CENTRE-STATE FISCAL RELATIONS IN INDIA – NEED FOR RESTRUCTURING

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Abstract

It is well-known that federal form of government is best suited for a society with vastly diverse economic and cultural background such as India. There are not only political reasons but also powerful economic arguments for preferring a federal system to unitary system of governance.

In India the necessary institutional structure has been evolving over the past six decades. Yet, the system in India remains imperfect: Firstly, there exist several unresolved issues in the operationalization of the federal fiscal sharing management; and, Secondly, the changing contours in the economy and the resultant policy changes in the economic governance call for fundamental revamping of the federal fiscal mechanism. Especially, in recent years with the land mark changes such as the shift towards liberalization in 1991, the introduction of the Fiscal Responsibility and Budgetary Management (FRBM) Act, the replacement of the Planning Commission with National Institution for Transforming India (NITI) Aaayog, implementation of the Direct Tax Code, and introduction of the Goods and Services Tax (GST) that might alter the revenue positions of the Centre, State and Local level governments. All this signal that it is time for revamping of the system of federal fiscal arrangements for inter-governmental transfers in India.

The purpose of the present paper is to suggest suitable alterations in the federal fiscal system in India considering the possible changes in the structure of the economy and the potential revenue generation at different levels of government. It lists out the broad requirements of federal fiscal system; analyzes the Indian experience so far; explains the need for reforming and revamping the system; explains the methods for revamping the system; and suggests broad lines of reform. The suggestions include:

1. Set up a permanent Finance Commission
2. Converge the relevant bodies into the Commission
3. Extend the terms of reference, and expand the membership
4. Involve the National Development Council for States' cooperation
5. Federal fiscal sharing should be from all revenue sources
6. Transfers should be consensus based
7. Vertical sharing choices and methods
8. Horizontal sharing should be more rational and objectively determined
9. Grants-in-aid to reflect broad economic policy objectives
10. Incentivize the Grants-in-aid
11. Capital grants should be project by project based on economic and financial viability ;

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CENTRE-STATE FISCAL RELATIONS IN INDIA – NEED FOR RESTRUCTURING

J V M Sarma[1]

0 Introduction

It is well-known that federal form of government is best suited to maintain democratic characteristic and inculcate decentralized governance, especially appropriate for a society with vastly diverse economic and cultural background. A federal system is preferred to unitary system of governance not only for political and administrative reasons but also because of economic benefits. "Federal governance promotes efficiency, both economic and political. Economic efficiency is advanced by the division of governmental functions among different levels depending on their comparative advantage. Assignment of matters that concern the nation, or where there are externalities or large economies of scale to the government at the Centre, combined with decentralization of responsibility to provide services that benefit smaller segments of the country or the community to lower level governments, promotes efficiency in the allocation of resources in the economy. What is more, in a federal polity the economy benefits from the operation of a common market facilitated by free flow of goods,

[1] This paper is based on a report submitted by the author as a National Fellow of the Indian Council of Social Science Research, New Delhi. (Sarma J. , 2018)

services and factors of production within the country.” (Bagchi, 2001, pp. 1-2). Thus, there are not only political reasons but also powerful economic arguments for preferring a federal system to unitary system of governance. In recent years, it is the economic benefits of federalism that is drawing sovereign nations to join together in economic union even while not surrendering their independence. The European Union is a prime example.

Federal system involves multi-layer governance structure and has proximity advantage safeguarding the local ethnic and cultural diversities with freedom to adopt local specific policies. Though federal form of governance involves more expenditure and might lead to unnecessary competition between sub-national government units, the advantages override such disadvantages. Originated in Britain sometime in late 18^{th} century, the federal form is shaped by the American Revolution. Currently, it covers about 40 percent of world’s population in 25 countries.

India with its diverse social, economic and cultural background is an ideal case of adopting the federal form of the government and has its roots in the pre-Independence era itself. It has come a long way and the necessary institutional structure has been evolving over the past six decades.

Yet, the system in India remains imperfect. Firstly, there exist several unresolved issues in the operationalization of the federal fiscal sharing management. Over time, there has been steady widening of the Commission’s mandate and of late, the Finance Commission (FC) that is primarily responsible for federal fiscal sharing, has been entrusted with many tasks of macroeconomic and fiscal management.

Secondly, the structural changes in the economy and the resultant policy changes in the economic governance needs fundamental revamping of the federal fiscal mechanism. Especially, in recent years with the land mark changes such as the shift towards liberalization in 1991, the introduction of the Fiscal Responsibility and Budgetary Management (FRBM) Act, the replacement of the Planning Commission with National Institution for Transforming India (NITI) Aayog, implementation of the Direct Tax Code, and introduction of the Goods and Services Tax (GST) that might significantly alter the revenue positions of the Centre, State and Local level governments. All this signal that it is time for revamping of the system of federal fiscal arrangements for inter-governmental transfers in India.

The overall purpose of the present paper is to suggest suitable alterations in the federal fiscal system in India considering the possible changes in the structure of the economy and the potential revenue generation at different levels of government. The paper contains six Sections: Section 1 lists out the broad requirements of federal fiscal system; Section 2 briefly analyzes the Indian experience so far; Section 3 explains the need for reforming and revamping the system; Section 4 explains the aspects and methods for revamping the system; Section 5 lists the broad recommendations for the reform; and Section 6 contains the concluding remarks.

1 Federal Fiscal System: Broad Requirements and Indian experience

Federal system is a mixed or compound mode of government, combining a general government (the central or 'federal' government) with regional governments (provincial, state, cantonal, territorial or other sub-unit governments) in a single political system. World over, the consensus seems tends to have three levels of governments: federal, provincial and local.

