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INDIAN FISCAL FEDERALISM FROM A COMPARATIVE PERSPECTIVE

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Abstract

In this paper, an attempt is made to analyse the intergovernmental fiscal relationships in the Indian federation in the light of the principles of fiscal federalism and the practices and experiences of some important federal countries. The paper views the vertical and horizontal inter-relationships between governmental units as essentially one of competition and tries to identify the preconditions required to maximise welfare gains in this competitive federalism. The paper analyses the following issues:

(i) The problems arising from uncontrolled vertical intergovernmental competition. The issues arising from overlapping tax, expenditure and regulatory functions between different layers of government are examined to evolve coordinated pursuit of fiscal policy;

(ii) The allocative distortions and inequity arising from inter-state tax competition and tax exportation, and expenditure spillovers; and

(iii) The problems arising from improper designing of intergovernmental transfer schemes and the need to improve the vertical and horizontal competition through properly designed intergovernmental transfers.

The paper also brings out the directions for improving intergovernmental relationships in terms of enhancing mutual trust and developing proper demoncratic institutions to successfully monitor vertical and horizontal intergovernmental competition.

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M. Govinda Rao**

I. Introduction

In the evolution of intergovernmental fiscal arrangements and in the resolution of regional disparities, the economic principles do play a role to a lesser or greater extent in all federations. 'Fiscal federalism' represents a polar case where the fiscal arrangements are decided purely on economic principles. In reality such ideal situations can never be observed; yet, it is useful to evaluate the existing arrangements within such a framework, if only to identify the sources of inefficiency and inequity in a federal system and to get an idea of the extent the actual deviation from the ideal.

Equally important are the lessons that can be drawn from the practices and experiences of other federations. While the material conditions can and do vastly differ among federations, the analyses of their working help us to draw lessons which would have a certain degree of generality and hence, can be helpful in resolving the problems of particular federations.

Thus, it is helpful for Indian scholars to have an understanding of both the principles of fiscal federalism and practices and experiences of other federations for evaluating fiscal relationships in existing federations. The analysis of the principles of fiscal federalism helps us to understand welfare maximizing organization of and interactions among governmental systems. The experiences of other federations are useful to identify the feasible options to restructure the federal fiscal arrangements.

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Economists tend to view federalism somewhat differently from political scientists. Their concern is not only with equity but also (often primarily) with efficiency. "Federalism", to an economist does not merely refer to the constitutionally declared federations but to all multilevel governments with varying degrees of decentralization.[1] The economics of multilevel governmental systems helps us to understand, *inter-alia,* (a) the factors determining the optimal degree of fiscal decentralization, (b) principles underlying the assignment of functions and sources of finance of different levels of government, (c) the extent of coordination in tax and expenditure policies required (i) to foster welfare improving inter-jurisdictional interactions and (ii) to design suitable intergovernmental transfer schemes to fulfil the objectives of equity and efficiency.

The principles of fiscal federalism, however, can only help us to find purely economic solutions to the federal problems. In shaping the actual fiscal arrangements in federations, however, historical, social and political factors have played roles far more important than merely the consideration of economic efficiency (Bird, 1986, p.205). The influence of non-economic factors on federal fiscal arrangements places a constraint on the efficacy of purely economic solutions in solving federal fiscal problems.[2] It is in this regard that the lessons drawn from the practices and experiences in other federations can be helpful.

This paper makes an attempt at analyzing the problems of Indian fiscal federalism from a comparative perspective. The approach to the analysis of Indian fiscal federalism adopted in this paper is to view the intergovernmental relationships as being competitive. The efficient organization of a federation will depend upon the way the competitive relationships are harnessed productively. The evaluation of multilevel fiscal arrangements will be done keeping in view two perspectives. (a) the economic principles of fiscal decentralization, and (b) experiences and practices of other federations in dealing with similar issues.

Section II will analyse the question of assignment of tax and expenditure powers between different layers of government. It will also highlight the problems arising from

1. As stated by Livingstone, (1952, p.52),"The essence of federalism lies not in the institutional or Constitutional structure, but in the society itself", see Oates (1977 p.4). Even in unitary systems there is a considerable degree of hierarchical ordering of governments. As noted by Breton (1989 p.1) in many unitary countries including France and Italy, there are as many as four levels of elected governments.

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

uncontrolled vertical intergovernmental competition[3]. Section III will deal with the questions of horizontal intergovernmental competition and inter-jurisdictional coordination. Section IV will analyse the design of intergovernmental transfers and section V will summarise the arguments and also make some concluding remarks.

II. Functional Assignments: Principles and Practices

This section has three parts. The first re-examines the principles of fiscal federalism; the second considers the experience of various federations; and the third focuses on India.

a. Principles: the Case for "Competetive Federalism": Assignment of functions and sources of finances among different layers of government is an important first step in the efficient organization of governmental systems. For analytical convenience, the layer-cake (as opposed to marble-cake) perspective on federalism in the Musgravian tripartite division of governmental functions assigns the stabilization and redistribution mainly to the central government[4], and the allocation function is shared among the hierarchical layers depending upon their comparative advantage.[5] The decentralization theorem suggests that, so long as there are no scale economies, the sub-central provision of public services, *ceteris paribus*, results in welfare gains. The gains will be greater, the larger the variations in the preferences for public services between the residents of different jurisdictions (Oates, 1968, 1977). This broadly implies that the progressive and mobile tax bases should be assigned to the central government and the sub-central governments should levy mainly the benefit taxes and taxes on static tax bases (Musgrave, 1983). At the same time, to reap welfare gains, the lower level jurisdictions would have to provide all non-national public services and this creates a serious asymmetry between revenue sources and expenditure functions or what is termed as "vertical fiscal imbalance" (Hunter, 1977).

3. The relationship between national government and the various states or provinces is termed "vertical" and between various regional governments, "horizontal".

4. As the national government (as opposed to regional governments) is called by different names like union government, federal government or central government in different federations, we have used these terms interchangeably.

5. There are, however, some disagreements on such a functional allocation. Gramlich (1987) and more recently Inman and Rubinfeld (1992) have argued that the sub-central units can make effective contributions to counter-cyclical policy. Similarly, Pauly (1973) has argued that decentralized layers of governments do have an important role to play in poverty alleviation. For a more detailed discussion on this, see, Rao and Dasgupta (1993).

The above problem can be alternatively stated in terms of the literature on "competitive federalism".[6] Successful inter- jurisdictional competition requires that assignment of functions are done according to comparative advantage. Given that many tax bases are mobile across jurisdictions, the more senior governments have a comparative advantage in levying taxes as they can control 'free-riding' (or sharing the benefits of public services without making commensurate payments) more effectively. Free riding can take the form of tax avoidance and evasion, inter-state tax exportation or benefit spillovers. At the same time, the more junior governments have a comparative advantage in reducing welfare costs of providing public services, for, at lower levels mismatch between goods supplied and demanded would be lower and 'bundling' of public services would be more flexible.[7] Welfare costs can be reduced by either moving to the jurisdictions providing preferred bundle of public services (exit) or consumers influencing the policies to provide preferred pattern of public services (voice). Thus, assignments done according to comparative advantage would result in revenue concentration and expenditure decentralization. This problem of vertical imbalance would have to be resolved through intergovernmental transfers.[8]

b. Practices: Concurrence and Coordination: The analysis of the fiscal assignments actually made in various federal countries, however, brings out three important features. First, the existence of vertical fiscal imbalance is a common feature seen in all federations. This has occurred broadly due to the principle of comparative advantage implicit in the assignment of tax powers and expenditure functions among different layers of government. Of course, from this we cannot conclude that higher vertical fiscal imbalance necessarily denotes greater efficiency in assignments. Nor can we see strict uniformity in the pattern of assignment in different federations. Second, any attempt at optimal assignment of powers minimizing concurrence or overlap can only be done in a *de jure* sense, but in a *de facto* sense overlapping of tax and expenditure powers between different jurisdictions is unavoidable. This necessarily sets governments of different jurisdictional levels in competition with one another. A certain degree of policy coordination, particularly among hierarchical governments is necessary to ensure that intergovernmental competition is beneficial. Thus, we have the third important feature namely, the necessity of having coordinated and harmonized policy

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6. "Competitive federalism" views governmental systems as competitive entities analogous to entrepreneurs. It combines the results of electoral competition in a democratic polity with the federal form of government. The competition analysed in this context is not the restricted notion of price competition, but the Schumpeterian entrepreneurial competition. For an interesting analysis of competitive federalism, see, Breton (1987, 1989).

