major States	1346.90	32.74	1599.29	100.00	108.59	100.00	0.00	6.79	0.00	0.00

Note:
1. Column 3 = Column 1 + column 2
2. Column 4 = Percentage of individual States in column 3 to their total
3. Column 6 = Percentage of individual States in column 5 to their total
4. Column 7 = Column 6 - column 4
5. Column 8 = (Column 5/column 3) x 100
6. Column 9 = (Total (all States) sales tax collections x column 7)/100
7. Column10 = (Column 9/column 5) x 100

Source:
1. Budget documents of the State governments.
2. National Sample Survey on Consumer Expenditures, 42nd round.

As already mentioned, one possible reason for the States' actual tax shares varying from consumption shares is the difference in the ETR. If the ETR in poorer States are systematically lower than those in the richer States, it is possible that tax shares of the poorer States would be lower than their consumption shares. However, the actual tax shares as shown in column 6 of Table 3.4 are possible without involving any inter-State tax exportation only if the effective tax rates vary from 3.5 per cent in Bihar to 11.5 per cent in Gujarat as shown in column 8. In other words, even if the assumption of uniform effective tax rate is relaxed, the evidence would indicate tax exportation from the richer to the poorer

States so long as, on an average the percentage reduction in the effective tax rate is less than the percentage reduction in per capita incomes.[11] While it is important to note that these estimates must be taken with a note of caution, they clearly bring out the extent of inequitable inter-State resource flows from the relatively more developed to less developed States.

f. Distortionery Effects of Other State Taxes

The effects of inter-State differences in other State taxes too have been distortionery. For example, the imposition of prohibition on the sale of liquor and levying very high taxes on it, besides encouraging cross-border purchases, has led to illicit brewing, and the consumption of illicit liquor, often containing fatal substitutes of potable alcohol, has frequently had adverse impact on health, including causing a number of deaths. The States imposing prohibition have had to make up the revenues through other tax sources, leading to disharmony in other taxes. Levying very high rates of taxes on motor vehicles and goods and passengers, besides inducing evasion, has placed impediments to the free movement of goods causing the transporters to go on strike from time to time to pressurise the governments to lower these taxes. Even in the case of taxes on transfer of property, higher rates of stamp duty and registration fees have led to large scale evasion of the tax through undervaluation of property. Besides actively contributing to the underground (informal) economy, this has, in fact, contributed to distortions in the real estate markets. All these issues deserve more detailed analysis, but that is beyond the scope of this chapter.

g. Fiscal Disharmony: Trends and Comparison with other Federations

In this section, we make an attempt to measure the degree of disharmony in the States' tax systems in India, analyse its trend over time and compare it with the tax disharmony seen in three other federations for which similar estimates are available namely Australia, Canada and the U.S.A.

i. Methodology of Estimating Inter-State Tax Disharmony: At the outset, it must be mentioned that the measurement of sub-national tax disharmony is beset with inherent

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11 This is given by the elasticity of effective tax (t) rates with respect to per capita incomes (y) which is estimated by the regression equation, $\log t = -5.9124 + 0.973 \log y$. The elasticity of 0.97, while close to unity, is actually an overestimate as we are really trying to estimate the elasticity of ETR with respect to home consumption, while the t here is based on tax collection inclusive of tax exportation and on home consumption alone. Thus, the figures for t are themselves overestimates.,

problems and any summary measure is likely to be too simplistic to adequately take account of the inter-State variations in the tax bases and tax rates. This is particularly true when the States' tax systems are as complicated as is seen in India. Also, it may not be possible to infer the allocative and distributive consequences of such variations through any summary measure. Yet, like all summary measures, the measure of tax harmony can broadly indicate its extent, its trend over time and can help to make inter-country comparisons.

The standard methods employed to measure tax disharmony is to estimate coefficient of variations (CV) in (i) nominal tax rates (ii) effective tax rates with respect to the tax base, and (iii) effective tax rates with respect to GDP (tax-GDP ratio in the States). Given the complexities in the structure of taxes, it is virtually impossible to estimate (i) and (ii) for all the State taxes in India. In particular, variation in the coverage, multiplicity of tax rates and difficulties in identifying the exact tax base itself renders the estimation of the coefficient of variation in nominal tax rates and effective tax rates with respect to the tax base difficult. However, to demonstrate the complexities in the sales taxes, we have estimated coefficients of variation in the nominal tax rates in respect of 20 groups of commodities, ignoring some details such as differences in the point of tax levy, the levy of additional surcharges or turnover taxes. However, we have mainly relied on the coefficients of variation (cv) in the percentage of tax revenues to Net State Domestic Product (SDP) in respect of other major State taxes to draw inferences on the trends in inter-State disharmony in individual as well as aggregate State taxes in India.[12]

For the purpose of estimating inter-State tax disharmony, the important State taxes analysed are (i) the sales tax, (ii) the State excise duty, (iii) tax on motor vehicles, passengers and goods, and (iv) stamp duty and registration fees. These four taxes together contributed about 89 per cent of States' tax revenue in 1990-91 in India. We have estimated the CV in tax-SDP ratios for the four individual taxes as well as the total tax revenue. We have carried out the analysis for the 14 major States as well as all the States excluding those

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[12] This, however, creates some difficulty for making inter-country comparisons as the CV computed for them are of tax-GDP ratios. However, the difference in the denominator (the net factor income from outside the State) is not likely to make much of a difference to render the comparison meaningless, though this fact must be kept in the background.

for which data are not available.[13] The results for the 14 major States which broadly form a homogenous group show a clear trend and are discussed here in some detail. The all-State analysis does not provide any additional insights except showing a higher degree of disharmony in respect of each of the major taxes.

The results of our analysis presented in Table 3.5 bring out the following features:

(1) A very high degree of inter-State tax disharmony can be inferred from the large CV in effective tax rates in respect of each of the individual taxes as well as the total tax revenues of the States even when only the 14 major States are considered. The CV in effective tax rates among the States vary from 34 per cent in the case of sales tax to 56 per cent in the case of State excise duty in 1990-91. The CV in the effective tax rates for aggregate State taxes in 1990-91 was 27 per cent.

(2) A comparison of the CV in States' effective total tax rates in India with those in Australia, Canada and the USA estimated by Vaillancourt (1992a) shows that in 1986-87, the extent of tax disharmony in India at 26 per cent was the highest. The comparable numbers for Australia at 8 per cent was the lowest. In Canada and U.S.A., they were 18 per cent and 14 per cent respectively.

(3) Our analysis brings out the steadily increasing trend in the degree of inter-State tax disharmony for total taxes in India over the years, 1975-76 to 1990-91. The CVs show continuous increase over the years (Table 3.5). As may be seen from the table, the CV in aggregate State tax-SDP ratios increased from 19 per cent in 1976-77 to 27 per cent in 1986-87 in India. The major source of this increase in the CV was the effective rate of sales taxes. This divergent trend in tax disharmony contrasts sharply with the trends seen in other selected federations. In the three other federations for which estimates are available (Vaillancourt,

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13 Of the 25 States, three (Arunachal Pradesh, Goa and Mizoram) were formed only in 1987 and for Meghalaya and Sikkim, data on SDP are not available for the time period prior to 1985-86. Thus the analysis is confined to 20 States.

1992a), the CVs actually converged by varying degrees, the highest being in Australia showing a decline from 16 per cent in 1976-77 to 8 per cent in 1986-87.

Table 3.5

Coefficient of Variation in Tax-SDP Percentages - Major States (14)

(Per cent)

Year	Sales tax	Stamps and Registration	State excise duties	Taxes on vehicles, goods and passengers	States' total tax revenue
1975-76	25.3	39.2	66.9	34.6	19.7
1976-77	21.8	36.8	68.3	31.7	18.7
1977-78	24.3	38.1	68.5	33.9	21.4
1978-79	25.0	40.5	74.2	37.7	22.3
1979-80	20.5	37.6	78.9	33.9	19.6
1980-81	28.4	41.6	76.0	38.0	23.5
1981-82	26.0	43.4	62.5	39.5	22.3
1982-83	29.3	40.0	62.1	33.1	25.1
1983-84	28.3	39.6	65.4	36.8	26.2
1984-85	28.4	38.4	64.9	34.7	26.2
1985-86	30.5	37.2	67.7	35.0	26.8
1986-87	29.1	38.0	66.7	36.2	25.7
1987-88	30.0	36.6	64.0	38.8	23.5
1988-89	31.7	40.3	65.1	33.4	25.2
1989-90	29.6	39.4	60.7	34.6	25.2
1990-91	34.4	38.4	56.4	36.8	26.9

(4) Interestingly, the CV in the effective tax rates of aggregate State taxes are appreciably lower than those of individual State taxes. It thus appears that a significant proportion of tax disharmony among individual State taxes is not due to the variation in their preferences for public services, but merely indicates differences in the preferences

of the States in the pattern in raising revenues. This finding is also in conformity with the findings for other federations.

(5) The major source of increasing degree of tax disharmony over the years in India is seen in the sales tax and to some extent, taxes on motor vehicles and goods and passengers (Table 3.5). The CV in the effective tax rates in respect of the sales tax increased from 25 per cent in 1975-76 to 34 per cent in 1990-91 and in the case of taxes on motor transport, the increase was from 35 per cent to 37 per cent. The CV in effective tax rates of stamp duty remained more or less at the same level while that of State excise duty declined from 67 per cent to 56 per cent during the period.

Table 3.6

Variations in Sub-National Effective Total Tax Rates in Selected Federations

Countries	1976-77	1986-87
Australia	16	8
Canada	20	18
India	19	26
U.S.A.	16	14

(6) We had, in the previous section, highlighted problems arising from inter-State tax competition and tax exportation in the levy of sales tax by the States. However, a comparison of variations in effective tax rates in the 14 major States with Canada and U.S.A. would give an impression that the degree of sales tax disharmony in India is actually lower. The CV in sales tax rates for the 14 major States at 29 per cent is much lower than about 50 per cent observed both in Canada and the U.S.A. Such a conclusion, however, would be unwarranted for two important reasons. First, the sales taxes levied by the States and provinces in the U.S.A. and Canada are at the retail stage whereas in India it is predominantly a tax at the first point of sale (producer or importer). Second the inter-State sales taxation in India brings in strong elements of origin based tax as against the destination type tax levied

in the two other federations. Further, our analysis of the nominal tax rates in the 14 major States in respect of 20 groups of commodities which constitute over 80 per cent of consumption shows a very high degree of inter-State variation (Table 3.3). The unweighted CV in the nominal tax rates of these 20 groups of commodities show a high degree of both inter-commodity variations in the tax rates within each of the States as well as inter-State variation in the tax rates for each of the commodity groups. The inter-commodity variation in the tax rates ranged from about 40 per cent in Bihar and Rajasthan to over 60 per cent in Maharashtra and Tamil Nadu. As regards inter-State variation, over 50 per cent CV in the nominal tax rates is seen in seven out of the 20 commodity groups.

It is not our claim that the inter-State tax disharmony arising from interjurisdictional tax competition is necessarily efficiency reducing. In many countries, tax competition has led to convergence in the tax rates and has reduced tax disharmony. But in India, tax competition by the States to attract capital and trade into their jurisdictions and their attempts to export the tax burden to the non-residents has tended to create a divergence in the effective tax rates and thus, has enhanced the degree of tax disharmony. Given the acute inter-State differences in the levels of development and the abilities of the States to export the tax burden to non-residents, it would be hard to escape the conclusion that inter-State tax competition in India has, in fact, led to resource distortions. Therefore, minimising inter-State tax disharmony should receive immediate attention of the policy makers and this would have to be achieved without unduly infringing on the States' autonomy. To minimise resource distortions and inequity, simplification of States' indirect tax structures and levying taxes according to destination principle should, therefore, receive immediate priority.

h. Sub-national Tax System and Impediments to Internal Trade

A major advantage of a federal system as opposed to the balkanised economy is the availability of a larger common market. This enhances efficiency in the economy by enabling the producers to reach the optimal scale of production and thus be cost-efficient. This, however, requires a federation to be a complete customs union where there are no impediments to free trade and movement of factors of production and goods and services. When a minimum level of social and economic infrastructure is provided across the federation, free mobility of capital and labour tends to equalise marginal productivities across different regions, thus realising the maximum possible output in the economy. The inter-jurisdictional competition among different States in providing varying public expenditure-tax mix to attract capital could provide a conducive environment for innovations. Thus, fiscal federalism helps in not only ensuring efficient utilisation of resources (operating on the production possibilities frontier) but also in technological progress (shift in the frontiers) to result in higher economic growth than in a balkanised economy. But these gains are predicated upon unhindered movement of factors and products, irrespective of regional or local interests.

Of course, there may be some valid attempts to regulate the free movement of commodities across the States or local bodies. In a scarcity hit economy, regulatory impediments are placed to prevent speculation and profiteering and to ensure fair distribution of the commodity across regions and persons at a reasonable price (rationing). Though this has adverse effects on resource allocation in the long-run, it may be justified in the medium and short-run as a measure to manage the fair distribution of the scarce commodity. The restrictions on the movement of foodgrains until the country attained surplus in foodgrain production is a case in point. However, when a jurisdiction erects fiscal or non-fiscal barriers to provide local protectionism, the effects on resource allocation could be very adverse from the viewpoint of economic efficiency.

The local protectionism can arise either as a measure to protect local trade and industry or merely to export the burden of providing public services to the non-residents. This could take the form of placing restrictions either on the exports out of a State or imports into a State. The restrictions may be placed on either the inputs or the outputs and this could take the form of fiscal impediment or physical restrictions. The restriction can be placed on inter-State movements or even on intra-State movements.

There are several regulatory impediments imposed by different State governments. Mos of these are informal and non-transparent. Most State governments have the knowledge of local language as a precondition for State government employment. Preference given to the products of the enterprises of the State government in its purchase policy even when there is a price disadvantage is not very uncommon. Some State governments even stipulate that the non-residents cannot conduct trade and commerce in the State unless they have a local partner with them. Some States restrict the sale of raw materials on inter-State sale to ensure that the value addition takes place inside the State. The restrictions on the inter-State sale of oilseeds in Gujarat, raw cashew nuts in Kerala and monopoly procurement of cotton in Maharashtra fall into this category. Even the regulation against the closure of financially unviable firms acts as an impediment. Also, some States insist on the employment of local personnel as an eligibility condition for getting concessions and incentives. The industrial policy of Karnataka, for example, stipulates that 80 per cent of additional employment opportunities created by the industry should accrue to the local people. Similarly, in Kerala, the State government and its public enterprises give price preferences of 15 per cent on the purchases made from the small scale units and 10 per cent on the purchases made from the medium and large scale industries located in the State.

The non-fiscal impediments mentioned above, are of lesser consequence as compared to the fiscal impediments on inter-State and intra-State trade. The two most important fiscal impediments are the levy of (i) tax on inter-State trade in goods, and (ii) 'octroi' or tax on the entry of goods into a local area for consumption, use or sale. Until recently, the States having large deposits of coal like Bihar, Madhya Pradesh, Orissa and West Bengal used to impose a cess on the royalty at very high rates. However, this had to be abolished after the Supreme Court disallowed this. The exact extent of adverse economic consequences of all these levies, though unknown are significant and hence, deserve discussion in greater detail.

i. Taxation of Inter-State Trade: Major Issues

One of the most obnoxious features of the Indian sales tax system is the taxation of inter-State trade. As mentioned earlier, entry 92A of the Union list empowers the Central government to levy a tax (Central Sales Tax or CST) on inter-State sale of commodities and the Central government has in turn allowed the States to levy the CST subject to a ceiling rate of 4 per cent on their sales outside the State.

Initially, the CST was levied on the recommendation of Taxation Enquiry Committee (1953). The main objectives of the tax was to minimise the evasion of the local sales tax. Levying a tax on inter-State sale at a low rate was expected to prevent the intra-State sales being passed off as inter-State sale. To begin with, the tax was levied at the ceiling rate of only one per cent, but, over the years, the ceiling rate has been raised in stages to four per cent, more as a revenue measure than as a method of containing tax evasion. In the event, the tax created as many tariff zones within the country as there are States and Union Territories in the Indian Union.

Thus, the CST is a major source of local protectionism in India. The non-uniformity in the rates of CST across commodities and States and the levy of tax on both inputs and outputs has resulted in high and unintended pattern of protection in different States. The effect of this on relative prices and resource allocation is difficult even to perceive. In addition to this, the CST has also became an important instrument of perverse resource transfers. In a sellers' market when the commodity taxes are shifted forward, this becomes an important avenue of tax exportation from richer producing States to poor consuming States. The net exports of high-income producing States are higher than the low-income consuming States. Besides, the effective rates of tax on the exported tax base is usually higher than those of the poor States, making tax exportation doubly serious, as discussed earlier.

The above analysis underlines the need to undertake three specific measures to minimise resource distortions and inequity arising from inter- State tax disharmony in the levy of sales taxes in the Indian federation. First, destination based taxes should replace the prevailing origin based taxes by removing the taxes on inter- State trade. Second, there is an imperative need to simplify the structure the taxes by reducing rate differentiation and removing sales tax incentives for industrialiation, and third, the levy of the sales tax itself must be rationalised by broadening the base to cover value added in stages subsequent to manufacturing and inputs and by giving set off on the tax paid on inputs and capital goods. A consumption type value added tax by zero-rating the inter-State transaction appears to be an ideal solution to harmonise inter-State tax disharmony in India, but whether the States would agree to give up their right to levy taxes on inter-State transactions or not is still uncertain. We discuss the issue of sub-national tax harmonisation in the next chapter.

CHAPTER IV

HARMONISATION OF TAX SYSTEMS IN INDIA

a. Introduction

In the previous chapter, we examined the efficiency and equity implications of the vertical and horizontal overlapping in the Indian tax system. Overlapping taxes can rob the tax system of simplicity and transparency, alter relative prices in unintended ways, make tax crediting on exports difficult, cause inter-state tax competition and tax exportation to result in inequitable resource flows. It was also pointed out that tax overlapping can occur due to overlapping assignment of tax powers itself, but more often, the problem arises because of the very nature of economic interactions. Interdependence in tax bases and concurrent pursuit of distributional functions by different levels of governments and by different units within each of the levels assumes enormous significance in all federations attempting to achieve efficient and equitable allocation of resources.

In this chapter, we attempt to analyse alternative approaches to tax coordination and tax harmonisation in the Indian federation. It is notable that at present, indirect taxes constitute about 84 per cent of total tax revenue and domestic trade taxes constitute over 60 per cent. At the State level, the share of indirect taxes is over 90 per cent and the contribution of sales tax alone is more than 55 per cent of the States' tax revenue. Therefore, overlapping in commodity tax system surely is a major problem in the Indian federation. In order to focus the study, we have concentrated on issues of harmonising commodity taxes levied by different governmental units in the Indian federation.

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1 This however does not mean that the disharmony in the levy of direct taxes is unimportant and can be ignored. In particular, mention must be made of the problems arising from the separation of the power to levy taxes on income and wealth on the basis of whether the source of the tax base is agriculture or otherwise. The exclusion of the power to levy taxes on agricultural incomes and wealth from the purview of the Central government is alleged to have opened up enormous avenues of evasion and avoidance of these taxes resulting in the violation of both horizontal and vertical equity. See, Chelliah (1993).

b. Fiscal Disharmony in Indian Federation: A Summary and a Starting Point

Before exploring the possible approaches to inter-governmental tax coordination and harmonisation, it may be useful to recount the important problems with vertical and horizontal tax disharmony in India highlighted in the previous chapter. The major deficiencies in the prevailing commodity tax systems may be briefly stated here.[2]

i. Vertical overlap of commodity tax systems: The levy of union excise duties by the Centre, sales taxes by the States and octroi by local bodies has made the tax system non-transparent and rendered the pursuit of the objectives of tax policy by any level of government difficult. In such a tax system, the incidence of taxes on different commodities remains unknown and repeated taxation of the same commodities by different levels of government creates broader wedges between producer and consumer prices. This is particularly true as the Centre levies the tax at the manufacturing stage and the States levy the sales tax predominantly at the first point of sale - on the excise duty paid value. In respect of commodities which have high price elasticity of demand, the levy of commodity taxes at high rates by higher levels of government leaves very little tax room for lower levels of government. While in the past, the market sheltered from both foreign and domestic competition could sustain such a tax system, it may not be sustainable when the liberalisation process is carried further to allow the import of consumer goods.

ii. Cascading type commodity taxes: Although giving tax credit to inputs in respect of most of the industries and extension of tax credit to capital goods has resulted in the union excise duties acquiring the character of a manufacturing value added tax, sales taxes levied by the States are of cascading type; they are levied not merely on final consumer goods but also on inputs and capital goods. Along with excise duties levied on manufactures, sales tax payable at the first point of sale and the taxes on inputs and capital goods can cause a very high degree of cascading. Consequently, the divergence between producers and consumer prices would be larger than the tax element by varying degrees, and the extent of

[2] A comprehensive review of the weaknesses of the commodity tax systems in India is available in the recently submitted report on the reform of domestic trade taxes in India by the NIPFP (1994) to the Government of India.

divergence and eventually the incidence of the tax remains uncontrolled. This alone can cause large and unintended effects on relative prices and may be an important source of inefficiency in resource allocation. Given that the domestic trade taxes, particularly the sales taxes have an anti-protective effect, it would be difficult even to hazard a guess on the effect of such a tax system on the effective rate of protection on various commodities.

iii. Narrow tax base: A major shortcoming of the commodity tax system in India is its narrow base. The prominence of pre-retail commodity taxes at both the Central and State levels like the taxes on inputs, bring a larger wedge between producer and consumer prices and alter relative prices in an uncontrolled manner. The constitution allows the Centre to levy excise duties on manufacturers. The problems of defining "manufacture" has given rise to several legal disputes. But more importantly, the tax levied at the point of production cascades through stages to cause price increases larger than the tax element. The States are allowed to levy taxes on sale of goods which can extend all the way upto the retail stage, but administrative consideration has prompted all the States to move towards the taxing at the first point of sale (or purchase) where the tax base is the (excise duty paid) sale of the producer or the importer. The value added at subsequent stages simply escapes the tax net. The sales tax base is rendered narrower also because the Constitution empowers the States to levy the sales tax only on goods and not services. This creates anomalies as in the complex processes of production, distribution and exchange use of services is inter-twined with the goods sold and such an arrangement artificially separates the sale of commodities from after-sale service or services in the course of sale.[3]

iv. Multiplicity of tax rates: To begin with, multiplicity of objectives in sales tax policy has led to minute differentiation in the structure of tax rates. In addition, the acute tax competition between different States has caused further rate differentiation and contrary to what is observed in many countries, this has resulted in divergence in the tax rates among different States. Tax competition takes different forms in respect of different commodities. In respect of commodities with fairly high price elasticity of demand, the States can maximise revenue by lowering the tax rates and encouraging cross-border purchases (trade

3 For a detailed analysis of this, see NIPFP (1994).

diversion). In the case of price inelastic commodities, particularly those which are primarily sold outside the State, increasing the tax rate may be the appropriate strategy. In an economy where the spread of production structure and infrastructural facilities are largely the consequence of history, the ability (power) of different States to play this strategic game is not equal and therefore, retaliatory action may not be a relevant consideration. In such a situation, the rate differentiation that would ultimately result will be entirely different from the one made to fulfil a given set of objectives. Further, the strategic interactions among the States would not result in a converging tax system. The strategic action, as mentioned above, is to export the tax burden to the residents outside the States and such free-riding behaviour cannot be expected to enhance efficiency.

iv. Sales tax incentives - its costs and efficacy: The competition among the States manifests itself not only in varying nominal tax rates but also in the variety of fiscal incentives provided. While variation in tax rates in the process of tax competition represents attempts to pass on the burden of financing public services to the non-residents, sales tax incentives are given by the States to attract capital into their respective jurisdictions. Such incentives discriminate between various regions, different industries and even within an industry between different firms depending on the period for which the incentive is accorded. At the same time, some of the sales tax incentives accrue right from the period when production commences and hence, are costly. When all States attempt to attract capital, the tax incentives result only in the loss of revenue without any perceptible increase in the volume of investments in the States.

v. Inter-State sales taxation - its consequences on efficiency and equity: The most serious consequence of sales taxation with respect to efficiency in resource allocation and inter-regional equity arises from the fragmentation of the economy and local protectionism. Local protectionism is a direct result of the levy of taxes on inter-State trade in goods. Although to begin with, the tax was levied as a measure to monitor the inter-State transaction in goods and check evasion by passing off intra-State as inter-State sales, the instrument came to be used increasingly as a revenue measure. As the tax rate was increased in stages to 4 per cent, the fragmentation of the economy into as many tariff zones as there are States in the Indian union was complete. At the same time, the original purpose for which the tax was imposed could not in any case be achieved as the traders resorted to the practice of consigning goods to their branches in different States and selling them from there to avoid the inter-State sales tax. Of course, to the extent that consignment transfers took place, the fragmentation of the economy was avoided and in that sense, it actually acted as a factor unifying the market. For a State, the inter-State sales tax is in the nature of export duty. Though levied at 4 per cent, as exported goods already include local sales taxes paid on the inputs and capital goods; in an oligopolistic market with full forward shifting of taxes the effective tax rate exported is much higher.[4]

Another adverse effect of this tax has been the inequitable transfer of resources from the poorer to richer States. The exports of richer States to poorer States are higher and as larger proportion of the exports of the former are in the nature of finished goods, their effective tax rates are also higher. Interestingly, the input taxes are exported even when the goods are transacted through consignment transfers, and the extent of such tax exportation can be significant as was shown in the previous chapter.

vi. Taxation of intra-State trade and allocative distortions: Fiscal impediments to internal trade has resulted not merely from the levy of inter-State sales tax. Octroi, the tax on the entry of goods into a local area for consumption, use or sale is in the nature of import duty levied by urban local bodies. Besides providing local protectionism and fragmenting the economy, as the tax is check-post based and collected at the discretion of the personnel managing the check-posts, this has been a source of corruption and has been a major impediment to free movement of goods across the country. In some States, notably, Madhya Pradesh and Karnataka, entry tax - an account based levy has replaced the check-post based 'octroi'. But, entry tax like octroi is in the nature of an import duty levied by urban local bodies. It divides the country into several tariff zones. Besides, most of the metropolitan cities are centres of entrepot trade and being distributional centres, they could collect the tax and export the burden to non-residents. The location decision would depend on the amount of octroi paid on inputs coming in and the amount of octroi saved by locating inside the city.

