

INDIAN FISCAL FEDERALISM NEW CONTOURS

**PRESENTATION TO OFFICER TRAINEES OF ALL-
INDIA SERVICES AND CENTRAL CIVIL SERVICES
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STRUCTURE OF PRESENTATION

- Fiscal Federalism-Concept and Theory
- Evolution of Fiscal Federalism in India
 - 1950-51 to 1999-2000
 - 2000-01 to 2014-15
 - 2015-16 to date
 - ✓ 14th Finance Commission
 - ✓ Replacement of Planning Commission by NITI Aayog
 - ✓ Introduction of GST from July 1, 2017 and its Implications for Fiscal Federalism
- Concluding Remarks

Fiscal Federalism- Concept and Theory

- Fiscal federalism refers to financial relations between units of governments in a federal system. It deals with the division of governmental functions and financial relations among levels of government.
- **Decentralization Theorem:** Economic stability, national security and income inequalities can be better addressed by the federal government. Decentralization of services and their delivery by States will result in welfare maximization as they are closer to people and can cater to their diversified needs.
- Combines benefits of decentralization and economies of scale.
- **The other view:** Decentralization may result in exploitation of fiscal commons, lack of hard budget constraint and accountability. Lack of coordination among States.

Rationale for Inter-governmental Transfers: India

- States assigned more functional responsibilities relative to their sources of revenue - vertical imbalance.

○ Revenue raised by the Centre	--	63%
○ Revenue raised by States	--	37%
○ Expenditure by the Centre	--	47%
○ Expenditure by States	--	53%

- Horizontal Imbalances.

- Wide variations in per capita income: Rs. 3,27,059 (Goa), Rs.31,454 (Bihar)-2015-16
- Tax-GSDP ratio 9.6 in Goa and 2.1 in Nagaland (2014-15)
- Per capita own resources vary from Rs.2,149 in Bihar to Rs.42,680 in Goa (2014-15)

Perceptions about Inter-governmental Transfers

- **Federal/Central View:** Giving money and power to sub-national governments is giving them pleasure of spending without pain of earning.
- **Provincial and Local View:** We need more grant monies to fulfill constitutional responsibilities.
- **Citizens:** The magical art of passing money from one government to another and seeing it vanish in thin air.
- The problem of Fiscal Commons- Provision of pork-barrel projects.
- Are these perceptions well grounded in reality? Properly designed transfers are part of the solution rather than part of the problem.

Objectives of Inter-governmental transfers

- Offsetting the mismatches in revenue raising capacity and expenditure commitments
- Provision of comparable level of services across all states (horizontal equity)
- Keeping the nation with diversities together
- Maintenance of macro economic stability
- Promotion of national objectives
- Equitable sharing of nation's resources

Guidelines for Inter-Governmental Transfers

- **Clarity** in objectives, **consistency** of design with objectives and **singular focus**
- **Simplicity, objectivity** and **transparency** of allocation criteria
- **Incentives** for fiscal prudence and competitive service delivery and results based accountability to citizens
- **Autonomy**: Independence in designing programs and flexibility in use of resources
- **Revenue Adequacy** and **responsiveness**
- **Predictability**
- **Fairness**: entitlements vary inversely with fiscal capacity and directly with fiscal needs; one size does not fit
- **Affordability**
- **Review** :Sunset clauses to ensure periodic review and assessment

Evolution of Indian Fiscal Federalism (1951-2000)

- Gol Act 1935 formed the main basis of Indian Constitution
- Quasi-federal, Centripetal bias in fiscal matters
- Union List, State List and Concurrent List with the Union bestowed with overriding powers over the subjects in the Concurrent List. Taxation powers based on the principles of separation.
- States' requiring Gol's permission to borrow.
- Discretionary transfers
- Proliferation of Centrally sponsored schemes and Central sector schemes.
- Direct transfers to implementing agencies
bypassing the States
- Planning Commission and Centralized Planning
- Regional policies and invisible transfers
- Automatic monetization of Centre's deficit till 1997.
- 73rd and 74th amendments to the Constitution (regular elections to local bodies and appointment of a State Finance Commission and insertion of Schedules XI and XII).
- Introduction of taxes on services in 1994-95 and their gradual extension

Evolution of Indian Fiscal Federalism (1951-2000) Contd..