7. Bundling of public services as a package on a "take it or leave it basis" is said to increase welfare costs. See, Breton (1990).

8. See, Breton (1992).

framework. While such an "Executive Federalism" is necessary to avoid distortionary effects, care should be taken to ensure that senior levels of governments do not dominate and subvert the very concept of multilevel decision making.

The functional assignments in actual practice, do not strictly follow the broad principles as mentioned earlier. In many federations including Canada, Australia and India, the Constitutional assignment is merely confined to central and state governments, and the local governments are clearly the creations (and creatures) of the states.[9] Again in reality, the fiscal assignments to a large extent reflect historical legacies of intergovernmental bargaining processes and do not strictly follow economic rationality. In Canada both federal and provincial governments have access to all major taxes except customs duty which is exclusively levied by the federal government and property taxes which are the prerogative of the provinces (levied by local bodies). In the United States, the states and local bodies enjoy concurrent powers to levy income taxes with the federal government. In Switzerland, a large proportion of both central and municipal revenues accrue from taxes on income and wealth. In contrast, in Australia, the major state taxes are the payroll tax, stamp duties and motor vehicles tax and even the levy of sales taxes is the prerogative of the Commonwealth (central) government. Among the developing federations too, we see a considerable degree of concurrence in tax assignments. The natural resource taxation in Malaysia is assigned mainly to the states. In Nigeria, the powers to levy personal income tax and export taxes vest with the states. Brazil allows the local bodies to levy excises on selected services (Gandhi, 1983, Shah, 1990).

c. **Vertical Intergovernmental Competition: Need for Coordinated Policies:** Competitive relationship between the governmental units occurs at two levels. One is the competition between the federal government and the states, i.e., vertical intergovernmental competition, and the other is the competition between different units within a governmental level, i.e., horizontal competition. As in other federal countries, in India too, the assignment of tax powers and expenditure functions have created a high degree of vertical fiscal imbalance. The central government in 1987-88 collected almost 65 per cent of the total revenues, but the state governments actually incurred 56 per cent of total government expenditures (Table 1), and 43 per cent of their expenditures was financed from their own sources of revenue. It is also seen that the extent of dependence or the coefficient of vertical imbalance in India was the highest among the selected federations. The extent of self-financing in the states was just about 43 per cent and only Australia with 45 per cent has a similar degree of imbalance. In all other federations the states were able to finance over two-thirds of their expenditures from own sources and in U.S.A. the extent of states' dependence on federal transfers was the least. The table also shows that the difference between revenue and expenditure concentration was the highest in India. Austria and Malaysia had high revenue and expenditure concentrations. This

9. For a discussion on this see, Bird (1986).

is, to a lesser extent, true also of Australia, Brazil, Switzerland and U.S.A. Of course, in both U.S.A. and Brazil, the units below the state level play a significant role and the degree of expenditure decentralisation is much greater when this factor is taken into account Canada and India are the two countries where the share of states' expenditure in total was more than one-half, but while in Canada the provinces were able to finance over 75 per cent of their expenditure from own sources of revenue, the states in India could finance only about 43 per cent.

The major tax sources assigned to the centre consist of taxes on non-agricultural income and wealth (including corporation income tax), customs and manufacturing excises the bases of which have nationwide mobility (Annexure I). The main items assigned in the state list are the taxes on agricultural incomes, sales taxes, sumptuary excises on alcoholic beverages, stamp duties and registration fees, taxes on road transport and passengers and goods, taxes on electricity, taxes on the entry of goods into a local area for consumption, use or sale and the taxes on property. The states have delegated the last two items to local bodies. On the other hand, major responsibility of providing social and economic services has been assigned to the states. In 1990-91, about 85 per cent of total expenditure on social services was incurred at the state level (Table 2) and in economic services, the states' share in total spending was about 55 per cent.

Table 1

Vertical Fiscal Imbalance in Selected Federations (1987)

Countries	Percentage of Central government revenues collections in the total	Percentage Central government expenditures in the total	Percentage of States' own revenues (excluding loans) in States' expenditures
(1)	(2)	(3)	(4)
Australia	79.1	63.6	44.6
Austria	85.8	82.7	75.0
Brazil	83.3	67.0	67.4
Canada	54.9	46.0	75.4
Germany	55.3	70.4	79.0
India	69.8	45.6	43.4
Malaysia	86.6	81.5	68.0
Switzerland	68.4	61.8	73.7
U.S.A.	70.7	69.1	88.1

Source: Government Finance Statistics, 1990.
International Monetary Fund, Washington D.C.

Table 2

Share of State Expenditures in Total (Revenue + Capital) Expenditures of Centre

Per cent

	1981-82	1990-91 (RE)
A. Interest payments	38.94	35.27
B. General Administrative Services		
a. Administrative services	70.04	67.02
of which: police	74.36	68.86
b. Others	67.19	55.63
Total B	33.81	36.28
C. Social and Community Services		
a. Education, art and culture and Scientific services	84.11	83.91
of which: education	92.87	90.83
b. Medical and public health	93.57	90.33
c. Family welfare	93.11	91.78
d. Housing and urban development	76.75	77.83
e. Social security and welfare	91.31	91.34
f. Labour and employment	74.28	62.50
Total C	86.03	84.50
D. Economic Services		
a. Agriculture and allied services	83.11	78.38
b. Industry and minerals	19.03	42.56
c. Power, irrigation and flood control	82.44	67.83
d. Transport and Communications	47.27	49.54
e. Public works	91.15	79.43
Total D	55.87	54.51
E. Net Loans and Advances (Net Disbursement)	50.63	57.55
Grand Total	55.29	53.77

Note: Re - Revised Estimate

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

Although in a *de jure* sense, the Constitution has avoided concurrent tax powers, *de facto*, the inter-jurisdictional tax overlapping is a major problem faced in the Indian fiscal federalism. The problem is particularly severe in the case of indirect taxes. The levy of manufacturing excises by the central government, sales taxes by the states and octroi by the urban local bodies has had serious adverse consequences on the economy.

Levying tax on tax and the margins on these taxes has led to divergence between producers' and consumers' prices greater than the tax element. The practice of taxing inputs, capital goods and final consumer goods alike has further exacerbated this problem. Further, minute rate differentiation in pursuit of various objectives at all the three levels has resulted in the unintended changes in relative prices. All these have led to inefficiencies and distortions. As the total tax element in the price of a commodity is not transparent, even getting tax credit on exportables has been based on judgements.

Overlapping tax bases across different layers of government in different degrees is found in all the federations. In some countries like Australia, the problem has been kept to the minimum as all major taxes are assigned to the Commonwealth government and although the states have concurrent powers to levy indirect taxes except customs and excises, the courts' ruling that sales taxes fall into the excepted category virtually rules out concurrency (ACIR, 1981). In U.S.A. and Canada, the federal and state (provincial) governments have concurrent powers to levy income taxes, but inter-jurisdictional coordination has ensured that the tax base adopted by the states and the federal government by and large, are uniform. In Canada, the arrangement essentially is one of piggybacking. In U.S.A., although in a majority of the states the tax bases are not identical to the federal government's, in respect of both corporate and individual income taxes, the differences are not significant enough to cause major distortions. In the levy of taxes on goods and services considerable degree of vertical coordination between the federal and state (provincial) levels has been achieved to make the tax system simple and transparent. In the United States, the federal government does not levy any broad based internal indirect tax and the states have the exclusive right to levy the sales tax. In Canada both federal and provincial governments can levy consumption taxes[10]. Thus, while the federal government levies the goods and services tax (GST), the provinces levy the retail sales tax (RST). The nature of RST, however, varies among the states. The eastern provinces levy RST on the GST paid value of the goods sold to consumers. Ontario levies the tax on the value excluding the GST. Alberta does not levy the RST at all. Quebec, however, has harmonised its tax fully with the GST and it collects the tax on behalf of the federal government as well. However, the GST in Quebec has significant differences with the GST levied by the federal government in other parts of the country. There is thus, some degree of vertical overlapping of indirect taxes. In

10. The constitution allows the levy of all direct taxes by both federal and provincial governments and the courts have interpreted retail sales tax as a direct tax.