The adaptation and operationalization of federal system of governance generally involves certain basic choices: The division of powers, types of fiscal transfers – vertical and horizontal tax sharing, Options for grants, methods towards balanced regional growth across the constituent states.

1.1 The division of powers

Constitutional division of revenue and expenditure powers between national and sub-national governments is one of the fundamental requirements for adopting the federal form.

An important consideration for the division of fiscal powers – vertical or horizontal – is the management of ‘spill-over’ effects. As per this theory, public goods and services have spill-over effects with different ‘spans’ – local, provincial, regional, national and international. Ideally, fiscal powers relating to public goods with larger spans of spill-over effects should be assigned to higher levels of governments. Further, in the literature it is suggested that the assignment of expenditure functions should precede the division of revenue raising powers so that the latter can be determined by the requirements of different spending agencies.

World over, the division of functions and responsibilities varies from one federation to the other depending upon the basic preference as to whether to have a centripetal federation or ‘cooperative’ federation. For example, India follows the centripetal federalism where the central government holds more powers than the states either directly or indirectly.

In India, the Article 246 of the Constitution divides the law-making powers under three lists: The Union List (List I), the State List (List II) and the Concurrent List (List III) each assigning the expenditure responsibilities and the revenue sources of the respective governments. As regards the revenue sources, most broad-based taxes have been assigned to the Center, and among the taxes assigned to the States, only the tax on the sale and purchase of goods has been significant for state revenues. The Center has also been assigned all residual tax powers. The Central government has the power to collect tax and nontax revenues to the extent of 68 to 70 percent of the total combined revenue collections. However, the States undertake nearly 67 percent of the expenditure functions. Thus, the required extent of transfers would be about 34 percent on average.

In India, the fiscal transfers are essentially of three types: from current revenues as determined by the Finance Commission (FC), capital transfers for financing investment by the erstwhile Planning Commission (PC), and transfers under centrally sponsored schemes (CSS).

The inadequacy of resources to meet expenditure functions makes the subnational government dependent on the federal government. The central tax revenues need to be shared between the three levels of governments.

In federal systems, two types of fiscal imbalances can occur: Vertical Fiscal Imbalance (VFI) and Horizontal Fiscal Imbalance (HFI). When the fiscal imbalance occurs between two levels of government (such as center and states, or states and local) it is called VFI. When the fiscal imbalance occurs between the governments at the same level it is called HFI. This imbalance is also known as regional disparity. While HFI requires equalization transfers, VFI is a structural issue and thus needs to be corrected by reassignment of revenue and expenditure responsibilities between the national and sub-national governments.

The FC transfer formulae in India, appear to follow an incremental approach. FC after FC the objective seems to increase the share of the States *albeit* marginally. There is no evidence of any scientific derivation of the share. An important improvement has been the combining of all the Central taxes for revenue sharing as recommended by the Tenth Finance Commission (10FC) excluding the cesses and surcharges. The aggregate share of States in the net proceeds of all Union taxes and duties, excluding surcharge, cesses and the cost of collection during the last two decades has fluctuated between 26 per cent and 30 per cent.

1.2 Vertical fiscal imbalances and transfer options

The vertical fiscal imbalance (VFI) is a structural issue and might arise by design. Generally, the expenditure responsibilities assigned to the sub-national governments would require larger share of revenue resources. The raising of taxes, however, must be largely centralized for efficiency and economic reasons. Thus, a large part of the VFI is by design. Among the established federal countries Australia seems to have a higher vertical imbalance.

VFI is justified on the basis of the following reasons. Firstly, the central government functions are public goods with larger span of externalities ('spill-overs') such that they serve the 'national' interests as opposed to the narrower regional interests. The functions like defense, border security and integrated planned macroeconomic development do require huge resources. Secondly, the central government needs to meet the equity objectives through the tax policy and expenditure policy. The horizontal fiscal equalization needs greater access to revenue sources Thirdly, certain national taxes such as income tax and manufacturing tax require a centralized uniform administration. Also, the centralized tax administration reduces scope for needless 'tax competition' among the sub-national governments.

At the same time, there are certain arguments for minimizing the VFI. Firstly, there is the accountability argument. The fact that central government collects most of the revenues, and provincial governments collect less but spend more, which requires vertical transfers from the center to the provinces, may reduce the accountability of the provincial governments. Secondly, a large VFI makes the Central government financially very powerful and the provinces to be weak. Apart from the intended VFI, there could be other undesired components of VFI caused by several factors, some of them are as follows.

1. The nature and extent of actual fiscal autonomy;
2. Conflicting or uncoordinated federal and state priorities (for example, education, agriculture, social welfare, infrastructure expenditures);
3. The shortcomings in the existing revenue sharing arrangements;
4. Political conflicts.

More than the tax revenue sharing, tax power sharing could also cause VFI. It depends upon the degree of discretionary change to tax rates or tax bases required for generating additional revenue. This point can be illustrated by contrasting two governments one of which (say, the central government) raises its revenue from progressive income taxation and the other (say, a state government) from sales tax. In a period of high inflation accompanied by correspondingly high increases in money incomes with little growth in output, the central government would experience high and automatic growth in its tax revenue without having to increase the rate of tax or broaden the tax base while the state's revenue would remain static. The basic idea in correcting the VFI is that 'government at each level can command the financial resources necessary for them to carry out their expenditure responsibilities'.

The vertical transfers should be fixed in such a way, the sub-national governments should be able to meet their assigned expenditure functions. There are two options to reduce the revenue gaps through vertical transfers.