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4 The oligopolistic market condition arises from the high degree of protection offered from foreign competition and prevention of domestic competition due to industrial licensing and similar other policy measures adopted under development planning.

The rate of tax on inputs has been generally lower, and therefore industries in their attempt to minimise octroi or entry tax have tended to locate inside these urban conglomerations adding to urban congestion.

c. What is Fiscal Harmonisation?

Reform of domestic trade taxes in India is a major current policy issue not only because of its overwhelming fiscal importance but also due to its adverse economic effects. Indirect taxes in India as mentioned earlier constitute over 84 per cent of total tax revenue and the share of the States in total indirect taxes is over 50 per cent. At the same time, the levy of two principal domestic trade taxes - Union excise duties levied by the Centre and sales taxes levied by the States have given rise to distortions and inequity. As stated in the NIPFP (1994, p.1) report, ".... the system that is operating at present is antiquated, complex - according to knowledgeable experts the most complex in the world - and injurious to the economy in many ways. It follows no rational pattern, having evolved over the years mostly through changes made *ad hoc* from time to time in response to exigencies and violates all time-honoured canons of taxation - certainly, neutrality and equity". The Centre-State and inter-State concurrency and disharmony in the levy of Union excise duty and State sales taxes not only takes the level of discussion on the subject to the level of acrimony, but also has serious adverse effects on efficiency and inequity. Vertical and horizontal tax harmonisation, therefore, is an important policy issue calling for urgent attention particularly in an economy trying to liberalise and achieve export orientation.

Disharmony in the levy of commodity taxes can be both vertical - between the Centre and the States, or horizontal among the State *inter-se*. Vertical disharmony arises from the effective concurrency in tax jurisdiction and if the goals pursued by the two levels are contradictory, overall achievement of the objectives may be difficult.[5] Besides, taxation by the Central government leaves smaller tax room for the State governments. This contradiction will become sharper as the country opens up the markets for foreign competition. High levels

5 The traditional solution to this problem has been to assume away the redistributive role of the sub-Central governments altogether. In such a case, redistribution is entirely a central goal and redistributive taxes are entirely assigned to it.

of taxation of outputs and inability to relieve the tax on inputs may simply drive the domestic industrial units in the State out of competition. Horizontal disharmony between different States results from the combination of at least a minimum required degree of autonomy that the federating units enjoy and inconsistent preferences with respect to their tax systems.

Before we go into the question of harmonising the tax systems, it is necessary to be clear about the concept of tax harmonisation itself. Although much has been discussed about tax (fiscal) harmonisation, the concept itself has not been clearly defined. Often, harmonisation is understood to mean uniformity in the tax system. Such a non-discriminatory fiscal system is said to contribute to efficiency. Uniform effective tax rates across different States and non-discriminatory expenditures create identical fiscal residuals and do not influence the pattern of resource allocation.

The 'uniformity in tax' view of harmonisation is clear in the way Oates defines it. Tax harmonisation, to him is "...... a cooperative effort to secure a system of taxation that minimises excess burden and yields a desirable pattern of incidence" (Oates, 1972, p. 145). Full harmonisation, according to this view requires complete uniformity, for, minimising excess burden and controlling the pattern of incidence can be achieved only when the tax powers are centralised. Although the definition makes it clear that the *process* of minimising excess burden is through *cooperative effort,* centralising view of taxation is implicit in it.

In other words, according to the 'uniformity' view, a 'harmonious' tax system which minimises resource distortions should generate a uniform pattern of net fiscal residuals. This can be achieved only when the States' tax powers are limited to residence (destination) based taxes and intergovernmental transfers are designed to offset inefficiencies and inequities arising from the imperfections in the initial assignment of taxes to different levels of government (Thirsk, 1983 p. 236).

But uniformity in tax system goes against the very tenet of federalism, where people of different jurisdictions can have their preferred bundles of public services and tax rates. As Musgrave (1959, pp. 179-80) puts it, "The very purpose of federalism .... is to permit different groups living in various states to express different preference for public services; and this, inevitably leads to differences in the levels of taxation and public services. The resulting differentiation in tax levels may interfere with the most efficient allocation of resources and location of industries for the region as a whole, but such is the cost of political subdivision, be it on an intranational or international level." Further, the Tiebout mechanism of voting-by-feet postulated to approximate a private good type solution to the problem of optimal supply of public goods is ruled out with uniformity in the tax system.

Thus, harmonisation in the sense of having perfect uniformity in taxation across States can be beneficial only in a homogenous society and only if it is perceived that States do not have any role in the distribution policy. But, in such societies there is hardly any need for decentralised provision of public services. In such an economy the federating units are merely the agencies of the Central government. In a fiscal federalism with diversities in demand for public services, uniformity in the rates and forms of taxation across States cannot be considered tax harmonisation, for, it does not take into account the objectives of individual States (Oates, 1972, p. 145-146).

The approach to tax harmonisation in a fiscal federalism must recognise regional diversity and local autonomy. The essence of federalism is to allow the States to vary the levels of public services. Local autonomy in varying public services cannot be achieved unless there is a linkage between revenue raising and expenditure decisions at the State level. Only under such a set up we can have experimentation and innovation in the provision of State level public services and greater choice available to individuals. This would necessarily call for divergence in the tax structure. Here, the efficiency losses from tax disharmony has to be set off against welfare gains from decentralisation.

Does this mean that under a truly federal framework, it is not possible to enhance efficiency of the tax system? Surely, the tax exportation problem to a large extent can be resolved in the way tax assignments are made. It should be possible to 'negotiate' a system where the State's existing origin based commodity taxes are transformed into destination type taxes. Agreement to abolish the tax on inter-State sale of goods and relieving the taxes on inputs and capital goods will go a long way in reducing inter-State tax exportation. Harmonisation in the tax system can be greatly facilitated if the States agree to make the tax system broadbased, simple and transparent with minimum rate differentiation. Alternatively, the Centre has to offset the imbalances created by tax exportation arising from the States' access to source-based taxes through suitably designed federal transfers so that unintended differences in fiscal residuals are ironed out.

d. Tax Harmonisation: Some General Principles

Thus, the design of a harmonised tax system in the federal form of government should reflect both the principles of a sound tax system and that of fiscal autonomy of sub-national governments. Often, conflicts between fiscal autonomy of sub-national units and principles of a growth-oriented and growth-responsive tax system in a unitary form of government may be unavoidable. In such cases, the trade-off is between welfare gains from fiscal decentralisation and welfare loss on account of departure from an ideal tax system in a unitary set up.

Tax reform experiences of several countries have brought out important lessons which can aid the design of a growth oriented and growth-responsive tax system. The experiences have underlined the desirability of broadening the base, levying lower and less differentiated tax rates, simplifying the tax system, thus making it transparent, and avoiding cascading type of taxes. Broader tax base obviates the need to have high tax rates; it also imparts neutrality and reduces the incentive effects.

Avoiding multiple objectives to be fulfilled by tax policy and confining it mainly to raising revenues at the least cost to the economy reduces the need for rate differentiation and makes the tax system simple. Such a tax system is easy to administer and minimises misclassification. This reduces avoidance and evasion on the one hand and litigation on the other. Relieving the taxes on inputs and capital goods helps the governments to control the incidence of tax on various commodities, minimises cascading and also resource distortions arising therefrom.

The consumption taxes are considered 'neutral' when tax rates are uniform across commodities. Of course, conceptually, optimal tax structure requires making minute rate differentiation on the basis of compensated price elasticities of demand for different commodities but prohibitive administrative and informational costs prevent designing of such a tax system (Musgrave, 1987). Often minute rate differentiation is made to impart progressivity to the tax system, but the lessons of tax reform have demonstrated that this can give rise to tremendous problems of misclassification and litigation. The true pattern of incidence of an indirect tax system is also difficult to estimate and simplistic notions of the distribution of tax burden can easily be misleading. Hence it is prudent to use the indirect tax system essentially to raise revenue, and distributional objectives should be pursued mainly through public expenditure policy and perhaps direct taxes.

Besides, excessive rate differentiation even when made for redistributional reasons, can be misused by special interest groups to seek and obtain concessions for themselves. In particular, business lobbies are quick to exploit these opportunities. Nevertheless, expenditures financed by regressive taxes are less effective as a redistributive tool and therefore, it is suggested that the regressivity can be substantially reduced by exempting unprocessed food items from taxation. This, however, does not mean that tax rates across different States should be uniform. In a fiscal federation, the States should have the autonomy to vary standards of public services as desired by their residents and to finance them, they should have the autonomy to vary the tax rates as well. Similarly, they can also assume some redistributive role and use their taxes to achieve them. At the same time, pursuit of serious redistributive policies by the States through tax policy could result in complicating their tax structures. In such a situation, mutual negotiation and agreement between the Centre and the States and among the States *inter-se* to avoid minute rate differentiation across commodities could significantly contribute to harmonising commodity taxes in a federation. In fact, the emphasis in the Indian context needs to be placed not on the *extent* of tax harmonisation, however defined, but on the *process* and *institutions* to facilitate it; the optimal degree of harmonisation would then emerge out of such a process of consultation and will not be an imposition.

An important finding our analysis is that avoidance of concurrency in the tax powers vertically between different levels of government in a legal sense does not necessarily avoid *de facto* concurrency and overlap. Nor does concurrency in a legal sense necessarily result in the evolution of an inefficient tax system. In the vertically overlapping commodity tax system, two factors are critical to avoid inefficiency. First, commodity taxes levied at the manufacturing point, be it by the Centre or States, is inefficient. The farther the point of levy from the consumption point, *ceteris paribus*, the greater is the divergence between producers' and consumers' prices. Second, vertical coordination in the tax bases has to be achieved not by segregating the point of levy as is done in the Indian context, but by negotiated agreements to harmonise the tax base to leaving adequate tax room to the subnational governments. Such a negotiated settlement should be to the satisfaction of all the parties.

While the States should have the autonomy to determine the standards of public services and tax rates to finance them, it is necessary to ensure that the tax system should not be used by any State to gain at the expense of another. This implies that, generally, in the assignment of tax powers the States should be given the powers to levy mainly the residence based taxes. To the extent source based taxes are assigned to them, through the consultation and discussion process, it is necessary to negotiate a system where the existing source-based commodity taxes are transformed into residence based taxes. Equally critical is the role of Central government in monitoring the working of intergovernmental relationships. It should ensure "competitive equality" of the jurisdictions through regional policies and intergovernmental transfers so that all the States are placed on a level playing field in competing with other another.

e. Vertical Fiscal Harmonisation

The Constitutional assignment of tax powers between the Centre and the States in India essentially follows the principle of separation. But, as mentioned earlier, separation of tax bases can be done only in *de jure* sense. Interdependence of the tax bases makes it impossible to separate the tax sources in a *de facto* sense. Nor is there any economic rationale in support of separability. In fact, experiences in several countries suggest that concurrent taxation by two or more levels of governments has worked reasonably well, particularly when the tax is levied in a coordinated manner. In fact, coordinated concurrent taxation gives sub-national governments greater access to broader tax bases and this enables better linkage of revenues and expenditures at sub-national levels which ensures greater efficiency and accountability. It also ensures a certain amount of consistency in the tax policies of different levels of government. Surely, the emphasis should be on coordinated use of commodity taxes by both Centre and States.

The Indian tax system scores poorly not only because separation of tax sources has denied broad based tax handles to sub-national governments but also, it has not helped to develop the internal trade taxes on desirable lines. According to the Constitutional assignment, the Central government can levy taxes only at the manufacturing stage and the States can levy sales taxes. Of course, the extension of tax credit to inputs and capital goods in the case of excise duty has converted it into a virtual value added tax at the manufacturing stage with respect to the commodities covered. Yet, the tax at the production stage, as was pointed out earlier, can itself be a source of distortion, for, it creates divergence between producers and consumer prices. Besides, the exclusion of value added at subsequent stages makes the base of the tax narrower, and requires higher tax rates for the same amount of revenue.[6]

In view of the above, it is doubtful whether the attempted tax harmonisation of commodity taxes by the States surrendering the right to levy sales taxes on sugar, textiles and tobacco products and Centre levying additional excise duties in lieu thereof was desirable at all. This is clearly a case of sacrificing economic principles in favour of administrative ease. Of course, as the Centre did not revise the additional excise duties as frequently as the basic duties and as the States perceived that had they not surrendered the right to levy sales tax they would have been better off, the plan to extend the arrangement recommended by the Tripathy Committee (India, 1983) had to be given up.

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6 From this point of view, the recommendation of the Tax Reforms Committee to extend the Union excise duty to the wholesale stage and distribute the proceed to the States is an important suggestion. See India (1992).

From the point of view of economic effects, it seems preferable to allow concurrent powers to levy consumption taxes. But the tax levied by the Central and State governments should be coordinated through a negotiated settlement to minimise conflicts and administrative costs. One possible solution is to allow both Central and States levels to levy the tax upto the retail stage, preferably by levying value added taxes. The chosen tax base should include the consumption of not only goods but also services. Again, relief should be given to the taxation of inputs and capital goods. The States can simply piggyback their levies, i.e., add on their own rates to the Central rate on the tax base determined by the Centre. While such a measure harmonises the tax base, it still leaves the flexibility to alter the tax rates and various standards of public services to the States.

There can, however, be a major objection to such an arrangement as extending the power to the Centre to levy taxes beyond the manufacturing stage may be construed as an act of intrusion into the States' domain. Such an argument too is based on the inadequate understanding of the economic system, for, as it is the Centre has unlimited power to levy the tax at the manufacturing stage which would normally be included in the costs at subsequent stages. Extending this power to the retail stage only shifts the levy to the consumption stage. This helps in arriving at a negotiated coordination of tax base between the Centre and the States.

f. Horizontal Tax Harmonisation

As mentioned earlier, inter-jurisdictional tax competition does not necessarily result in welfare loss and hence is not always undesirable. In fact, public choice theorists consider it to be beneficial, for, it acts as a check against the leviathan or the monopoly power of the government to tax its citizens. In the words of Brennan and Buchanan (1980, p.22), "Tax competition is the fundamental ingredient in constraining the behaviour of local ....: tax competition among subnational jurisdictions, like price competition among firms is basically beneficial, in that it reduces the extent to which citizens can be exploited by the intrinsically coercive powers vested in government". In their view harmonising measures intended to curb or modify tax competition are undesirable.

However, even in the public choice approach, the literature on competitive federalism literature identifies some important preconditions necessary to be fulfilled for successful intergovernmental competition. Breton (1987), for example, while stating that the preconditions suggested by them are not exhaustive, nevertheless identifies 'competitive equality' of jurisdictions and 'cost-benefit' appropriability as two important factors necessary to make the competition *beneficent*.

Competitive equality ensures equality in the power of jurisdictions to compete for national resources and this ensures that no individual state is able to exploit or unfairly compete away the resources that should accrue to another State. In particular, the richer States, by virtue of their superior fiscal position (residents) can attract more capital into their jurisdictions. Enabling every State to provide a normative level of public services at a given standard tax rate ensures that fiscal disadvantage of poorer provinces, by itself will not be a cause for the migration of capital, and hence resource distortions. Such a competitive equality can be achieved either by the regional policies followed by the Central government or through equalising federal transfers. These issues will be discussed in detail in subsequent chapters.

It is the need for ensuring cost-benefit appropriability that truly calls for horizontal tax harmonisation. The link between costs and benefits is violated when the States are assigned the power to levy taxes on mobile resources. The assignment of source (origin) based as against residence (destination) based taxes enables the States to indulge in strategies to augment their public service levels by exporting the tax burden to non-residents. Again, as the ability to export the tax burden to non-residents is not uniform across States, the more powerful States tend to exploit the less powerful.

In the Indian context, as mentioned earlier, inter-State tax exportation can take place through tax competition to encourage cross-border purchases or by taxing inter-State transactions. The nature of tax competition varies with the characteristic of the commodity. In respect of commodities with very high price elasticity of demand, a State tends to gain by reducing the tax rates, so that it can attract out of the State consumers. In respect of commodities with high price elasticity, one per cent reduction in the tax rate results in more than proportionate increase in sales and therefore, tax revenue. As far as consumers are concerned, so long as the benefit from lower tax payments exceeds the transportation cost, it is preferable to make purchases in such "tax havens". This move is particularly gainful to States and Union Territories with little production base, because, in such States, net gains from trade diversion are large. Similarly, States having oligopolistic power in respect of some commodities stand to gain by charging higher tax rates on them.

A more important source of tax exportation, however, is the levy of taxation on inter-State sale of goods. We have already dealt with the equity and efficiency implications arising from this levy at length and these need not be repeated. We may, however, recapitulate here that the richer producing States tend to gain significantly by exporting the tax burden to poorer consuming States. Tax exportation gets accentuated when inputs and capital goods too are subject to local sales tax. In such cases, not only that the value of exports of richer States are larger than their imports but also, their effective tax rates exported is higher than those of the poorer States.

As has been pointed out in the previous chapter, another factor which has led to distortion in resource allocation in the Indian context is the inter-State competition to extend sales tax concessions. Of course, such concessions do not enhance the volume of investment in the economy which is governed by the basic macroeconomic factors, but simply redistribute them between different regions and industries. They discriminate between different States, different regions within the States and different industries depending upon their capital-output ratio and between old and new industries. This alters rate of return differentials between different regions, industries and firms of different vintage in unintended ways and causes resource distortions, the magnitude of which remains unknown. At the same time, its efficiency in determining or even attracting capital into a State is doubtful for, it is seen that volume of investment in a State depends more on factors like the availability of infrastructure, bureaucratic response, industrial climate and historical factors like the existence of an entrepreneurial class in the State rather than on the fiscal incentives.[7] Finally, the competition to extend concessions to business may shift resources and activities away from

[7] For a detailed evaluation of cost and efficiencies of fiscal incentives in the State of Madhya Pradesh, see Tulasidhar and Rao (1986). Studies abroad have either found little effect of local tax differentials on location decisions (Morse and Farmer, 1986) or response to State taxes varying greatly according to the type of firm (Papke and Papke, 1986), making a general tax policy to attract business practically impossible.

their most productive use to less productive ones, lowering the overall level of efficiency in the economy. This will be accentuated if the political worth of these concessions to the policy makers exceed their economic worth.

The horizontal tax harmonisation in the Indian context must concern itself with simplification and rationalisation of the tax system, converting the existing origin type commodity taxes into destination type consumption taxes and getting rid of sales tax incentives for industrialisation. Rationalisation and simplification of the tax system is necessary, not as a harmonising measure, but simply because it is desirable to have a simple and transparent tax system with a broad base, lower and less differentiated tax rates. Harmonisation measures should try to achieve destination-type consumption tax and to achieve this, it is necessary to provide relief on taxation of inputs and capital goods and also to get rid of the inter-State sales tax. Again, it is necessary to do away with the fiscal incentives, for, apart from being an instrument of "beggar my neighbour" policy, these are simply unsuitable to achieve the purpose for which they are intended.

f. Tax Harmonisation: Towards a Value Added Tax

The discussion on the problems of Indian commodity system clearly underlines the need for a value added tax (VAT). In fact, almost all successful tax reforms are associated with the introduction of VAT and by 1990, over 70 countries had comprehensive VAT (Rao, 1993a, pp. 161-62). Of these, as many as 24 were developing countries. Most of the countries reforming the tax system have preferred the adoption of VAT due to its high revenue potential. In the history of fiscal reforms, the near-universal adoption of VAT is perhaps the most important feature in the twentieth century. VAT is also considered to be the most neutral form of taxing consumption along with a retail sales tax. What is more, the self policing character of the tax not only enhances the revenue productivity of the tax, but also helps to improve the compliance of other taxes as well. Keeping these factors in view, the Union Finance Minister in his budget speech for 1993-94 observed,".....our long term aim should be to move to a Value Added Tax System. However, a nationwide value added tax system cannot be introduced overnight. There has to be a broad agreement among the Centre and the States on the design of such a system..". In order to promote an informed discussion on the subject, the National Institute of Public Finance and Policy (NIPFP) was requested to design a possible VAT system for the country. The study (NIPFP, 1994) made a comprehensive review of the existing domestic trade taxes and made detailed recommendations on the steps to reach a comprehensive and full fledged VAT in the Indian federation.

The application of the principle of tax reform in a federal economy, as mentioned earlier, requires that while the tax system is made simple, transparent, broad-based and neutral, the fiscal autonomy of the States must be respected. Thus, in reforming the consumption tax system in Indian fiscal federalism, it is necessary to consider not only the principles of tax reform but also the fiscal autonomy of the States. This implies that (i) in terms of revenue both Central and State governments should at least be as well off as before the reforms, (ii) the point of tax should be shifted to the consumption point from the production point, (iii) the system should relieve the tax paid on inputs, capital goods and those paid at earlier stages of transactions and (v) the tax on inter-State transactions should be zero-rated.

Extending the commodity tax upto the retail level, keeping the base broader to include not only goods but also services and relieving the tax on inputs in a systematic manner make out a good case for the conversion of existing taxes on commodities and services with the VAT. At the same time, preserving the revenue position of both Centre and States calls for the levy of concurrent VAT at both the levels of government. Of course, evolution of such a tax system warrants cooperation and coordination between both the levels of government which has to be achieved through negotiations and constant interactions. Admittedly, the larger the number of players, the more difficult it is to reach an agreement. Thus, while it may be relatively easy to hammer out a solution through negotiations in a country like Australia, it would be extremely difficult in a country like the U.S.A. India lies between these extremes; given the diversities between the States, reaching an agreement will not be easy, but with a proper institutional setup (the present one is probably inadequate for this important task), it should be possible to thrash out a solution.

The levy of concurrent VAT by both Centre and States has a number of advantages as mentioned earlier. Besides making the tax system efficient, this will safeguard the fiscal autonomy of the States, and when inter-State transactions are zero-rated, will get rid of tax exportation as well. The Centre too will have as much revenues as in the past to promote inter-regional equity. This will also help to link the expenditure and revenue raising decisions of the States better and thereby result in more efficient provision of public services.

The Centre and the States, however, should evolve such a coordinated tax system through a negotiated settlement. Through negotiations, it should be possible to have a uniform tax base for both the levels, but a State could levy different tax rates, if it so chooses, to finance a higher level of public services. Of course, this calls for the amendment of the Constitution to enable the Central government to levy the tax at stages subsequent to manufacturing and to allow the States to levy the tax on consumption of services in addition to those on goods permitted at present.

The international experience, however, does not show clear evidence of successful levy of VAT by sub-national levels of government. Among the federations, besides the countries in the European common market, Canada and Brazil levy the VAT. However, in all those countries except Brazil, the VAT is levied by the federal/Central government. At the same time, the result of the Brazil experiment with sub-national VAT is disappointing. It is yet to find a satisfactory method of eliminating inter-State tax exportation. The system of discriminatory levy on inter-State transactions[8] has enormously complicated the tax system and has caused considerable distortions. However, the system of VAT evolved in the European Common Market, with inter-country transactions within the community fully zero-rated, holds promise for a successful levy of VAT at sub-national levels.

8 The federal government allows higher tax rates on the exports of less developed States than on those of more developed States. See Longo (1992).

CHAPTER V

FISCAL IMBALANCES IN INDIAN FEDERALISM

a. Introduction

Fiscal imbalance refers to the mismatch between own revenue raising capacity and expenditure needs at different governmental units. In an abstract sense, this implies the gap between revenue and expenditure when both revenue sources and functions are allocated between various units of the government optimally. However, empirical estimates of fiscal imbalances are difficult to derive on the basis of such definitions, for, estimates of revenue capacity or expenditure needs in an absolute sense will depend heavily on the relevant value judgements made[1] and in practice, it is difficult to find an allocation of revenue sources and responsibilities which is strictly optimal in any sense. Thus, measurement of fiscal imbalances involves, of necessity, actual elements of federalism as opposed to normative ones, although the very concept of fiscal imbalance has a built-in normative consideration; the general presumption would be that the less of imbalance there is, the better it is. The concept almost axiomatically implies that if there are imbalances, they need to be corrected for, although this is not necessarily true as we see below.