Switzerland, the constitution allows scope for significant degree of tax overlapping between federal and cantonal governments but historical developments have ensured that federal government collects most of the indirect taxes and the direct taxes are collected mostly at cantonal level (ACIR, 1981). In Germany too, income taxes, customs and excises and important business taxes including the value added tax are leviable by the federal government, but the elaborate system of legislated sharing of taxes has ensured adequate resources to the states while achieving a high degree of vertical harmonisation (ACIR, 1981).

The essence of the above discussion is that many of the developed federations have, to a large extent, resolved the problem of vertical tax overlapping either through tax assignment or coordination. In the Indian context, however, the tax assignments have resulted in a large area of concurrency in indirect taxes and the attempts at coordination have not been serious enough to minimize distortions in the tax system.[11]

The vertical intergovernmental competition arising from concurrent tax jurisdiction has led to another form of distortion. Recognizing that the sources of revenue assigned to the states are inadequate to meet their expenditure requirements, the Constitution provides for the sharing of personal income tax (Article 270) and union excise duties (Article 272) between the central and state governments based on the recommendations of the Finance Commission appointed every five years (or earlier). According to the recommendations of the latest (ninth) Finance Commission, 85 per cent of the personal income tax collected and 45 per cent of revenue from excise duties are devolved to the states. With this, central government has virtually no incentive to collect more income tax and with regard to excise duties, the states have repeatedly alleged that in respect of public monopolies the centre unjustly enhances administered prices instead of increasing excise duties. It is also alleged that the centre, in order to collect more revenues for itself has converted import duties virtually into a revenue handle instead of a protective measure.[12]

The vertical intergovernmental competition in expenditure functions arises from the inter-dependency (complementarity and substitutability) of the policies of central and state governments. In a federal set-up, the policy measures undertaken at the centre affect the people

11. Some degree of coordination was achieved in 1956 when the states voluntarily surrendered the right to levy sales tax on sugar, textiles and tobacco, in lieu of which, the central government levied additional excise duties on these items, the proceeds of which were passed on to the states. However, over the years, the states have been dissatisfied with this arrangement and the recommendations of the Committee extending the arrangement to five more groups of commodities, (India, 1983) were unanimously rejected by the states.

12. The Report of the Tax Reforms Committee contains a more detailed discussion of these issues. See, India (1992).

in the states and *vice versa* and the optimal policy design necessitates coordinated actions by the two layers. In India, for example, the expansion of central government expenditure increasingly financed by budget deficits, has escalated the cost of providing public services at the state level and given the relatively hard budget constraints faced by the latter, this has caused significant decline in their investments in economic infrastructures (Rao and Sen, 1993). Similarly, sharp increases in expenditures at the state level financed through increasing volume of deficits in the past have had to be eventually accommodated by the centre through periodic write-off and rescheduling of central loans to states which in effect meant, transferring the burden from a state's taxpayer to the national taxpayer (free-riding). The policy interdependence was also seen in the fact that the states have had to increase pay scales of their employees in response to the central government's revision of pay scales, thereby further exacerbating their fiscal difficulties. The increase in the administered prices of the goods produced by the central public enterprises, such as petroleum products, railways, coal and steel, have caused cost increases at the state level and similarly, increase in the price of electricity has enhanced the cost of central public enterprises. Similarly, recent rationalisation of saving incentives for income tax by the central government has substantially eroded the small-saving loans accruing to the states.[13]

The most striking case of uncoordinated action is seen in the structural reforms undertaken since the middle of 1991.[14] A significant proportion of the reduction in fiscal deficit by the centre in 1991-92 and 1992-93 was achieved simply by reducing transfers to states unilaterally. On their part, the states, by and large, have not been seriously concerned with the fiscal reforms at all and did not plan to compress unproductive expenditures in response to lower resource transfers by the central government. For the successful implementation of fiscal reforms, surely, more coordinated approach is called for.

Intergovernmental coordination is a need felt in all federations. Experience has shown that to achieve successful coordination, the preconditions required are: (i) clearly enforceable property rights (assignment of functions); (ii) mutual trust; and (iii) a proper monitoring mechanism to enforce the rights (Breton, 1987). In fact, given that *de facto* clearly demarcated assignment is not possible, mutual trust among the hierarchical units and a proper monitoring mechanism are extremely important.

13. According to the existing arrangement, 75 per cent of the net collections from small savings are given to the states as loans, but with the rationalisation of these incentives, the small saving collections fell drastically and with it, fell the states' accruals.

14. For a more detailed discussion on these issues, see, Guhan (1993).

In a successful competitive federalism, monitoring assumes immense significance. This is necessary to evolve coordinated policies to enforce the rights and to ensure healthy intergovernmental competition. The central government is placed at an advantageous position to undertake this task, but when the relationship is competitive there is always a suspicion that it may use the monitoring role to its own advantage. Thus, one of the most vexed questions in all federations is who should monitor the monitor? Should there be only one ethical observer for the purpose or many, and in case there should be more than one, how to coordinate their actions? The advanced federations with more developed democratic institutions are better equipped to undertake this task. In many developed countries, the upper houses of their legislatures provide salience to the provincial dimensions of public policies. Besides, there are Supreme Courts and a relatively independent authority controlling money supply.

Even in the Indian context, the Constitution itself provides an elaborate mechanism of monitoring, but in actual practice, the monitoring has not been very effective. The *Rajya Sabha* (Upper House), though is a Council of States, has in fact, not acted as such, and has not been very successful in safeguarding the interests of the state governments. The Supreme Court interprets the Constitution, and has acted relatively independently, but the large area of concurrence with overriding powers to the central government limits its role. The central transfers are to be routed through the Finance Commission - a Constitutional body appointed every five years (or earlier), but an overwhelming proportion of transfers (about 60 per cent) are outside its purview as it is made through the Planning Commission and various central ministries. Nor have the Finance Commissions been effective in undertaking the role of providing transfers on an objective basis to resolve fiscal imbalance. The National Development Council[15] attempts to resolve some of the issues but, there is no mechanism to enforce the decisions taken by it. The most important problem is the lack of independence of the Reserve Bank of India from the Union Finance Ministry and as the central government incurs heavy budgetary deficits, the fiscal positions of the state governments get destabilised.

To sum up, considerations to minimise "free-riding" and maximise the welfare gains determine the assignment of tax powers, expenditure responsibilities and regulatory functions of different levels of government. But the arrangement thus evolved necessarily results in vertical fiscal imbalance, overlapping jurisdictions and intergovernmental competition. To reap maximum gains from federalism proper assignment, coordination and monitoring are the essential ingredients. The comparative analysis shows that, even as the Constitution in India

15. The National Development Council is chaired by the Prime Minister and its members include all cabinet ministers at the centre, Chief Ministers of the states and Members of the Planning Commission.

has tried to demarcate the assignment in the *de jure* sense, *de facto* intergovernmental overlapping in tax, expenditure and regulatory roles of central and state governments are probably the most severe and the degree of vertical coordination is the lowest.

III. Horizontal Intergovernmental Competition

The competition between different levels of government conducted in an environment of coordinated policy regime ensures efficient fiscal arrangements. However, efficiency gains in a dynamic sense can be had when the different governmental units within each level engage in a healthy competition with one another. In this section, we discuss the efficiency aspects of horizontal intergovernmental competition.

a. **Principles:** From the viewpoint of production efficiency, the institutional framework of fiscal federalism has the potential to effect a resource allocation superior to the 'best' possible allocation achievable under the centralized set-up and hence, *ceteris paribus*, economic growth under the former would be higher than under the latter (Breton, 1981). The nation-wide market enables the production units to reap advantages of economies of scale. At the same time, intergovernmental competition can help to create, improve and innovate and thereby enhance production efficiency in the provision of public services and infrastructural facilities suited to the resource endowments of different regions (King, 1985, Oates, 1972).

From the consumers' point of view, welfare gains accrue from the decentralized provision of public services as they match the preferences of people residing in different jurisdictions. This can happen in either of the two ways. One, when the wide ranging 'bundles' of 'public service-tax mix' are provided, consumer mobility in search of the bundle closest to their preferences can result in welfare gains as shown in a seminal paper by Tiebout (1956). Alternatively, the consumers residing in various jurisdictions can influence policies to provide their preferred levels and patterns of public services. In either case, an important precondition for the efficient functioning of a federation is that there should be a nation-wide market and the factors and products should move without any hindrance throughout the country.