Option A is to completely reduce the fiscal gaps of the sub-national governments to zero. This may result in wider fiscal gap at the central government level, which can be met through new borrowings. In this case, the vertical share should be made equivalent to the aggregate of subnational fiscal gap. There will not be any need for states to go for borrowing.

Option B is to partially fill the fiscal gaps of the federal and state governments keeping them at equal level, and allowing the sub-national governments, especially the state governments, to go for borrowing. This is a policy issue. In this case, the vertical share should be determined in such a way that the fiscal gaps at the national and sub-national level are equal. In this case, the additional fiscal gaps will have to be filled up by borrowings both by the central and state governments individually.

Under Option B, a measure of VFI can be developed given the Constitutional division of revenue and expenditure responsibilities. The positive difference between the Central and state level fiscal balance is follows.

$$VFI = (Rc - Ec) - (Rs - Es) \neq 0$$

Where, Rc and Rs denote revenues of Centre and States respectively, before devolution and transfers and Ec and Es are respective total expenditures.

As (Bird & Tarasov, 2002, p. 6) puts it if imbalance is the problem balance is the solution. Therefore, the transfer needed from Centre to States should be such that VFI=0. Let T be such transfers so that

$$(Rc - Ec) – T = (Rs – Es) + T.$$

And therefore, the required amount of transfers to the states is

$$T = [(Rc - Ec) – (Rs – Es)] / 2.$$

A part of the VFI is a policy issue over the desired degree of dependence of subnational governments on the federal government. As and when the VFI policy changes, the part of the VFI that is consciously built can be corrected to a manageable level by re-assignment of revenue and expenditure responsibilities between the two governments.

Clearly, the policy option A is suitable in the initial stages of federal governance where states by themselves may not be in a position to borrow from market and have to look up to the center to help them out. The second policy option requires less transfers from the center, gives more independence to the states to borrow to manage their fiscal gaps.

In India Some issues pertaining to the vertical revenue sharing between the Central and State governments that remain to be solved are as follows.

1. For example, it has been argued that the power to levy surcharges, instead of meeting any emergent requirements of a specific nature, is used as a normal source of revenue.
2. Similarly, although there is no explicit mention of services either in the 7th Schedule, taking cue from Entry 97 that the Central government to levy taxes on the residual items the Central government has been levying taxes on

services under this entry. The introduction of the Goods and Services Tax to some extent solved the problem of sharing the service tax proceeds.

3. Further, the non-tax revenue is not shareable. Hence, the Union Government is now better equipped, financially, to meet with its expenses and therefore there is a scope for higher devolution of union taxes to the States.

1.3 Revenue sharing vs Grants

Basically, there are two broad channels of transfers from the federal government to the subnational governments: Tax sharing and Grants. Once the vertical share is determined, decision needs to be taken as to how much should be the tax sharing and how much should be the grants. The issue to be resolved is how to apportion the vertical transfer to be channeled through tax sharing and grants.

The merits of tax sharing are as follows: Firstly, the transfer amount through tax sharing is in line with the productivity and growth of the central taxes unlike the grants which are usually not linked to tax revenue collections. Therefore, tax share being a fixed percent of the tax revenue collections of the federal government would mean the subnational governments can be assured of reasonably growing amount. Secondly, transfers through tax sharing could reduce uncertainty for the subnational governments. Subnational governments can be fairly sure of the amount of revenue they are going to get and accordingly make suitable spending plans in advance. Thirdly, although the federal government collects the taxes, the bases for the central taxes lie within the states. Therefore, state governments do get a feeling of re-claiming a portion of the central tax.

The disadvantages of tax sharing could be: Firstly, the federal government might be lax in collecting the taxes being aware that the revenue need to be shared. Secondly, transfers in the form of grants give flexibility to determine the form, method of transfers with and without certain conditions. Conditional grants, matching grants etc. gives control over the expenditure management of the subnational governments.

An issue pertaining to tax sharing that needs attention is whether the sharing should be from all the taxes collected by the federal government or should it be only from selective taxes. International experience shows that the tax sharing from all the tax revenues collected by the federal government is better than sharing specific tax revenues because experience shows that selective tax-wise sharing biases tax policy over time as federal governments invariably tend to focus more on those taxes which they do not have to share. This issue has been well-discussed in the literature. For example, Bird and Smart conclude "On the whole, the best way to provide both some degree of stability to local governments and some degree of flexibility to the federal government is to establish a fixed percentage of all central taxes (or current revenues) to be transferred as is (more or less) done, for example, in Colombia and Argentina. Sharing specific national taxes is less desirable than sharing all national taxes because experience shows that it biases tax policy over time as federal governments invariably tend to increase more those taxes which they do not have to share. Sharing all taxes also ensures that the ''pain'' as well as the ''gain'' of cyclical variations in central revenue is shared." (Bird & Smart, 2002, p. 900).

In some countries, the tax base sharing is in vogue. Tax base sharing could be when the federal and state governments tax the same base with different rates. This has become common especially in the case of value added tax or goods and services tax as in Australia, Canada, and India. For example, in Canada, Australia, and more recently in India the introduction of Goods and Services tax (GST) from July, 2017 provides for sharing of the GST base between the federal and state governments. With this, the current arrangement regarding tax devolution may undergo changes with the introduction of the unified GST.

1.4 Options for Grants

The other broad channel of federal fiscal transfers is grants. With the transformation to federal system from the unitary system, with the changes in the tax assignments to the subnational governments, and with the provisions to share the tax revenues, one can expect that the needs for grants could be smaller than earlier.

International experience shows there are certain common features regarding grant systems. For example, virtually, all federations have certain equalization grants. In addition, there are grants with conditions that induce the subnational governments to meet national objectives. The following are the types of grants provided to subnational governments in different countries. In some countries the equalization objectives are combined with the tax sharing.