Usually, two types of fiscal imbalances are discussed in the literature. The imbalances at different levels of the government (inter-governmental) are known as vertical fiscal imbalances, while those at different units at the same level of government (inter-jurisdictional) are known as horizontal fiscal imbalances. Although these two concepts are identifiable by themselves, they are, except under very special circumstances, related. If the distribution of revenue sources and expenditure responsibilities between the Centre and the States is such that the Centre raises more than it spends while the States spend more than they raise, the extent of this vertical fiscal imbalance can affect the horizontal fiscal imbalance (i.e., between different States) through the non-neutral incidence of Central revenue and expenditure

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1 Estimates of relative revenue capacity and expenditure needs, however, are frequently made. See India (1989), for an example in the Indian context.

package. Only when the benefits from the Central expenditure (or grant) exactly match the tax (revenue) collections in each State is the incidence of Central fiscal policy neutral. It is only under such a condition that the vertical and horizontal fiscal imbalances are fully independent. Usually, there is a certain amount of redistribution involved in the fiscal policy of the Centre, and this links vertical imbalances with the horizontal imbalances. Also, larger the horizontal imbalances, greater is the need for federal intervention to correct these imbalances. Such interventions can take the form of direct Central expenditure, or equalising transfers[2]. In both the cases, a centralising tendency in revenue raising becomes inevitable. However, in the latter case, the expenditure responsibilities of the States do not decrease, leading to vertical fiscal imbalance.

Empirical estimates of fiscal imbalances have to be, of necessity, based on actual revenues and expenditures as noted above. The simplest measure would then be:

$$I_i = E_i - R_i,$$

Where	I	=	the extent of imbalance,
	E	=	expenditures incurred,
	R	=	revenues raised by the concerned unit of government itself,

and the subscript i representing the unit of government concerned. Such a measure, of course, has to be normalised to make it comparable across governmental units. The comparable measure would then be

$$I_i = (E_i - R_i)/E_i = 1 - (R_i/Ei) \quad \text{...(1)}$$

However, the appropriateness of this measure really depends on the meaning attached to fiscal imbalance. If it is interpreted as a measure of fiscal independence, then it may become necessary to modify (1) to take into account the extent to which the concerned unit of government actually determines, or controls, the fiscal variable. Following this logic,

2 These refer to intergovernmental transfers aimed at providing the same level of basic economic and social infrastructure across regions. Detailed discussion follows in the next chapter.

Hunter (1977) actually suggested as many as three concepts of "coefficient of vertical balance", depending on how independent one considered the concerned governmental unit to be in the matter of specific revenue sources (in particular, unconditional grants and shared taxes). It can be argued that the same logic should be extended to the expenditure side also, and expenditures incurred due to the prompting of grants ought not be considered, if the grants themselves are not. After all, to the extent that the grants stimulate expenditures, the spending unit is only an agent of the grantor. But such separation of grants-induced expenditures, even in the case of expenditures fully financed by grants, is far from easy, given the fungible nature of resources and the lack of knowledge regarding the true demand for government expenditures. Even so, the inability to extend a particular idea to its logical conclusion cannot justify a 'halfway house'.

In fact, as Bird (1984) has concluded, fine tuning the measures of fiscal imbalance is not likely to be very productive because of several qualitative aspects of the problem that numerical measurements cannot capture adequately. At the same time, it is not very wise to throw the proverbial baby out with the bath water: the concept of fiscal imbalance is probably not as useless as he seems to believe. Although perfect correspondence between revenue sources and expenditure responsibilities is neither observed in actual practice nor prescribed by the theory of federal finance, a low degree of correspondence could imply lack of lower level autonomy as well as accountability, and this can cause fiscal irresponsibility (expense-account spending spree), as well as determination of lower-level government expenditure pattern by a higher level unit of government without adequate information, leading to loss of efficiency in resource allocation. Similarly, a very high degree of correspondence could signify inadequate attention to the problem of public goods with large spillovers and possible gains from centralised tax collection. Thus, a measure of fiscal imbalance can alert one to a situation of too much or too little, even if its utility in the middle range is indeterminate.

b. Vertical Fiscal Imbalance

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. Table 5.1 below puts together estimates of vertical imbalance based on (1) above.

Table 5.1

Vertical Imbalance in Selected Countries

Country	Year Ending	Degree of Vertical Imbalance			
		1988	1989	1990	1991
Argentina	Dec 31	0.24	0.18	--	--
Australia	June 30	0.51	0.46	0.47	0.45
Brazil	Dec 31	0.24	0.20	0.31	0.27
Canada	March 31	0.24	0.23	0.21	--
Germany	Dec 31	0.20	0.17	0.20	0.21
India	March 31	0.51	0.51	0.51	0.53
Indonesia	March 31	0.76	0.78	0.79	0.70
Malaysia	Dec 31	0.31	0.28	0.36	0.38
South Africa	March 31	0.86	0.83	0.84	0.83
United States	Sept 30	0.14	0.14	0.15	0.20

Note: The degree of vertical imbalance refers to only State/ Provincial/ Regional governments and have been computed as 1 - (total revenues including capital receipts but excluding intergovernmental grants / total expenditures).

Source: *Government Finance Statistics Yearbook, 1993*, International Monetary Fund, Washington D. C.

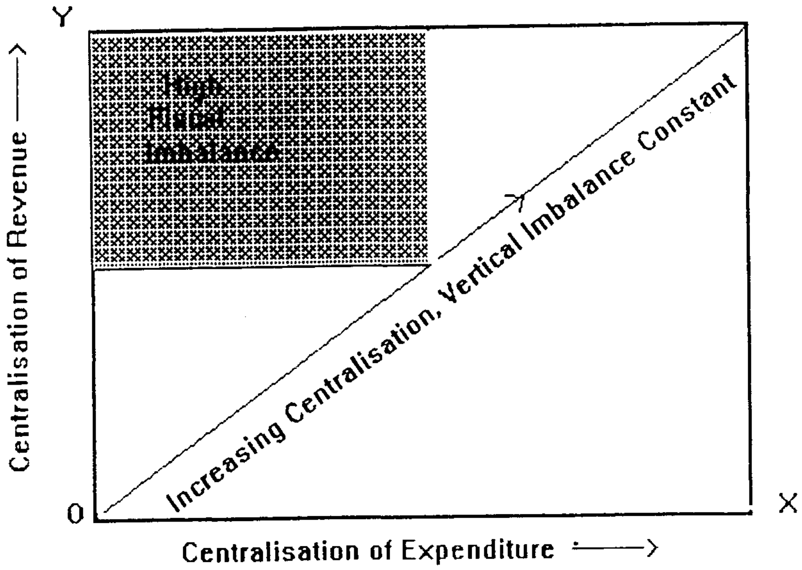
An obvious limitation of the reported estimates is that the computations use the perspective from the State or Province level only. Further, due to limitations of the available data, the ratio of revenues to expenditure is somewhat overestimated in all cases since borrowings are included in receipts but lendings are not included in the expenditures. Within these limitations, however, the table shows the degree of vertical imbalance to be the highest in South Africa, followed by Indonesia. Both Australia and India also exhibit fairly high degrees of vertical imbalance, although the imbalance appears to be declining in Australia.

The degree of vertical imbalance is seen to be low in Germany and the United States; however, in the latter case, it appears to be rising.

Clearly, there is more to vertical imbalance than merely the numbers. There are important nuances not captured by summary measures like the one reported above. One such issue is that of the link between vertical imbalance and 'centralisation' often alluded to in the literature. In fact, however, the same degree of vertical fiscal imbalance can be associated with varying degrees of centralisation, as Figure 5.1 below shows.

Figure 5.1

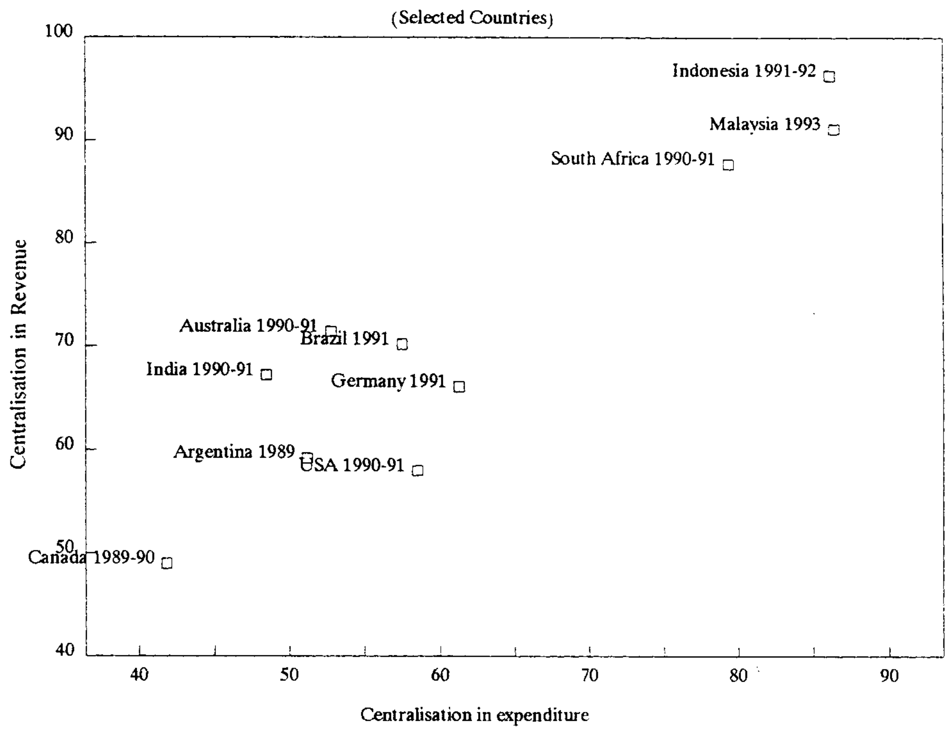
Centralisation and Vertical Fiscal Imbalance



In the diagram, centralisation of expenditure is depicted in the X-axis while Y-axis represents centralisation of revenues. The line OO´ denotes no vertical fiscal imbalance (in the sense that the Central share in revenues exactly corresponds to its share in expenditures). Points within the traingle OXO´ -- Central share of expenditures greater than its share of revenues -- are rarely observed in practice, while almost all federations would lie in the traingle OYO´. It should be noted that although all points on OO´ denote no vertical imbalance, the degree of centralisation increases as one moves from O to O´ along the line. Any line parallel to OO´ but within triangle OYO´ would denote a constant degree of fiscal imbalance (positive) but varying degrees of centralisation. Actually, the closer one moves to point Y, the greater is the vertical imbalance. The diagram serves to make the point that a high degree of centralisation of revenues is a necessary condition for high vertical imbalance; but the sufficient condition is provided by a low degree of centralisation of expenditure responsibilities. Figure 5.2 below uses the box discussed above to plot vertical imbalance in selected countries with reference to centralisation in revenues and expenditure.

Figure 5.2

Centralisation and Vertical Imbalance



Notes on the data used: Total revenues do not include intergovernmental grants. Total expenditures do not include lendings, repayment of loans and intergovernmental grants. Total government revenues and expenditures are based only on the data reported in the source cited below.

Source: ***Government Finance Statistics Yearbook 1993***, International Monetary Fund.

From the diagram, it is immediately clear that Indonesia, Malaysia and South Africa are highly centralised systems in terms of both expenditures and revenues; more so in terms of revenues so that there is significant vertical imbalance as well. Combining the State and local level governments, the United States does not have any vertical imbalance at all, and revenue sources and expenditure obligations are almost evenly divided. Canada has even less centralisation, but exhibits a small degree of vertical imbalance. Argentina and Germany also have only small degrees of vertical imbalance, but at higher levels of centralisation as compared to Canada. Australia, on the other hand, has about the same degree of centralisation (in terms of expenditure) as Argentina, but a much higher degree of vertical imbalance. India is the only other country among the selected ones which exhibits relatively low centralisation in terms of expenditures, but has a high degree of vertical imbalance due to the relatively high centralisation of revenues. Thus, even a small selection of only ten countries considered above exhibit a wide variety in terms of the combination of centralisation and vertical imbalance, demonstrating the lack of any direct link between centralisation and vertical imbalance in practice.

The above discussion highlights the fact that a single measure of fiscal imbalance can miss some important aspects of the overall situation, and for a proper assessment, it is necessary to look into various elements that affect the degree of vertical imbalance, and their qualitative aspects. Table 5.2 below provides some relevant figures for India, with columns 4 and 7 measuring R/E -- the key measure as per (1) for the current and the total transactions of the States, respectively.

The figures clearly show that the States' share of expenditures -- both current and total -- has remained more or less the same for more than thirty years. The same applies to the States' share of current revenues. However, the vertical imbalance in current terms appears to have risen over this period. This apparent paradox can be resolved if we realise that for the government sector as a whole, current revenues have financed progressively smaller parts of current expenditure in India. Thus, the falling trend exhibited by column 4 actually reflects an increasing tendency to divert capital receipts to meet current expenditures rather than increasing vertical imbalance. This is confirmed by the figures in column 5, 6 and 7 which show that due to a small degree of centralisation of both total receipts and expenditures over time (essentially upto middle sixties) -- marginally greater for receipts -- vertical imbalance remained almost unchanged since 1965-66 after an increase in the earlier years.

Although the quantitative indicators do not reveal much of increasing centralisation or increasing vertical imbalance, they cannot be taken to imply that the States' control over expenditure decisions has remained unchanged. This is mainly because of the specific purpose

Table 5.2

Trends in Vertical Fiscal Imbalance

Periods	Percentage of States' own current revenues to total current revenues (Centre and States)	Percentage of States' current expenditure to total (Centre and States) current expenditures	Percentage of States' own current revenues to States' current expenditures	Percentage of States' own receipts to total receipts of Centre and States*	Percentage of States' expenditure to total (Centre and States) expenditure	Percentage of States' own receipts to States' expenditure*
1955-56	417	59.02	68.85	50.60	61.70	57.79
1960-61	36.61	59.86	63.86	49.00	56.76	57.57
1965-66	32.58	55.62	63.46	43.92	53.33	54.97
1970-71	35.54	60.16	60.57	43.49	53.87	58.24
1975-76	33.54	55.05	70.39	39.21	47.55	60.29
1980-81	35.62	59.62	60.07	43.97	55.97	51.39
1985-86	35.47	55.97	57.69	42.12	51.97	54.10
1990-91	36.59	55.19	53.54	45.09	52.17	55.06
1991-92	37.64	58.25	54.76	45.29	54.53	56.85
1992-93 (RE)	35.28	57.27	53.72	42.26	53.26	54.94

* Current + capital receipts
RE Revised Estimates

Source: *Indian Economic Statistics/Public Finance Statistics*, Ministry of Finance, Government of India (relevant years).

matching plan transfers for Central sector and Centrally sponsored plan schemes[3]. Such transfers not only change the expenditure priorities of the States in the short run, but also have an effect in the longer term when transfers under the schemes are no more available, as the States get locked into many such schemes, having started them with financial backing from the Centre. Further, the Central government has gradually increased its presence in areas like agriculture, rural development, labour and employment, power and irrigation through expenditures at its own level rather than through the States, eroding the traditional dominance

3 A detailed discussion of the various types of intergovernmental transfers in India is taken up in the next chapter. However, it should be noted that the transfers referred to above amounted to more than 17 per cent of the total current transfers from the Centre to the States in 1992-93, and thus not insignificant quantitatively.

of States in these areas. This has been interpreted by the States as Central intrusion into their exclusive domain, although the Centre is not Constitutionally barred from entering all these areas by virtue of the fact that some of these functions are included in the concurrent list. However, irrespective of the legal position, this trend has certainly contributed to the declining authority of the States even in areas they dominated earlier. Thus, there are reasons to believe that centralisation is on the rise, at least in the qualitative sense.

The other side of the story is that instead of considering only the revenue raised by the States themselves, if one considered the revenue accruing to the States to be spent the way they thought fit following Hunter (1977), the degree of vertical imbalance would come down considerably. This is mainly due to the rising share of the States in the total *accrual* of taxes, although their share in the *collection* has been falling over time, as shown by Table 5.3. It can be easily seen that the States have been raising about a third of the total tax collections by the Centre and the States right from the Sixties. But on an accrual basis, their share first fell from 46 per cent in 1960-61 to about 39 per cent in 1965-66, but started moving up gradually after that. By 1980-81, their share in the accruals stood at 52 per cent, and it has been more than 50 per cent since then. The States have been complaining that their share could have been larger if (i) all the taxes under Art. 269 of the Constitution -- those levied by the Centre, but collected and appropriated by the States -- were being levied, (ii) the revenue from corporate income tax was interpreted to be a part of the shareable pool, (iii) the surcharge on income tax was not kept outside the shareable pool, (iv) the Centre did not resort to upward revisions of administered prices in markets where it had monopoly instead of raising the rates of excise duty on those products, and (v) more effort was put into the collection of additional excise duties on sugar, textiles and tobacco levied in lieu of sales tax on these commodities, which the States had handed over to the Centre under a tax rental arrangement. However, it should be noted that the Finance Commissions would probably not have granted the States the increasing shares in income tax and excise duty collections if the States already had a reasonable share in the total tax collections. In any case, as far as accruals are concerned, the States' share shows a small rise, thanks to the devolutions mandated by the Finance Commissions.

Table 5.3

Tax Collection and Accrual: States

(Rs. Crore)

Year	Total Taxes (Centre + States)	States' Tax Collection	(3) / (2) (%)	Tax Devolution	States' Tax Accrual	(6) / (2) (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1960-61	1350	455	33.70	168	623	46.15
1965-66	2922	861	29.47	276	1137	38.91
1970-71	4752	1546	32.53	756	2301	48.42
1975-76	11182	3573	31.95	1599	5172	46.25
1980-81	19844	6664	33.58	3789	10453	52.68
1985-86	43267	14596	33.73	7260	21856	50.52
1990-91	87723	30145	34.36	14040	44185	50.37
1991-92	103198	35837	34.73	16849	52686	51.05
1992-93 (RE)	118918	40136	33.75	20477	60613	50.97

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

The reasons for the existing vertical imbalance are, in essence, no different from similar imbalances seen in other federations. The major reason, of course, is the Constitutional assignment of higher expenditure responsibilities to the States in line with the well-known 'decentralisation theorem' (Oates, 1972), coupled with the relative advantage that the federal government has in collecting taxes. The traditional reasons for believing in the federal edge in taxation are based on the regionally uneven distribution of natural resources, economies of scale in tax collection costs and the possibility of tax avoidance through socially inefficient regional shifts by mobile tax bases when taxed by regional governments. The first reason certainly holds for India, as in most other large federations. There are clear indications that the second too holds in India (Rao and Sen, 1993). The fact that the third also holds true in India has been recently demonstrated by the taxation of cigarettes by some of the States.

Under a tax-rental agreement, which was itself a confirmation of the general principle of the desirability of federal taxation of at least some tax bases, State sales tax on cigarettes -- along with those on sugar and textiles -- was substituted by a Central levy called additional excise duty, net proceeds of which were shared among the States on the basis of the origin principle. The States, however, have been complaining of inadequate tax effort by the Centre with respect to this levy in recent years. In 1993, the Government of Maharashtra decided to tap this lucrative tax base themselves, sidestepping the agreement not to levy sales or purchase tax by levying a luxury tax on cigarettes. Taxable cigarette sales in the State promptly plummeted from around Rs. 400 million a month to about Rs. 20 million, the rest being smuggled in from adjoining States. The State hastily withdrew the levy in the 1994 budget, although this sobering experience has not stopped several other States like West Bengal from trying their luck with similar levies in their 1994 budgets, with similar results.

Apart from the federal advantages in levying some of the taxes, the levy of a broad based commodity tax like the excise duty by the Centre, along with the power to levy custom duties, has limited the manouvreability of the States with respect to sales tax which is the mainstay of their current revenues.

There are other ways in which the assignment of powers and responsibilities has given rise to vertical imbalance. The Central government in India also controls the monetary policy and deficit financing. The more or less uninterrupted inflation resulting from these policies have continuously raised the expenditures of States in current prices without commensurate rise in revenues, as many of the State taxes have specific rates. At any rate, more inflation elastic taxes like the income tax are levied by the Centre.

Effective Central influence on the expenditure pattern of the States, often achieved through the Planning Commission, has also contributed to the degree of vertical imbalance observed in India. Completion of every five-year plan has seen increase in States' non-plan expenditure due to the odd practice of classifying all formally completed Central sector and Centrally sponsored plan schemes, supported by substantial Central matching grants, started during a plan period into the non-plan account at the end of the particular five year plan, not qualifying for the grants any more. This, along with the eagerness of the States to avail of maximum Central matching transfers and the 'lock-in' problem mentioned above has provided a continuous push to government expenditures without a commensurate rise in revenues. The Planning Commission -- the apex planning body set up by the Central

Government -- has also encouraged State level plans too large for their resource base by facilitating loans to finance them. The resultant debt servicing burden has pushed up the State expenditures relentlessly. Moreover, until the Ninth Finance Commission, successive Finance Commissions adopted the 'gap-filling' approach of recommending grants to cover the non-plan deficits of the States, a strategy hardly conducive to fiscal responsibility. The normal growth of own tax revenues along with the additional resource mobilisation from their own revenue sources have not fully offset the rise in expenditures, failing to contain vertical imbalance. That the figures for vertical imbalance do not show an increase is explained to a large extent by increased recourse to borrowing from the market and financial institutions by the States.[4] Since States indebted to the Central government can raise market borrowings only with the Centre's approval[5], and because all the States are so indebted, this has resulted in greater Central influence over States. Even the major financial institutions are mostly owned by the Central government, and the utilisation of the loans from such institutions have in all probability been influenced by federal policies and priorities.

The States, on their part, have failed to raise sufficient revenues to finance their burgeoning expenditures over the years. Agricultural taxation, almost entirely left to the States, has not really been used at all. Administrative convenience has often prevailed over economic considerations, and this has resulted in narrower tax bases (e.g., first-point levy under sales tax, compounded levies under entertainment tax) and lower income elasticity of tax revenue. Tax competition among States to attract investments has resulted in low tax revenues for all States in many cases, leading to vertical imbalance through greater need for federal transfers and consequently higher Central taxation. The pressure to raise salaries and wages of government employees at the State level following such raises at the Centre have aggravated the problem. Thus, although numerical estimates of vertical imbalance do not

4 Net borrowings by the States rose from 2.5 per cent of the GDP in 1974-75 to 3.5 per cent in 1980-81 and further to 5 per cent in 1990-91. Of these, 0.9 per cent in 1974-75, 1.4 per cent in 1980-81 and 2.4 per cent in 1990-91 were accounted for by loans from the Centre.

5 The States got around this constraint earlier by obtaining overdrafts from the Reserve Bank of India - both authorised (within the presribed limits) and unauthorised (over the limit). Repayment of overdrafts did not pose a serious problem as the Centre usually converted the unpaid overdrafts to medium-term loans. Since 1985, however, the States' budget constraint has hardened due to the 'Overdraft Regulation Scheme', which allows the Reserve Bank to refuse payment on cheques issued by States if the unauthorised overdrafts are not repaid within ten working days.

show any significant rise, they do not fully reflect the erosion of State autonomy and fiscal independence that has taken place over the years.

c. Horizontal Fiscal Imbalance

Apart from the number of reasons for the existing vertical imbalance in India outlined above, significant horizontal fiscal imbalance provides an important reason. From the national point of view, it has been considered improper to allow the persistence of large horizontal imbalances, and these have been sought to be corrected through equalising transfers from the Centre, which automatically imply some amount of vertical imbalance. The horizontal imbalances have in turn arisen mainly from inter-State disparities in revenue capacity and effort as well as in expenditure needs.

Out of the 25 States in the Indian federation, 15 are relatively homogeneous while 10 hill States (seven North-Eastern States, Sikkim, Jammu & Kashmir and Himachal Pradesh) form a distinct category, generally grouped together as 'Special Category' States. The latter group is characterised by small industrial sectors and largely unorganised economies. At the same time, due to the geographical and demographic factors, the unit cost of providing various public goods and merit goods is relatively high in these States. As a result, their revenue capacity is low compared to their high per capita public expenditures, leading to fairly high degrees of fiscal imbalance. Most of these States are also located on the national boundary, which has historically resulted in frequent bouts of social and economic destabilisation; this has also led to increased fiscal dependence on the Centre. Even the 15 relatively homogeneous States exhibit wide disparities in the level of economic and social development, irrespective of the indicator(s) chosen. Naturally, their fiscal situation also shows wide divergences.