The above observations clearly indicate that governments within a particular level enjoy a competitive relationship. The demonstration effect of policies undertaken in other jurisdictions, the pattern of diffusion of various policies in different states, the inter-jurisdictional consumer mobility and the migratory competition of the 'Tiebout' variety alluded to above, and the attempts by different jurisdictions to offer outputs (public services) at competitive prices (tax competition) are all indicative of the competitive intergovernmental relationships [(Breton (1987)].

The existence of competitive intergovernmental relationship, in itself, does not ensure that the interactions among them will necessarily produce beneficial results. In this paper, we have not analysed all the preconditions necessary for efficient intergovernmental competition. But surely, uncontrolled competition can give rise to serious 'free-rider' problem through tax exportation and benefit spillovers and can create instability as the states indulge in the "race to the bottom" by reducing effective tax rates. In such a competition, more powerful units can 'free-ride' better at the cost of the less powerful.

The efficient and stable equilibrium in intergovernmental competition, therefore, requires that there should be 'competitive equality' 'cost-benefit appropriability' and a measure of harmony in tax rates. Competitive equality should ensure that the larger/stronger units do not dominate, coerce or prevent smaller/weaker units from efficient functioning. This has to be brought about through a set of regional policies followed by the central government and by providing intergovernmental grants to offset fiscal disadvantages of the weaker states. Cost-benefit 'appropriability' ensures that no state is able to finance its public services by exporting the tax burden to the residents of other states, nor some states be able to gain from the spillover of services from others without making commensurate payments. The assignment of taxes and coordination in the levy of taxes should minimize tax exportation and ensure minimum service levels which should help in the optimal provision of public services with high degree of spillovers. A measure of harmony in tax rates is required to ensure that the states do not provide incentive to divert trade or indulge in unhealthy tax competition to attract capital to their jurisdictions. At the same time, the attempt to achieve harmony should not force uniformity' in taxation, for, that is neither feasible nor preferable (Bird, 1986, p. 186).

In ensuring fair and efficient competition among the states, as mentioned earlier, the central government has an important supervisory or monitoring role. First, the central government should activate the process of competition by ensuring free flow of factors and products across the country. This is particularly important in a developing country where,the forces of competition are inactive. Second, it should ensure 'competitive equality' through regional policies and by giving intergovernmental transfers to offset the disabilities of the less powerful jurisdictions. Third, the centre should ensure harmonisation in tax policies among the states to minimize inter-state tax exportation and tax competition. Finally, it should, through cost-sharing programmes, ensure optimum standards in respect of services having high degree of inter-state spillovers.

b. **Horizontal Tax Competition and Resource Distortions:** The states indulge in tax competition as they attempt to attract business to their jurisdictions. In ensuring a healthy horizontal competitive relationship too, a certain degree of coordination in tax policy is essential. In particular, it is necessary to mention the need to avoid distortions arising from tax competition and minimise free-riding through inter-state tax exportation. Inter-state tax exportation can arise from the levy of origin based commodity taxes and even the corporate tax.

Inter-state tax competition is a feature commonly seen in federal countries. Attempts to divert trade and attract capital through progressive reduction in the effective tax rate persists in all federations but the nature of overt and covert methods employed in competition and the extent of actual variation in effective tax rates in the states in India are not seen in other federations. Of course, Australia has avoided the problem by relying more on tax sharing with, rather than tax assignment to the states. In Germany too, tax sharing is primarily relied upon and inter-state tax differences do not create serious resource distortions. In Canada, the problem was analysed even as far back as 50 years ago when the Rowell-Serois Report urged for a tax code of conduct "to prevent balkanization".[16] The problem has continued to persist, particularly in the levy of retail sales taxes but given that states' geographical areas are large, the problem is not very severe. In the U.S.A. too, there are wide variations in tax rates. Yet, a study by ACIR (1981a) concluded that "....tax competition between neighbouring states has yet to become a serious problem". In fact, recent computation by Vaillancourt (1993) shows that the coefficient of variation in Indian sales taxes was 0.66 as compared to about 0.50 in both Canada and the U.S.A. In Switzerland, there is vast scope for inter-cantonal tax variations in income tax but attempts have been made to reduce the differences over time (ACIR, 1981).

What is the ideal arrangement to minimize harmful effects of tax competition? *A priori*, it is difficult to provide a satisfactory answer to this question. A central viewpoint would call for a complete uniformity. But, the essence of federalism is the freedom of choice and the states should be able to choose the mix of standards of public services and tax-prices to suit the preferences of the people residing within their jurisdictions, and complete uniformity would deny that freedom altogether. At the same time, unbridled competition among the jurisdictions could encourage 'free-rider' behaviour and cause serious allocative distortions. Therefore, it is necessary that the states' tax rates should be coordinated so as to equate the losses on account of allocative distortions with welfare gains arising from fiscal decentralization at the margin. Perhaps, some coordination can be brought about by imposing floors and ceilings on the tax rates on the basis of a broad consensus among the states.

Of course, inter-state commodity tax exportation is seen in all federations in varying degrees. The tax exportation is particularly significant when the states have the right to levy taxes on commodities and services. In the more advanced countries like Canada and the U.S.A. the commodity taxation is levied broadly on the destination basis and here, the extent of tax exportation is confined to cross-border purchases. In countries like Brazil where the value

16. Quoted in Bird (1986 p. 209)

added tax (VAT) levied by the states is still on the origin principle, the inequitable inter-regional transfer has been sought to be minimised by having lower tax rates on the sales to consumers in poorer states (Longo, 1992). But, this has led to severe complications in the tax structure. In Australia, Switzerland and Germany, the sub-central units do not have the right to levy taxes on commodities and services and therefore, the problem is not serious.

The above discussion makes it abundantly clear that there has to be some degree of inter-state coordination in the levy of state taxes. This, however, cannot be achieved by voluntary actions of the states and the central government has an important role in achieving this (Breton, 1987). Unfortunately, in India, far from fulfilling this role of a monitor, the central government has itself actively participated in the unhealthy competition. In fact, the union territories where the central government has a direct administrative role, have been the 'tax heavens'. The abysmally low rate of sales tax on bus and truck chassis in union territories of Daman and Diu has served as a major cause of revenue loss to many of the states. Similarly, the union territory of Delhi, with its low effective rates of sales tax has served as a major source of tax evasion as well as trade diversion. It is also seen that whenever a President's rule is imposed in the states, large tax concessions are given purely for electoral reasons. Surely, tax coordination, in such an environment is difficult to achieve.

c. **Experience of Indian Fiscal Federalism**: The experience of Indian fiscal federalism in ensuring efficient inter-state competitive relationship has not been very successful. As will be shown in what follows, a number of fiscal and non-fiscal impediments have continued to persist causing severe resource distortions and inequities. Further, the regional policies of the central government and intergovernmental transfers have not succeeded in ensuring competitive quality among the states and acute inter-state tax competition has complicated the tax structures to cause allocative distortions.

The requirements of centralized planning in a mixed economy framework, have created several fiscal and non-fiscal impediments. Although there has been a considerable liberalization of the policy regime and rationalisation since July, 1991, the effects of the past controls on prices and outputs, fiscal and financial incentives and other regulations on trade continue to exert regional effects. The pattern of central government investments too have not created a balanced spatial spread of economic and social infrastructures to harness the resource endowments effectively, in spite of the repeated policy pronouncements to achieve balanced regional development during successive developmental plans. Even the central investments made in backward regions like the large investments in steel plants and coal mines in the backward states did not yield the desired forward linkages due to the policy to charge the same freight for transporting these items throughout the country.

The effect of uncontrolled inter-state fiscal competition in fragmenting the economy and bringing about allocative distortions has been even greater. While it is not feasible to make a detailed analysis of state tax systems here, it would not be out of place to point out some of the adverse consequences. Allocative distortions arise as the states, in their attempts to 'free-ride', orient their tax structures towards tax exportation and tax competition to attract business.