1.4.1 General purpose unconditional block grants

In the case of unconditional grants, no restriction is imposed on the use of funds. However, experience with the general purpose unconditional grants shows that these grants are prone to a phenomenon referred to as the 'flypaper effect'. It implies that grants to subnational governments tend to result in more local spending than they would have, had the same transfers been made directly to local residents for political and bureaucratic reasons.

1.4.2 Equalization grants

Adapting the federal system with decentralization of expenditure and revenue raising invariably creates different fiscal capacities across regions, making it impossible to provide comparable levels of public services at comparable rates of taxation. This is so because, to provide a given level of public goods and services, different states require different amounts of expenditure per capita, for various reasons. Since the tax sharing might not eliminate the inequity, additional grants can help to further reduce the horizontal inequity.

There are two broad types of fiscal equalization: Fiscal Capacity Equalization (FCE), and Horizontal Equity Equalization (HEE). Fiscal Capacity Equalization (FCE) is the traditional interpretation, widely used in Canada, Australia, Germany and Switzerland. This model calls for transfers from states with high per capita income and low per capita needs to those of opposite characteristics. The Horizontal Equity Equalization (HEE) is an alternative view which seeks to apply the rule of horizontal equity (the equal treatment of individuals in equal positions) across the fiscal operation of states and does so on a nationwide basis. The fiscal treatment given by lower level jurisdictions should be the same for individuals in equal positions, independent of the jurisdiction in which they reside. Usually, the FCE grants are easier to determine and are more popular. Across the OECD, fiscal equalisation transfers average around 2.5 percent of GDP, 5 percent of general government spending, and 50 percent of intergovernmental grants. (OECD, 2014).

In Canada, as a federal system of government, there is also a commitment to fiscal equity within the Canadian economic union. In Nepal, the new Constitution provides for distribution of fiscal equalization grants to the state and local governments, on the basis of two main criteria: expenditure need and revenue capacity. (Government of Nepal, 2015, p. Art 60 (4 and 5)). To some extent, the formula-based tax sharing can achieve the same objective. Yet, the fiscal equalization grant should aim at further reducing the horizontal imbalances in the administrative and other costs.

1.4.3 Conditional / specific purpose grants

Conditional grants are specific purpose grants or categorical grants, wherein the federal government specifies the purpose for which the recipient local body can use the funds. Conditional grants can be matching or non-matching. In the case of conditional matching grant the federal government asks local bodies to match certain portion of the expenses on specific programs as a condition to receive the grant.

1.4.4 Matching grants

Certain grants may incorporate matching provisions – requiring grant recipients to finance a specified percentage of expenditures using their own resources. Matching grants differ from permanent public transfers, such as subsidies for inputs and services or safety nets as well as equalization grant. Matching requirement encourages greater scrutiny and local ownership of grant-financed expenditures and is helpful in ensuring that the grantor has some control over the costs of the transfer program.

1.4.5 Special grants

Special purpose grants are project-based relating to supply of basic services like related to health education, drinking water. A reason for the use of special grant is to promote and consolidate the relation between the federation province and local level and encourage to work commonly with proper co-existence and coordinated way for national and sub-national interest.

1.4.6 Performance-based grants (PBGs)

Another category of grants that can be useful are the PBGs. PBGs can be used towards providing subnational governments with tangible incentives to improve their overall institutional, organizational and functional performance, thus making the grant more effective, efficient and responsive as a strategy for the delivery of public goods and services. By linking the level of funding that subnational governments receive in the form of fiscal transfers to their performance, such grants can provide incentives to improve their activities such as revenue collection, planning, budget execution, accountability, financial management, and good governance in general.

In countries such as India, the PBGs take the form of incentives under the Fiscal Responsibility and Budgetary Management (FRBM) system. Under this, states are required to keep the fiscal deficit and revenue deficit under certain limits, failing which they attract certain penalty which is then distributed among those states that manage the deficits within limits. There could be other types of PBGs

1.4.7 The minimum conditions and performance measurement (MCPM) grants

The MCPM is a performance-based system providing incentives to improve local governance, financial management, participation, revenue mobilization, planning, and budgeting, service delivery, among others. In Nepal, the government believes that MCPM system has helped promoting accountability at the local level and ensuring basic local service delivery.

MCPM grants are based on an objective evaluation of local bodies and a measuring rod to assess their accountability, transparency and responsiveness.

1.4.8 Capital grants

Federal governments have two reasons to be interested in what state and local governments do in financing infrastructure. First, some local infrastructure projects may involve significant externalities, second, some such projects may constitute essential elements of national development programs, and third, some of the capital projects may be part of the overall national development plans and therefore need federal government interventions and plan-related grants.

1.5 Horizontal fiscal imbalances

The horizontal tax shares are usually determined on the basis of a formula which is a weighted linear combination of selected criteria (suitably quantified). Three kinds of criteria are used for the purpose: (a) those representing need factors; (b) those representing the equity factors; and, (c) those representing the fiscal effort and fiscal management factors. Usually, certain proxy variables are selected as representing each of these basic criteria, and the revenue share of the lower tier government is determined as

$$S_i = \sum_{j=1}^{n} w_i X_{lj} \cdots j = 1 \ \ to \ \ n \ \text{ states}$$

where S_i = the share of i^{th} state /sub-national government; X_i = selected criteria variable suitably proxied; and w_i = appropriate weight.