■ Constitutional provisions

- Article 268: Taxes levied by the Centre but collected and retained by States (Certain stamp duties and excise duties on medicinal preparations).
- Article 269: Taxes levied and collected by the Centre but assigned to States (CST)
- Article 270: mandatory sharing of income tax between the Union and the States. Surcharges levied for the purpose of the Union are not shareable.
- Article 272: Sharing of Union excise duties, if Parliament by law provides
- Article 275: Grants-in-aid of the revenues of States.
- Article 282: Grants to States for any public purpose
- Article 293: Loans to States for any purpose.
- Article 280: Institutional arrangement for transfers. Constitution of a Finance Commission at the expiry of every fifth year or earlier.

Finance Commission Transfers

■ The FC is mandated to

- Recommend distribution between the Union and the States of the net proceeds of Union taxes and allocation across States
- Recommend principles and quantum of grants to States which are in need of assistance
- Make recommendations on any other matter referred to it in the interest of sound finance.
- Recommend measures needed to augment the Consolidated Fund of a State to supplement the resources of the panchayats and municipalities in the State. (Following the 73rd and 74th amendments to the Constitution in 1993)

Modalities of FC Transfers

- FC makes an assessment of the revenues and requirements of the Centre and the States on non-plan revenue account.
- It then determines the vertical distribution of income tax and Union excise duties.
- States' share in income tax varied from 55% (FC-I) to 85% (FC-IX). FC-X reduced it to 77.5%.
- Proceeds of a few duties of Union excise were recommended to be shared from FC-I to FC-IV. Proceeds from all duties became shareable from FC-V. States' share at around 25% till FC-VI. FC-VII increased the share to 40%.
- Separate formula for the inter se distribution of States' share in income tax and Union excise duties till FC-VII. (90% weight to population and 10% weight to contribution for IT. UED: 90% to population to 10% to others). FC-VIII reduced the weight to population to 25%.
- Deficit grants to States which are assessed to have a deficit on their non-plan revenue account after tax devolution (Fiscal dentistry).
- Grants for special problems and upgradation of administration.

Plan Transfers to States

- With the introduction of planned economic development, plan transfers have become important.
- Types of plan transfers:
 - A. Assistance for State Plans.
 - Normal Central assistance
 - Special plan assistance.
 - Special Central assistance
 - MPLADS
 - B. Centrally sponsored schemes
 - C. Central sector schemes

Normal Central Assistance

- Revised Gadgil-Mukherjee formula (30% earmarked for special category States)

<u>Variable</u>	<u>Weightage(%)</u>
1. Population	... 60.0
2. PCY	... 25.0
- Deviation (below avg. States)	... 20.0
- Distance (All States)	... 5.0
3. Performance	... 7.5
- Tax effort	... 2.5
- Fiscal performance	... 2.0
- National objectives	... 3.0
4. Special problems	... 7.5

Evolution of Indian Fiscal Federalism

(2000-2015)

- Following the 80th amendment to the Constitution in 2000, all the Union taxes became shareable with the States.
- States' share in net tax revenue was recommended at 29% by FC-XI, which was raised to 30.5% by FC-XI and further to 32 % by FC-XIII.
- Progressivity in the formula for tax devolution continued with FC-XI reducing the weight to population to 10% and increasing the weight to per capita income distance to 62.5%.
- Central Finance Commissions recommending grants to local bodies.

Evolution of Indian Fiscal Federalism

(2000-2015)

- Expansion in the ToR of the Finance Commissions which included restructuring the finances of the Union and the States (FC-XI and FC-XII), balancing the revenue and expenditure (FC-XII).
- Enactment of FRBM legislations by the Union and the States following the recommendation of FC-XII, a landmark development.
- Compliance of FRBM by States and non-adherence by the Union. FCs bark at the Centre but bite the States.
- Entitlement legislations by the Union- Employment Guarantee 2005, Right to Education 2009, Right to Food 2013.
- Greater recourse by the Union to cesses and surcharges.
- Direct transfer to State implementing agencies terminated from 2015-16.

Evolution of Indian Fiscal Federalism

(2015 to date)

- FC-XIV's recommendation increasing the tax devolution to 42% (2015-20) was a game changer. This was done to increase the flow of untied funds to States.