Table 5.4 gives an overview of the fiscal situation of all the States. Per capita own revenue, it can be seen, varies from as low as Rs. 168 in Tripura to as much as Rs. 1692 in Goa, i.e., the highest is about ten times the lowest. The variation in per capita current expenditures is not so much (Rs. 660 in Bihar to Rs. 4587 in Mizoram), but the highest is still

Table 5.4

Revenues and Expenditures of States - 1991-92

States	Per capita State domestic product (SDP) 1990-91 (Rs)	Per capita own revenue (Rs)	Per cent of own revenue to SDP	Per capita current expenditure	Per cent of own revenue to current expenditure
I. Major States					
a. High Income States					
1. Gujarat	5850	969.3	15.2	1260.4	76.9
2. Goa	7890	1691.5	19.3	2811.9	60.2
3. Haryana	7516	1112.9	12.8	1370.7	81.2
4. Maharashtra	7598	974.4	12.4	1264.8	77.0
5. Punjab	8428	1563.9	16.3	2058.2	76.0
Sub-Total A - High Income States	7100	1068.4	13.7	1387.8	77.0
b. Middle Income States					
1. Andhra Pradesh	4731	603.1	11.1	964.2	62.6
2. Karnataka	4631	778.7	13.8	1095.6	71.1
3. Kerala	4232	652.7	14.1	1202.6	59.3
4. Tamil Nadu	4619	865.8	16.8	1548.5	55.9
5. West Bengal	4794	393.2	7.5	777.5	50.6
Sub-Total B - Middle income States	4625	639.8	12.2	1076.6	59.4
c. Low Income States					
1. Bihar	2520	212.8	7.3	659.5	32.3
2. Madhya Pradesh	4021	473.8	11.5	813.4	58.2
3. Orissa	3596	293.0	7.2	827.1	35.4
4. Rajasthan	4035	514.4	11.7	920.4	55.9
5. Uttar Pradesh	3557	327.3	8.1	743.0	44.1
Sub-Total C - Low Income States	3509	346.2	9.9	764.6	45.3
II. Special Category States					
1. Arunachal Pradesh	5046	612.6	11.0	3204.5	18.5
2. Assam	3932	343.1	8.1	951.3	36.1
3. Himachal Pradesh	4790	514.2	9.6	1889.6	27.2
4. Jammu & Kashmir	3872	360.4	8.9	1955.5	18.4
5. Manipur	3893	194.6	4.7	2040.5	9.5
6. Meghalaya	4190	363.6	8.2	2056.4	17.7
7. Mizoram	4135	475.7	11.1	4587.1	10.4
8. Nagaland	4977	373.8	6.8	4006.5	9.3
9. Sikkim	5063	975.6	17.9	3782.9	25.8
10. Tripura	3569	167.6	4.8	1970.1	8.5
Sub-Total - Special Category States	4063	363.5	8.3	1593.2	22.8
All States	4567	576.9	11.5	1026.0	56.2

Source: 1. *Reserve Bank of India Bulletin*, February, 1994.
2. *Public Finance Statistics*, Ministry of Finance, Government of India.

about seven times the lowest figure. Even when we exclude the special category States, the highest per capita revenue and current expenditure as percentages of the lowest are still about 800 and 450 per cent. It is interesting to note that the special cateogry States are fiscally special due to their expenditure pattern only; average per capita own revenue in these States at Rs. 364 is actually higher than in low income States on an average (Rs. 346). Of course, per capita income -- a crude indicator of revenue capacity -- is also higher in the special category States as compared to the low income States. In fact, average per capita own revenue in all the four categories of States vary in line with per capita income, pointing to the importance of revenue capacity. However, this is not to say that only capacity considerations determined the actual revenue; the wide variation in the ratio of own revenue to SDP (from 7.2 per cent in Orissa to 19.3 per cent in Goa) clearly shows that the other relevant factors vary significantly between States. These 'other factors' refer primarily to the exploitation of existing revenue potential and the ability of a State to 'export' its taxes to other States, although varying impact of Central policies on individual States has also been responsible for the variation in the ratio.

An idea of revenue effort can be had from the relative tax effort indices based on computations by the Ninth Finance Commission. These indices measure the actual tax collections against estimates of tax potential, computed using figures for actual or proxy tax bases and an average relationship between these bases and tax revenue. Table 5.5 presents these indices along with another indicator of revenue effort -- cost recovery rates with respect to State expenditures on social and economic services, weighted by the ratio of the highest per capita expenditure on social and economic services as a ratio of the per capita expenditure on these services in the State concerned.[6] Casual observation reveals that the States with the lowest per capita expenditures on social and economic services cannot be faulted for their relative revenue effort (vide columns 2 and 4).

The flip side of revenue potential is expenditure needs, determined by the needed supply of the social goods as well as the cost per unit of such goods. The first element depends mainly on the level of social and economic development at the State level; this in turn could partly be a result of the success or failure of the intergovernmental transfers to offset adequately the differences in tax potential and in the unit cost of providing the social goods. The second element depends on a variety of factors like geographical characteristics and demographic features. While it is not possible to provide with any degree of objectivity

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6 The cost recovery rates depend on the methodology adopted to compute these which is detailed in Mundle and Rao (1990). The weighting is meant take the level of expenditures into account; the same cost recovery at higher expenditure levels would result in a lower weighted rate. The presumption, of course, is that States with higher expenditure levels also have higher revenue capacity, and ought to recover costs at correspondingly higher rates.

point estimates of the expenditure needs of States, or even demand for such expenditures here, the following table (Table 5.6) provides some physical indicators of the level of development along with the relative expenditure needs (at the base year levels of public services) as assessed by the Ninth Finance Commission. The extent of inter-State disparities can easily be gauged from the figures presented. Both the infrastructure index and the human development index take high values in high income States and low values in the low income

Table 5.5

Revenue Effort by States

State	Tax Effort (%)	Cost Recovery: Social & Economic Services (%) (1987-88)	Weighted Cost Recovery (%) (1987-88)	Per capita Expenditure on Social & Economic Services (Rs.) (1987-88)
(1)	(2)	(3)	(4)	(5)
Andhra Pradesh	103.37	16.04	34.87	483
Bihar	96.52	9.68	28.13	361
Gujarat	88.49	13.19	17.62	786
Haryana	97.54	28.19	37.36	792
Karnataka	96.52	18.48	33.20	584
Kerala	96.29	9.9	20.23	514
Madhya Pradesh	104.68	30.54	68.43	469
Maharashtra	93.25	25.52	39.38	680
Orissa	103.05	25.17	55.83	473
Punjab	97.25	12.23	12.23	1050
Rajasthan	108.68	23.20	39.14	622
Tamil Nadu	89.39	8.80	15.60	592
Uttar Pradesh	100.43	13.29	40.91	341
West Bengal	114.52	10.75	28.27	399

$$\text{Weighted cost recovery} = \text{cost recovery} \times \frac{(\text{Per capita expenditure on social and economic services})_{MAX}}{\text{Actual per capita expenditure on social and economic services}}$$

Source: India (1989) and Rao and Mundle (1992).

Table 5.6

Inter-State Disparities in Level of Development

State	Per capita SDP (1990-91) (Rs.)	Composite Infrastructure Index (India=100) (1992-93)	Human Development Index	Percentage SC/ST Population in State Population (1991)	Per capita Non-Plan Expenditure on Social and Economic Services (1986-87) (Rs.)	
					Normative Estimate	Actual
(1)	(2)	(3)	(4)	(5)	(6)	(7)
High Income States						
Gujarat	5850	125	545.3	22.33	291.92	304.81
Haryana	7516	152	599.5	19.75	228.99	225.46
Maharashtra	7598	111	643.0	20.36	252.25	275.38
Punjab	8428	205	713.1	28.32	256.09	294.35
Middle Income States						
Andhra Pradesh	4731	103	339.7	22.24	204.81	204.16
Karnataka	4631	97	477.2	31.90	244.97	234.22
Kerala	4232	140	774.9	11.02	276.22	304.95
Tamilnadu	4794	138	487.3	20.21	253.42	237.36
West Bengal	4794	113	417.6	29.22	225.73	241.92
Low Income States						
Assam	3932	93	444.1	20.22	N. A.	N. A.
Bihar	2520	96	133.4	22.22	152.43	143.55
Madhya Pradesh	4021	75	186.3	37.82	185.88	185.13
Orissa	3596	89	213.2	38.41	209.09	192.29
Rajasthan	4035	80	229.4	29.73	205.68	187.68
Uttar Pradesh	3557	109	109.5	21.25	161.71	148.41

Source: Columns (3) and (5) are taken from *Basic Statistics Relating to States of India*, CMIE, September 1994. Column 4 is taken from *EPW Research Foundation* (1994), Table 5(b), column 3, but we have scaled up the numbers by a factor of 1000. Columns 6 and 7 are taken from India (1989).

States. The low income States also have a larger share of disadvantaged population in general, as shown by the figures for the share of population belonging to either scheduled castes (SC) or scheduled tribes (ST). Columns 6 and 7 clearly show the inability of the low income States to meet their expenditure obligations in contrast to the high income States; this is despite the fact that the Ninth Finance Commission estimates of normative expenditure levels reproduced here do not take into accout investments for raising the level of infrastructure.

Apart from revenue effort and expenditure needs, the extent of inter-State tax exportation, discussed earlier, has its impact on the horizontal imbalance. Since explicit taxation of the agricultural sector is light compared to the manufacturing and processing sector at the State level (it is practically non-existent at the Central level), the States with a strong industrial base and supplying the products to other States are able to export a significant portion of their tax revenue through the taxes built into the cost of these products, as well as through the origin-based central sales tax. This results in perverse transfer of resources from the less developed, net importer States to the others. The higher ability of high income States to put up the required funds for obtaining matching transfers also has aggravated horizontal imbalances.

Some of the Central policies have also been responsible for such perverse transfer of resources. One such policy has been the tight-fisted payment of royalty on minerals extracted from within a State. While the Central government has the right of extraction, it must pay a royalty on the quantity of minerals extracted at rates fixed by itself. These rates have been fixed at fairly low levels compared to the price; moreover, these rates are fixed in rupee terms, which require frequent revision in times of inflation but are actually revised only at long intervals. The mineral-rich States -- which happen to be the low-income States -- resent this, as they see this as the refusal of the Centre to give them their due share in the rising prices of the minerals extracted. They tried to levy a cess at high rates on the royalty paid (going upto even 600 per cent) to force the Centre to pay up, but this attempt was struck down as unconstitutional by the judiciary in 1984. The freight equalisation policy, another Central policy which was in force until recently, also worked against the interests of these mineral-rich low-income States. This policy ensured that the railways charged uniform freight throughout the country on coal and steel transportation. Thus, the administered prices of a major mineral like coal and a basic input like steel was equalised all over the country; in the event, even the small advantage in the industrialisation process that these States had due to their mineral resources and the Central investments made in the steel plants in these States was neutralised.

The effect of the factors discussed above has been to perpetuate the horizontal imbalances that originally arose mainly due to historical factors, which include the confinement of the first round of modern socio-economic development process in and around the few major centres of activity chosen by the British (Bombay, Madras, Calcutta and Delhi) during their occupation of India. The fiscal disparities are still evident, as can be seen from the statistics given in Table 5.7, which measure the variation in per capita government expenditure on publicly provided services at a disaggregated level.

Table 5.7

Inter-State Variation in State Government Expenditures (Per Capita)

	Co-efficient of Variation				Lorenz Ratio			
Expenditure/SDP Items Per Capita	1975-76	1980-81	1985-86	1990-91	1975-76	1980-81	1985-86	1990-91
General administration	23.4	21.9	25.0	29.3	0.132	0.125	0.142	0.159
Education	32.9	31.7	26.4	20.3	0.164	0.168	0.146	0.115
Health	28.8	24.3	27.6	25.8	0.161	0.134	0.157	0.139
Total social services	35.2	29.6	31.1	26.0	0.196	0.164	0.177	0.145
Transport and communication	81.2	74.3	75.4	75.3	0.365	0.347	0.326	0.362
Irrigation	33.6	39.7	40.6	39.5	0.190	0.220	0.223	0.222
Industry and minerals	68.7	48.0	40.0	47.3	0.331	0.229	0.228	0.256
Total economic services	37.4	34.0	41.0	36.7	0.201	0.192	0.214	0.204
Total current expenditure	26.0	23.5	24.8	23.2	0.148	0.132	0.142	0.131
Total capital expenditure	38.7	28.1	54.3	40.2	0.205	0.156	0.247	0.210
Total expenditure	26.6	23.0	28.3	24.2	0.148	0.128	0.157	0.134
Total Net State Domestic Product	29.9	31.7	31.7	34.1	0.163	0.173	0.173	0.186

The computed statistics indicate a slight fall in the variation in per capita government expenditure by the 15 major States. A careful look reveals that this is due to the clear converging trend with respect to expenditure on social services, particularly education. Expenditure on economic services and capital expenditure exhibit greater variation in recent years; given that capital expenditures are mostly on economic infrastructure, the prospect of converging economic growth appears quite dim. The only silver lining in this otherwise grim scenario is the lower variation in per capita expenditures as compared to that in per capita SDP, which indicates a certain amount of equalisation through intergovernmental transfers.

In fact, equalisation could have been brought about through four major channels: (i) direct Central expenditure and investment, (ii) developmental plan outlays, (iii) credit from financial institutions and (iv) intergovernmental transfers. Excepting the last-mentioned, which we discuss in detail in the next chapter, none of the other three had an equalising influence. In the absence of data on Statewise distribution of Central expenditures, Rao and Sen (forthcoming) consider the proxy of investments in Centrally owned public enterprises and show that their distribution has been broadly in favour of the higher income States. Similarly, the per capita plan outlays have also been in favour of the high-income States, mainly because they depend to a great extent on the ability to raise own resources, as shown by Bagchi and Sen (1991). Even plan transfers have not been distributed in an equalising fashion (Chelliah, Rao and Sen, 1992); we postpone a detailed discussion to the next chapter. As for the equalising impact of major financial institutions, George (1988) documented the lack of such an impact in detail for the early eighties. The data given in Table 5.8 indicate that the situation has not changed very much since then.

Assistance from the financial institutions (including NABARD, linked to the Reserve Bank of India) are clearly biased in favour of higher income States and against low income States. While this pattern of distribution may have valid reasons (possibly low demand for debt in low income States, lack of commercially viable projects and high recovery risks in the poor States), the fact remains that it accentuates the existing uneven regional development process. The bias is not so pronounced in the case of commercial banks and the rural banks

Table 5.8

Statewise Distribution of Activities: Banks and Other Financial Institutions

State	Index of Credit Deposit Ratio @		Per Capita assistance disbursed in 1991-92 (Rs.)							
	RRBs (Sept. 1992)	SCBs (March 1991)	NABARD*	ICICI	IDBI	IFCI	SIDBI	UTI	LIC	GIC
High Income States										
Gujarat	101	91	216.7	64.9	135.4	45.5	63.2	48.4	21.5	17.4
Haryana	85	95	595.2	24.6	85.4	43.2	35.9	8.9	5.3	0.9
Maharashtra	166	114	235.8	63.3	132.1	37.2	35.7	144.9	28.4	11.4
Punjab	94	71	684.5	10.7	64.2	42.2	40.5	2.5	2.4	3.2
Middle Income States										
Andhra Pradesh	166	126	289.8	26.4	91.4	23.8	20.4	25.8	25.6	0.5
Karnataka	163	125	310.5	25.0	56.3	11.6	39.8	10.3	4.4	1.2
Kerala	201	93	244.3	6.8	38.4	4.2	37.0	2.4	0.4	0.2
Tamilnadu	153	153	209.5	29.5	74.8	20.8	38.1	10.5	19.2	3.4
West Bengal	80	83	95.8	4.6	30.9	4.9	12.2	5.7	5.1	1.8
Low Income States										
Assam	129	105	106.1	9.4	25.3	7.5	4.5	2.8	1.9	0.1
Bihar	81	60	111.3	5.6	14.3	1.5	3.9	0.3	9.6	1.0
Madhya Pradesh	104	102	192.9	18.2	47.4	15.2	13.6	3.4	3.7	0.4
Orissa	136	109	169.3	21.5	43.6	13.4	13.5	2.0	4.0	1.2
Rajasthan	66	89	199.0	19.7	51.5	20.5	20.3	5.8	4.1	1.6
Uttar Pradesh	70	71	203.1	9.0	27.1	17.3	9.9	9.0	2.6	0.1

Note: * figures relate to March 1993.
@ Average credit-deposit ratio = 100.

Abbreviations: RRBs = Regional Rural Banks; SCBs = Scheduled Commercial Banks; NABARD = National Bank for Agriculture and Rural Development.; ICICI = Industrial Credit and Investment Corporation of India Ltd.; IDBI = Industrial Development Bank of India; IFCI = Industrial Finance Corporation of India; SIDBI = Small Industries Development Bank of India; UTI = Unit Trust of India; LIC = Life Insurance Corporation of India; and GIC = General Insurance Corporation of India.

Source: *Report on Development Banking in India 1991-92*. IDBI, Bombay and *Banking Statistics*, Volume 20, March 1991, Reserve Bank Of India, Bombay.

affiliated to the commercial banks. However, their credit-deposit ratios show a distinct favour to the middle income States, again reflecting the preoccupation with risk, but tempered with distributional concern.[7]

d. Economic Reforms and Fiscal Imbalance

The economic reforms programme initiated in 1991 has many facets, some of which unveiled as yet. But even the major reforms that have already come about, and the ones that are expected in the near future are likely to change the character of fiscal federalism in India in general, and the vertical as well as horizontal imbalances in particular. These are likely to follow directly from some components of the reform programme as well as indirectly from the declared shifts in policy stance.

The major impact of the reforms is likely through the indirect and more long-term effect of the shift in policy from widespread government intervention in the economy to a more market-oriented one, with reduced role for Central planning, and government intervention in selected spheres only. The reduced emphasis on planning is likely to increase the responsibilities of the States by itself. Further, according to the new policy, the primary responsibility of the government is to ensure provision of adequate social and economic infrastructure. These include education, health, water supply, agricultural research and extension, poverty alleviation programmes, social security, telecommunications, transport, irrigation and power. In some of these areas like telecommunications, transport and power full or partial privatisation is feasible, and is in fact being undertaken. But in other activities where the private rate of return is unlikely to cover costs, privatisation may not be feasible. But the social rates of return can be much higher, and the government will then have to either subsidise private production and perhaps provision, or produce and supply the goods itself at subsidised prices. It needs to be noted that almost all these services are in the traditional domain of the States. This implies that the Central government can potentially shed more of its activities than the States. With unchanged revenue assignments, this is likely to raise

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7 Unlike the financial institutions, the banks have two-way transactions with essentially the same set of clients. That is the reason for computing the credit-deposit ratios in their case.

vertical imbalance. However, an unchanged net revenue distribution also does not appear likely.

For the success of fiscal reforms at its own level, the Central Government must bring its deficits under control. This cannot be achieved by working on only the receipts side of the budget; the Centre has to lower the rate of growth of its expenditure. The burden of this fiscal adjustment has to be largely borne by current expenditures which have been primarily responsible for the accelerated growth of Central expenditures. A part of this adjustment burden is likely to be passed on to the States through lower current transfers not mandated by the Finance Commission. In fact, such a trend is already visible (Sen, Rao and Ghosh, 1994). Regarding tax receipts, rates of custom duties levied and collected by the Centre have been and are being lowered as a part of the globalisation of the economy. But this need not necessarily reduce collections, since the tax base is likely to be larger. The net result may well be nil, i.e., approximately the same level of collections. But if other tax reforms broadly follow the suggestions of the Tax Reform Committee (India, 1992), particularly regarding the introduction of a value added tax, then the tax collections ought to rise somewhat, perhaps after an initial fall. Recent trends do indicate an upswing in tax collections at the Central level. Unless there is a similar rise in the tax collections at the State level, and there is nothing to indicate such a rise[8], this trend is likely to raise vertical imbalance. Moreover, in the absence of directed industrial investment through licensing requirements, competition among States to attract investments is likely to intensify. Such competition can be through lowering effective tax rates, or better provision of industrial infrastructure, or both. In all these cases, vertical imbalance is likely to rise.

The capital receipts of the States are also likely to be lower for several reasons. Through lower requirements of Statutory Liquidity Ratio of commercial banks, government borrowings (including those by States) will be lower. Also, the rationalisation of income tax incentives for small savings has already affected the collections from such schemes; the States' resources are likely to be smaller on this count as the lion's share of the collections

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8 In fact, expanding foreign trade itself is likely to have two opposite effects on tax revenue of the States. While increased imports at lower tariffs would raise the possibility of higher sales tax revenue, increased exports would lower the possibility, as export sales and the sale leading to export at the next stage are exempt from sales tax in India.

are passed on to the States as loans from the Centre. Other loans from the Centre to the States also are not likely to be available on the same scale as before due to lower availability of resources at the Centre. The Centre has to reduce its own borrowings to lower the fiscal deficit; in particular, the agreement to phase out treasury bills with the Reserve Bank of India would considerably harden the budget constraint of the Centre. While the implications of these developments for fiscal imbalances are not clear yet, they are certain to cause severe resource problems for the States unless they succeed in effecting significant economies in their expenditures.

Further, in certain areas, the States may be at a disadvantage as compared to the Centre in terms of carrying out unpopular reforms. The withdrawal of a large part of the food subsidy to consumers is a case in point. While the reaction to this step at the national level was muted, the rise in price of foodgrains obtained from the Food Corporation of India[9] cannot be transmitted to the consumers of the public distribution system by the State governments in some of the States due to the heavy political costs involved. States like Kerala, Tamil Nadu and Andhra Pradesh are examples of States facing such a dilemma; ultimately, the Central policy is likely to shift a part of the food subsidy burden to the States.

The process of liberalisation initiated as a part of the economic reforms package is likely to cause substantial structural unemployment in India in the short run. This is still not very evident because of the lack of an 'exit policy'. But appropriate reorganisation of the economy presupposes closure of firms perpetuated by the controls on domestic industrial sector and foreign trade. This logical extension of the present policy cannot be denied for long. Once exit of firms is allowed, the newly unemployed are likely to add to the woes of the States, as the burden of providing social security, retraining and employment to them will fall on the States.

Large scale privatisation, while plugging several drains on State finances, will require setting up an adequate regulatory framework requiring higher State expenditure. The

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9 The Government of India procures foodgrains from States with surplus through the Food Corporation of India (FCI) at annually determined procurement prices. These are then sold to States at subsidised rates for distribution through the Public Distribution System. The prices charged by FCI have been substantially raised in stages since 1992 to reduce the consumer subsidy element in the food subsidy.

burden on the legal system also is likely to rise with privatisation -- government provision of goods and services often ruled out litigations simply through statutes -- and this can also add to State level expenditures on the maintenance and possibly expansion of the judiciary.

While there can be many other implications of the economic reforms currently under way, on balance, it appears that the States have little chance of reducing their expenditures (even if the Centre succeeds in doing so), at least in the short run, while the overall resource constraints can be expected to become tighter. Thus, although rising vertical imbalance is probably a good working hypothesis, the actual degree of vertical imbalance in future years will depend on how this impassé is negotiated by the States; of greater concern is the possibility that their ability to manage their finances will face a difficult test in the coming years.

Predicting the trends in horizontal imbalance is far more hazardous at this point, because the impact of the economic reforms on individual States will depend crucially on the speed, nature and extent of policy adjustments at the State level in response to the changed scenario. The better-off States have the advantage of a better-equipped and better-informed administration along with better social and economic infrastructure. The lower income States, on the other hand, are better endowed with non-agricultural natural resources and cheap labour, which could attract industrial investment. The relative weights attached to these factors by the private industrial sector and the ability of the individual States to provide the necessary infrastructure will determine whether past patterns of regional development will be accentuated or reversed; the trends in horizontal fiscal imbalance will, in turn, depend on the outcome.

CHAPTER VI

INTERGOVERNMENTAL TRANSFERS IN INDIA : MAJOR ISSUES.

a. Introduction

Intergovernmental transfers is one of the most widely discussed and yet, controversial topics in fiscal federalism. In most federal countries these transfers have been employed as a potent instrument to resolve fiscal imbalances, both vertical and horizontal and to offset inter-jurisdictional spillovers. Intergovernmental transfers are also often employed by the Central government to influence the pattern of spending of sub-central governments or to implement its expenditure plans through the sub-central governments using them as agencies. The political role of the transfers is even more important. Intergovernmental transfers has been an important instrument of keeping the country together, enabling the sub-Central units to pursue their own goals while influencing their priorities through conditionalities. In this chapter, we review the rationale for intergovernmental transfers as discussed in the literature, examine the design of transfers to fulfil alternative objectives and in the light of this conceptual framework, analyse various forms of intergovernmental transfers in India.

A large part of the literature on intergovernmental transfers deals with their economic rationale. In this it is presumed that the economic objectives are the sole consideration for determining the quantum and distribution of transfers and the transfer systems are designed accordingly. In actual practice, however, the volume and the distribution of transfers reflect to a large extent political compromises, and their design reflects political and historical factors as much as economic objectives. A realistic analysis must recognise these political constraints without being hamstrung by it. Nevertheless, the emphasis on economic objectives helps to focus the analysis on the ideal design of the transfer schemes and the departures from this ideal can then be analysed in terms of various non-economic objectives. From this perspective, it is important to focus on the effects of intergovernmental transfers on allocative efficiency, distributional equity and macroeconomic stability rather than analysing the design of the transfers *per se* (Bird, 1993). In this chapter, we present the economic rationale for transfers to begin with and analyse the appropriate design of transfers to fulfill the stated economic objectives. Within this conceptual framework, we evaluate the designs of the prevailing transfer systems in India and examine their probable economic effects. At the same time, without a proper institutional mechanism, the transfer systems, however well designed, cannot be effective. The institutional mechanism evolved to dispense intergovernmental transfers is as important to instill confidence among different jurisdictions and to develop a healthy intergovernmental relationships as the design of the transfer system itself and therefore, the analysis of the existing arrangements assume relevance.

b. Intergovernmental Transfers: Economic Rationale

The design of intergovernmental transfers depends on the objectives they are required to subserve. The discussion on economic rationale for transfers, therefore, is important. In the literature, intergovernmental transfers are recommended to (i) close the fiscal gap; (ii) ensure fiscal equity; and (iii) offset interjurisdictional cost and benefit spillovers or for merit good reasons. In addition, transfers may also be given to carry out some agency functions for the Central government.