It is important to analyze what factors cause the fiscal gap. Differences in the fiscal gap can be partly attributable to structural differences among the states leading to differential costs of providing public goods and services, and partly to differences in the effort in raising the revenues. Each of the criteria is to be represented by one or more proxies depending upon the available data and converted to relative index. An important drawback of this method is the arbitrariness in identifying the factors, difficulties in choosing the right proxies and quantifying them, and objectively assigning the weights before combining them into a composite index. Utmost caution is needed as the resultant share pattern could be highly sensitive to even small alteration in quantifying the factors.

A more refined procedure could be to express the fiscal gap as a function of all possible factors and estimate the function through regression method on cross-section or panel data as suggested by Sarma (Sarma J. V., Federal fiscal relations in India: The issue of horizontal transfers, 1997).

The advantage of this method is: Firstly, it is possible to objectively identify the relevant factors or their proxies. For example, if variations in urbanization (measured as share of urban population in total) is not relevant for variations in fiscal gap, its regression coefficient tends to become statistically insignificant. If on the other it is responsible for variations in the fiscal gap, then the regression coefficient will be statistically significant. The final regression will contain only those factors which are significant, implying that those are the factors responsible for the size of the fiscal gap. Of course, caution needs to be exercised in properly identifying the fiscal gap, properly identifying the factors, properly specifying and quantifying the proxies and properly estimating the regression. An important advantage of this method is that the weights of the factors emerges as regression coefficients. What is more, through a more refined weighted least squares method is used, the resultant weights reflect the relative importance of the factors. The estimated fiscal gaps can be used to derive the horizontal shares for each state. The development of the method in more detail is given in (Sarma J. V., Federal fiscal relations in India: The issue of horizontal transfers, 1997). The regression (more specifically the weighted least squares regression) can be estimated based on the pooled cross-section and time series data of the states. The estimated fiscal gaps of the states can indicate the size of the tax shares.

1.5.1 Issues pertaining to horizontal sharing

Inter-governmental transfers are also needed to reduce the possible inequalities across the sub-national governments with respect to their revenue-capacities and unit costs of providing public goods and services. with regard to the horizontal revenue sharing however, not much attention seems to have been paid.

1. One aspect that remains a source of controversy is the near-subjective use of the criteria determining the horizontal shares, and arbitrary assignment of weights to them.
2. Further, the proxying and quantification of the criteria such as the population, the poverty and economic backwardness used have been sources of controversy. [The best example has been the use of population as a criterion. See Appendix I The Population Criterion for Determining the Horizontal Shares of the Indian States. (Sarma J. V., 2018, p. 55)].
3. Even if one is in broad agreement with the selected criteria for horizontal transfers the assignment of weights to these factors still poses a problem. The weights assigned by the Finance Commissions do not seem to flow from any comprehensive theoretical framework.
4. Of late, the formula used for the purpose tends to be more complex and less transparent, the specification of the criteria subjective and the exact form of the criteria incomprehensible.

2 Need for revamping

There is thus, a need for fundamental revamping of the federal fiscal sharing system. Over the last two decades the Indian economy has been experiencing significant growth along with structural transformation necessitating vital economic reforms.

Three important milestones in the economic reforms that can have deep impact on the federal fiscal relations and therefore calling for revamping of the relevant institutions are: the economic liberalization in 1991, the abolition of Planning Commission and setting up of NITI Aaayog in 2014, and the introduction of GST in 2015.

2.1 The economic liberalization 1991

The changeover to a more liberalized and open economy in 1991 involved designing and sequencing of the reforms and redefining the governmental role. In the new situation, the governments at the central, state and local levels need to shift their focus from direct participation in production and distribution activities to strengthening the regulatory mechanism. It in turn, has necessitated relatively more active participation of the sub-Central governments in the regulatory setup than during the earlier era. This is because the market regulation is more effective when implemented at decentralized levels. At the same time, the subnational governments will have to continue to provide quasi-public goods.

2.2 Abolition of the Planning Commission and NITI Aayog

In May 2014, the Government of India abolished the Planning Commission and instituted the NITI Aayog. The main idea for this step appears to be to strengthen the role of the States in the process of economic development.

2.2.1 Planning Commission

It is a paradigm shift in the development strategy. The Planning Commission established in 1950 had the basic aim to formulate five-year plans (FYPs) for the country outlining the policies and programs that were to be followed by the center and states towards the objective of all-around development. India saw 12 FYPs developed by the Planning Commission. It functioned under the overall guidance of the National Development Council (NDC).

Policies were first developed by the Planning Commission and states were consulted at the stage of allocation of funds. Planning Commission held the power of allocation of plan funds to ministries and states. States along with Union Government formed part of National Development Council to which Planning Commission reported.

The Planning process followed the ‘top-down’ model, deciding from the perspective of the whole nation and then trickling it down.

2.2.2 NITI Aayog

As for the NITI Aayog set up by the government in 2015 replacing erstwhile Planning Commission with changed objective of indicative policy formulation and development of “National Development Agenda” broadly outlining policy initiatives for union or states government to work on. NITI Aayog does not develop FYPs anymore and instead of NDC, it is governed by a Governing Council.

The basic objective of NITI is to act as a think tank for the government, to develop indicative plans and policies after due consultation with states at the stage of policy formulation itself rather than at the stage of allocation of funds.

States along with Central Government form part of Governing Council which is a platform much similar to erstwhile NDC but with a difference that all stakeholders like experts from NITI Aayog, Union government and state governments participating in its meetings for a coordinated strategy of development as equal partners.

Most importantly, NITI Aayog does not have the power to allocate plan funds to ministries and states. Unlike the Planning Commission, NITI follows the ‘bottom-up’ model, as opposed to the highly centralised Planning Commission.

With states becoming partners in policy formulation and not just approver of allocation of funds, policies have started becoming state specific. Moreover, consensus building is the norm.