Criteria

Weights(%)

1. Population (1971)	...	17.5
2. Population (2011)	...	10.0
3. Income Distance	...	50.0
4. Area	...	15.0
5. Forest Cover	...	7.5

- FC-XIV dispensed with all grants except those to the local bodies and revenue deficit grants.
- Developments following the increase in devolution.
 - Termination of normal plan assistance, BRGF, etc.
 - Restructuring of CSS/ increase in the matching contribution of States in a way offsetting the advantage of higher untied transfers.
 - 34 schemes to be fully supported by the Union.
 - Changed sharing pattern of 20 schemes-Higher burden on States.

Evolution of Indian Fiscal Federalism (2015 to date) Contd...,

- Replacement of Planning Commission by NITI Aayog consisting of Prime Minister and all CMs.
- Replacement of Five-Year and Annual Plans by 15-year Vision, 7-year strategy and 3-year action agenda
- Niti Aayog's main mandate:
 - To act as a primary platform for operationalising cooperative federalism with active participation by States.
 - Evolving a shared national agenda.
 - Promoting decentralized planning
 - Vision and Scenario planning.
 - Domain expertise and strategies.
 - Sounding board
 - Knowledge and Innovation hub

Evolution of Indian Fiscal Federalism (2015 to date) Contd...,

- Introduction of much awaited GST from 1st July, 2017, a game changer and a major reform in indirect taxation
- From exclusive tax powers to concurrent power to tax the same base. GST has numerous advantages.
 - Subsumes numerous taxes being levied by the Union and the States including cesses. Petroleum products, power, liquor and real estate are kept out of GST.
 - Keeps an audit trail of all transactions. Removes cascading or tax on tax
 - Brings informal economy into formal and increases tax base and compliance.
 - Brings down the cost to the manufacturers and consumers

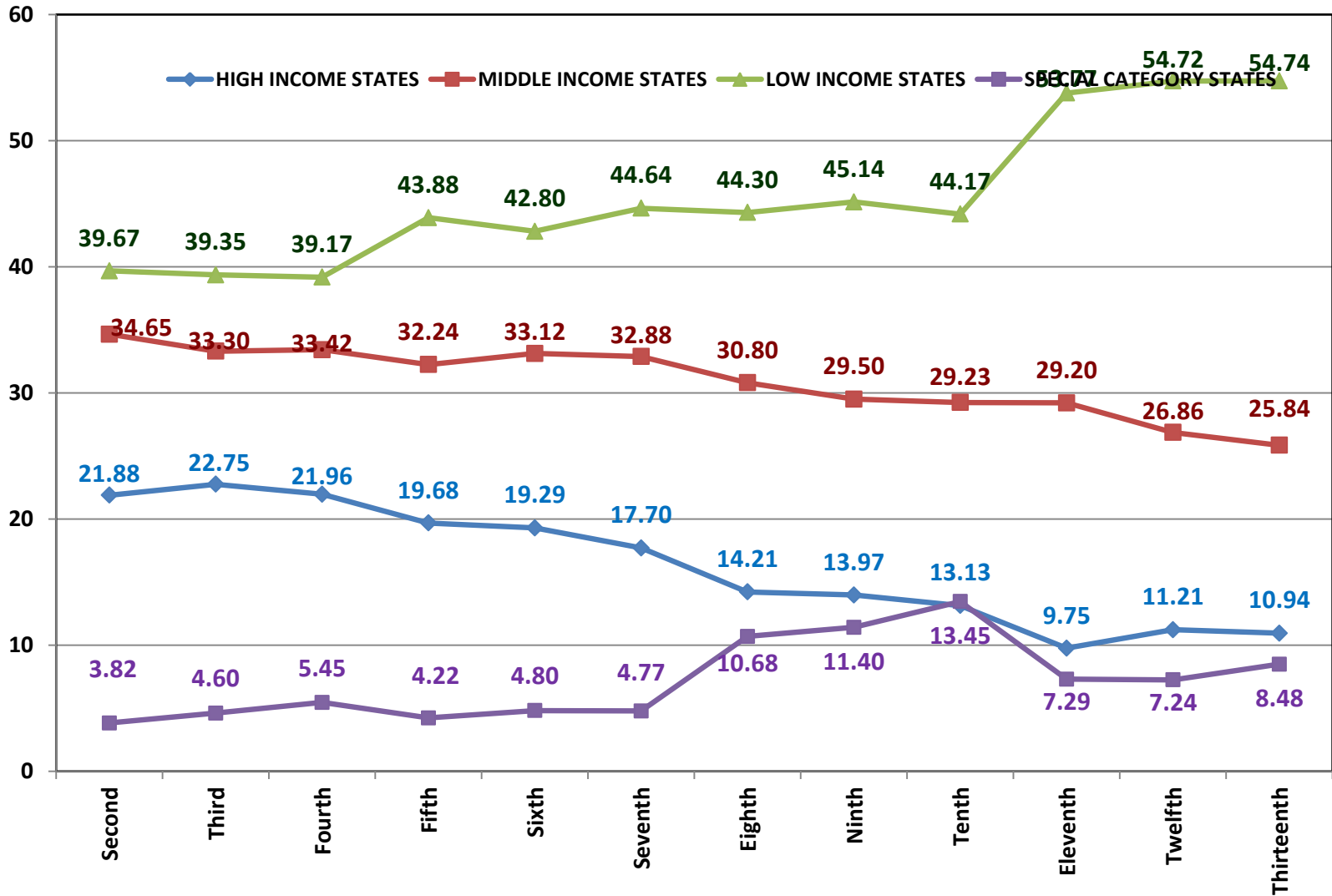
Evolution of Indian Fiscal Federalism (2015 to date) Contd...,

