



## **Federal fiscal structure in India**

**Dr. BN Harisha**

Post Doctoral Fellow, Department of PG Studies in Economics, Kuvempu University, Jnana Sahyadri, Shankaraghatta, Karnataka, India

### **Abstract**

India's Federal System has suffered from many difficulties and there is an adverse trend from 1980s. State governments have been facing various budgetary hardship which affecting their developmental expenditure. Among the hardships, inadequate revenue sources, low central transfers are prominent. The Indian constitution sets three fold classifications for expenditure responsibility between state and centre. Constitution accordingly also sets forth the respective taxation powers of centre and state governments. It is generally perceived that the state taxation powers are inadequate in relation to their expenditure responsibilities and that imbalances have been worsening over time. In addition to centre state tax collection and sharing, the constitution has some other provision of resource transfers to the states through various mechanisms determined by the finance commissions. The finance commission plays a vital role in centre state tax sharing and resource transfers. The planning commission and both five year and one year plans which are not mandated in the constitution, have become very important part of centre-state financial relation. With this backdrop the present paper attempts to bring the federal issues related to the recent Indian federal Scenario.

**Keywords:** federal, finance commission, tax sharing, resource transfers

### **1. Introduction**

#### **Nature of Indian Federation**

The Constitution of India which was adopted on November 26, 1949, became operative on January 26, 1950. It makes provision for two layers of government, one at the central level, and the other at the level of the states. This type of federation requires classification of powers and responsibilities between the Centre and the States. The country which is very large and diverse, requires to work in co-operation at the two levels of government.

The very first Article of the constitution defines India as a Union of States. India's Constitution defines supreme law of our land. The Constitution derives the authority of both the centre and state governments. There is a division of legislative, administrative, and financial functions and powers between the union and the state governments. Under Article 246 of seventh schedule of the Constitution, the powers and functions are assigned according to the three lists in the schedule. Thus, the centre has more powers to legislate the matters which contains in List.1 (union List) such as defense, citizenship, foreign affairs, railways, telephones, post and telegraph, broadcasting, airways, banking, coinage and currency. Similarly, the states have the power to legislate on matters which mentioned in List 2 (State List) such as public order, police, local government, public health, agriculture and fisheries.

The parliament and the state legislatures have concurrent powers on the matters in List 3 (concurrent List). Some of the items included in the Concurrent List are: marriage and divorce, population control and family planning, forests, economic and social, legal, planning, medical and other professions. The matters of national concern are mentioned in the union list and those of state level significance are with the State List. Matters of common Centre- State interest are included in the concurrent list.

#### **2. Constitutional Provisions Pertaining to Taxes**

The constitution makes arrangements relating to the distribution of taxes, the power of borrowing, and provision for grants-in-aid by the union to the states between the union and the states. Article 265 of the constitution states that no taxes shall be levied or collected except by the law. Entries 82 to 92B of List 1 in the seventh schedule refer to the taxation powers of the union government. Entries 45 to 63 of List 2 in the same schedule refer to the taxation powers of the state governments. List 3 does not contain any head of taxation that means centre and state have no concurrent powers of taxation.

#### **3. Mechanism of Central Transfers to the States**

The favorable position given to the centre in regard to financial resources reflects the strong- centre.

**Table 1:** Centralization of Tax and Non-tax Revenues in India, 2009-10

Sl. No.	Particulars	Rs. crore	share
01.	Centre's Tax collections (before transferring states share)	456536	55.7
02.	State's own Tax collections	363060	44.3
03.	Total Tax collections (all Indian) (1+2)	819596	100
04.	Centre's Non-tax Revenue	116275	55.6
05.	State's Non-tax Revenue	89092	43.38
06.	Total Non-tax Revenue (All India) (4+5)	205367	100
07.	Total Revenue Raised by the centre [1+4]	572811	55.8
08.	Total Revenue Raised by the states (2+5)	452152	44.2
09.	Total Revenue [All India] [7+8](combined)	1024963	100

*Source:* Report of the Commission on Centre-State Relations, NDC.

Emergence of imbalances between functional responsibilities and financial resources of different levels of government is a common feature of all federations. Even in older federations, like the United States and Canada, financial imbalances between the national and sub-national governments persist. The mismatch between functions and taxation powers occur partly because of changing responsibilities of governments at different levels. Therefore, vertical imbalances in terms of resources and expenditure responsibilities emerge between different levels of government. That calls for resource transfer from the centre to the states. This is the familiar problem of every federal government; this mismatch can be corrected by central transfers effected through three main channels.

#### 4. Statutory transfers through the Finance Commission

Transfers routed through the finance commission pertain to sharing of certain central taxes, and grants-in-aid of revenue of the states. Revenue from certain taxes and duties which can be levied by the centre are totally assigned to or shared with the states to meet their needs.