(i) Closing the fiscal gap: An important reason for giving transfers arises from the inadequacy of the assigned revenues to finance the required levels of public services by sub-Central governments. When the public services and tax rates are set at efficient levels and if the tax rates are set at levels to raise the required revenues, the sub-Central governments end up with deficits whereas the Central government would have a surplus. This vertical fiscal imbalance arises even when the assignments of functions and sources of finance are done solely on economic considerations. We have earlier referred to the comparative advantage of the Central government in raising revenues due to its predominance in undertaking redistributional and stabilisation functions. Therefore, the more progressive and broad-based taxes have to be assigned to the Centre and for efficiency reasons, sub-Central units are better placed to provide most of the public services as they can cater to the diversified preferences of the people residing in different jurisdictions better. Consequently, revenue sources do not match expenditure needs even in the most prosperous unit of sub-Central governments (Bird, 1993). In other words, even in the efficient system of assignments, the Centre has the comparative advantage of raising revenues and control "free-

riding" whereas the sub-Central authorities are better placed to provide public services corresponding to varying preferences of people in different jurisdictions (Breton,1987). In addition, there are political limitations on raising tax rates at sub-Central levels as well. In fact, the sub-Central governments compete with one another by reducing tax rates to attract trade and industry and consequently, the levels of public services provided will be non-optimal. Therefore, the Centre has to raise larger proportion of taxes and the States and local governments have to incur larger proportion of spending. Of course, this vertical fiscal imbalance problem can be resolved by giving greater tax powers to the sub-Central governments. But, assinging mobile tax bases to sub-Central governments could result in efficiency losses. Therefore, it is suggested that the problem of vertical fiscal imbalance has to be resolved by making vertical intergovernmental transfers.

(ii) *Fiscal Equity:* Equity is the most common argument put forward for giving Central transfers to States. In spite of many attempts to make out an objective basis on equity grounds, economic rationale for equalisation payments is yet to be thoroughly formulated and, in spite of the voluminous literature on the subject, the rationale for equalising intergovernmental transfers is mostly based on broad judgements rather than any objective criterion. It is therefore not surprising that equalisation is one of the most controversial topics in fiscal federalism.

The fiscal equity argument views intergovernmental transfers essentially as an instrument to resolve horizontal imbalances. Even the efficient assignment of functions and sources of finance necessarily causes imbalances between the capacity to raise revenues and expenditure responsibilities of the States (or more generally, sub-Central governments) and therefore, inter-jurisdictional differences in revenue capacities and expenditure needs will have to be resolved through horizontal equalisation. Thus, intergovernmental transfers are required to offset the fiscal disabilities of the States with lower than the stipulated (often set at the average level) revenue capacities and higher than the stipulated (average) expenditure needs.

The argument for intergovernmental transfers on equity grounds has been made either in terms of ensuring horizontal equity of individuals across the States or simply, to ensure inter-regional equity. Both the approaches build a case for unconditional or general purpose transfers from the Centre to the States on a progressive scale so as to offset the fiscal disabilities arising from low revenue capacity and high expenditure needs. In the literature, the efficiency and growth implications of equitable transfers have also been discussed at considerable length, though the controversy itself has remained rather inconclusive. (Scott, 1964, Wiseman, 1987).

The most persuasive case for intergovernmental transfers has been made on horizontal equity grounds by Buchanan (1950). Buchanan's argument is based on three premises. First, it is more sensible to consider equity in terms of persons rather than regions. According to him, "....equity in terms of States is difficult to comprehend and it carries little ethical force for policy implementation" (p. 586). Second, although fiscal justice in all-inclusive sense is illusory, its formulation in terms of 'equal treatment of equals' has been widely accepted and taken to be a central tenet. The requirements of horizontal equity is more meaningful than that of vertical equity. Third, the measurement of equity should consider both taxes and benefits. Given these premises, Buchanan demonstrates that so long as there are differences in fiscal capacity among the States, even when the Centre and the States separately treat equals equally, overall horizontal equity is violated. In order to ensure horizontal equity, the Central government can levy geographically discriminating tax rates. However, that may not be Constitutional in many countries (although it may be possible to get around this difficulty when tax bases are distributed between regions in a non-uniform manner, by an appropriate combination of revenue from different taxes) and even if it is, it could cause unintended allocative distortions. The alternative, therefore, is to make unconditional transfers from the richer to the poorer States to ensure horizontal equity among individuals.

The discussions that followed this seminal paper helped to clarify a number of issues and brought out important implications on intergovernmental transfers. It has been effectively argued by Musgrave (1962) that transfers are not necessary to establish horizontal equity if the States do not adopt a redistributive role. If, for example, the States levy benefit taxes, fiscal residuum (expenditure minus taxes) for all individuals will be automatically zero and as long as the Central fisc does not discriminate among individual equals geographically, horizontal equity is not violated. Thus, giving intergovernmental transfers is not necessary for ensuring horizontal equity. Nor is intergovernmental transfer a sufficient condition to ensure horizontal equity, for, it only ensures *potential* and not *actual* equality of equals (Musgrave, 1962). Another criticism of this horizontal equity argument is that having the same fiscal residuum is not the same thing as being on the same indifference curve; an individual with a given income level can be indifferent among many tax-benefit combinations each with a different fiscal residuum, depending upon her preferences (Scott, 1964 and Graham, 1963). The basic problem arises from differing indicators of horizontal equity -- equal fiscal residuum versus equal level of utility as indicated by being on the same indifference curve. If fiscal residuum is argued to be more tractable and therefore better suited to policy determination, it is not entirely convincing due to the fact that estimating the benefits from government expenditure for any economic agent is a very difficult task, as the existing literature on expenditure incidence shows. Even within the Buchanan framework, the information requirements on the part of the Central government is so large, that in making such an assumtion, as Buchanan does implicitly, the basic rationale for decentralisation -- better knowledge of local preferences at the sub-Central levels -- is denied. Realistically, it is difficult to progress logically from inter-personal equity to inter-regional equity and one might simply take the latter as a prescribed policy objective. The California Supreme Court judgement in the famous *Serrano vs. Priest* case (school finances should be independent of local wealth), or the Constituitonal requirement of ensuring similar availability of basic public services to all the citizens at similar tax costs in Canada are examples of such prescriptions.

Even more controversial was the issue of equity-efficiency trade off. According to Buchanan, inter-regional transfers designed to equalise fiscal positions of equals across the federation are also desirable from the viewpoint of allocative efficiency. Such transfers eliminate fiscal differentials across the States and thereby avoid fiscally induced distortions arising therefrom. Scott (1950, 1952) disagrees with this view. According to him, when income levels reflect resource endowments, the marginal productivity of labour in low income States is necessarily lower and, therefore, transfers given to these States prevents labour from migrating to States with higher marginal productivities and thereby, reduces the average product of the federation. Thus, equitable transfers do involve a cost in terms of lower GDP. Similar apprehension has been voiced also by Courchene (1978) who argues that transfers from high income regions to low income regions causes misallocation of nation's resources and reduces the incentive for the persons in the recipient States to work, save, migrate and to take risks.

The discussion that followed did not satisfactorily resolve the trade off between equity and efficiency. Whether or not the objectives of equity and efficiency are competing depended on the whether or not the income levels in the States reflected their resource endowments. Buchanan and Goetz (1972), argued that even when labour is freely mobile across States, migration decision of individuals has an implicit fiscal externality.[1] As the marginal migrant ignores this effect in his migration decisions, free migration would be generally inefficient. This conclusion was substantiated also by Flatters, Henderson, and Mieszkowski (1974) in their model of local government behaviour.

A more systematic approach to the analysis of efficiency implication of equitable transfers has been developed by Boadway and Flatters (1982). Taking comprehensive income as the index of wellbeing, they argue that the federal income tax as presently structured cannot ensure horizontal equity, for, its base does not accurately reflect the real income of persons. The problem arises because it would be virtually impossible for any of the States' budget policies to be distributionally neutral except in the unlikely event of having benefit taxes. The redistributive effect of States' fiscal operations is not taken account of in the Central tax base. The States provide quasi-public services, which are often perfect substitutes for private goods (incomes). When these are financed through resource rents or source-based taxes as against residence-based taxes, the net fiscal benefits (NFBs) will vary systematically over the provinces depending on their resource endowments.[2] The residents in the resource rich (high income) regions will have higher NFBs and their higher public consumption will not be taken account of in the tax base of the Central government. Thus, concurrent pursuit of redistribution by both Central and sub-Central governments violates horizontal equity and, the information cost of undoing States' redistribution is very high.

1 See also, Buchanan and Wagner (1970).

2 The problem exists even when the quasi-public services are financed through residence-based taxes, so long as there is no benefit taxation and the operation of the States' fiscal operations results in redistribution.

Boadway and Flatters define horizontal equity in two alternative ways. According to the *broad* view, the fiscal system should be equitable nationwide vis-a-vis the actions of all Governments. Two persons equally well off before federal and States' action must also be so afterwards. To fulfill 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 the States' 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. Two persons equally well off after the State budgets should be equally well off in the presence of both Central and State budgets. The Central budget need not offset the inequities introduced by the operation of the State budgets *per se*, but take the income distributional effects of the States' fiscal operations as a given datum. The transfers made to ensure horizontal equity will also be efficient, for, the marginal productivity of labour in the equilibrium will be equal to the wage rate including the implicit income arising from distributional effects of States' fiscal operations whereas, the efficient wage should exclude the latter. Thus, the redistributive effects of States' fiscal operations prevent the equalisation of marginal productivities of labour across the federation. Equalising transfers, in contrast, will eliminate the distortion created by the States' redistributional effects and help to equalise marginal productivities across the federation.[3]

The above analysis does not consider the existence of commodity taxes. When this is taken account of, and if the States' commodity tax systems are 'origin' based rather than 'destination' based, the possibility of inter-State tax exportation opens up an additional source of inequity and distortion. In such a situation, the implicit income on account of States' fiscal operations in more developed producing States would be larger, and labour in such States will get its wage rates higher than its marginal productivity. The problem gets compounded when we operate in an import substituting planned economy with entry barriers on both external and internal fronts. In such cases, the objectives of equity and efficiency are not conflicting.

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3 For a detailed analysis of these issues and a proof of this proposition, see Boadway and Flatters (1982), Chapter 3.

To summarise Boadway-Flatters view, equalising transfers are necessary on both equity and efficiency grounds. The sub-Central budgetary operations necessarily cause variations in NFBs and therefore, ensuring horizontal equity necessitates equalising transfers. Such transfers would also help in equating marginal productivity of labour across the federation and therefore, desirable on the grounds of allocative efficiency as well. In fact, economic efficiency calls for full equalisation of NFBs. Full equalisation of NFBs is necessary also for equity reason if the broad concept of horizontal equity is taken as the objective to be pursued. In contrast, if the narrow view is considered, full equalisation is not necessary; but this necessarily involves an efficiency cost.

To evolve an operational formula for equalisation, it is necessary to identify the sources of inequity. The inter-State differences in NFBs can arise from the differences in the States' own revenues or in the unit cost of providing public services. Differences in own revenues can be due to differences in fiscal capacities among the States or due to variations in their tax efforts. Transfers should equalise only the capacities and any attempt to equalise total revenues could have adverse incentives on the tax efforts of the States. Similarly, differences in the unit cost of providing public services can be due to factors which are beyond the control of the States or may simply arise from the States' profligate behaviour. It is important to ensure that the equalisation formula designed to ensure horizontal equity does not cause disincentives on the States' fiscal performances.[4] Therefore, transfers should be designed to offset differences in revenue capacities and variations in the unit cost of providing public services due to reasons beyond States' control. In other words, the objective of equalising transfers is to *enable* every State to provide a given normative level of public services at a given tax-price. This will, in addition to ensuring horizontal equity also enable the poorer sub-Central governments to respond efficiently to Central transfers intended to correct spillovers and thereby ensure a minimum bundle of public services to citizens as agents of the Central government (Feldstein, 1975).

(iii) Intergovernmental transfers to correct spillovers: In the literature, the most frequently advanced rationale for intergovernmental transfers is on the grounds of internalising

4 For a discussion on alternative equalising formula and their incentive effects, see Musgrave (1962).

externalities. When some proportion of the benefits of public services provided by a State spills over its jurisdiction, it ignores the benefits accruing to the non-residents while deciding the amount of the service to be provided. The jurisdiction equates the marginal benefits from the public service to the marginal cost of providing it and as this ignores the part of the benefit accruing to the non-residents, it results in non-optimal provision of the public service. Optimal provision of the service in question can be ensured through Coasian bribes or the jurisdictions voluntarily acting to compensate the spillovers (Gramlich, 1993). However, a more feasible way to handle these spillovers is through Central grants akin to 'Pigovian' subsidies to compensate the spillovers.[5] These transfers must necessarily be specific-purpose, requiring matching contributions from the States and the exact matching rate should depend upon the size of spillovers. This implies that the matching rate should vary with the degree of externality generated by various public services. Further, uniform rate of matching transfers would have non-uniform responsiveness in different States depending upon their level of development even when equalising transfers completely equalise fiscal capacities. In any case complete equalisation in fiscal capacities is never achieved in any federation and therefore, an individual State's responsiveness to a given matching rate could vary considerably. This calls for equalisation in the matching rate itself (Feldstein, 1975; Rao and Das-gupta, 1995).

(iv) Other objectives: As mentioned earlier, two other objectives of intergovernmental transfers are notable, namely, ensuring minimum standards of services considered as 'merit goods' in all the States and giving transfers to implement Central programs using the States as agencies. Central government may consider certain services as "meritorious" and therefore, may attempt to secure a certain minimum outlay on them. Accordingly, the transfers may be designed to secure specified minimum outlays on these services (Musgrave and Musgrave, 1976). Such transfers have to be purpose specific with or without matching requirements. These matching transfers could be close-ended with the matching ratios varying inversely with the States' response to them. The specific-purpose non-matching transfers, however, can achieve the objective of ensuring a specified minimum

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5 It is, however, far easier to encourage specific activities through subsidies than discourage activities with negative spillovers through taxes in the federal context. Negative intergovernmental grants are not very common, for obvious reasons.

expenditure outlay only when the entire amount required for the outlay is given as transfers. In that sense, this is not a cost effective way to ensure the minimum outlay. Nevertheless, this is equivalent to the Centre using the States as agencies to execute their spending programmes.

c. The Design of Intergovernmental Transfers

The design of intergovernmental transfers depend upon the objectives they are intended to subserve. The transfers given to offset vertical imbalances cannot be conditional, but have to be given in equal per capita terms. The transfers given to ensure horizontal equity, as mentioned earlier, have to be designed depending upon whether the broad or the narrow concept of horizontal equity is chosen. Generally, it is useful to consider the grants given to resolve vertical and horizontal imbalances together as the two concepts are inter-related. As already mentioned, the transfers given to offset spillovers should be specific purpose and open-ended with matching ratios varying for different services depending upon the degree of spillovers. Similarly, the transfers given to ensure minimum outlays on specified services should be specific purpose and close-ended with matching provisions. There is also a case for having matching ratios varying inversely with the level of development of the States to ensure uniformity in the responses of all the States to these transfers. The argument for equalising the matching ratios is particularly strong when equalising transfers do not fully offset the fiscal disabilities of poorer States.

While as mentioned above, the transfer schemes may be designed to suit the objectives they are intended to subserve, the general purpose transfers and specific purpose matching transfers are the two common forms seen in most federations. The designs of these transfers may be discussed in somewhat greater detail.

i. *General Purpose Transfers:* To resolve vertical and horizontal imbalances general purpose transfers from the Central to sub-central units are recommended. As the objective of these transfers is to enable the sub-central governments to provide a given level of public service at a given tax rate, the transfers should offset the fiscal disadvantages arising from lower revenue capacity and higher unit cost of providing public services. This is achieved by giving unconditional transfers 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.

Thus, the need-revenue gap for the i[th] State can be taken as

$$G_i = \overline{Q}C_i - \bar{t}B_i \qquad (1)$$

where G_i is the gap (per capita), $\overline{Q}$ is the desired (normative) level of composite public service provided by the State per capita. C_i is the unit cost of the public service (reckoned at justifiable costs given State specific cost disabilities beyond the control of the government), $\bar{t}$ is the standard tax effort, and B_i is the per capita tax base.

The fiscal disadvantage of the State (D_i) is determined on the basis of the difference between a State's need-revenue (G_i) gap and the normative gap (G^*) or the gap of the base line State. That is

$$D_i = G_i - G^* = \overline{Q}\,\overline{C_i} - \bar{t}B_i - G^* \qquad (2)$$

A State with a disadvantage [$D_i > O$] is eligible to receive aid, whereas one without [$Di < O$] is not. If the Central government sets apart 'M' amount to be distributed to the eligible States on the basis of their fiscal disadvantage, the amount of funds the i[th] eligible State would receive is given by

$$S_i N_i = \frac{(D_i N_i)^a}{\sum_{i=1}^{n} (D_i N_i)^a} M \text{ for all } D_i > 0 \qquad (3)$$

where S_i represents per capita transfers received by the i[th] State, N_i its population and the exponential 'a' represents the degree of progressivity that the Central government wishes to impart to the system.

First, whether or not a State is eligible to receive aid depends on the normatively chosen G^*. It is possible to select G^* such that even the State with the lowest G_i (or the State with the highest fiscal strength) is also eligible to receive aid. Second, the States may not be given grants to fill the entire gap, G_i - G^*; the share of individual States in such a case is determined by the exponential 'a' of the gap to be equalised, total amount of funds available for transfer (or perceived vertical fiscal imbalance), and gap of the State in relation to the total gap. The degree of equalisation achieved, thus, depends upon the normatively chosen G^*, the value of the exponential (a), and the amount of funds available for transfer (M).

ii. *Specific Purpose Transfers:* Specific purpose transfers as mentioned above are intended to set the prices right to ensure optimal provision of sub-central services having spillovers. Under the scheme, additional per capita outlay (Aij) required to ensure a minimum level of the public service 'j' in the i^{th} State would be the difference between the justifiable cost of providing the required minimum level of the service per capita ($Q^*_jC_{ij}$) and the same of the actual per capita service level provided in the State ($Q_{ij}C_{ij}$). That is

$$A_{ij} = Q_j^*C_{ij} - Q_{ij}C_{ij} \qquad (4)$$

The per capita grant to be given to each State to ensure the minimum standard of service is given by

$$S_{ij} = r_c(Q_j^*C_{ij} - Q_{ij}C_{ij}) \qquad (5)$$

such that

$$r_c + r_s = 1 \qquad (6)$$

where 'r_c' is the proportion of additional outlay the Central government bears and 'r_s' is the matching proportion the State government contributes. As the response to a given r_c can vary between States, to obtain a given uniform impact r_c should vary inversely with the rate of response. Similarly, to ensure the specified level of service, 'r_c' should be inversely related to the price elasticity of demand for the service. If the price elasticity is zero, to ensure the minimum level of service it would be necessary for the Central government to transfer the entire quantum of expenditure required to provide the prescribed level of the public service.

The ideal design of the transfer schemes discussed above, however, is hardly found in actual practice. This is because, as mentioned earlier, in actual practice, federal transfers are influenced as much by political bargaining and other non economic factors as by economic rationality. Therefore, it would be useful to keep the ideal system in the background in evaluating the actual systems obtaining in a country. It is also important that the transfers should be transparent and predictable and should take account of the particular problems and diversities of each country (Bird, 1993).

Table 6.1

Central Transfers to States

Years	Per Capita Transfers (Rs)	Transfers as Percentage of GDP	Transfers as Percentage of Central Revenues	Transfers as Percentage of State Revenues	Transfers as Percentage of State Expenditures
1975-76	47.5	3.66	31.8	38.6	44.8
1980-81	96.4	4.81	34.8	43.5	47.5
1985-86	183.2	5.27	35.3	43.3	44.8
1990-91	315.7	4.97	34.4	42.1	39.6
1991-92	376.5	5.23	33.9	41.3	39.1
1992-93 (RE)	446.3	5.52	35.6	43.8	42.4

Source: *Indian Economic Statistics/ Public Finance Statistics*, Ministry of Finance, Government of India.

d. Intergovernmental Transfers in India

Intergovernmental transfers have played an important role in resolving vertical fiscal imbalances in India. Transfers from the Central government constitute a significant part of State finances (Table 6.1). They finance about 42 per cent of the States' current expenditures; their share in States' total revenues is 44 per cent and almost 36 per cent of the revenues collected by the Central government is transferred to the States by way of tax devolution and grants. What is more, on an average, the transfers have grown at a rate faster than the revenues collected by both the Centre and the States. During the one and a half decades since the mid-seventies, while the annual average rate of growth of States' own revenues was just about 15 per cent and that of Central revenues was even lower at 14.5 per cent, the Central transfers to States increased at 16.9 per cent per year. As a proportion of Central revenues, the transfers steadily increased from 31.8 per cent in 1975-76 to 35.6 per cent in 1992-93. Similarly, as a ratio of States' revenues, the transfers increased from 38.6 per cent to 43.8 per cent during the period.

A notable feature of the fiscal arrangements in the Indian federal system is the existence of multiple channels of transfers from the Centre to the States. The founding fathers of the Constitution sought to ensure that the finances of the Centre and the States are kept on an even keel. Therefore, the Constitution provided for the sharing of individual income tax and union excise duties, and for giving grants-in-aid to the States in need of assistance and through these, vertical and horizontal imbalances were sought to be offset. To ensure an impartial and objective arrangement, the tax devolution and grants were to be made based on the recommendations of a semi-judicial body, the Finance Commission, to be set up by the President of India every five years (or earlier, if necessary), under Article 280. However, with development planning gaining emphasis, the Planning Commission became a major dispenser of funds to the States by way of both grants and loans. As there is no specific provision in the Constitution for the distribution of plan transfers, the Central government channelled the transfers under Article 282, construing it as a miscellaneous provision for giving grants.[6] In the initial years the plan transfers were schematic but since 1969, they have been distributed on the basis of a consensus formula decided by the National Development Council (NDC)[7]. Since then, however, various ministries at the Centre felt the need to influence States' outlays on selected items of expenditure through specific purpose transfers with or without varying matching requirements. Thus, at present, there are three major channels of Central transfers to States namely, (i) tax devolution and grants mandated by the Finance Commission, (ii) grants and loans determined by the Planning Commission, and (iii)

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6 The constitutional experts have questioned the legality of transferring funds under Article 282. Some experts, notably Mr. K.K. Venugopal and A.G. Noorani argue this to be clearly unconstitutional. Others like N. A. Palkhivala consider this to be permissible. However, even they consider that this provison should be used only sparingly and channelising large amount of funds for plan purposes under this article is not in keeping with the spirit of the Constitution (See, NIPFP, 1993).

7 The NDC is chaired by the Prime Minister and its members include all cabinet ministers at the Centre, Chief Ministers of the States and members of the Planning Commission.

transfers for several Central sector and centrally sponsored schemes devolved by various Central ministries.

Table 6.2

Current Transfers from the Centre to the States

(Rs billion)

Plan periods/ years	Finance Commission Transfers			Plan Grants			Other Grants	Total
	Tax devolution	Statutory grants	Total	State plan schemes	Central sector and Centrally sponsored schemes	Total		
Fourth plan (1969-74)	45.62 (54.2)	8.59 (10.2)	54.21 (64.6)	10.77 (12.8)	9.69 (11.6)	20.46 (24.4)	9.26 (11.0)	83.93 (100.0)
Fifth plan (1974-79)	82.67 (50.2)	28.23 (17.1)	110.90 (67.3)	29.07 (17.7)	19.32 (11.7)	48.39 (29.4)	5.39 (3.3)	164.68 (100.0)
Sixth plan (1980-85)	237.28 (57.0)	21.39 (5.1)	258.67 (62.1)	73.82 (17.7)	69.0 (16.6)	142.82 (34.3)	15.06 (3.6)	416.54 (100.0)
Seventh plan (1985-90)	494.63 (54.2)	62.73 (6.9)	557.36 (61.0)	155.23 (17.1)	165.10 (18.0)	320.33 (35.1)	35.45 (3.9)	913.14 (100.0)
1991-92	171.97 (52.2)	34.47 (10.5)	206.44 (62.7)	57.17 (14.2)	55.36 (16.8)	112.53 (34.1)	10.17 (3.1)	329.14 (100.0)
1992-93	205.24 (53.4)	20.83 (5.5)	226.07 (58.9)	80.34 (20.9)	66.78 (17.4)	147.12 (38.3)	10.48 (2.7)	383.66 (100.0)

Note: Figures in parenthesis are percentages to total transfers.

Source: *Indian Economic Statistics/Public Finance Statistics*, Ministry of Finance, Government of India.

The relative shares of the three channels of Central transfers to States since the fourth five year plan presented in Table 6.2 bring out three important features namely, (i) The share of transfers recommended by the Finance Commission or statutory transfers in total current transfers has shown a decline from about 65 per cent during the fourth plan (1969-74) to just a little over 60 per cent in the seventh plan; the statutory transfers now account for less than 59 per cent. (ii) Within statutory transfers, the proportion of tax devolution has not only been high but also has shown a steady increase whereas that of the grants has declined. The tax devolution which constituted 84 per cent of statutory transfers during the fourth plan period increased to almost 90 per cent during the seventh plan. (iii) The formula based transfers given by the Finance and Planning Commissions have declined significantly since the fifth plan. These transfers formed 85 per cent of total transfers in the fifth plan period and during the seventh plan period, the share was much lower at 78 per cent. The non-formula related transfers, particularly for Central sector and Centrally sponsored schemes have shown a substantial increase. This indicates an increasing degree of discretion exercised by the Central government; (iv) The specific purpose transfers, a large proportion of which was with matching requirements from the States, increased steadily from 11.6 per cent in the fourth and the fifth plan periods to about 18 per cent during the seventh plan period. This clearly indicates the rising tendency of the Central government to influence the expenditure priorities of the States through the instrument of federal transfers. It would be instructive to discuss the three major channels of Central transfers to States in some detail.