A major source of distortion is introduced when a state attempts to export the tax burden on the residents of other states. In India, this is mainly done through the sales taxes. Perhaps, India is the only federation where the inter-state sale is subject to tax by the exporting state in addition to the tax levied by the importing state[17] and this is permitted in the Constitution (item 92-A of the union list in the Seventh Schedule). It is thus not surprising that in 1987-88, the more developed states, having 41 per cent of population and accounting for 45 per cent of total household consumption collected 74 per cent of revenue from inter-state sales tax (Table 3). In fact, the extent of inter-state tax exportation is much larger if it is assumed that the taxes are entirely shifted forward, for, the goods sold outside the state include the tax on the inputs and capital goods in addition to the tax levied at the stage of manufacture. Besides, inter-state sales tax has also led to distortions in the tax structures as the states tend to levy higher tax rates on commodities predominantly exported out of the states.[18]

In the Indian context, inter-state competition has manifested itself in terms of differential sales tax rates and open-ended and comprehensive schemes of sales tax incentives for industrialisation. This practice, among other reasons, has complicated the tax structure. There are multiple sales tax rates ranging from six in Orissa to as many as 17 in Bihar and Gujarat. The sales tax systems in different states have a mix of the first point (manufacture/import stage), last point (wholesalers to retailers) and multipoint sales taxes. In addition, many states levy additional taxes and surcharges. All these have caused minute rate differentiation which is totally unintended. The attempts to conceal the tax element have resulted in taxing inputs and capital goods. Similarly, the diverse sales tax incentives to attract new industries have distorted relative prices between different industries and between old and new units in the same industry in unintended ways. Besides, in the long run, with each state offering progressively more incentives, all the states are left with large revenue losses.

A more serious problem is posed by the impediments placed on the the inter-state movement of goods by various sub-central tax measures. The levy of octroi or tax on the import of goods into a local area for consumption, use or sale (entry 52 of the state list in the Seventh

17. In Brazil too origin-based VAT causes a high degree of inter-state tax exportation.

18. The foodgrain surplus states, for example, levy the tax at 4 per cent. Often, in some states this has led to a bizarre situation in which colour television sets are taxed at lower rates than foodgrains. See Bagchi and Nayak (1990).

Table 3

Shares of Population, Consumption and Central Sales Tax Collection in Major States

	Per cent of population		Per cent of total consumption		Per cent of Central sales tax collection	
	1977-78	1987-88	1977-78	1987-88	1977-78	1987-88
	(1)	(2)	(3)	(4)	(5)	(6)
I. More Developed States						
Maharashtra	9.8	9.9	11.6	11.5	23.8	22.8
Gujarat	5.3	5.3	5.6	5.6	10.7	11.4
Punjab	2.6	2.6	4.1	3.7	5.7	5.2
Haryana	2.0	2.1	2.5	2.6	5.8	7.1
Karnataka	5.8	5.7	5.5	5.6	6.4	7.0
Tamil Nadu	7.7	7.3	7.3	7.6	9.2	10.6
West Bengal	8.6	8.6	7.9	8.6	10.4	9.6
Total I	41.8	41.4	44.6	45.1	72.1	73.7
II. Less Developed States						
Andhra Pradesh	8.4	8.4	8.4	8.5	3.6	2.7
Bihar	10.9	11.0	8.9	8.9	5.0	7.9
Kerala	4.0	3.8	4.1	4.8	2.4	2.5
Madhya Pradesh	8.1	8.3	7.2	7.6	6.0	7.3
Orissa	4.2	4.0	3.1	3.2	3.6	0.4
Rajasthan	5.2	5.5	7.4	5.9	3.1	1.2
Uttar Pradesh	17.3	17.5	16.2	16.0	4.1	4.3
Total II	58.2	58.6	55.4	54.9	27.9	26.3
Total: All Major States	100.0	100.0	100.0	100.0	100.0	100.0

Source:
1. NSS Consumption Expenditure Survey, 32nd and 42nd Round.
2. Population projection from Registrar General (adjusted pro-rata to conform to financial years)
3. Budget Documents/Finance Accounts

Schedule: Annexure II) is a clear example of this. This is a local tax collected at the entry-points into urban areas. Presently, the tax is levied by urban local bodies in six major states and Karnataka and Madhya Pradesh replaced it with a similar entry tax.[19] In addition, some states also levy a tax on the entry of commercial vehicles registered in other states into the state.[20] Thus, the prevailing sub-central tax system has created a host of tariff and non-tariff barriers.

IV. Intergovernmental Transfers

A major instrument to ensure the smooth functioning of 'competitive federalism' is the intergovernmental transfers. In this section, we discuss the principles of federal transfers, the practices in various federations and in the light of these, evaluate federal fiscal transfers in India.

a. Principles: Federal fiscal transfers to sub-central units have three broad objectives. First, the transfers have to be made to resolve the vertical fiscal imbalance. Second, they should achieve "competitive equality" to ensure stability of competitive federalism. Third, the transfers are required to ensure optimal provision of public services having inter-jurisdictional spillovers. The design of the transfer schemes should broadly reflect these objectives.

We have, already alluded to the case for intergovernmental transfers to offset the vertical fiscal imbalance. Minimization of free-riding necessitates revenue concentration and minimizing welfare losses call for expenditure decentralization. Therefore, in any optimal fiscal arrangement in a multilevel set-up, vertical imbalance is inherent and transfers to offset this are necessary.

The rationale for intergovernmental transfers, in the mainstream literature on fiscal federalism, is rooted in the horizontal equity argument that individuals with identical incomes should enjoy identical net fiscal benefits (Boadway and Flatters, 1982). The equity arguments, however, fail to satisfactorily explain why intergovernmental transfers are necessary to ensure inter-personal equity. The literature on competitive federalism argues that intergovernmental transfers are required to achieve competitive equality or to equalize the powers of jurisdictions to ensure stable competition. This argument is appealing though, it would be operationally difficult to measure an abstract concept like "power". In any case, both the approaches would indicate that the federal fiscal transfers should enable every state to provide a given normatively determined level of public services at a standard tax-price. This implies: (i) the objective of

19. The states of Gujarat, Haryana, Maharashtra, Punjab, Rajasthan and West Bengal levy octroi.

20. The central government has succeeded in persuading the states to abolish this levy after the All India Motor Transporters' Association went on a strike.

such transfers is only to ***enable*** the states to achieve the normative levels of services at a given tax effort and not to ***ensure*** them. The states can vary the actual levels of services as well as the actual tax-rates as preferred by their voters. The transfer envisaged, therefore, is unconditional in terms of the end-use of the resources transferred; (ii) The emphasis is on equalizing the levels of services and not just the expenditures. This implies that the transfers have to offset the fiscal disadvantages arising from not merely low revenue raising capacity but also high unit cost of providing public services which are beyond the control of the recipients.

The transfers made to ensure optimal provision of public services having significant spillovers across the states are typical shared-cost programmes. The objective of such specific purpose matching transfers is to provide adequate incentives to the states to provide these public services at desired quantities by subsidizing the provision of the services in question. The subsidy rate or the cost-share borne by the centre can vary with the programmes depending upon the extent of spillovers and it is also possible to vary the cost-shares (matching rates) from state to state to introduce an element of equalization.

b. Experiences of Other Federations: Although, in principle, the objectives of intergovernmental transfers are clear, the actual transfer systems are not strictly designed to fulfil them. As already mentioned, in actual practice, the design of intergovernmental transfers in any country is the outcome of political compromises, though, the principles discussed above do play an important role in reaching such compromises. As stated by Harvey Perry "........our principles have always been rationalisation of the mathematics that produced a compromise and all attempts to have the arithmetic to follow from application of principles have failed".[21]

The analysis of the intergovernmental transfer schemes undertaken in the major federations confirms the above observation. The Australian and Canadian systems have strong equalizing features. In Australia, for example, the extent of inter-state income disparities is the lowest; the maximum variation in per capita incomes in the state is just about 10 per cent of the average. Yet, the design of "tax sharing grants" fulfils the major objectives of offsetting both vertical and horizontal fiscal imbalances to a large extent. A fixed share of the Commonwealth tax revenue is distributed to the states on the basis of 'relativities' computed by the Commonwealth Grants Commission. The relativities are computed based on three factors - a basic entitlement (to offset vertical imbalance), revenue disabilities and cost disabilities. The specific purpose grants are mainly given to augment the standards of social services with 50 per cent matching contribution from the states.

21. Quoted in Bird (1986, p.20)

In the Canadian system, under the Fiscal Arrangements Act, 1977, broadly three types of transfers are made to the provinces. (i) equalization grants to raise the fiscal capacities of the deficient provinces to the average level; (ii) established programme financing - initially (until 1977) given to hospital insurance, medicare and post-secondary education on a matching basis, but was later converted into a general purpose transfer. About one-half of the grants under this is given as "tax-room" instead of cash grants; (iii) specific purpose grants are given under the Canada Assistance Plan (CAP) for several social schemes started with provincial initiatives.