#### 5. Finance Commission

The flexible manner of sharing taxes and the determination of grants is left to the Finance Commission which is appointed by the president (Under Article 280) for every 5 years or earlier if necessary. The powers conferred on the commission are set out in detail in section 8 of the Finance Commission Act, 1951.

As the sixth finance commission remarked, "The purpose of

finance commission remarked, as envisaged in the Constitution, is primarily to facilitate a periodical assessment of the fiscal needs of the state and the formulation on an objective basis of proposals for transfer of resources from the centre to the states through devolution of taxes and grants-in-aid. But an incidental and by no means insignificant advantage of the appointment of a Finance Commission has generally been to rekindle interest in issues pertaining to financial relations between the centre and the states and to promote and enlightened national debate on several facets of our federal fiscal set up".

#### 6. Size and Pattern of Central Transfers

The states always complain that resources allocated to them are inadequate to enable them to discharge their responsibilities. They complain against widening gap between their own resources and needs. Similarly, the centre also feels constrained at the widening gap between its resources and needs, as reflected in the budgetary deficits.

#### 7. Trends in Vertical Fiscal Imbalances

Vertical fiscal imbalance is usually given primary importance in the discussions of fiscal imbalances regarding mismatch in the assignment of taxing powers and expenditure responsibilities. Constitutional assignments and developments over the years have contributed to create a high degree of fiscal centralization and vertical fiscal imbalance. This is described in Table 2.

**Table 2:** Trends in Vertical Fiscal Imbalances (Rs in Crore)

years	Per cent of SOCR to TCR (C&S)	Per cent of SCE to TCE (C&S)	Per cent of SOCR to SCE	Per cent of SE to TE (C&S)
1990-91	37.4	55.4	55.1	55.7
1991-92	38.0	57.7	56.2	58.1
1992-93	36.9	57.7	54.8	58.8
1993-94	39.7	56.9	56.4	57.5
1994-95	40.5	56.7	59.5	58.3
1995-96	38.9	56.0	59.1	57.5
1996-97	37.4	56.6	55.1	58.0
1997-98	38.9	56.5	55.6	58.1
1998-99	38.1	54.5	50.6	56.3
1999-00	37.4	55.4	50.0	57.0
2000-01	38.1	55.6	50.2	57.1
2001-02	38.6	55.4	49.9	56.5
2002-03	37.9	53.6	51.9	58.2
2003-04	36.9	55.0	51.3	64.6

2004-05	37.1	55.1	56.8	63.6
2005-06	36.8	54.3	59.4	58.5
2006-07	36.0	54.2	62.5	59.3
2007-08	34.3	54.2	62.6	57.2
2008-09	36.1	50.2	59.2	55.2
2009-10	37.3	50.6	56.6	54.8
2010-11(RE)	34.5	52.3	55.6	54.9
2011-12(BE)	31.7	54.3	50.1	57.6

Source: Reserve Bank of India, State Finances – A Study of Budgets of Various Years

Handbook of Statistics on State Government Finances (2010) RBI.

The states' own revenues financed 50 percent of their revenue expenditures and about a half of their total expenditure in 2011-12. The states' own revenues in the total have shown a marginal increase from about 37 percent until 1990-91 to about 40 percent in 1994-95, but declined to 32 percent in 2011-12. However, their share in expenditures has increased from about 55.7 percent in 1990-91 to 57.6 percent in 2011-12.

Percent of states' own current revenues to states' current expenditure has shown a declining trend i.e. 50.1 percent in 2011-12, remaining had come from transfers. It indicates the states' dependency on the centre is very high.

The reasons for the existing vertical imbalance are not 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 'Decentralization theorem', 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. There are clear indications that both the reasons hold for India.

## 8. Trends in Horizontal Fiscal Imbalances

Apart from the number of reasons for the existing vertical imbalance in India as mentioned above, significant horizontal fiscal imbalance provides important reasons. The horizontal imbalances have arisen mainly from inter-state disparities in revenue capacity and effort as well as in expenditure needs.

Out of 28 states (29 including Telangana, recently set up) in the Indian federation, 17(18 including Telangana) are relatively homogeneous while 11 are hill states (Arunachal Pradesh, Assam, Himachal Pradesh, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, Uttarakhand) form a distinct category, generally grouped together as 'Special Category' states. The latter group is characterized by small industrial sectors and largely unorganized 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 capital public expenditures, leading to fairly high degrees of fiscal imbalance. Most of these states are also located on the national boundary.

Table-3 gives an overview of the fiscal situation of all the states. States' own tax Revenue to Revenue expenditure, it can be seen, varies from as low as 3.8 percent in Mizoram to as much as 71.2 percent in Karnataka. And the variation in states own non-tax revenue to revenue expenditure is also high (2.6 percent in Bihar, to 47.4 percent in Goa). But highest is still about 18 times of the lowest figure.