2.2.3 Funds Allocation Powers

Internationally, the power of allocation of government funds rests with the Ministry of Finance. In India, it was exceptionally given to the Planning Commission. States were part of NDC along with Central Government and Planning Commission reported to it.

As discussed above, the Planning Commission consulted states only at the time of allocation and not at the time of policy formulation. Due to this, states could not provide inputs into planning for their specific needs. Some critics even held that Planning Commission was used by the Central Government as a rubber stamp to prioritise development in states which were ruled by the political party that was also in power at the centre.

With the power of allocation of funds getting transferred to the Ministry of Finance, an institution meant for planning like NITI Aayog is expected only to generate the new ideas and roadmaps for their implementation. States along with Central Government are now part of the governing council of NITI Aayog where both are duly consulted at the time of policy formulation itself. This leads to more focused planning. Even in this, NITI Aayog does not have the power of the allocation of funds which makes it an independent institution to formulate policies and suggest feedback to states without political interference.

2.2.4 Cooperative Federalism

Planning commission as already discussed was not able to keep up with the spirit of co-operative federalism. The role of states in the planning commission era was limited. The states annually needed to interact with the planning commission to get their annual share. NITI Aayog has been tasked with the same vision, "To foster cooperative federalism through structured support initiatives and mechanisms with the States on a continuous basis, recognizing that strong States make a strong nation".

"Representation of the States in the successor organization, NITI Aayog, is stronger than in its predecessor, but the source of real change will be changes in the way in which Central transfers are made to the States. This has to be done in ways that increase the flexibility and control of the States, but at the same time, increase their accountability. Simplicity, timeliness, transparency, monitoring and evaluation of CentreState transfers-all need improvement. Without these fundamental changes, new think tanks, or claims of cooperative federalism, will not make a difference to India's economic development." (Singh, 2015).

2.3 Goods and service taxation

An important milestone in the Indian economy is the introduction of GST. India has been making efforts towards transforming its indirect tax system into a full-fledged VAT system in line with the worldwide trends. However, being a federal country where the constituent states enjoy independent fiscal powers, countrywide tax system reform involves coordinated and harmonized changes across the country to minimize the likely distortions in the centre–state and interstate economic relations. The introduction of GST required the states to surrender their power to tax sales, which has been their most important revenue source. This would compel them to depend more on federal fiscal tax sharing arrangements. Although the loss in revenue of the States due to introduction of GST is promised to be compensated by the Centre (as provided for in the GST Bill) for some time, yet, it does not make good a state's loss of the political right to fix its own tax rates. The States will have no power to decide what rates to impose on which goods, including luxuries and necessities.

Thus, with the tax powers of states severely limited, fiscal decentralization would be seriously undermined. Further, if the revenue is collected by the states but pooled and distributed through a revenue sharing formula, there would be little incentive for the states to take the responsibility for administering it unless the distribution is made largely based on collection. The state governments will be left with negligible control over funds for the working of their States and will be dependent on the Centre for means to fund disasters and welfare programmes. In the light of the introduction of GST and the possible increase in the States dependence on the Centre, the sharing responsibility of the Finance Commission increases. This would call for reviewing the sharing formulae making it less arbitrary and more acceptable.

3 Towards rationalization of federal fiscal system

The main duty of the Finance Commission relates to the sharing of Central taxes under Article 270 and determination of grants for the States as provided for under Article 275. Overtime, the principles and methods adopted have undergone substantial changes and rightly so in keeping with the changing economic structure and policy environment. However, there is a need to bring more fundamental changes in the approach to make it more objective and scientific.

3.1 Expanding FC responsibilities

It can be observed that over time, there has been steady widening of the Commission's mandate and the change in the terms of reference (ToR). Of late the FC has been entrusted with many tasks of macroeconomic and fiscal management. Besides the macroeconomic management, issues like calamity relief to States, need for ensuring reasonable returns on investments in power, transport and industrial enterprises (Government of India, 1988). More notably, the last four Commissions were required to go into the fiscal management aspects more deeply. Instead of such cosmetic changes such as in the terms of reference, it is time for fundamental institutional changes in the form and working of the Finance Commission.

3.2 Permanent Finance Commission:

An aspect that has received persistent attention is whether the Finance Commission should be a permanent body like the Planning Commission or continue to be in the present form. The functioning of the Finance Commissions suffers from two major handicaps. The first is the absence of a permanent secretariat with cells for collection and maintenance of databases and for undertaking research studies on issues coming within the purview of the Commissions.

As a permanent body, the role and powers of the Finance Commission needs to be specified more carefully. The permanent Finance Commission can be expected to be the country's macroeconomic manager, as an apex instrument body to monitor the economy of the country as well as the States and Local bodies, and as the think-tank for the design of the important economic policies.

3.3 Revamp the taxing powers of the Centre and States

The important question is whether a permanent Commission will be able to inspire the States to put in a little more effort to mobilize resources. A permanent commission can take up these matters with the States and make them implement reforms such as the tax reforms, and GST. The GST Council will be part of the Finance Commission.

3.4 Fiscal Transfers: Vertical Sharing:

The measure of VFI should be such that it preserves the basic idea that 'government at each level can command the financial resources necessary for them to carry out their expenditure responsibilities'. Given the Constitutional division of revenue and expenditure responsibilities, a measure of VFI can be defined as the positive difference between the Central and state level fiscal balance. The suggestions for better management of fiscal sharing are as follows.