1. The Finance Commission Transfers:

The terms of reference: As already mentioned, under Article 280 of the Constitution, the President of India appoints the Finance Commission every five years or earlier to make recommendations on:

"(i) the distribution between the Union and the States of the net proceeds of taxes which are to be or may be divided between them and the allocation between the States of the respective shares of such proceeds;

(ii) the principles which should govern the grants-in-aid of the revenues of the States, out of the consolidated fund of India and the sums to be paid to the States which are in need of assistance by way of grants-in-aid of their revenues under Article 275 of the constitution; and

(iii) any other matter referred to the Commission by the President in the interest of sound finance".[8]

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8 Under this sub-clause, the Finance Commissions have been asked to examine and make recommendations on matters such as the distribution of certain assigned taxes like estate duty on non-agricultural land, grants in lieu of tax on railway passenger taxes, additional excise duties in lieu of sales tax on sugar, textiles and tobacco, to assess States' indebtedness and suggest corrective measures to be taken and to review the policy and arrangements in regard to financing of relief expenditures by the States affected by natural calamities and recommend appropriate remedial measures.

The 73rd and 74th amendments to the Constitution now make it obligatory upon the Commission to recommend "the measures needed to augment the Consolidated Fund of a State to supplement the resources of the panchayats/municipalities in the State on the basis of the recommendations made by the Finance Commission of the State." Although the State Finance Commissions had not submitted their reports by the time the Tenth Finance Commission submitted its own, the latter recommended some *ad hoc* grants to the States to be passed on to the local bodies.

So far, ten Finance Commissions have made their recommendations and, by and large, their recommendations have been accepted by the government. Yet, the working of these Commissions, the design of the transfer schemes evolved by them and the approach and methodology adopted by them in formulating their recommendations have come in for severe criticism. The main criticisms are (i) those relating to attempts to restrict the scope of the Finance Commissions through the Presidential terms of reference; (ii) those on the approach and methodology employed by the Commissions to arrive at their recommendations and the consequent implications for the design of the transfer scheme evolved by them in terms of equity and incentives.

(i) Restrictions on the scope of the Commission: As pointed out, with the Planning Commission gaining predominance in allocative decisions, restrictions were sought to be placed on the Finance Commissions' role through the Presidential order detailing the terms of reference. The problem did not surface for the first three Commissions as development planning itself was in its infancy. With the Planning Commission assuming the responsibility of improving the standards of social and economic infrastructures and separately giving grants and loans to the States to ensure the planned outlay on them, the Finance Commissions' role was restricted to the examination of the non-plan revenue (current) accounts of the States. The conflict in the jurisdictions surfaced when the third Finance Commission made its recommendations. The Government rejected the majority recommendation of the Commission covering 75 per cent of current plan requirements of the States and accepted the suggestion contained in the note of dissent given by the member-secretary to stay clear of the plan side of the States' budgets altogether. Though the Constitution does not place any restrictions on the scope, the Presidential terms of reference

itself excluded the Finance Commissions from examining the plan budgets from fourth Commission onwards. This provoked the Chairman of the fourth Commission to clarify that ".... there is nothing to exclude from its purview, grants for meeting revenue expenditures on the plan schemes nor is there any explicit bar against grants for capital purposes" (India, 1965. p.12.). Yet the Commission did not do so "... as it would blur the entire division of functions between the (Finance) Commission and the Planning Commission" (p.12.). In this sense, the blame for restricting the scope of the Finance Commissions has to be placed as much on the hesitancy on the part of the Commissions themselves as on the terms of reference given to them.

Restricting the scope of Finance Commission to meet only the non-plan requirements has led to several problems. First, this has prevented the Commission from undertaking a comprehensive overview of the finances of State governments. Second, the plan and non-plan sides of the budget are interdependent and compartmentalisation of the two sides has created problems in proper fiscal management and cost-efficient provision of public services. The maintenance expenditures on completed plan projects are considered non-plan and so are the interest payments on the loans incurred to finance the plans. Sometimes even some important developmental projects are undertaken outside the plan, particularly if such projects involve inter-state disputes as in the case of some irrigation projects in Karnataka. Of course, the terms of reference of the Ninth Finance Commission did not impose any restriction on its scope, but the Commission could not break the shackles imposed by history; the convention of assessing the non-plan side separately from the plan side evolved over the years was continued. But even this discretion was withdrawn in the terms of reference given to the Tenth Finance Commission and the Commission was restricted to assess only the current non-plan requirement of the States.

(ii) Methodology - the gap-filling approach: The Finance Commissions' approach to federal transfers consists of (i) assessment of overall budgetary requirements of the Centre and States to determine the volume of resources required by the individual States and available for transfer with the Centre during the period of recommendation, (ii) projecting States' own current revenues and non-plan current expenditures, (iii) distributing

assigned taxes,[9] broadly on the basis of origin, (iv) distributing shareable taxes -- the personal income tax and Union excise duties -- between the Centre and the States and among the States *inter se*; and (v) filling the gap between projected expenditures and revenues after tax devolution with grants.[10] This is popularly known as the "gap-filling" approach.

There are no serious problems in distributing assigned taxes, as they have to be done according to the origin. In any case, after the abolition of estate duty on non-agricultural property in 1985, the only item for distribution under this category is the grants in lieu of tax on railway passenger fares. Also, the proceeds of additional excise duties in lieu of sales taxes of sugar, textiles and tobacco products which were voluntarily surrendered by the States to the Centre in 1957, are required to be distributed on the basis of origin. Of course, the States have often highlighted that the Centre has not put in adequate effort in mobilising revenues from the taxes under Article 269 which are to be levied by the Centre, but the proceeds of which would accrue to the States. In particular, there has been a repeated demand to levy the tax on advertisements. Some of the Finance Commissions did explore the feasibility of levying the tax, but felt that the revenue potential from these taxes was not large enough to make any significant impact. True, the State's demand was to include advertisements in radio and television also in the tax base but the Finance Commissions did not go into the issue of amending the Constitution to enlarge the scope of Article 269 to include advertisements in audio-visual media along with newspaper advertisements. In any case, revenue from assigned taxes are small at present forming less than 5 per cent of total transfers and do not have the potential to be significantly larger without the necessary Constitutional amendment.

Shared taxes, as mentioned above, consist of non-corporate income tax and union excise duty. The net proceeds from non-corporate income tax (excluding revenue from

9 These are additional excise duties in lieu of sales tax, estate duty in non-agricultural land (abolished since 1985), wealth tax on agricultural property (abolished since 1982) and grants in lieu of repealed tax on railway passenger fares.

10 The grants (G_i) receivable by the i^{th} State is given by,

$$G_i = E_i - (R_{oi} + R_{ai} + R_{si}), \qquad G_i \geq O,$$

where E_i denotes projected non-plan current expenditures of the i^{th} State, R_{oi} = projected own revenues of the i^{th} State, R_{ai} = projected share of assigned revenues of the i^{th} states, and R_{si} = projected shared taxes of the i^{th} State.

certain items such as tax on emoluments of Central government employees and surcharges) **must be** shared between the Centre and the States under Article 270 of the constitution. On the other hand, revenue from Union excise duties **could be** shared under Article 272 of the Constitution as decided by the Parliament. The Parliament did decide to share the proceeds of this tax with the States. The States' share of the net proceeds from personal income tax and Union excise duties and the criteria adopted for their distribution among individual States according to the recommendations of the ten Finance Commissions are summarised in the Annexures 6.1 and 6.2. Of course, the Tenth Finance Commission has recommended appropriate Constitutional amendments to specify a fixed percentage (29 per cent) of the gross total tax revenue of the Centre to be shared among the States, and merge the additional excise duty with the basic excise duty.

An important feature of tax devolution recommended by the Finance Commissions is that, while the criteria adopted for distributing them are different from the principles adopted for giving grants-in-aid, nowhere is it made clear that the economic objectives of the two instruments are different (Rao, 1987). The tax devolution is recommended mainly on the basis of general economic indicators and not fiscal disadvantage *per se* and grants are given to offset the residuary fiscal disadvantages of the States as quantified by the Commissions. Even in the case of tax devolution, the criterion adopted for the distribution of non-corporate income tax was different from those used to distribute excise duty until the tenth Finance Commission eliminated the distinction. The tenth Finance Commission, however, set aside a part of the Union excise duty to distribute to post-devolution deficit States. Further, assigning weights to contradictory factors like 'contribution' and 'backwardness' in the same formula has rendered the achievement of the overall objective of transfers namely, offsetting the fiscal disadvantages of poorer States, difficult. In fact, these are instances which illustrate the difference between the process concept of equity and outcome concept of equity as distinguished by Friedman (1986).

Grants, as mentioned above, are determined on the basis of projected gaps between non-plan current expenditures and post-tax devolution revenues. In this sense, the Finance Commission's role has been to act as fiscal "dentists" filling in budgetary "cavities". Thus, the design of transfer schemes by the Commission not only does not serve the overall objective of federal transfers, but also provides an incentive for lax fiscal management. Some of the Commissions (particularly after the sixth), being aware of the fact that the grants did not enable the poorer States to enhance the standards of their services, attempted to increase outlays on specified administrative, social and economic services in the States with less than average expenditure by making closed-ended specific-purpose non-matching grants. Such a design of transfers too is clearly inappropriate, for, the objective of enhancing outlays on specified services can be best achieved through open ended specific-purpose transfers and not through close ended specific purpose non-matching transfers.

(iii) *Evaluation of Finance Commission transfers:* The 'gap-filling' approach outlined above suffers from a number of shortcomings. First, none of the Finance Commissions made an assessment of the overall resource position of the Centre and the proportion of the resources required to meet its commitments on any objective basis, although the terms of reference explicitly required them to do so. They merely made judgements about the distribution of non-corporate income tax and union excise duty between the Central and the States. In fact, the Commissions found it difficult to evolve any objective criteria for evaluating Centre's needs. On the other hand, by continuously raising States' share in sharable taxes, they implicitly presumed that the Centre had more resources than its needs or that it was the Centre which should or could raise more resources. With the deterioration in the Centre's own fiscal position in the eighties, larger devolution meant higher fiscal imbalance at the Centre and the exercise of distributing transfers became one of distributing deficits.

Second, the prevailing practice of dealing with plan and non-plan requirements of the States separately by the Planning and Finance Commissions has not only prevented them from taking a holistic view of fiscal needs of the States, but also led them to work at cross-purposes. The plan and non-plan expenditures are interdependent. The expenditures on completed plan schemes are classified as non-plan if a State chose to do so. The interest payable on plan loans is a non-plan item. On the other hand, there are several instances when new expenditures of developmental nature are undertaken on the non-plan side. In fact, whether or not a particular developmental scheme should be included under plan is left to the discretion of the State concerned. A number of irrigation projects in Karnataka, for example have not been included under plan schemes because of river water dispute with other States. In Kerala, the Mahatma Gandhi University in Cochin was started entirely as a non-plan item. Besides the lack of coordination, the compartmentalised treatment of plan and non-plan expenditure needs has had the effect of inadequate provision for the maintenance of assets created to save resources to have a large sized current plan in earlier plans. From the States' point of view, the separate assessments gave them the opportunity to submit different projections to the two Commissions, with an overestimated non-plan budgetary gap to the Finance Commission and overestimated saving in the non-plan account to the Planning Commission. Even the presence of a common member in both the Commissions has not made any difference to this tendency.

The third important weakness of the transfer scheme evolved by the Finance Commissions is the lack of purposiveness in their design. These transfers have not been designed to meet the major objective of unconditional transfers, namely, offsetting fiscal disadvantages of the States. The tax devolution was decided on different considerations from those of the grants in aid, and, even in the case of the former, the criteria used for distributing personal income tax were different from those of excise duties until the Tenth Finance Commission. The earlier Commissions recommended tax devolution mainly on the basis of population but, with the deterioration in Central finances, better targeting had to be done to offset fiscal disadvantages of poorer States by assigning greater weight to the backwardness factor by the later Commissions. Even so, a predominant proportion of transfers continued to be given as tax devolution and these were made on the basis of general economic indicators, though with high weights assigned to the backwardness factor, but not targetted to offset fiscal disadvantages of the States *per se*. The tendency continues to hold sway, as the Tenth Finance Commission completely rejects the small weight earlier Commissions attached to collections, i.e., the origin, but only substitutes an infrastructure index for the backwardness factor. This, apart from being an imperfect indicator for fiscal equalisation, is a misfit in the context of revenue expenditures. Actually, the higher the index, the greater is the need for maintenance expenditure, which the Tenth Finance Commission fails to consider. This index is really applicable in the context of capital transfers only.

Fourth, in spite of the attempts by the successive Commissions to ensure larger flow of resources to poorer States by assigning greater weight to the backwardness factor in the tax devolution formula, the methodology adopted by the successive Commissions has had an inherent bias against poorer States. As the projections were made by taking the existing revenues and non-plan expenditures with some minor modifications as bases, the standards of services in the States with lower tax bases could not be enhanced as the budgetary gaps projected on the basis of existing low levels of services in these States would be small. Thus the tyranny of the base year persisted. At the same time, as bulk of the transfers - the tax devolution - was distributed on the basis of general economic indicators, even the States with no fiscal disabilities in the Commissions' own reckoning received substantial amounts. Consequently, while the States with greater means ended up with high levels of estimated per capita non-plan surpluses after the award of the Finance Commissions, those with low tax bases were barely able to balance their non-plan accounts and often, as the Finance Commissions' assumptions were unrealistic, the States had to use the plan funds to finance non-plan current deficits.

Table 6.3 shows the non-plan surpluses of the major States after the Finance Commission recommendations as estimated by them. Of course, the actual surpluses were substantially lower than those estimated figures because, in actual practice, the States did not adhere to the selective norms used by the Commissions in their projections and the Commissions also made unrealistic price assumptions. Nevertheless, these numbers represent policy targetting actually attempted by the Commissions and hence, useful to evaluate the design of transfer schemes evolved by them.

The estimates as projected by the Commissions reproduced in Table 6.3 clearly show that the high income States consistently had per capita surpluses significantly higher than the average whereas the surpluses in the low income States were below the average. The differences in surpluses have also been increasing over the years. In fact, the per capita non-plan surpluses in high income States were about three times that of the low income States according to the Sixth Finance Commission's recommendation, but according to the Ninth Finance Commission's recommendation it was about four times with the Tenth Commission's recommendations, it would be almost five times. According to the Ninth and

Tenth Finance Commissions' recommendations, the average surplus of low income States was less than 50 per cent of the average surpluses of all the States. Given this unequal starting position, the richer States could make larger plan investments resulting in imbalances in the pattern of development itself.

Table 6.3

Per Capita Non-plan Revenue Surpluses After the Recommendations of Finance Commissions

(Rupees per annum)

States	Sixth Finance Commission (1974-79)	Seventh Finance Commission (1979-84)	Eighth Finance Commission (1984-89)	Ninth Finance Commission (1990-95)	Tenth Finance Commission (1995-2000)
High Income States	**153.12**	**435.11**	**826.52**	**1176.67**	**2523.72**
Gujarat	120.32	331.66	629.89	915.47	2400.78
Haryana	217.84	509.69	920.12	1445.40	3311.79
Maharashtra	135.74	465.53	885.37	1380.40	2803.22
Punjab	234.71	473.58	927.41	686.78	988.57
Middle Income States	**43.06**	**220.97**	**438.23**	**600.96**	**1258.19**
Andhra Pradesh	15.21	178.03	333.82	660.24	389.04
Karnataka	80.47	263.4	478.84	993.08	2935.55
Kerala	3.41	94.41	228.48	138.11	1253.86
Tamil Nadu	42.67	140.43	601.53	752.46	1690.95
West Bengal	21.17	143.13	29.66	358.64	666.08
Low Income States	**49.74**	**253.68**	**366.81**	**273.49**	**510.26**
Bihar	29.89	159.96	132.48	433.17	289.07
Madhya Pradesh	37.61	218.85	356.05	323.67	1208.79
Orissa	30.89	27.91	47.18	168.96	155.62
Rajasthan	26.01	77.57	97.33	205.31	813.38
Uttar Pradesh	30.02	183.50	309.88	195.82	297.60
Average	**55.48**	**215.58**	**380.80**	**562.26**	**1159.80**
Proportion of Maximum/ Minimum	68.76	18.26	31.27	10.47	~~4.70~~ 31.28

Source: Reports of the Finance Commissions.

Fifth, the fiscal 'dentistry' or the 'gap-filling' approach adopted by the Finance Commissions has had adverse effects on incentives. At the Central level, it is pointed out that the Centre has tended to concentrate on non-shareable sources of revenue like the import duties, thereby distorting the pattern of resource mobilization. Transferring 85 per cent of the net proceeds from personal income tax is said to have created lack of interest in it for the Centre.[11] Similarly, it is pointed out that the Centre has tended to mobilise resources by increasing administered prices on public monopolies rather than increasing excise duties on them. Again concentrating on administered price increases of public monopolies purely for revenue reasons can alter relative prices in unintended ways. At the State level, the gap-filling approach is said to have had not only disincentive effects on tax effort but also has led to profligacy in spending. At the same time, as tax devolution is not related to the assessments made by the Finance Commissions and the grants are given as a residuary form of assistance, the methodology of scrutinising the budgets has had relevance only to the States with post-devolution gaps in their non-plan revenue accounts.[12]

The more recent Commissions modified the approach in response to the above criticisms in two ways. First, tax devolution was enhanced substantially so that very few States were left with deficits after tax devolution. The seventh Commission, for example, increased the States' share of excise duty from 20 per cent to 40 per cent. Alongside, higher weights were assigned to the backwardness factor to devolve larger tax shares to the poorer States. Attempts by successive Commissions to better target tax devolutions to 'backward' States employing a variety of factors as indicators of backwardness resulted in complicating the formula for distribution. For example, the ninth Finance Commission used both "inverse" and "distance" variants of per capita income besides a 'composite index' to denote backwardness (Annexure 6.1). Further, as an overwhelming proportion of transfers was given on the basis of general economic indicators, the detailed exercises on making assessments had relevance only to a small proportion of transfers. Second, the more recent Commissions introduced selective norms for the Centre and the States by targeting the rates of growth of

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11 For arguments on these lines, see Burgess and Stern (1993). Das-Gupta and Mookherjee (1994), however, refute this hypothesis. In any case, the Tenth Finance Commission has reduced the States' share to 77.5 per cent and has recommended sharing of all Central taxes after the necessary Constitutional amendment.

12 For details, see, Rao and Chelliah (1991).

revenues and expenditures and by assuming certain rates of return on their loans and investments. In fact, the ninth Finance Commission went as far as estimating revenue capacities and expenditure needs of the States. This is a marked improvement over the past practices; yet, the practice of having different approaches for making tax devolution and grants reduced the relevance of such exercises. Although the norms prescribed for both the Centre and the States lack a mechanism of enforcement (in fact, there is no strong reason for the Finance Commission to do so as long as the 'right' incentives are built into the system), the Central government has a greater ability to nullify the possible penalties for not conforming to the norms, primarily due to its greater command over resources raised through different means including deficit financing. While Finance Commissions could bite the States, they could only 'bark' at the Centre (Guhan, 1989). Of course, the Tenth Finance Commission has eschewed normative estimates of revenue and expenditures for want of detailed data.

2. Plan transfers:

Plan transfers from the Centre to the States consist of grants and loans. Prior to 1969 these were distributed largely on schematic basis in which both the quantum of transfers and its loan-grant components were discretionary. However, since 1969, the plan assistance has been distributed on the basis of the "Gadgil formula" approved by the National Development Council modified from time to time. The latest modification in the formula was done in December, 1991. According to this, 30 per cent of the funds available for distribution is kept apart for the special category States. Assistance to them is given on the basis of plan projects formulated by them and 90 per cent of the transfer is given by way of grants and the remaining part as loans. The 70 per cent of the total funds available for 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 States. Of the 25 per cent weight assigned to per capita SDP, the major portion of the funds (20 per cent) is allocated only to the States with less than average per capita SDP on the basis of the "inverse" formula; remaining 5 per cent of the funds is assigned to all the States according to the "distance" formula. For the major States, assistance is given by way of grants and loans in the ratio of 30:70. The transfers given to the States for plan purposes are not related to the size or composition of plan investments (See, Annexure 6.2).

The Planning Commission works out five year plan investments for each of the sectors and the States. Keeping this in the background and based on the estimated resource availability consisting of balance from current revenue, contribution of public enterprises, additional resource mobilisation, Central plan assistance (grants and loans), market borrowings and other miscellaneous capital receipts, the States work out their respective annual plans for each year which is approved by the Planning Commission. Thus, in the final analysis, given the quantum of Central transfers to States as determined by the Gadgil formula at the margin, it is mainly the own resources of the States that determine the plan size in the States. Therefore, the link between the five year plans initially drawn up by the Planning Commission and the annual plans finally worked out by the States is rather tenuous.

Further, the transfers are not directly related to the shortfall in States' resources, given the required volume of plan investments and own resources reckoned at a standard level of effort. Thus, transfers given to the States for plan purposes as also their grant-loan components are determined independently of the required plan investments, their sectoral composition, resources available with the States and their fiscal performances. In fact, the grant component of the Central plan assistance has been kept at 30 per cent because, at the time the Gadgil formula was introduced, the current component of plan outlay was approximately 30 per cent. Of course, there were considerable variations in the ratio of current plan expenditures among individual States, but the grant-loan component of plan assistance for the major States has been kept constant though, for the special category States the grant portion has been kept at 90 per cent. The constancy in the grant portion to all the major States does not take into account the differing repayment abilities of the States; besides, this is inherently biased against the States which lay greater emphasis on human resource development as compared to those with emphasis on material capital formation. In the former, the current expenditure component according to the prevailing budgeting practices would be higher and in the medium term, the return on these expenditures would accrue to the individual rather than the government; these States with larger current component of plan expenditures would have as much of interest liability as the States with larger share of capital expenditures, but with much lower levels of revenue yielding assets. There is certainly a case for varying grant component of Central plan assistance depending on at least the repayment capacity of individual States.

The case for varying the grant-loan ratio can be made on regional equity grounds also. Assuming a progressive initial distribution of Central Assistance to States, the higher loan component in the assistance to major States causes a greater debt servicing burden for the lower income States. Also given that the public investments yield a rate of return sufficient to cover debt servicing liabilities in hardly any State, the future burden of these costs are higher for the backward States as compared to the other States, which reduces the degree of initial progressivity in the distribution of plan assistance to a considerable extent.

Table 6.4

Per Capita Federal Fiscal Transfers and plan Outlay in the States During the Seventh plan

(At 1981-82 Rupees)

States	Per capita annual SDP (1982-85) (at current prices)	Index of taxable capacity 1984-85	States' own resources for the plan before statutory transfers	Statutory transfers shared taxed and FC grants	Non-plan loans	States' own resources for the plan after statutory transfers	Central plan assistance including centrally sponsored schemes	Plan outlay
			(7-6-5)		Actuals	Actuals	Actuals	Actuals
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
High Income States	**3340**	**146.30**	**-134.24**	**321.43**	**534.83**	**722.02**	**533.18**	**1255.20**
Punjab	4013	169.18	-459.28	280.45	318.05	139.23	1131.83	1271.06
Maharashtra	3384	142.75	229.72	316.24	509.77	1055.73	233.52	1289.25
Haryana	3043	151.11	-175.07	344.39	570.99	740.31	463.18	1203.49
Gujarat	2929	122.16	-132.35	344.62	740.53	952.79	304.20	1256.99
Middle Income States	**2206**	**112.82**	**-271.46**	**439.65**	**255.78**	**423.96**	**227.88**	**651.84**
Karnataka	2461	117.68	-49.98	389.70	112.04	451.76	213.36	665.12
West Bengal	2230	76.09	-421.11	483.04	278.40	340.34	140.56	480.90
Kerala	2144	117.60	-521.60	440.26	380.98	299.65	308.19	607.84
Tamil Nadu	2142	138.64	-186.56	439.21	316.60	569.25	229.51	798.76
Andhra Pradesh	2053	114.04	-178.07	446.02	190.87	458.82	247.77	706.59
Low Income States	**1689**	**50.06**	**-265.69**	**472.19**	**171.11**	**377.60**	**287.94**	**665.55**
Madhya Pradesh	1860	58.14	-139.69	422.13	227.32	509.75	200.00	700.76
Rajasthan	1820	67.46	-380.23	389.99	291.74	301.50	421.77	723.27
Orissa	1728	37.72	-250.75	582.07	126.74	458.07	310.56	768.63
Uttar Pradesh	1713	54.14	-256.19	440.86	143.54	328.21	272.18	600.39
Bihar	1323	32.85	-301.61	525.89	66.20	290.49	235.21	525.70
14 States' Average	**2345**	**99.97**	**-211.92**	**428.94**	**261.35**	**478.36**	**276.90**	**755.27**

Source: Columns 1 and 2: Second Report of the Ninth Finance Commission, Ministry of Finance, Government of India, 1990.
Other Columns: Finance/planning departments of the State governments.

The tenuous relationship between required plan investments and plan transfers becomes abundantly clear when we examine per capita plan outlays during the seventh plan presented in Table 6.4. The States' own resources after meeting their non-plan expenditures but before any transfer is made shows varying deficits and these deficits are generally larger in the middle and the low income States than in the high income States. The statutory transfers have an equalising tendency, but the non-plan loans tend to be disequalising. Consequently, after the statutory transfers and non-plan loans from the Centre, it is seen that the high-income States have larger per capita resources than the poorer States. This is further accentuated by transfers for State plan and centrally sponsored schemes and in the end, average per capita plan outlay in the high income States is almost twice as much as in the middle and low income States.