Table 3: Major Fiscal Indicators

State	2010-11 (Accounts)	2011-12 (RE)	2012-13 (BE)	2010-11 (Accounts)	2011-12 (RE)	2012-13 (BE)	2010-11 (Accounts)	2011-12 (RE)	2012-13 (BE)	2010-11 (Accounts)	2011-12 (RE)	2012-13 (BE)
1	14	15	16	17	18	19	20	21	22	23	24	25
I. Non- Special Category												
1. Andhr Pradesh	12.3	11.2	10.9	57.5	55.4	58.8	13.6	12.7	12.3	27.2	28	27.1
2. Bihar	11.3	8.5	8.5	25.8	22.7	25.7	2.6	1.9	5.2	68	62.3	64.5
3. Chhattisgarh	6.2	4.9	4.7	46.5	41	42.8	19.8	17.7	18.8	42.8	37.9	36.5
4. Goa	13.6	11.1	10.5	44.7	40.9	45.5	47.4	36.6	35.1	17	16.3	14.6
5. Gujarat	16.8	18.1	17.2	63.3	68.7	70.9	8.6	9.5	9.4	15.7	19.1	18.1
6. Haryana	11.7	12.1	13.2	59.3	58.3	60	12.1	12.5	12.1	16.4	18.9	19.1
7. Jharkhand	10.7	9.5	8.8	29.5	28.3	31.4	15.5	14.3	14.2	41.5	48.2	53.3
8. Karnataka	10.4	9.2	9.3	71.2	70.1	64.3	6.2	4.9	4	24.9	25	28.6
9. Kerala	16.4	14.1	14	62.7	58.7	62.2	5.6	6.1	6.8	18.9	20.3	21.7
10. Madhya Pradesh	11.2	10.2	9.9	47.6	46.4	44.6	12.7	12.5	11.5	43	38.9	44.5
11. Maharashtra	14.7	13.6	13.6	70.5	67.9	68.3	7.7	7.8	8	18	20.1	20.9
12. Odisha	10.4	10.9	10.9	38.1	36.1	37.7	16.3	13.5	12.6	48.6	49.8	45.5
13. Punjab	16.8	17.1	16.2	51.2	55.5	57.9	16.2	10.3	12.8	15.2	17.1	18.6
14. Rajasthan	16.4	14.2	13.4	46.3	43.5	43.1	14	15.6	14.4	35.8	34.8	37.3
15. Tamil Nadu	10.9	10.3	10.6	65.5	70.5	72.8	6.4	6.5	6.1	21.1	19.4	19.7
16. Uttar Pradesh	13.2	11.5	10.9	38.4	39.2	40.6	10.4	10.5	9.3	43.9	45.2	44.2

17. West Bengal	21.4	21.1	21.6	32.7	32.6	37.3	3.7	3.8	3.9	33	36.1	42.9
Total I	13.7	12.6	12.4	52.5	51.7	53.2	9.9	9.4	9.3	30.8	31.8	32.8
<b>II Special Category</b>												
1. Arunachal Pradesh	10.7	6.5	8	5.7	5.2	6.8	14.2	7.7	10	83.8	70.5	80.9
2. Assam	8.3	6.5	5.8	25.8	22.4	22.1	10.3	8.3	9.6	56.7	59.6	61
3. Himachal Pradesh	14.7	14.8	14.1	27.5	30.6	31.7	12.8	13.1	12.5	45.9	48.4	46.1
4. Jammu and Kashmir	12.4	11.3	10.8	18.9	21.3	22	5.9	8.2	8.6	65.1	63.1	68.3
5. Manipur	8.9	7	6.7	6.5	5.5	5.3	6.4	5.2	6.3	80.2	69.1	83.9
6. Meghalaya	6.4	5.9	5.6	14.2	11.8	12.1	7.5	7.9	7.9	71	74.5	77.1
7. Mizoram	7.4	6.9	5.8	3.8	4.6	4.6	4.3	6.1	5.5	74.9	75.4	84.7
8. Nagaland	9.4	8.5	9.4	5.4	5.2	5.6	4.4	3.3	3.9	82.3	78.7	82
9. Sikkim	6.4	5	5.6	9.6	7.1	9.9	39.1	33.6	28.7	47.4	61.7	67.1
10. Tripura	10.3	9.9	9.7	14.3	15.6	15.2	3	3.2	3	78.5	77.4	75.1
11. Uttarakhand	12.7	12.5	12.9	37.9	39	38	5.8	7.3	7.7	46.9	43.6	42.7
Total II	10.7	9.4	9.1	21.3	21.1	21.5	9.2	8.8	9.2	61.6	61.1	63.6
All States(I+II)	13.4	12.3	12.1	49.4	48.6	50.1	9.8	9.4	9.3	33.9	34.9	35.9
<b>Memo item</b>												
1. NCT Delhi	17.9	15.3	14.5	114.6	105.6	115.2	29.1	3.4	3.2	17.1	7	5.8
2. Puducherry	9.4	11.7	8.6	42.3	52.9	47.5	21	4.1	2.5	28	31.7	40.9

RE: Revised Estimates. BE: Budget Estimate.