1. Employ scientific methods to derive the optimal vertical transfers to the States.
2. Surcharges/Cesses should be treated as normal source of Central tax revenue and included in the divisible pool. Various Commissions have observed that Surcharges/cesses should not be levied by the Centre except to meet emergent requirements only for limited periods but still the Centre raises revenue through this measure for longer periods.
3. A minimum guaranteed devolution of Central taxes from the Centre to the States should be fixed. To restore predictability in devolution of share of Central taxes to the States and provide necessary stability in fiscal management of the States.

3.5 Fiscal Transfers: Horizontal sharing:

As regards the horizontal sharing the approach adopted so far reflects some inherent confusion: whether and to what States' efficiency should be rewarded, to what extent equity should be built, to what extent the state-specific factors and circumstances should be taken into account while assessing the fiscal management of the States etc.

It is only fair that the criteria and the weights for horizontal distribution should be related to the basic economic motivations of the federating units for coming together. To be more specific, federal fiscal efficiency requires offsetting of the inequity among the federating units (hereafter referred to as States) with respect to the net marginal benefit due to federating (NMBF). The NMBF of each federating unit can be understood as the difference between the marginal fiscal benefit and marginal fiscal costs of federation (Breton, 1965, Gramlich, 1977, Rao and Chelliah, 1991). The fiscal costs to a state for agreeing to be in the federation are in terms of tax powers and revenue forgone, while the fiscal benefits are the gains in terms of increases in the government revenues (owing to possible rise in the tax base due to lower trade barriers across the States and so on), and increased supply, and/ or lower unit costs, of providing the public goods.

Operationalization of this principle requires as a first step, measurement and comparison of the NMBF of each state which, in a way, is likely to be reflected in its own revenue – total expenditure gap (hereafter referred as 'fiscal gap').

3.6 Merge all economic advisory councils with the FC.

The FC should be an apex body advising the Finance Ministry with sufficient fiscal management plan. Entrust it with the duty of not only making recommendations for revenue sharing but also closely monitoring it. Entrust it with the overall macroeconomic management.

4 Summary of recommendations

The art of federalism lies in designing institutions with appropriate assignment of powers and functions among different orders of government and rules to regulate their relationship especially in the fiscal arena that can strike the right balance among different objectives and resolve tensions. According to many, the Indian federal system though decentralised, is quasi-federal at best and does not allow enough room for the States to function freely. The restricted decentralization has been the problem of the Indian economy and a major factor responsible for its stunted growth. In China, on the other hand, growth has been propelled greatly by the 'market preserving federalism' practiced there allowing autonomy to provinces in running their economies.

This study recommends revamping of the federal fiscal transfer system in India. Basically to make the fiscal transfers more acceptable and to take into account the changing structure of economic and fiscal governance.

4.1 Recommendation 1: Permanent Finance Commission

Make the Finance Commission permanent. The setting up of the Finance Commission at five-year intervals has been leading to a variety of immature acts.

4.2 Recommendation 2: Converge the relevant bodies into the Finance Commission

Merge all the bodies concerned with economic and fiscal policy design such as the PMEAC, NITI Aayog, with the Finance Commission. This will reduce possible duplication, conflicts and coordination problems.

4.3 Recommendation 3: Extended ToR and expanded membership

The Finance Commission will have expanded membership and expanded terms of reference. It will also take care of macroeconomic planning and management. Already there has been substantial diversification in the terms of reference given to the Finance Commission. The additional ToR include the tax design, macroeconomic stabilization, fiscal monitoring, public debt management and dealing with natural calamities and so on.

4.4 Recommendation 4: Involve the NDC for States cooperation

Before submitting the quinquennial report to the President as required and deliberated in the Parliament, the Finance Commission will present it to the NDC with proper representation from the States and make it acceptable. This will reduce the possible dissent from the States and it will make the system closer to cooperative federalism.

4.5 Recommendation 5: Federal fiscal sharing should be from all revenues of Centre

Federal fiscal sharing should be from all the revenues of the Central government and not just the tax revenues alone. This will include not only the taxes, but also the surcharges and cesses, as also the non-tax revenues of the Central government. This will eliminate the room for allegations of biases in raising the revenues by the Centre and

4.6 Recommendation 6: Transfer share (revenue share + grants) to be consensus based

The total transfers (tax devolution + grants) from the Centre to the States can be fixed on the basis of consensus. For example, 50 percent of the Centre's total revenues.

4.7 Recommendation 7: Vertical sharing choices

Out of the total share of 50 percent, part of it should be in the form of revenue sharing or part of it could be in the form of grants. The vertical sharing could have three alternative aims: (a) the vertical share equals the total sum of normative fiscal gaps of the States. This may reduce the need for borrowing of the States, but widen the fiscal gap of the Central government and thereby compelling it for higher borrowings. (b) the vertical transfer is such that it will equalize the sum total of fiscal gap of the States to that of the Central government. However, this arrangement might call for allowing the States to go for new borrowings in case of fiscal gap being a deficit.

4.8 Recommendation 5: Horizontal sharing to be more scientific and objective

The horizontal revenue sharing should be based on objective formulae such as the method described in this report and eliminate the arbitrary selection of the criteria, arbitrary proxying of the criteria and arbitrary assignment of weights in the linear formula. It is advisable that the criteria should be relevant and capable of affecting the fiscal gaps of the States. If a particular criterion is not relevant to the fiscal gap, then to that extent the transfers on that basis, are not going to improve the fiscal gap. The criteria can be of three types: the capacity criteria, the effort criteria and the need criteria. The horizontal share determination should have built-in reward system to encourage better fiscal management. GSDP and Population are the two most important criteria that influences the fiscal gaps at the States' level. Higher the GSDP, higher would be the revenue generation that would reduce the fiscal gap, while higher population would raise the need for more expenditure and thereby widen the fiscal gap. The resultant horizontal share will be higher for the States with large populations and smaller for the States with high GSDP. While this pattern might achieve the equity objective, but it will have negative impact on the tax effort and better fiscal management. Therefore proper care is needed in fine-tuning the horizontal sharing methods.