3. Assistance for Central Sector and Centrally Sponsored Schemes:

Another major item of Central transfers to States is the assistance given to Central sector and centrally sponsored schemes. In fact, these transfers have attracted the sharpest criticism. It has been pointed out that these schemes have grown in both value and number over the years in spite of the States' objection to their proliferation and the decision of the National Development Council (NDC) in 1970 to roll back the assistance to such schemes to 1/6th of Central assistance for State plans. At present, there are over 250 Centrally sponsored schemes with detailed conditionalities though only about half a dozen are important from the financial point of view. Besides the discretionary element implicit in these transfers, it is pointed out that the conditionality imposed by the Centre including those on staffing pattern tend to distort States' own priorities and programmes. It is often pointed out that the proliferation of schemes has increased even the village level bureaucracy considerably with no visible gains to the people. In response to these criticisms, the NDC appointed a committee to review the schemes which recommended significant scaling down of these schemes in terms of both number and coverage. This has been acted upon only in a limited way so far. There is clearly a strong case for consolidating a number of schemes into specific purpose transfers under broad heads with greater flexibility given to the States in the use of funds.

e. Central Transfers to States and Inter-State Equity:

The appropriate design of intergovernmental transfers discussed earlier in the chapter provides a useful conceptual framework to evaluate the existing system of transfers in India. However, it must be noted that transfers are never designed purely on economic considerations; more often than not, they are evolved by the political bargains. Even so, economic objectives of transfers must be kept in the background to evaluate the extent to which the transfer system has helped to achieve horizontal equity, which of the sources has had greater effectiveness in achieving this objective and on what lines should the transfer system be reformed to fulfil its objectives more effectively. In what follows, an attempt is made to analyse the equity implications of Central transfers to States in India.[13]

Table 6.5

Correlation Coefficients of Per Capita SDP and Per Capita Federal Transfers

Correlations	Shared Taxes	Totao Non-Plan Grants	Total Finance Commission Transfers	State Plan Schemes	Central and Centrally Sponsored Schemes	Total Plan Grants	Gross Current Transfers	Net Current Transfers
Sixth Finance Commission (1974-79)	-0.1672	-0.24	-0.2724	-0.2628	0.3416	0.0986	-0.1944	-0.2517
Seventh Finance Commission (1979-84)	-0.7059**	-0.2885	-0.5500*	-0.5240*	-0.1009	-0.3268	-0.5192*	-0.5732*
Eighth Finance Commission (1984-89)	-0.8489**	-0.1098	-0.6638**	-0.0104	-0.1620	-0.0916	-0.6630**	-0.7942**
Ninth Finance Commission (1989-92)	-0.7166**	-0.4039	-0.6657**	-0.6690**	-0.2073	-0.5001*	-0.6531**	-0.7681**

* Significant at 5 per cent level
** Significant at 1 per cent level

13 The evaluation of the objective of offsetting spillovers is admittedly very difficult in view of the problems of quantifying spillovers. Therefore, only a few qualitative remarks are made here on this issue.

Table 6.5 presents the correlation coefficients of per capita transfers from different sources with per capita State domestic product (SDP) since the period of award covered by the sixth Finance Commission. These results help us to draw interesting inferences. First, significant negative correlation between per capita SDP and per capita transfers is observed only from the period of award covered by the seventh Finance Commission (1979-80). The absolute value of the (negative) correlation coefficient as also the significance level of the coefficients, however, are higher in more recent periods. Second, the major contribution to equity in the transfer system was made by the Finance Commission transfers. In fact, it is only since the recommendations of the seventh Finance Commission were implemented in 1979-80 that the Finance Commission transfers and consequently, total transfers have had significant negative correlations with per capita SDP. This is entirely due to the increased weightage given to the backwardness factor in tax devolution by the Commissions since the Seventh; the correlation of per capita shared taxes with per capita SDP was consistently negative and significant since the award of the seventh Commission. It may be noted that the seventh Commission enhanced the States' share of excise duties from 20 per cent to 40 per cent and factors like backwardness were given high weightage in inter-State distribution (see Annexure 6.1). It is also seen that the grants given by the Finance Commissions (non-plan) had no significant relationship with per capita SDP. The grants given for State plan schemes do not show a consistant pattern. This is a little surprising in view of the weightage given to the backwardness factor in the formula for the distribution of grants for State plan schemes. It appears that the progressive bias imparted by the weightage assigned to the backwardness factor (25 per cent at present) in the Gadgil formula is inadequate or is largely offset by the discretionary element in the Gadgil formula in the name of "special problems" and the regressive bias imparted by the simplistic 'tax effort' factor. In addition, as advance plan assistance is given to the States when they are faced with natural calamities or severe resource problems due to other reasons, even the formula based transfer does not give a clear relationship with per capita income in all periods.

Table 6.6 presents the estimates of elasticity of different types of transfers (per capita) from the sixth Commission period awards (1974-75) with respect to per capita SDP. These indicate the degree of progressivity of transfers from various sources. An interesting finding from these results is that during the seventh and ninth Commission award periods, although the Finance Commission transfers show higher negative correlation with per capita SDP than the transfers for State plan schemes, the elasticity of the latter with respect to SDP is seen to be actually higher. At the same time, it must also be noted that systematic significant relationships in the case of plan transfers was seen only during these periods; during the periods covered by sixth and seventh Commission awards, the elasticities were not significant. The absence of a systematic and consistent pattern of relationship of per capita State plan grants with the per capita SDP comes out clearly in these results.

Table 6.6

Elasticity Co-efficients of Per Capita Federal Transfers

	Shared Taxes	Total Non-plan Grants	Total Finance Commission Transfers	State Plan Schemes	Central and Centrally Sponsored Schemes	Total Plan Grants	Gross Current Transfers	Net Current Transfers
Sixth Finance Commission (1974-79)	-0.024	-0.716	-0.201	-0.243	0.460	0.072	-0.115	-0.159
Seventh Finance Commission (1979-84)	-0.195*	-0.870	-0.280*	-0.426**	-0.066	-0.236	-0.268**	-0.338*
Eighth Finance Commission (1984-89)	-0.507*	0.302	-0.403*	-0.029	-0.095	-0.060	-0.277*	-0.491*
Ninth Finance Commission (1989-92)	-0.504*	-0.802	-0.540*	-0.704*	-0.140	-0.355	-0.482*	-1.006*

Note: ** Significant at 5 per cent level
* Significant at 1 per cent level
Elasticity co-efficients relate to cross section of 14 major States.

Table 6.7

Effect of Federal Transfers: Inter-State Inequalities in Gini Co-efficient

Variable	Sixth Finance Commission Period (1974-79)	Seventh Finance Commission Period (1979-84)	Eighth Finance Commission Period (1984-89)	Ninth Finance Commission Period (1989-92)
1. Per capita own revenue (PCOR)	0.2262	0.2355	0.2329	0.2575
2. PCOR + shared taxes	0.1805	0.1718	0.1640	0.1842
3. PCOR + Finance Commission transfers	0.1599	0.1615	0.1576	0.1742
4. PCOR + transfers from the State plan schemes	0.2092	0.2138	0.2167	0.2350
5. PCOR + transfers under the Central plan and Centrally sponsored schemes	0.2186	0.2184	0.2126	0.2350
6. PCOR + Planning Commission transfers	0.2030	0.1994	0.1993	0.2154
7. Total revenue accrual	0.1490	0.1417	0.1394	0.1508
8. Degree of equalisation through shared taxes	-0.0457	-0.0637	-0.0689	-0.0732
9. Degree of equalisation through Finance Commission transfers	-0.0662	-0.0740	-0.0753	-0.0832
10. Degree of equalisation through State plan grants	-0.0170	-0.0217	-0.0162	-0.0224
11. Degree of equalisation through Central Plan and Centrally sponsored schemes	-0.0076	-0.0170	-0.0203	-0.0225
12. Degree of equalisation through Total plan transfers	-0.0232	-0.0361	-0.0336	-0.0421
13. Degree of equalisation through Total current transfers	-0.0772	-0.0938	-0.0935	-0.1067

Source: *Finance Accounts* of the State governments, various issues.

Note: Inter-State Gini coefficients correspond to 14 major States only.

While the intergovernmental transfers in recent years have shown greater degree of equalisation than in the earlier years, it is important to analyse the extent to which they have succeeded in offsetting the fiscal disadvantages of the poorer States. The equalising effect of transfers can be seen by the differences in inter-State inequalities in per capita own revenues and per capita total revenues (including transfers) as measured by the differences between the Gini coefficients of the two sets of variables (Table 6.7). The estimates show that, (i) in the aggregate, the transfers tend to be equalising as Gini coefficients of revenues including transfers are found to be lower than the coefficients of own revenues. But the degree of equalisation achieved by these transfers is significant but not high. In the aggregate, the reduction in Gini coefficient during 1989-92 was 0.1067 or about 40 per cent of the Gini coefficient for per capita own revenue. It is also seen that the equalising effect has shown a marginal increase over the years; (ii) taken separately, the reduction in the value of Gini coefficient caused by Finance Commission transfers is about twice as much as that of Plan transfers; (iii) the equalisation achieved by both Finance Commission and Plan transfer has increased over the successive periods; (iv) of the Finance Commission transfers, shared taxes have shown the highest degree of equalisation and the equalisation effects of transfers given for State plan purposes and Centrally sponsored schemes in contrast, have been low throughout the period.

At the same time, if own revenues are assumed to represent revenue capacities (if there are no systematic variations in tax effort with the level of per capita revenues), clearly, the equalising effect of the transfers is inadequate to offset the fiscal disabilities of the poorer States. This comes out clearly when we examine the buoyancy of per capita own revenues and per capita revenue accruals of different States with respect to SDP (table 6.8). It is seen that there is only a marginal change in the upward slope of the least-squares line after the transfers are included. On an average the responsiveness of per capita revenue accruals as well as revenue expenditures to per capita SDP is 0.15 whereas the responsiveness with respect to own revenues is 0.18 and the rate of increase in per capita revenue accruals to increase in per capita income is not very different from the responsiveness of States' own revenues to per capita income.

Table 6.8 **Buoyancy of States' Revenue and Expenditure**				
Dependent Variable	Constant	Buoyancy	$\bar{R}^2$	F Statistic
1. Per capita own revenue	-296.3650 (-2.4714)	0.1760 (8.720)	0.8524	76.0590
2. Per capita total revenue	168.2228 (1.3369)	0.1500 (7.2019)	0.7965	51.8670
3. Per capita revenue expenditure	208.520 (1.10)	0.158 (5.0146)	0.6500	25.1464
4. Per capita total expenditure	341.4971	0.1801	0.6395	24.0591

Note: 1. The results pertain to 14 major States for the year 1991-92.
2. Figures in parentheses are 't' values of regression coefficients.

f. Institutional Mechanism for Intergovernmental Transfers

An important precondition for successful intergovernmental transfer system is that besides being equitable and generating proper incentives, it should be transparent, adaptable to the changing needs of the Centre and individual States and should be distributed in an objective manner. A proper institutional mechanism, therefore, is an important pre-requisite for an effective transfer system. The mechanism should not only help in designing and implementing the transfers in accordance with the overall objectives but also should foster mutual trust and confidence between the Centre and States and among the States *inter se*. The transfer system can play the nation building role only when an impartial and a transparent system of intergovernmental transfers is developed and harmonious interactions through mutual consultation process is evolved. In this task, evolving a proper institutional mechanism is critical.

Keeping in view the need to evolve such a transfer system to ensure that the Centre and the States are placed on an even keel, the Constitution provides for the appointment of the Finance Commission. As the Commission is to be appointed every five years, the mechanism provides for taking account of the changing needs of the Centre and the States. The Finance Commission (Miscellaneous) Act also lays down qualifications of the Chairman and members of the Commission and the presence of a judicial member/chairman in the Commission gives it a semi-judicial status. The provision for setting up the Finance Commission has been on the lines of the Commonwealth Grants Commission in Australia, through there are important differences in both their status and working.

Ironically, although the Constitution provides a specialised agency for the distribution of Central transfers to States, as our foregoing discussion shows, the system of intergovernmental transfers evolved in India has not been based on sound principles. In spite of such an institutional arrangement it has not been possible to design the general and specific purpose transfer systems to meet the intended objectives of offsetting the fiscal disabilities of poorer States and ensuring minimum standards of services in respect of aided activities. As already mentioned, the transfers lack simplicity and transparency, are ill-targeted and have serious disincentives.

As already mentioned, contrary to the spirit of the Constitution, a large proportion of transfers is given by agencies other than the Finance Commission -- by the Planning Commission and various Central ministries. The multiple agencies giving transfers in an uncoordinated manner cannot be expected to effectively serve the objectives of intergovernmental transfers in a cost-effective manner. Often, they work at cross-purposes. In addition, the Finance Commission has failed to evolve a satisfactory methodology for dispensing transfers, being a temporary body. Although a small Finance Commission Cell has been created in the Ministry of Finance , it is ill-equipped to undertake continuous studies in State finances and to improve the methodology of making projections: it does not have the necessary expertise for estimating fiscal capacities and needs of the States, and for undertaking analysis of their indebtedness. It is not even able to maintain up-to-date data required for the technical analyses undertaken by the successive Finance Commissions. Each Commission, therefore, has to start afresh and given the time constraint, is rarely able to make recommendations based on detailed scientific analysis. In the event, there has been very little improvement in the methodology adopted by the Commission.

To some extent, the problem lies in the composition of the Commission and the lack of professionalism in the staff of the Commission itself. Often, the Chairman and the Members, though eminent public figures, hardly have any detailed understanding or knowledge of the fiscal problems of the Indian federal polity. Many a times, the Chairman is an active politician, who cannot find enough time to devote to the work of the Commission. The economist Member of the Commission usually is also a Member of the Planning Commission. The judicial Member, though well versed in law, has no idea about the economic and fiscal problems. What is more, the appointment of Member-Secretary itself has rarely been according to the background or aptitude of the person. Usually, a senior official of the Indian Administrative Service is appointed as Secretary and the post is perceived to be lower in rank than that of the Secretary to different ministries. As 'better' (Secretary's) posts become available, they get themselves transferred. The Central government on its part has not been responsive to the needs of the structure either. Often, it takes a long time for the government to appoint a new Member once a Member resigns. There are instances when Members have been appointed for a short time merely to fulfill the formality of signing the report.[14] The staff of the Commission, barring the economic advisor and one or two other persons, come on deputation from various Central ministries. While they may be familiar with the budget documents and the traditional approach followed, they hardly have a research background to understand and evolve the appropriate approach and methodology for designing intergovernmental transfers based on sound economic principles. In short, the whole approach to the appointment of the Finance Commission and its functioning has been unprofessional and it is not surprising that they have not been able to contribute significantly for evolving an objective and scientific methodology for determining intergovernmental transfers to satisfactorily resolve fiscal imbalances and infuse confidence to cement stronger intergovernmental relationships.

The mechanism provided for in the Indian federal polity deserves to be compared with the one prevailing in Australia, mainly because of the similarity of the institutions. Like the Finance Commission in India, the Commonwealth Grants Commission

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14 For example, an active member of the ruling party was appointed as a Member of the Ninth Finance Commission. On assuming charge as the Chief Minister of a State, he relinquished the office, but no Member was appointed in his place until just five days before the report was submitted.

in Australia undertakes the assessment of relative fiscal needs of the Commonwealth government and the States and recommends transfers on the basis of the relativities estimated. The similarity, however, ends here. Unlike the Indian Finance Commission, the Commonwealth Grants Commission is a permanent body undertaking continuous research on various aspects of Australian federation and has been able to develop an up-to-date data bank over the years and has evolved a detailed and scientific methodology to estimate relativities of different States based on measures of fiscal capacities and needs. The appointment of qualified officials to the staff of the Commission, their continuity due to its permanent tenure and the nomination of professionals of high standing as Chairman and Members has made the Commission an autonomous and highly professional body. Consequently, the Commission has been successful in working a scientific and yet simple system of transfers. Of course, it must be admitted that the magnitude of regional disparities in Australia is much lower than that of India, the country is much less diverse and therefore, the problem of evolving an appropriate transfer system is much less problematic. Yet, this does not take away the fact that the entire approach to the transfer scheme, unlike in India, is purposive, simple and objective which is essential for the healthy development of a federation.

Is a separate autonomous body to dispense intergovernmental transfers necessary in a federation? The Australian experience points towards the desirability of such a mechanism. In contrast, it is interesting to see that in Canada transfers are given directly by the Department of Finance. The horizontal transfers calculated by the Department of Finance are based on the equalisation of revenue capacities of five 'average' provinces. It is also interesting to see that the transfer system has evolved over time to meet changing situations. While the system of transfers in Canada may fall short of the theoretical ideal, it is important to note that, by and large, the transfers are seen to have been made on an objective basis and the provinces have not felt the need to have a separate independent body for the purpose. The existing framework provides ample scope for consultation process and the Department of Finance undertakes detailed exercises to evolve a simple and transparent system of transfers.

The question of whether or not an independent body to determine transfers is necessary, however, cannot be answered simply by referring to the experiences of these countries. The need for such an institution depends on the objective conditions prevailing in each country. In a federation where there is mistrust between the Centre and the States and among the States *inter se*, such an institution can play not only the important role of an objective arbiter but also can work as an institution monitoring the working of intergovernmental fiscal relationships. The confidence created by the transfer mechanism can go a long way in building such a role. This is particularly important in a country like India where in a number of States, the ruling parties are different from that at the Centre. However, if an institution like the Finance Commission has to play the role assigned to it in the Constitution satisfactorily, the approach to its appointment and its functioning has to be professionalised. It should be a permanent body managed by competent personnel with an up-to-date data bank and information system and conducting continuous studies on various aspects of State and Central finances and intergovernmental relationships. The Chairman and members of the Commission too should be professionals who can act independently of the Centre and the States for the duration of their tenure of five years.

It is also important to coordinate the functioning of the Planning and Finance Commissions. In the changing liberalised environment, the role of the planning agency should be merely to ensure spending on public and merit goods, in the provision of which the government has a comparative advantage. If the Finance Commission is converted into a permanent body it can assess all current resources and needs of the States. This body can make all current transfers and in regard to specific purpose transfers, even the monitoring needed for the purpose can be done by it in collaboration with the Central ministries. The role of the Planning Commission in such an arrangement will be to plan the development of economic infrastructures which can be loan-financed. Thus while the Finance Commission can look after the current needs of the States including investments in the social sectors (human capital) and give necessary current transfers, the Planning Commission can look after the building of economic infrastructure and find alternative means of financing them through market borrowing and Central loans to the States.

g. Intergovernmental Transfers in India: Concluding Observations

As already pointed out, the design and implementation of intergovernmental transfer schemes suffer from a number of important weaknesses rendering the achievement of their objectives difficult. First, it is pointed out that multiple agencies transferring Central resources with overlapping roles result in wasteful duplication in functioning. The compartmentalised functioning of Planning and Finance Commissions to assess what is essentially interdependent and many a time artificially distinguished plan and non-plan needs of the States have posed difficulties in the clear pursuit of the objectives of these transfers.

Second, the designing of both general purpose and specific purpose transfers by the Finance and Planning Commissions has left much to be desired. In the case of statutory general purpose transfers, the overwhelming share of tax devolution vis-a-vis grants-in-aid and implicit and explicit weight assigned to the population factor have resulted in higher non-plan surpluses to richer States and consequently, larger plan investments by them. This has constrained the pursuit of the objective of balanced regional development. Again, the tendency has been to make bulk of the transfers on the basis of general indicators of backwardness rather than designing the transfers to offset the States' fiscal disadvantages arising from the shortfall in revenue raising capacity and higher cost disabilities in the provision of public services due to factors beyond their control. The fiscal 'dentistry' practised by the Finance Commissions has tended to have adverse effects on fiscal prudence and tax effort. The general purpose transfers given by the Planning Commission, on the other hand, is totally independent of the planning process as it does not take into account either the States' normative (required) plan outlays or the resources available to them. In fact, the absence of a clear and coordinated approach for distributing unconditional transfers to the States is a major weakness in the Indian federation. In the case of specific purpose transfers too, the designing of the schemes in terms of the services chosen for equalisation, its grant-loan components of assistance and the matching ratios appear to be *ad hoc*.

While the above observations are relevant to the design of the transfer system, the degree of equalisation actually achieved is an empirical question. As shown earlier, in terms of offsetting the fiscal disabilities of the special category States, the transfer system has, in fact, achieved a good deal, not only in enabling these States to incur more than average levels of per capita expenditures, but also in making 90 percent of plan transfers by way of grants. Considering the general category States, however, despite the overall transfer system achieving a certain amount of equalisation, the degree of equalisation achieved through general purpose transfers from the Finance and Planning Commissions was not sufficient to offset the fiscal disadvantages of poorer States. In the event, the per capita expenditures in richer States have continued to be higher. This is also indicated by the trends in per capita plan expenditures in the States.

The specific purpose transfers given by the Commission too have not been clearly designed to ensure minimum levels of services in all the States or offset spillovers. The detailed study of transfers given to alleviate poverty has brought out the lack of proper targetting of various Central sector and Centrally sponsored schemes on poverty alleviation. We have also pointed out the proliferation of the schemes with detailed conditionalities which probably better serve the political objectives of the ruling party at the Centre than the economic objectives of specific purpose transfers.

The analysis of transfers has also brought out the various types of disincentives created by the transfer systems. It has been repeatedly pointed out that transferring large proportions of non-corporate income tax and union excise duty has created disincentives to the Centre in raising revenues from these sources and has led to distortion in the tax structure itself. As regards the States, the methodology followed by the Finance Commissions has tended to promote laxity in raising revenues and profligacy in spending. The lack of correspondence between revenue raising and expenditure decisions at the margin has tended to promote laxity in fiscal management at both Central and State levels.

The institutional mechanism for making intergovernmental transfers in India too has left much to be desired. In order to make transfers purposive, proper coordination between the various agencies making transfers is essential. It is also important that the Finance Commission, the sole agency to make transfers as envisaged in the Constitution should be a permanent body consisting of professionals and all the grants should be given through the Commission. The Planning Commission could undertake the task of developing economic infrastructure and dispensing loans for the purpose.

Our analysis of the system of intergovernmental transfers in India has been extremely critical. This has been done deliberately to highlight the mistakes and weaknesses of the system so that they are avoided. Indeed, there are some noteworthy positive features of Indian fiscal federalism. The very fact that the system has worked for over 50 years in a country so diverse in economic, political, linguistic and cultural factors implies the broad acceptability of the basic structure and functioning of the federal fiscal arrangements. The method of resolving the problems of special category States, the introduction of formula based transfers in the place of discretionary transfers, achieving a measure of equalisation through the formula based transfers and the attempt to reach consensus solutions to many contentious issues are some of the important features. These factors impart a degree of optimism on the future of Indian fiscal federalism. Of course, the system needs to be remedied in several respects. But what is important is, it is possible to reform it.

Annexure 6.1

Distribution of the States' Share in the Net Proceeds of Non-corporate Income-tax

(per cent)

Finance Commissions	Net Proceeds distributed to the States	Criteria for Distribution (weight)			
		Contribution	Population	Per capita SDP	Others
First	50	20	80	-	-
Second	60	10	90	-	-
Third	60.67	20	80	-	-
Fourth	75	20	80	-	-
Fifth	75	10	90	-	-
Sixth	80	10	90	-	-
Seventh	85	10	90	-	-
Eighth	85	10	90	45* 22.5*	-
Ninth (First Report)	85	10	22.5	45* 11.25**	11.25 (Proportion of the poor in the States to total population)
Ninth (Second Report)	85	10	22.5	45* 11.25**	11.25 Composite index of backwardness@
Tenth	775	X	20	60*	5 - Area 5 - Index of infrastructure# 10 - Tax effort (T/Y^2)

* According to "distance" formula - see notes under Table 6.6

** According to "inverse" formula - see notes under Table 6.6

@ The variables included are (i) the population of scheduled castes and tribes; and (ii) number of agricultural labourers. Equal weights are assigned to the two factors.

\# Composite measure including infrastructural facilities available in eight major sectors: agriculture, banking, electricity, transport, communications, education, health and civil administration.