'-' Nil/Negligible/not applicable

Note: 1. Negative (-) sign indicates surplus in deficit indicators

2. Figures for Jharkhand for the year 2010-11 (Accounts) Relate to revised estimates.

**Source:** Budget documents of the state government, state finance account, CAG for 2010-11 in respect of Jammu and Kashmir

Due to equalization grants special category states get more transfers to meet their needs. It is interesting to note that the special category states are fiscally special due to their expenditure pattern only, average states' own tax revenue in these states at 21.3 percent is actually lower than in Non-special category states on an average (52.5 percent). In fact, average states' own tax revenue and states' own non-tax revenue in both the categories of states vary in line with revenue expenditure, pointing to the importance of revenue capacity.

## 9. Conclusion

Transfer routed through the Finance Commission Pertain to sharing of certain central taxes, and grants-in-aid of revenues of the states. Revenue from certain taxes and duties which are levied by the centre are totally assigned to or shared with the states to meet their needs.

The states always complain that resources allocated to them are inadequate to enable them to discharge their responsibilities. They complain against widening gap between their own resources and needs, similarly, the centre also feels constrained at the widening gap between its resources and needs, as reflected in the budgetary deficits.

The states' own revenue in the total revenue has declined from 37 percent in 1990-91 to 32 percent in 2011-12. But their share in total expenditure has increased from 55 percent in 1990-91 to 57.6 percent in 2011-12. In 2000-01, the government of India took initiation to issue guidelines to the states to prepare Medium Term Fiscal Reform Programmes (MTFRPs). The purpose of MTFRPs was to reduce wasteful expenditure and improving efficiency of the tax administration. The MTFRPs did not succeed in improving the fiscal situation to the desired level.

The share of Share in Central Tax (SCT) in total transfers has grown-up followed by grants from the centre. SCT covers nearly half of the total transfers.

In the total revenue receipts of centre and states, Tax revenue has major share. The non-tax revenue has declined gradually over the study period. The states' revenue receipts trend gives more or less the same trend as it was in the central government's.

States are suffering from their own revenue because of their taxable capacity and they differ in natural resources. The quantity of tax amount (including SCT) that they are supposed to get is very less compared to their expenditure responsibilities.

Due to the geographical and demographic factors, the unit cost of providing various public goods and merit goods is relatively high in special category states, as a result, their revenue capacity is low compared to their high per capita public expenditure, leading to fairly high degree of fiscal imbalances.

Despite an improvement in the revenues from states' own taxes and tax devolution from the centre, revenue receipts in 2010-11 were lower, reflecting the impact of reduced receipts from states' own non-tax revenues.

With a view to promote equity while maintaining fiscal efficiency, the Thirteenth Finance Commission has changed the shares of the states drastically in its recommendations. However, it is making a paradigm shift to change the structure of equity and fiscal incentives as an inherent part of the fiscal transfer system of the Government of India. The Thirteenth Finance Commission has designed the fiscal transfer system with the aim of promoting equity and providing fiscal incentives even to the states which have a better record of providing education and infrastructure development to

improve their services further from quantity to quality. This study also highlighted the tax devolution and sharing of union taxes with state government in the light of the awards of various Finance Commissions.

All the special category states have had an average revenue surplus over the 2005 to 2008 period, while six states have an average fiscal deficit higher than 3 percent of GSDP over the same period. The reason is that these states are highly dependent on central grants.

It is important to recognize that for successive fiscal consolidation, the key lies in maintaining the growth dynamism of our economy. Except some variation during some years, as on day vertical and horizontal fiscal imbalances are widening. There is a need for change in government's policies and practices for which lessons may be drawn from other federations in the world.

### References

1. Bagchi A, Bajaj JL, Byrd WA. State finances in India, Vikas Publishing House Pvt. Ltd. N. Delhi, 1992.
2. Rao M, Govinda, Jena PR. Recent Trend in state finances, in Rao M. Govinda and Anwar Shah (ed) States Fiscal Management and Regional Equity; An Overview, Oxford University Press, 2009.
3. Sen Tapas k., Reforming State Finances: An Agenda" NIPFP, New Delhi, 2004.
4. Srivastava DK, Chattopadhyay S, Rangamannar TS. State Fiscal Studies, Assam, NIPFP, New Delhi, 1999.
5. Rao M. Govinda Linking Central Grants to Revenue Deficit Reducing by States, *Economic and Political Weekly*, June 3, 2000, 1883-1884.
6. Budget documents, Government of Assam, Dispur. 09, 2008.