Interestingly, although inter-state differences in fiscal capacities are relatively high in both Switzerland and the U.S.A., unconditional transfers play a relatively minor role. In Switzerland, sharing of taxes is done in a somewhat complicated manner, but an overwhelming proportion of it is distributed according to derivation or simply, population. The emphasis in both the countries is to equalize the levels of services through specific purpose transfers and equalizing elements are built into these transfers by varying matching requirements with the financial capacity of the cantons/states.

In Germany, the Constitutional commitment of providing "unity of living standards" has necessitated substantial equalization. This is attempted through (i) direct federal payments to poorer states, (ii) direct payments from the richer states to poorer states and (iii) intergovernmental grants and subsidies for various special and joint projects. The first is effected through negotiated transfer of a share in turnover tax (value added tax). Horizontal payments from the richer to the poorer states are effected according to a complicated formula.[22] In a sense, such horizontal transfers indicate the strength of the federation and the strong desire of the states to be a part of the federation.

c. **Intergovernmental Transfers in India:** An important feature of intergovernmental transfers in India is the existence of multiple channels of transfer from the central government to the states. The Finance Commission recommends shares of central taxes and grants-in-aid to meet the non-plan requirements of the states. The Planning Commission provides plan assistance to the states by way of both grants and loans. Both Finance Commission transfers and plan assistance can be characterized as general purpose transfers, as the end use of the funds is not stipulated by the donor. In addition to these, specific purpose transfers are given by various central ministries for various schemes. These are the central sector (where the central assistance is 100%) and centrally sponsored schemes. The latter is a shared cost programme, with matching ratio varying with projects (but not across states).

22. See, Advisory Commission on Intergovernmental Relations (1981).

The Finance Commission recommends the shares of personal income tax and union excise duties and non-plan grants to states. The overall needs of the centre vis-a-vis the states are supposed to determine the states' share of the two taxes and the shares of individual states are determined mainly on the basis of some general economic indicators. The Ninth Finance Commission, for example, transferred 85 per cent of the net collections of income tax and 45 per cent of the union excise duties to the states and individual states' shares are determined on the basis of factors like backwardness, population and collection. The basis of allocating the shares of the two taxes to the states are summarized in Tables 4 and 5.

The Finance Commission's method of making transfers has come to be popularly known as 'gap-filling' approach. The Commission makes assessment of revenues and non-plan current expenditures of the states. After adjusting the states' share in taxes, the remaining gaps between non-Plan expenditures and revenues are filled in through the grants-in-aid.

The Plan transfers, on the other hand are distributed on the basis of the "Gadgil" formula, evolved on the basis of a political consensus reached in the NDC in 1969, and modified from time to time. The latest formula is given in Table 6. Here again, the transfers, both grants and loans given in 30:70 ratio are distributed on the basis of mainly, population, backwardness and fiscal management.

The third component of transfer is given for specific purposes with or without the matching provisions. These are called the central sector and centrally sponsored schemes. Grants for central sector schemes are given to the states to undertake certain agency functions and therefore, are entirely financed by the central government. Centrally sponsored schemes are undertaken mainly in respect of services falling within the states' jurisdictions, and are initiated to ensure that adequate levels of such services are provided. These are shared cost programmes, and the matching ratios vary from project to project, but are uniform across states. The schemes are taken up in a wide variety of "activities" and as many as 262 such schemes were in vogue in 1985 and some more have been added in subsequent years. In fact, the transfers given under the centrally sponsored schemes have attracted the sharpest criticism due to the discretionary nature and conditionality implicit in them. The states have criticized the proliferation of such schemes as unwarranted intrusion into their domain, though for financial reasons have partaken in them. Although it was decided in the NDC to role back the volume of assistance under such schemes to one-sixth or one-seventh of the central assistance to state plans in 1979, transfers under this category have continued to grow in importance to form 36 per cent of the total plan assistance and 20 per cent of total current transfers in 1988-89.

Table 4

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

Finance Commission	Net proceeds distributed to the States	Criteria for Distribution			Others
		1 Contri-bution	2 Popula-tion	3 Per capita SDP	
(1)	(2)	(3)	(4)	(5)	(7)
First	50	20	80	-	-
Second	60	10	90	-	-
Third	60.67	20	80	-	-
Fourth	75	20	80	-	-
Fifth	75	10	90	-	-
Sixth	80	10	90	-	-
Seventh	85	10	90	-	-
Eighth	85	10	22.50	45* 22.5*	
Ninth (First Report)	85	10	22.5	45* 11.25**	11.25 (proportion of poor in the states to total poor population)
Ninth (Second Report)	85	10	22.5	45* 11.25**	11.25 composite index of backward-ness.@

* According to "distance" formula - see notes under Table 5.
** According to "inverse" formula - see notes under Table 5.
@ The variables included are (i) the population of scheduled castes and tribes; and (ii) number of agricultural labourers. Equal weights are assigned to the two factors.

Table 5

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

			Criteria Used for Distribution among the States			
Finance Commissions	Coverage	States' share (per cent)	Proportion of population of the State to the total population of all States	Per capita income	Economic or social backwardness	Other criteria
(1)	(2)	(3)	(4)	(5)	(6)	(7)
First	Three commodities: tobacco, matches and vegetable products	40	100	-	-	-
Second	Eight commodities: (Tobacco, matches, vegetable products, sugar, coffee, tea, paper and vegetable non-essential oils)	25	90	-	-	10 per cent used for adjustment
Third	All commodities yielding more than Rs 5.9 million in 1960-61 (about 35).	20	Mainly population basis along with relative financial weakness and economic backwardness as other factors. Specific details are not available.			
Fourth	All commodities excluding regulatory duties, special excises and earmarked cesses	20	80	-	20 According to relative backwardness as indicated by seven factors, which are: i) per capita gross value of agricultural production ii) per capita value added by manufacture iii) percentage of workers to total population iv) percentage of enrollment in class 1 to 5 to the population in the age group 6-11. v) population per hospital bed vi) percentage of rural population vii) percentage of scheduled caste population	
Fifth	All types of union excise duties (for the first three years (1969-72), however, regulatory duties and earmarked cesses are excluded.	20	60	13.3 Distributed among only those states whose per capita SDP was below all States average: in proportion to the shortfall of the State's per capita SDP from all State average multiplied by the population of the concerned State.	6.7 According to an integrated index of backwardness as indicated by six factors, which are: i) scheduled caste population ii) number of factory workers per lakh of population iii) net irrigated area per cultivator iv) length of railways and surfaced roads per square kilometer area v) enrollment ratio of school going age children; and vi) number of hospital beds per thousand person	

(1)	(2)	(3)	(4)	(5)	(6)	(7)
Sixth	For 1974-75 and 1975-76 all articles on which Union excise duties were levied excluding auxiliary duties of excise and cesses levied under special Acts and earmarked for special purposes	20	75	25 According to the "distance" formula		
Seventh	Net proceeds from all Union excise duties collected on all commodities excluding the net proceeds of the duty on the generation of electricity	45	25	25 Inverse* of per capita SDP formula	25 Percentage of poor	25 According to a formula of revenue equalisation this represents equalisation of revenue capacity which has been computed by regressing States' per capita revenue on per capita SDP and substituting the actual values of per capita SDP in the equation.
Eighth	Net proceeds: excluding cesses levied under special Acts and earmarked for special purposes	45	25	25	50	(5 per cent to deficit States) in proportion to the deficit of a State to the total deficit of the State in that year
Ninth First Report (1989-90)	Net proceeds excluding cesses levied under special Acts and earmarked cesses	45 (40 per cent to all States and 5 per cent to the States having post-devolution deficits	25	50 Distance formula** Inverse formula*	12.5 Percentage of people below poverty line	
Ninth Second Report (1990-95)	Net proceeds excluding cesses levied under Special Acts and earmarked cesses	45	25	12.5 Inverse* formula 33.5 Distance formula**	12.5 Index of backwardness computed with equal weights assigned to population of scheduled castes and tribes and number of agricultural labourers	16.5 On the basis of deficits computed after devolving assigned taxes.