Annexure 6.2

Distribution of States' Share in the Net Yield from Union Excise Duties

Criteria Used for Distribution among the States

Finance Commi-ssions	Coverage	States' share (per cent)	Proportion of population of the State to the total population of all States	Per capita income	Economic or social backwardness	Other criteria
1	2	3	4	5	6	7
First	Three commodities: tobacco, matches and vegetable products	40	100	-	-	-
Second	Eight commodities: tobacco, matches, vegetable products, sugar, coffee, tea, paper and vegetable non-essential oils	25	90	-	-	10 per cent used for adjust-ment
Third	All commodities yielding more than Rs 5.9 million in 1960-61 (about 35)	20	Mainly population basis along with relative financial weakness and economic backwardness as other factors. Specific details are not available	-	-	-
Fourth	All commodities excluding regulatory duties, special excises and earmarked cesses	20	80	-	20 According to relative backwardness as indicated by seven factors, which are: i) per capita goods value of agricultural production; ii) per capita value added by manufacture; iii) percentage of workers to total population, iv) percentage of enrolment in class 1 to 5 to the population in the age group 6-11, v) population per hospital bed, vi) percentage of rural population, vii) percentage of scheduled caste population	-

1	2	3	4	5	6	7
Fifth	All types of union excise duties (for the first 3 years (1969-72), however, regulatory duties and earmarked cesses are excluded	20	60	13.3 Distributed among only those States whose per capita SDP was below all States average: in proportion to the shortfall of the State's per capita SDP from all State average multiplied by the population of the concerned State	6.7 According to an integrated index of backwardness as indicated by six factors, which are: i) scheduled caste population, ii) number of factory workers per lakh of population iii) net irrigated area per cultivator iv) length of railways and surfaced roads per square kilometre area v) enrolment ratio of school going age children; and vi) number of hospitals beds per thousand person	
Sixth	For 1974-75 and 1975-76 all articles on which Union excise duties were levied excluding auxiliary duties of excise and cesses levied under special acts and earmarked for special purposes	20	75	25 According to the "distance" formula	-	-
Seventh	Net proceeds from all Union excise duties collected on all commodities excluding the net proceeds of the duty on the generation of electricity	45	25	25 Inverse* of per capita SDP formula	25 Percentage of poor	25 According to a formula of revenue equalisation this represents equalisation of revenue capacity which has been computed by regressing States' per capita revenue on per capita SDP and substituting the actual values of per capita SDP in the equation.
Eighth	Net proceeds: excluding cesses levied under special Acts and earmarked for special purposes	45	25	25	50	(5 per cent to deficit States) in proportion to the deficit of a State to the total deficit of the State in that year

Ninth First Report (1989-90)	Net proceeds excluding cesses levied under special acts and earmarked cesses	45 (40 per cent to all States and 5 per cent to the States having post-devolution deficits)	25	50	12.5 Percentage of people below poverty line	-
Ninth Second Report (1990-95)	Net proceeds excluding cesses levied under Special Acts and earmarked cesses	45	25	12.5 Inverse* formula 33.5 Distance formula**	12.5 Index of backwardness computed with equal weights assigned to population of scheduled castes and tribes and number of agricultural labourers	16.5 On the basis of deficits computed after devolving assigned taxes
Tenth (1995-2000)	As above	47.5 (40 per cent to all States and 7.5 per cent for States with post devolution deficits)	20	60 (Inverse formula)	5 Index of infrastructure	10 - tax effort (T/Y^2) 5 - Area

* Inverse formula = $\dfrac{P_i/Y_i}{\sum P_i/Y_i}$

** Distance formula = $(Y_h-Y_i)P_i/\sum(Y_h-Y_i)P_i$
where Y_i and Y_h represent per capita SDP of the i^{th} and the highest per capita SDP State, P_i - the population of the i^{th} State, $(Y_h - Y_i)$ for the 'h' State is taken to be the distance between the highest and the next highest per capita SDP.

Annexure 6.3

Formula for Distributing State Plan Assistance*

Criteria	Share in central plan assistance (per cent)	Share of grants and loans	Criteria for distribution in non-special category States
A. Special category States (10)	30	90:10	
B. Non-special category States (15)	70	30:70	
(i) Population (1971)			60.0
(ii) Per capita income, of which			25.0
(a) According to the 'deviation' method covering only the States with per capita income below the national average			20.0
(b) According to the 'distance' method covering all the fifteen States			5.0
(iii) Fiscal performance, of which			7.5
(a) Tax effort			2.5
(b) Fiscal management			2.5
(c) National objectives			2.5
(iv) Special problems			7.5
Total			100.0

Note: 1. The formula as revised in December, 1991.

2. Fiscal management is assessed as the difference between States' own total plan resources estimated at the time of finalising annual plan and their actual performance, considering latest five years.

3. Under the criterion of the performance in respect of certain programmes of national priorities the approved formula covers four objectives, viz. (i) population control, (ii) elimination of illiteracy, (iii) on-time completion of externally aided projects, and (iv) success in land reforms.

CHAPTER VII

RESTRUCTURING INTER-GOVERNMENTAL FISCAL RELATIONS IN INDIA: MAJOR ISSUES

a. Motivation for the Study

In this study, we have attempted to make a comprehensive review of inter-governmental fiscal arrangements in Indian federation. The study begins with the critical examination of the assignment of tax powers and expenditure functions. This is followed by the examination of allocative and distributional consequences of vertical and horizontal fiscal overlapping and disharmony. This analysis leads to the examination of feasible approaches to tax harmonisation in Indian federation. Then, the study quantifies the degree of imbalance between revenue and expenditure powers vertically between the Centre and the States and horizontally among different States themselves and evaluates the efficacy of inter-governmental transfer system in resolving these imbalances. The study also reviews the institutional arrangements for making inter-governmental transfers. In this chapter, we bring together the main conclusions of this study and suggestions for the restructuring of inter-governmental fiscal arrangements in the Indian federation.

There are particular reasons for the review of federal fiscal arrangements at the present juncture. In general, there has been a resurgence of interest in fiscal decentralisation virtually in every country irrespective of the level of development or ideological persuasion. But, economic and political changes and the outward orientation in economic policies attempted in recent years in the Indian federation call for restructuring the federal fiscal relationships. Therefore, a critical review of fiscal assignments, arrangements and institutions conducting and monitoring inter-governmental relationships has become necessary.

In the economic sphere, the need for the review of inter-governmental relationships has arisen from the economic liberalisation initiated since mid-1991. The transition towards a market friendly development strategy and the attempt to give outward orientation to the economy has led to the need for greater diffusion of economic power not only from the government to the market but also from the Central government to sub-Central governments.

In particular, the stabilisation and structural adjustment programme initiated at the instance of the International Monetary Fund after the economy plunged into an economic crisis cannot be carried out successfully without the active participation and cooperation of the State governments. While stabilisation policy primarily rests with the Central government, the sub-Central governments play a critical role in allocating resources efficiently. Their active involvement is critical in ensuring the success of the structural adjustment policies. The recent attempts at furthering the process of decentralisation by activating the governmental units below the State level in urban and rural areas by formally assigning greater powers through Constitutional amendments has further underlined the need for a review of inter-governmental relationships. More active participation of the sub-Central governments in the economic restructuring to ensure a market friendly regulatory set up calls for redesigning of inter-governmental fiscal arrangements.

At the political level, in general, there has been a weakening of the ruling political parties at both Central and State levels. The ruling party at the Centre no longer controls the levers of power at the State level. Even when the same party is in power at both the levels of government, the control of Central leadership over the State policies is much less than what was seen in earlier years. Apart from the changes in inter-governmental relationships needed to accommodate changing political power structure, the weakening of the oligopolistic power of the political parties and the emergence of coalition governments has shifted the policy focus from long term benefits to visible and short terms gains. Thus, 'competitive populism' of the political parties has shifted the emphasis of the government to the provision of quasi-public goods, subsidies and other transfer payments rather than attending to the cases of market failure. The increase in the influence of the special interest groups in influencing tax and expenditure policies have further accentuated this phenomenon.[1] These changes have differential effects on the Centre and individual States and thus affect their inter-relationships.

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1 Olson (1982) calls such interest groups as "distributional coalitions" as their objective is mainly to distribute a larger share of the available output in their favour rather than increasing the volume of output itself.

b. Objectives, Constraints and Measures

It is necessary to be clear about the goals to be achieved and the constraints faced in achieving these goals before attempting to redesign federal fiscal arrangements. The goals are given by the principles of fiscal federalism and these are: (i) efficient provision of public services corresponding to the diversified preferences of consumer-voters and by reaping fully the economies of scale; (ii) promoting efficiency and competition in the market; and (iii) promotion of nation-building through equitable regional spread of resources and human resource development. These goals have to be achieved taking into account the Constitutional and institutional constraints, though to some extent, it is possible to overcome them. Such constraints can be particularly important in a planned economy with a long period of regulatory and controlled regime. The existence of these constraints makes it necessary to supplement the pure fiscal federalism prescriptions with the lessons of experience from comparable federations.

Restructuring inter-governmental economic and fiscal relationships to ensure efficient provision of public services and to promote efficiency and competitiveness in the market calls for a number of measures. First, in order to ensure cost-effective delivery of public services and regulatory framework, it is necessary to strengthen the sub-Central governments to achieve greater degree of fiscal decentralisation than in the past. Transition from a planned economy to one where the resources are allocated according to market forces necessarily calls for diffusion of power and a greater degree of fiscal decentralisation than was observed so far. The economic advantages of federalism in a market economy can be reaped only when the public services are provided to correspond to the diversified preferences of consumer-voters while reaping the economies of scale in their provision. Second, it is necessary to remove all impediments to the mobility of factors and products throughout the economy to ensure smooth functioning of the market. Restrictions on the movement of goods and factors created in the past to regulate and manage an economy with shortages and the fiscal impediments to the mobility of factors and products arising from the attempts to export the burden of financing public services to the non-residents need to be lifted to ensure a nation-wide market for factors and products. Third, it is necessary to strengthen the system of regulating and monitoring the market to enable its smooth functioning and to ensure that the property rights are protected effectively. In the past, it was believed that governmental ownership would by itself ensure the functioning of the system according to requirements and, therefore, an effective regulatory system was not developed. As the role of the market is restored, the regulatory system needs to be strengthened. Fourth, competition among jurisdictions, to be beneficial, requires maintaining competitive equality among different jurisdictions. Exploitative tendencies and 'free-riding' by different jurisdictions can be minimised when the jurisdictions are broadly equal in their competitive power. This has to be brought about either by the Central government's regional policy - through balanced spread of Centre's own investments - or by the inter-governmental transfer system. The importance of regional equalisation has never been as important before, for, given that the existing distribution of social and physical infrastructure is skewed in favour of the advanced States, assigning larger role to the market in resource allocation is likely to accentuate inter-regional disparities. Designing a transfer system to offset the fiscal disabilities of the State, therefore, should receive high priority in the reform agenda on inter-governmental fiscal arrangements. Fifth, the fiscal compression at the Central level constrains the amount of resources available for transfer to the State governments. This necessitates the need for more effective targeting of the inter-governmental transfers and making them cost effective to the donor while ensuring accountability and proper incentives for the State governments. Finally, it is necessary to restructure the institutions, strengthen the system of monitoring inter-governmental interactions to ensure efficient provision of public services and to make them responsive to the needs of market economy.

A detailed review of the existing arrangements to identify the reform areas is a necessary pre-requisite for restructuring inter-governmental relationships on the lines suggested above. Keeping in view the principles of fiscal federalism, and practices and experiences in comparable federations, the analysis has attempted to review the existing arrangements, bring out the shortcomings and indicate directions of reform in the areas of assignment of functions and sources of finance to different levels of government, interactions between different governmental units - both vertical and horizontal, the systems and methods evolved over the years to resolve overlapping functions and disharmony in the levy of taxes between different governmental units, the effectiveness of inter-governmental transfers in offsetting revenue and cost disabilities and the institutional framework to conduct inter-governmental fiscal relationships.

c. The Question of Assignments

The reform of federal fiscal arrangements should truly begin with the re-examination of the functions and powers exercised by the Central and State governments. The actual exercise of the functions and powers of different jurisdictions in any federation depends upon the Constitutional assignments and the conventions and practices developed over the years in the course of executing the Constitutional provisions. In the Indian context, as mentioned earlier, the evolution of the practices in the course of executing a planned development strategy has played as much, if not greater, role in actually shaping the assignments as provided in the Constitutional framework.

Our analysis of fiscal assignments in the Indian federation has brought out a number of shortcomings in both the Constitutional assignments and in the way these assignments have been executed in practice over the years. The Constitutional assignments do not adequately take account of the policy interdependencies of the economic system involving multi-level governments. On the other hand, the exercise in development planning required massive mobilisation of resources to finance ever growing public consumption and investment requirements at both Central and State levels. Thus, the emphasis was on resource mobilisation, and often this was achieved without adequately considering the distortionary effects of the instruments of resource mobilisation. The highly regulated economy combined with relatively stable democratic polity, in turn, created strong interest groups. The influence of these special interest groups on fiscal decisions resulted in the evolution of tax systems which cannot be justified on rational economic considerations.

We may recapitulate the major shortcomings of the fiscal assignments. First, the tax assignment to the Central and State governments do not adequately take into account the economic interdependnce of tax bases. Second, the principle of separation followed in the assignments has not prevented *de facto* concurrency and vertical and horizontal tax disharmony. Nor has federal fiscal arrangements developed a satisfactory mechanism to coordinate and harmonise the overlapping fiscal systems. Finally, the assignments clearly exhibit a centripetal bias with most broad-based taxes assigned to the Centre, and the evolution of the fiscal system to suit the needs of development planning strategy has further accentuated this tendency.

On specific reforms in assignments, the international experience points towards two alternative models. Centralising the tax system may ensure an efficient tax system, but does not ensure overall efficiency. In particular, this is not a federal solution for, in such a system sub-Central jurisdictions cannot vary public service and tax rates according to the preferences of consumer-voters. On the other hand, giving concurrent tax powers could require evolving proper mechanisms to harmonise the tax systems to minimise distortions arising from overlapping taxation. Of course, in either system, it is not necessary to assign the tax bases to different jurisdictions by following the principle of separation. Further, the Indian experience shows that assigning taxes according to separation principle, in any case, does not avoid concurrence. In fact, in the absence of mechanisms to coordinate and harmonise, the assignments done on the basis of separation principle can lead to the development of irrational tax systems.

In the model followed mainly in Australia and in some of the European federations like Germany and Switzerland, the emphasis is to have efficient tax structures. Uniformity in the tax structures throughout the federation is considered to be the hallmark of efficiency and therefore, in these federations most of the broad based taxes are centralised. Even when the sub-Central governments are involved in the decisions on tax rates, the fact that the Central government levies and collects the tax minimises the degree of disharmony. In such a situation, fiscal decentralisation is confined to expenditure functions and the vertical imbalances are resolved through a system of revenue sharing or block grants. Such a system, however, does not enable the sub-Central units to vary the mix of public service and tax rates according to the preferences of consumer-voters nor is it conducive to good fiscal management as it does not link the expenditure decisions of the sub-Central governments with their tax rate decisions. More importantly, in the prevailing political environment in India, the option of centralising tax decisions cannot certainly be exercised.

The alternative model is given by the experiences of the U.S.A. and Canada. In these countries, the emphasis is on assigning more revenue handles to sub-Central governments, and this is done by giving them concurrent tax powers with the Central government in respect of some important broad-based taxes. In the U.S.A. for example, the States exercise the power to levy income taxes along with the Federal government. In Canada, in addition to income taxes, the provinces share the power to levy consumption taxes with the Federal government. However, in this model it is necessary to evolve appropriate mechanisms to Co-ordinate and harmonise the tax systems to ensure that overlapping of the tax bases does not result in tax disharmony. Thus, the provinces in Canada as well as many of the States in the U.S.A. simply piggy-back income taxes on the tax base determined by the federal government.[2]

Our analysis has also brought out some important anomalies in the tax systems which have arisen from the assignments. First, it is necessary to examine whether the distinction drawn between the income and wealth derived from agricultural and non-agricultural sources serves any useful purpose. Of course, inclusion of stable agricultural incomes would involve some measurement problems, but this is not insurmountable. At the same time, efficient functioning of the market requires that the taxes impeding free trade in factors and products across the country should not be levied. Thus, efficient tax regime in a market economy does not accommodate either the inter-State sales tax or Octroi and there is no place for such taxes. Therefore, sub-Central governments should not be authorised to levy all those taxes impeding free movement of goods or persons.

d. Tax Overlapping and Harmonisation

As mentioned earlier, even in the most efficient system of assignments, it is not possible to avoid tax overlapping between different levels of government or between different jurisdictions within each of the levels. The only way to avoid overlapping is to centralise the power to levy all major taxes. But this, as mentioned earlier, is a non-federal solution, though some of the federations like Australia, Germany and Switzerland have adopted this course. Also, centralising tax powers necessitates evolving an elaborate and objective system of inter-

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2 Of course, in the U.S.A., some of the provinces determine their tax bases themselves and therefore, the degree of disharmony in the U.S.A. is more than that of Canada. See, Vaillancourt (1992).

governmental transfers. The decentralised option, of course, is to assign progressive and mobile tax bases to the Central government and relatively immobile bases to the sub-Central governments. In this system, clear separation of the tax jurisdictions in the economic sense may not be possible and therefore, appropriate mechanisms to coordinate and harmonise tax systems based on mutual trust and confidence will have to be developed.

The analysis of the tax system in the Indian federation brings out considerable degree of vertical and horizontal tax overlapping the disharmony. On the one hand, the exclusion of incomes from agricultural sources from the purview of the Central government has given scope for considerable amount of tax evasion and avoidance, thus rendering the tax base narrow. On the other hand, there has been a phenomenal expansion of government activity financed by indirect and non-transparent revenue sources due to, among other reasons, the operation of special interest groups. Thus, both the Central and the State governments have over the years developed non-transparent, complex and distorting tax systems. The levy of consumption taxes by both Central and State governments has contributed to a considerable degree of vertical tax overlapping.

Horizontal tax disharmony has arisen from the States 'free-riding' on one another. The levy of inter-State sales tax has facilitated inter-State tax exportation and the practice of levying the tax on inputs and capital goods has only accentuated this phenomenon. Inter-State competition to attract trade and industry has led to excessive rate differentiation and extending liberal sales tax incentives with unintended effects on relative price structure and resource allocation. Besides, the welfare effects of impediments to the free movement of goods and the segregation of different regional economies caused by the taxation of exports from one State to another through inter-State sales tax and of imports into urban local body jurisdictions through octroi could be considerable. These developments have not only caused resource distortions but also led to inequitable transfer of resources from poorer to richer regions.

The vertical and horizontal tax disharmony in India is not only higher than in other federations, but also has been increasing over time. At the same time, hardly any effective steps have been taken so far to harmonise and co-ordinate the tax systems of the Centre and the States. Although the Central government itself has tried to rationalise the Union excise duties by converting it into a modified value added tax at the manufacturers' level, the attempt is only partial and the distortionery effects of a pre-retail sales tax has persisted. Besides, no attempt has been made to resolve the disharmonies arising from vertical and horizontal overlapping of consumption taxes. In this inter-governmental competition, the Central government itself is a competitor and therefore, it is not surprising that it could not satisfactorily carry out the role of the monitor and co-ordinate the tax systems.

The process of tax co-ordination and harmonisation should incorporate the principles of a sound tax system as well the principles of fiscal federalism. The elements of a sound consumption tax system suggest that the tax should be levied closest to the consumption point, have a broad base to include services in addition to goods, have low and less differentiated rates, relieve tax on inputs and capital goods, be simple and transparent and should not tax inter-regional trade. On the other hand, the principles of fiscal federalism would suggest that the sub-Central governments should have adequate tax powers to enable them vary the mixes of public services and tax rates. The ideal form of tax harmonisation in the Indian context would be to evolve a concurrent value added tax system at both Central and State levels with some broad agreement on the maximum rate of tax to be levied to ensure a reasonable burden on the consumer. The process of harmonisation, however, requires constant interaction at official and political level. While official committees and formal procedures can further the process of harmonisation to some extent, much more needs to be done to initiate informal consultation processes and confidence building measures to foster mutual trust between the Centre and the States on the one hand, and among the States *inter se* on the other. Unless this is achieved, it would be difficult to keep the Indian manufactures competitive.

e. Fiscal Imbalances and Inter-governmental Transfers

The existence of vertical and horizontal fiscal imbalances is a common feature observed in all federations. Even under the most efficient assignments, these fiscal imbalances cannot be avoided. The Central government has a comparative advantage in raising revenues and sub-Central governments, in spending. Similarly, taxable capacities and unit cost of providing public services do vary across different jurisdictions due to differences in not only the resource endowments but also historical and political factors. Nor is the mere existence of fiscal imbalance in itself undesirable. What is important is to evolve appropriately designed inter-governmental transfer system to resolve fiscal imbalances in a satisfactory manner.

Our analysis of Indian fiscal federalism, however, shows that the Constitutional assignments as well as the execution of federal fiscal arrangements over time have severely impacted on horizontal and vertical fiscal imbalances. The resulting imbalances have not only been high (in fact, much higher than many of the federations), but also have been increasing over time. As the revenue raising and expenditure decisions have been progressively delinked, the growing imbalances have had adverse effects on fiscal responsibility and management at both Central and State levels. At the same time, the mechanism to resolve these imbalances has not worked satisfactorily, thus creating a serious problem in inter-governmental fiscal relationships.

There are basic problems with the structure and design of, and in the institutional mechanism determining inter-governmental transfers. The multiplicity of agencies making transfers with overlapping jurisdictions has blurred the purposiveness and rendered the achievement of the objectives difficult. The role of the Finance Commission, the statutory body meant to dispense transfers, has been considerably diluted over the years as the Planning Commission increasingly usurped its role. The artificial distinction between plan and non-plan requirements has not helped to fulfil the objectives of transfers and often, the two institutions have worked at cross-purposes. The excessive reliance on the sharing of personal income tax and Union excise duty by the Finance Commissions has caused the Central government to lose interest in these taxes and consequently, its excessive reliance on import duties and administrative price changes in public monopolies to raise revenues has tended to distort the tax system. The use of gap-filling approach to determine grants has had adverse effects on tax effort and expenditure economy and, at the same time the methodology did not help in targeting the transfers to offset the fiscal disadvantages of the States. The plan transfers, on the other hand, were given on the basis of general economic indicators and were not designed to offset the fiscal disabilities of the poorer States either. These transfers are not designed to make up for the shortfall in investment expenditures in States with poor physical and social infrastructure after adjusting their own resources reckoned at standard efforts. In the event, the transfer system has not helped the States with low levels of infrastructure to catch up with the more advanced States. Thus, neither the Finance Commission transfers nor the transfers given by the Planning Commission could fulfil the objectives of general purpose transfers.

The reform of general purpose transfers should begin with clearly delineating the roles of the Finance Commission and the Planning Commission. The Planning Commission can undertake the function of building physical infrastructure and for this, can be given the powers to give loans to the State governments. The Finance Commission, on the other hand, should have the authority to comprehensively assess the entire current needs of the States, both of developmental and non-developmental nature. Further, the transfers thus given should be so designed as to offset fiscal disabilities arising from shortfall in revenue capacity and excessive unit cost of providing public services due to factors beyond the States' control. Better targeting of the Finance Commission transfers can be achieved by reducing the share of tax devolution and increasing the share of grants in the transfer scheme and designing the grants to offset fiscal disadvantages as mentioned earlier.[3] This calls for undertaking detailed studies on estimating these fiscal parameters on a continuous basis. The ninth Finance Commission did make attempts to measure these concepts and design the transfers to offset fiscal disadvantages as measured by the Commission. It is necessary to define and improve the methodology of measures like fiscal capacities and needs of the States fairly accurately. As a matter of fact, however, the tenth Finance Commission has not done so, and uses more simplistic yardsticks for recommending transfers to States.

As mentioned above, the Central government has employed the inter-governmental transfers to influence the States' allocational decisions in a variety of activities. The various Ministries of the Central government have initiated several Central sector and Centrally sponsored schemes. The Central sector schemes, on the other hand, are specific purpose transfers or cost sharing schemes with matching ratios varying from one project to another, but constant across different States for each project. There are over 250 such specific purpose transfer schemes at present with detailed conditionalities specifying not only the purpose or

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3 The tenth Finance Commission has done the opposite.

use, but also the method of using the grants. In the process, the resources are spread thinly across several schemes without adequately funding any of them. At the same time, excessive restrictions on the method of spending has not helped the States to implement the programmes in a cost-effective manner. Designing specific purpose transfers in this manner cannot serve any economic objective though this can be used to serve the political objective of influencing States' expenditure decisions. The transfers thus designed cannot achieve the objective of attaining the targeted physical levels of services either.

The reform of specific purpose transfers should, therefore, begin with the consideration of these multiple schemes into a few, with broad conditions specified on the purpose of their use. There is no need for specifying the conditionalities on the manner in which these funds should be used. The matching ratio for these transfers should depend on the merit good element or the judgements on the degree of benefit spillovers of the expenditure function across the country. It is also necessary to ensure that the share of specific purpose transfers is not overwhelming. To begin with, it may be a useful benchmark to take the NDC committee's judgement that the specific purpose transfers should not exceed one-sixth of the amount distributed by way of plan assistance (grants and loans).

Another important area of reform pertains to institutions. There can be two alternative institutional mechanisms for making inter-governmental transfers. The first is to have the Union Finance Ministry itself determine the quantum and distribution of transfers. Although this mechanism has been fairly successful in Canada, at the present stage of political and economic development, its applicability to the Indian situation is doubtful. More importantly, the prevailing level of confidence and trust between the Central and State governments may not permit such as experimentation. The alternative is to strengthen the existing mechanism of having an impartial statutory body to determine the transfers. In this the experience of Commonwealth Grants Commission in Australia provides valuable lessons which can be adapted to reforming the Indian federal fiscal institutions.

The reform of institutions should begin with a clear demarcation of the roles of Finance and Planning Commissions and the responsibilities of giving the current transfers should be assigned to one agency. Given that the Constitution already entrusts the Finance

Commission with this task, it could be strengthened to undertake the task in a satisfactory manner. For this, it is important to transform the Finance Commission into a professional body. This requires that the Finance Commission should be made a permanent body staffed with professionals and undertaking continuous research on various issues relating to Central and State finances and inter-governmental relationships. The Chairman and Members of the Commission once appointed could hold office for five years and should not be eligible for reappointment. It is also important to ensure that only persons with specialised knowledge of fiscal matters are appointed to the Commission as Chairman and Members and to avoid appointing politicians to the Commission. It is only when persons of eminence are appointed to the Commission, and only when the Commission functions in an impartial and transparent manner that the confidence in this institution will be restored. The strengthening of such monitoring institutions go a long way in restoring the confidence in the institutional mechanism and in fostering trust between the Centre and individual States.

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