- Implications of GST in fiscal federalism
 - Have the States ceded more ground?
 - Being a destination based tax, predominantly manufacturing States may lose revenue in the initial years.
 - Centre can veto the decisions of GST Council. But the Centre needs the support of at least 19 States for any decision to be pushed through.
 - Despite the initial apprehensions, GST is a win-win for the Union as well as the States. Paved the way for cooperative fiscal federalism.
 - The model of GST Council can be replicated for arriving at major national policies as an alternative to Inter-State Council and now defunct NDC.

Concluding Observations

- Relative stability in the percentage of expenditure incurred by the Union and States post transfers. The more things change, the more they remain the same.
- Development of India lies in States. Trust deficit between the Union and the States to be bridged.
- States have matured enough to plan their priorities.
- Except in areas with huge externalities, the number of CSS in other areas should be cut to the minimum to serve national priorities.
- Indian fiscal federalism is work in progress. But Constitutional provisions have stood the test of time.
- The institution of the Finance Commission has acquitted itself well. The credit for no breakdown in fiscal relations goes to this institution.
- NITI Aayog should become the major change agent to make India a vibrant economy.

Shares of States in Tax Devolution



SHARE OF TAX DEVOLUTION AND GRANTS IN FC TRANSFERS

FCs	% share of		FCs	% share of	
	Tax devolution	Grants		Tax devolution	Grants
1 st	87.9	12.1	7 th	92.3	7.7
2 nd	81.2	18.8	8 th	86.3	9.6
3 rd	81.4	18.6	9 th	82.9	17.1
4 th	75.8	24.2	10 th	91.0	9.0
5 th	86.6	13.4	11 th	86.5	13.5
6 th	73.9	26.1	12 th	81.1	18.9
13 th	84.8	15.2	14 th	88.0	22.0

TRENDS IN CENTRAL TRANSFERS

Period	FC transfers	Plan and other transfers	Total
1969-74	64.4	35.6	100.0
1974-79	67.3	32.7	100.0
1980-85	62.1	37.9	100.0
1985-90	61.0	39.0	100.0
1990-91	62.7	37.3	100.0
1992-97	61.8	38.2	100.0
1997-01	64.7	35.3	100.0
2002-07	61.9	38.1	100.0
2010-15	66.2	33.8	100.0
2015-16	71.2	28.8	100.0
2016-17	71.8	28.2	100.0
2017-18	71.9	28.1	100.0

RELATIVE SHARES OF THE CENTRE AND THE STATES IN EXPENDITURE (POST DEVOLUTION)

Average FC	Shares in total exp.		Shares in rev.exp	
	Centre	States	Centre	States
First	43.83	56.17	40.77	59.23
Fourth	47.69	52.31	41.77	58.23
Seventh	44.79	55.21	41.98	58.02
Ninth	45.58	54.42	43.45	56.55
Tenth	43.35	56.65	43.18	56.82
Eleventh	43.77	56.23	44.03	55.97
Twelfth	46.08	56.82	47.59	52.41
Thirteenth	46.64	53.92	47.16	52.84
Average	46.16	53.84	43.56	56.44

Thank you very much

Questions

Comments

Suggestions

Observations

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