4.9 Recommendation 6: grants should reflect broader economic policies

The remaining quantum of transfers will be by way of grants. Thus, if the total transfers are fixed at 50 percent of the Central government, the total quantum of grants would be the remaining amount left over after the revenue sharing. The grants could be unconditional, conditional, specific purpose, post-devolution deficit grants. The grant allocation pattern is a policy choice.

4.10 Recommendation 8: Incentivize the grants

Part of the grants can be used to incentivize better fiscal management of the sub-national government.

4.11 Recommendation 9: Capital grants should be project by project based on viability

The capital grants should be more on the basis of project management studies rather than on equity basis. The financing of the capital projects will be on the lines of project viability studies.

5 Concluding remarks

Notwithstanding certain weaknesses, the system of intergovernmental fiscal arrangements in India has served well for over 50 years. It has achieved a significant equalization over the years, instituted a workable system of resolving the outstanding issues between the Center and the States and among the States, and adjusted to the changing requirements and thus has contributed to achieving a degree of cohesiveness in a large and diverse country. Thus, it is increasingly being realized that there is no alternative but to reform the fiscal institutions of the federal system and the task needs to be faced upfront by the country. Smooth functioning of a fast globalizing world economy presupposes a stable, secure and predictable environment for economic agents to operate.

Appendix I The Population Criterion for Determining the Horizontal Shares of the Indian States.

One issue pertaining to the population criterion that could not be resolved so far has been as to which Census figures of population to be used. The 1FC used population figures according to the Census of 1951. The 2FC also used the same figures. The 3FC and 4FC as also the 5FC presumably used the 1961 census figures available to them though no specific mention was made of any particular census in their reports. The 6FC might have used the 1971 figures that was the latest available at that time. It was only in case of the 7FC, the terms of reference clearly mentioned that the Commission shall adopt the population figures of 1971 which, in any case, would have been the latest census figures available. At the time of the 8FC, however, the Commission was specifically asked to adopt the population figures of the 1971 Census although the 1981 Census figures would have been available to this Commission, however, in para 7 of the terms of reference,

"In making its recommendations on the various matters aforesaid, the Commission shall adopt the population figures of 1971 in all cases where population is regarded as a factor for determination of devolution of taxes and duties and grants-in-aid." (Government of India, 1984). The Commission, while following this directive, noted that this was in accordance with a policy Statement made by the Government of India. "In a federal system, the sharing of Central resources with the States is a matter of considerable importance. In all cases where population is a factor as in the allocation of Central assistance to State Plans, devolution of taxes and duties, and grants-in-aid, the population figures of 1971 will continue to be followed till the year 200l". (Government of India, 1982).

Subsequently, all Commissions followed this directive in their terms of reference and did not make an issue of it. However, the Ninth Commission, in its second report, raised the issue whether the constraint in the terms of reference applied only where population was a factor for the determination of devolution of taxes and duties, and grants-in-aid. It argued that the distribution of additional duties of excise fell under a different category.

"5.18 As far as population is concerned, we are making a departure from our first report. Earlier we had adopted the 1971 population for calculating the shares of the States. We have reconsidered at length whether for calculating the shares of the States in the net proceeds of Additional Duties of Excise, the 1971 or the 1981 census figures of population should be used. Paragraph 6 of the terms of reference, no doubt, lays down that this Commission should adopt the population of 1971 in all cases where population is regarded as a factor for determination of devolution of taxes and duties and grants-in-aid. But the question is whether distribution of Additional Duties of Excise is really devolution or grant." (Government of India, 1990). The 10FC also agreed with this view and used 1991 census figures for the distribution of additional excise duties. The next three FCs followed suit.

The 14FC had a different term of reference with regard to the population. "Contrary to the earlier requirement that the Commission shall generally take the base of population figures as of 1971, in all cases where population is a factor, our ToR indicates that we may also take into account the demographic changes that have taken place since 1971, which are best captured by the census figures of 2011." Taking cue from that the 14FC considered another factor called the 'demographic change' as a criterion for horizontal share determination. "Our ToR mandates us to take the population figures of 1971 when framing our recommendations, but, at the same time, allows us to consider subsequent demographic changes." (Government of India, 2015). The 14FC felt that there is a case for using the latest Census data on population. Yet, they also realized that the use of latest population data would penalize those States that have taken effective population control measures. "On the basis of the exercises conducted, we concluded that a weight to the 2011 population would capture the demographic changes since 1971, both in terms of migration and age structure. We, therefore, assigned a 10 per cent weight to the 2011 population (See Annex 8.2)." (Government of India, 2015)

The 15th Finance Commission's suggestion to use population figures from 2011 census instead of 1971 census for sharing tax revenue among states has triggered strong opposition from South India. The practice of past population figures was justified by some as disincentivizing States from letting their population proliferate. Especially, States like Bihar and Chhattisgarh with higher rates of population growth may become relative winners compared to their southern and eastern counterparts under the 15th Finance Commission (FFC), if the latest census data of 2011 is considered for allocation of resources, against 1971 census data used earlier. Among major states of India, Bihar with annual population growth of 25.1%, Chhattisgarh with 22.6% and Jharkhand with 22.3% have the highest decadal (2000-2011) population growth rates, according to the 2011 Census. On the other hand, States like Andhra Pradesh with 11.1%, West Bengal with 13.9%, Odisha 14% and Punjab with 13.7% have the lowest decadal population growth rates.

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