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

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

Table 6

Formula for Distributing State Plan Assistance*

Criteria	Share in Central Plan Assis-tance (per cent)	Share of grants and loans	Criteria for Distribution to Non-special Category States
(1)	(2)	(3)	(4)
A. Special Category States (10)	30	90:10	
B. Non-Special Category States (15)	70	30:70	
(i) Population (1971)			60.0
(ii) Per capita income, of which			25.0
a) According to the 'deviation' method covering only the states with per capita income below the national average			20.0
b) According to the 'distance' method covering all the fifteen states			5.0
(iii) Fiscal Performance, of which			7.5
a) Tax effort			2.5
b) Fiscal management			2.5
c) National objectives			2.5
(iv) Special problems			7.5
Total			100.0

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

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

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

There is a rich volume of literature evaluating the design of intergovernmental transfer schemes and the consequences of transfers on equity and efficiency (Rao and Chelliah, 1991). We will only summarize the major issues here. First, it is pointed out that the design of general purpose transfer schemes from both Finance and Planning Commissions do not adequately offset the fiscal disadvantages to enable "competitive equality". The design of transfer schemes also have disincentive effects and tend to promote laxity in fiscal management. In the event, the system of federal transfers evolved in India has not helped to reduce inter-state disparities in the levels of services or incomes.

Thus, Finance Commission transfers form about 60 per cent of current transfers and about 44 per cent of total transfers. These transfers are not specifically designed to offset states' fiscal disadvantages. Almost 80 per cent of the transfers given by way of shares in central taxes[23] are distributed on the basis of general economic indicators wherein population receives very high (explicit and implicit) weightage. Even the states not having any non-plan gaps get substantial volume of money by way of tax shares and this gives them substantial surpluses in their non-plan current accounts. This helps them to have large sized developmental plans (Bagchi, Sen and Tulasidhar, 1993). The per capita estimated surpluses after the awards of the Sixth, Seventh and Eighth Finance Commissions clearly substantiate this (Table 7).

Nor does the methodology followed by the Finance Commissions help in the balanced inter-regional spread of social and economic infrastructures. As the projections are based on the existing expenditures (and not on the basis of expenditure needs), the less developed states with smaller revenue bases are not enabled to raise the services to the levels prevailing in the states with higher revenue bases. No wonder, even the poorest state like Bihar did not qualify to receive revenue-gap grants according to the recommendations of many Finance Commissions. Also, the "fiscal dentistry" undertaken by the Finance Commissions to fill in 'budgetary cavities' of the states have, over time enlarged the cavities to make them chronic. Making grants on the basis of projected gaps has tended to encourage the states to indulge in laxed tax effort and profligate spending to enlarge the gaps.

The plan transfers, in any case, have been distributed on the basis of a political consensus and cannot go far enough in offsetting the fiscal disadvantages. But, in spite of repeated assertions on 'balanced regional development', the Planning Commission determines plan transfers not on the basis of the requirements to create a given level of social and economic infrastructure in different states consistent with the plan objective, but on the basis of an entirely exogenous "Gadgil" formula.

23. This percentage excludes the portion of tax shares distributed on the basis of states normative deficits.

The consequence of this is not difficult to see. In per capita terms, the seventh plan outlay in high income states was about 93 per cent higher than the middle income states and 88 per cent higher than the low income states (Table 8). It is also seen that the distribution of plan assistance does not show any attempt by the centre to equalize plan investments across states.

Table 7

Per capita Non-plan Revenue Surpluses of the States According to the Recommendations of Various Finance Commissions

(Rupees)

	Sixth Finance Commission (1974-79)	Seventh Finance Commission (1979-84)	Eighth Finance Commission (1984-89)	Ninth Finance Commission (1989-90)
	(1)	(2)	(3)	(4)
Andhra Pradesh	15.21	178.03	333.82	576.96
Bihar	29.89	159.96	132.48	442.67
Gujarat	120.32	331.66	629.89	947.48
Haryana	217.84	509.69	920.12	1489.36
Karnataka	80.47	263.40	478.84	1008.09
Kerala	3.41	94.41	228.45	135.30
Madhya Pradesh	37.61	218.85	356.05	345.48
Maharashtra	135.74	465.53	885.37	1501.73
Orissa	30.89	27.91	47.18	172.54
Punjab	234.71	473.58	927.41	723.56
Rajasthan	26.01	77.57	97.33	208.25
Tamil Nadu	42.67	140.43	601.53	756.85
Uttar Pradesh	30.02	183.50	309.88	204.72
West Bengal	21.17	143.13	29.66	383.13
Average	55.48	215.58	380.80	578.73
Proportion of Maximum/Minimum	68.76	18.26	31.27	11.10

Note: The special category states are not included in the table.

Source: Bagchi, Sen and Tulasidhar (1993).

Table 8

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

(At 1981-82 Rupees)

States	Per Capita Annual SDP (1982-85) (at current prices)	Index of Taxable Capacity 1984-85	States' own resources for the plan before statutory transfers	Statutory transfers shared taxes and FC grants	Non-plan loans	States own resources for the plan after statutory transfers	Central paln assistance including centrally sponsored schemes	Plan outlay
					Actuals	Actuals	Actuals	Actuals
(1)	(2)	(3)	(4) (7)-(6 + 5)	(5)	(6)	(7) (9)-(8)	(8)	(9)
High Income States	**3340**	**146.30**	**-134.24**	321.43	**534.83**	**722.02**	**533.18**	**1255.20**
Punjab	4013	169.18	-459.28	280.45	318.05	139.23	1131.83	1271.06
Maharashtra	3384	142.75	229.72	316.24	509.77	1055.73	233.52	1289.25
Haryana	3043	151.11	-175.07	344.39	570.99	740.31	463.18	1203.49
Gujarat	2919	122.16	-132.35	344.62	740.53	952.79	304.20	1256.99
Middle Income States	**2206**	**112.82**	**-271.46**	**439.65**	**255.78**	**423.96**	**227.88**	**651.84**
Karnataka	2461	117.68	-49.98	389.70	112.04	451.76	213.36	665.12
West Bengal	2230	76.09	-421.11	483.04	278.40	340.34	140.56	480.90
Kerala	2144	117.66	-521.60	440.26	380.98	299.65	308.19	607.84
Tamil Nadu	2142	138.64	-186.56	439.21	316.60	569.25	229.51	798.76
Andhra Pradesh	2053	114.04	-178.07	446.02	190.87	458.82	247.77	706.59
Low Income States	**1689**	**50.06**	**-265.69**	**472.19**	171.11	**377.60**	**287.94**	**665.55**
Madhya Pradesh	1860	58.14	-139.69	422.13	227.32	509.75	200.00	709.76
Rajasthan	1820	67.46	-380.23	389.99	291.74	301.50	421.77	723.27
Orissa	1728	37.72	-250.75	582.07	126.74	458.07	310.56	768.63
Uttar Pradesh	1713	54.14	-256.19	440.86	143.54	328.21	272.18	600.39
Bihar	1323	32.85	-301.61	525.89	66.20	290.49	235.21	525.70
14 States' Average	**2345**	**99.97**	**-211.92**	**428.94**	**261.35**	**478.36**	**276.90**	**755.27**

Source: Column 1 and 2: Second Report of the Ninth Finance Commission (Ministry of Finance, Government of India, 1990.

Other columns Finance/Planning departments of the state governments.

In fact, it shows a regressive distribution. The distribution of non-Plan loans too varied directly with per capita incomes mainly due to higher shares of small saving loans in richer states.[24] Although the Finance Commission transfers, by and large, had a progressive distribution, this was not enough to offset the inherent fiscal disabilities of the poorer states, as seen in the non-plan deficits, before central transfers. Clearly, the intergovernmental transfers in India have not helped to offset fiscal disadvantages of the states with low revenue capacity and have failed to equalize the levels of plan investments to effect a fair inter-regional distribution of social and economic infrastructure.

It must be mentioned that equalizing role of intergovernmental fiscal transfers is particularly important for balanced regional development because there are other forms of inter-regional resource transfers which have a regressive bias. We have already alluded to the regressive transfers arising from inter-state tax exportation. The revenue transfers effected by banking and financial institutions too have tended to be biased against the poorer states (George, 1988). In addition, the method of financing central transfers itself can result in inter-regional resource transfers, the distribution of which is not known. To ensure "competitive equality", it is necessary to know the magnitude of such resource flows.

V. Concluding Remarks

We have, in this paper, tried to analyse the problems of Indian federalism in the light of the principles of fiscal federalism and the practices and experiences of some important federal countries. Of course, this analysis can help only in identifying the problems and policy directions to resolve federal fiscal issues. The specific policy measures to deal with federal fiscal problems in India will have to be determined taking into account the constraints posed by the nature of Indian federal polity and institutions.

Identifying optimal intergovernmental competition and evolving policies to achieve this is the essence of successful fiscal federalism. The competition, however, can not be uncontrolled, for, that will be anarchic and will lead to an unstable situation. The interdependence of policies vertically among different layers calls for a high degree of coordination in policies to avoid inefficiency arising from conflicts and contradictions. The vertical coordination should be achieved so that the competitive federalism would minimize 'free-riding' and maximize welfare gains from decentralization. Similarly, horizontal intergovernmental competition will be stable and gainful only when we have "competitive equality" among different jurisdictions and one jurisdiction is not able to free-ride on others. For achieving this, it is important that assignment should be optimal, but the constitutional assignment can only be *de jure* and cannot avoid *de facto* interdependence and overlap between

24. The states receive 75 per cent of the net collections on small savings as non-plan loans.

different layers and among different units within each layer in a federation. The role of mutual trust among governments and proper enforcement of rules and monitoring are crucial to the functioning of efficient fiscal federalism.

The experience of Indian fiscal federalism in achieving optimal intergovernmental competition cannot yet be considered successful; surely much less in comparison with the experiences of other federations. The constitutional assignment has left a large area of concurrency and overlap and there are no mechanisms to coordinate and satisfactorily resolve the friction between central and state policies. The vertical intergovernmental competition has worked to the disadvantage of the states. The monitoring mechanism too has not been very effective. Nor have effective ways been evolved to control free-riding by more powerful jurisdictions at the cost of the less powerful. The acute inter-state competition and tax exportation has further caused instability and inequity.

The answers to the problems of Indian fiscal federalism do not lie merely in constitutional changes to ensure proper assignment and effective enforcement. The intergovernmental relationships should foster mutual trust among different governments - both horizontal and vertical. In this task, the central government has a major responsibility not merely in monitoring the competition among the states, but in dealing fairly in its relationships with the states. Also, it is necessary to strengthen the institutions and mechanisms even to monitor the central government. Having an independent monetary authority and effective functioning of the institutions like National Development Council, the Finance Commission, the High Courts and the Supreme Court and of course, the Parliament - particularly the Council of States (Rajya Sabha) are necessary for the success of "competitive federalism" in India.

Equally important for efficiency is the need to have competitive equality among the federating units. This has to be ensured through the regional policies followed by the central government in allocating investments and through properly designed intergovernmental transfer schemes. This is particularly important in India where the public sector investments form almost one-half of total investment in the country. The geographical spread of central government investments and the pattern of central transfers to states, however, have not helped to offset the fiscal disadvantages of poorer states in providing adequate standards of social and economic infrastructure. In the absence of a level play field, it is unreasonable to expect that the objective of 'balanced regional development' can be fulfilled. Given the high degree of complementarity between infrastructure availability and private sector investments, unbalanced governmental investments would only accentuate inter-regional disparities in public and private consumption levels.

We have, in this paper, confined to the analysis of the intergovernmental fiscal relationships among only the centre and the states. This is not to imply that the intergovernmental fiscal arrangements below the state level are either satisfactory or unimportant. Many of the problems faced by the local bodies in their relationship with the state governments are similar to the centre - state relationships outlined in the paper. The issue of lack of resources, autonomy and inequity in the transfers at the local body level is even more acute than that is faced by the states. Equally important is the arbitrariness and the absence of proper designing of intergovernmental transfer schemes. These issues have not been gone into in this paper as they deserve to be analysed in greater detail in a separate study.

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Annexure I

TAXATION HEADS ASSIGNED TO THE UNION AND THE STATES IN THE CONSTITUTION (AS LISTED IN THE SEVENTH SCHEDULE OF THE CONSTITUTION)

Union		States	
Entry in List I of the Seventh Schedule	Head	Entry in List II of the Seventh Schedule	Head
82	Taxes on income other than agricultural income	45	Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue pur-
83	Duties of customs including export duties.	46	Taxes on agricultural income
84	Duties of excise on tobacco and other goods manufactured or produced in India except - a) alcoholic liquors for human consumption; b) opium, Indian hemp and other narcotic drugs and narcotics; but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.	47	Duties in respect of succession of agricultural land.
		48	Estate duty in respect of agricultural land
		49	Taxes on lands and buildings
		50	Taxes on mineral rights subject to any limitations imposed by Parliament by law by law relating to mineral development.
85	Corporation tax	51	Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: a. alcoholic liquors for human consumption; b. opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
86	Taxes on the capital value of the assets, exclusive of agricultural land of individuals and companies; taxes on the capital of companies.		
87	Estate duty in respect of property other than agricultural land.		
88	Duties in respect of succession to property others than agricultural land	52	Taxes on the entry of goods into a local area for consumption, use or sale therein.
89	Terminal taxes on goods or passengers carried by railway, sea or air: taxes on railway fares and freights	53.	Taxes on the consumption or sale of electricity.

90 Taxes other than stamp duties on transactions in stock exchanges and futures markets

91 Rates of stamp duty in respect of bills of exchange cheques promissory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.

92. Taxes on the sale or purchase of newspapers and on advertisements published therein.

*92A Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.

**92B Taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.

97 Any other matter not enumerated in List II or List III including any tax not mentioned in either or those Lists.

@54 Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I.

55. Taxes on advertisements other than advertisements published in the newspaper@@ and advertisements broadcast by radio or television.

56. Taxes on goods and passengers carried by road or on inland waterways.

57. Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads including tramcars, subject to the provision of entry 35 of List III.

58 Taxes on animals and boats

59 Tolls

60 Taxes on professions, trades, callings and employments

61 Capitation taxes

62 Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

63 Rates of stamp duty in respect of documents other than those specified in the provision of List I with regard to rates of stamp duty.

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* Ins. by the Constitution (Sixth Amendment) Act, 1956 s.2

** Ins. by the Constitution (Forty-sixth Amendment) Act, 1982, s.5

@ Sub. by the constitution (sixth Amendment) Act 1956, s.2 for entry 54

@@ Ins. by the Constitution (Forty-second Amendment) Act, 1976, s.57 (w.e.f. 31.1.1977

Extracts from the *Report of the Commission on Centre-State Relations* (Ch. Justice R.S. Sarkaria), 1987.

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

(A) Union List

S.No.	Entry No.	Subject
1.	6	Atomic energy and mineral resources necessary for its production.
2.	22	Railways
3.	23	Highways declared by or under law made by Parliament to be national highways
4.	24	Shipping and navigation on inland waterways, declared by Parliament by law to be national waterways, as regards mechanically propelled vessels the rule of the road on such waterways.
5.	25	Maritime shipping and navigation including shipping and navigation on tidel waters provision of education and training for the mercantile marine and regulation of such education and training provided by States and other agencies.
6.	26	Lighthouses, including lightships, becons and other provision for the safety of shipping and aircraft.
7.	27	Ports declared by or under law made by Parliament or existing law to be major ports, including their delimitation and the constitution and powers of port authorities therein.
8.	28	Port quarantine, including hospitals connected therewith seamen's and marine hospitals.
9.	29	Airways aircraft and air-navigation provision of aerodromes; regulation and organisation of air traffic and of aerodromes; provision for aeronautical education and training and regulation of such education and training provided by States and other agencies.
10.	30	Carriage of passengers and goods by railways, sea or air, or by national waterways in mechanically propelled vessels.
11.	31	Posts and telegraph: telephones, wireless, broadcasting and other like forms of communication.
12.	41	Trade and commerce with foreign countries; import and export across customs frontiers: definition of customs frontiers.
13.	42	Inter-State trade and commerce

14.	52	Industries, the control of which by the Union is declared by parliament by law to be expedient in the public interest.
15.	53	Regulation and development of oilfields and minerals oil resources; petroleum and petroleum products; other liquids and substances declared by Parliament by law to be dangerously inflammable.
16.	54	Regulation of mines and mineral development to the extent which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest.
17.	56	Regulation and development of inter-State rivers and river valleys to the extent to which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest.
18.	57	Fishing and fisheries beyond territorial waters
19.	65	Union agenda and institutions for - a) professional, vocational or technical training including the training of police officers; or b) the promotion of special studies or research; or c) scientific or technical assistance in the investigation or detection of crime.
20.	66	Coordination and determination of standards in institutions for higher education or research and scientific and technical institutions.
21.	68	Survey of India, the geological, botanical, zoological and anthropological surveys of India, meteological organisations.

B. State List

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

(C) Concurrent List

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

Extracts from the *Report of the Commission on Centre-State Relations* (Ch. Justice R.S. Sarkaria), 1987.