India's System of Intergovernmental Fiscal Relations*

Nirvikar Singh+

Department of Economics
University of California, Santa Cruz
Santa Cruz, CA 95064, USA

August 2004

(Revised)

Abstract

This paper examines several aspects of India's system of Intergovernmental Fiscal Relations (IGFR). It first reviews the origins and context within which the IGFR system was established and examines how it has evolved. It describes the nature of the system, including assignment of powers and functions, intergovernmental fiscal transfers and the principles that guide their design. It examines several other dimensions of the IGFR system, such as its interface with policy imperatives, evolution of norms, and recent institutional developments. It concludes with an assessment of lessons learned so far, and key challenges that lie ahead.

---

* This is a revised version of a paper presented at the 10th Anniversary Conference of the Financial and Fiscal Commission of South Africa, held on August 10-12 2004 at the Capetown International Convention Center, Capetown, South Africa. The paper draws on joint work with M. Govinda Rao, as well as other joint work with T.N. Srinivasan. I have learned a tremendous amount from each of them, and express my deep gratitude for the opportunity to work with each of them, and the resulting knowledge transfer. Nevertheless, they are totally blameless for errors and shortcomings in this piece. I am grateful to Renosi Mokate, Commissioner of the FFC, for giving me the opportunity to participate in the conference, and for her valuable suggestions on an earlier draft. Again, she is absolved of any responsibility for remaining shortcomings in this paper, which in no way represents her views, or those of the FFC.

+ Phone: (831) 459-4093, Fax: (831) 459-5077, Email: boxjenk@ucsc.edu

India's System of Intergovernmental Fiscal Relations

Nirvikar Singh
University of California, Santa Cruz

1. Introduction

India has shown remarkable resilience as the world's largest democracy, evidenced most recently by the successful conclusion of its 14th general election, and the resulting peaceful transition of power from one ruling coalition to another. Despite several challenges over the last fifty years, India's institutions have functioned reasonably well, maintaining order, and supporting some degree of economic development. While economic reforms have received considerable attention over the last decade and more, India's governance institutions have also begun to attract renewed scrutiny.

In particular, one can argue that economic liberalization and market-oriented reform are only part of the reform agenda for countries like India. While reducing the role of government in certain economic activities can promote efficiency and growth, it is also critical that the government do better in areas where it has a key role, such as improving infrastructure and, even more importantly, basic human capabilities in areas such as health, nutrition and education. One can argue that inefficient delivery of government services has been a major reason for relative failure on the latter front, and that inadequacies in the workings of India's federal system have, in turn, been important causes of inefficiency.

All this motivates continued attention to India's system of federal governance, and intergovernmental fiscal relations (IGFR) in particular. This paper provides an overview of some of the historical factors behind India's system of IGFR, as well as its structural features and working in practice. It identifies some of the most important institutional developments and policy imperatives that face India's system of IGFR. It concludes with a summary of lessons and challenges for this system.

2. Origins and Context

The origin of many of India's federal institutions can be found in its history as a British colony. At the same time, the circumstances of independence, with its traumatic partition of the country, also played a major role in shaping the structure and working of the country's intergovernmental relations. Different ideological positions and economic circumstances have affected overall federal institutions, which are briefly reviewed in this section.

Historical Development

In the nineteenth century, the British gradually took over a subcontinent that had long since become politically fragmented and strife ridden. Creeping extension of British rule crystallized with the Government of India Act, 1858, which imposed direct sovereignty under the British Crown, with an *ad hoc* mixture of centralized and decentralized administrative structures.

Centralization was reflected in the power of the London-based Secretary of State for India, governing through the Viceroy, an Executive Council, and a small number of district level British administrators, who exercised all sovereign powers, with no separation of legislative, executive and judicial functions. Decentralization was exemplified by the relationship of Indian princely states to the British administration, which retained considerable internal sovereignty.

As Crown rule was consolidated in the second half of the nineteenth century, the British attempted decentralization based on administrative considerations. Municipal governments were introduced in the 1860s. In some cases, sub-national units ("presidencies") were split with administrative convenience in mind. As a national political movement grew, the British developed their fiscal structures, motivated by an interplay of administrative and political considerations. In 1858, the provincial governments depended completely on annual central allocations, since the center had authority over all revenue receipts and expenditures. In 1870, some financial decentralization was begun as a prelude to meeting the perceived need for some local self-government. Initially, some expenditure categories (e.g., police, health, education) were assigned to the provincial governments, which received annual lump-sum grants, and had to have separate budgets. Subsequently, further expenditure assignments were devolved to the provinces, along with some revenue authority and arrangements for revenue sharing.

After World War I, the British dealt with the rise of sub-nationalism and nationalism in a series of political and administrative responses, which included federal ideas to varying degrees. The 1918 Montagu-Chelmsford Report on constitutional reforms articulated a vision of India as a decentralized federation. The Government of India Act of 1919, based on the report, devolved some authority to the provinces, and nominally restricted the powers of the central government over matters assigned to the provinces. While the Indian government remained essentially unitary, there was some relaxation of central control over provinces by separating the subjects of administration and sources of revenue into central and provincial jurisdictions. Provinces received unambiguous control over sources of revenue such as land, irrigation and judicial stamps. The initial assignment of revenue authority proposed would have required provincial contributions to fund the central government, but this scheme was quickly modified towards greater central fiscal autonomy, including the sharing of central income taxes with the provinces.

The Indian Statutory Commission of 1928, headed by Lord Simon, also included a review of India's financial arrangements. Sharing of the income tax between the center and the provinces was an important part of the new fiscal proposals. Various innovations in taxation were also proposed. Subsequently, several committees met to consider the new bases for revenue sharing, particularly the formulas for distributing income tax proceeds between the center and the various provinces. The beginning of the 1930s was marked by three conferences involving Indian leaders, on the future status of India's governance. These conferences, and the British government's own deliberations, led to the 1935 Government of India Act, which proposed relatively loose federal structures that would build alliances and support their rule. The 1935 Act provided for the distribution of legislative jurisdictions with the three-fold division of powers into Federal, Provincial and Concurrent Lists. The legislature, however, did not have the features of a sovereign legislature, as its powers were subject to several limitations. The Act also enabled the establishment of Federal Court to adjudicate the disputes between units of the federation and was also the Appellate Court to decide on constitutional questions. On the fiscal front, the Act provided an assignment of tax authorities and a scheme of revenue sharing that, in many respects, laid the foundations of fiscal federalism in independent India.

The Second World War and the intensification of the Indian freedom movement overtook the implementation of the federal provisions of the 1935 Government of India Act. Partition along with independence became more and more likely in this period. Nevertheless, the framers of the Indian Constitution, beginning in the Constituent Assembly in 1946, relied heavily on the 1935 Act for the new constitutional framework. However, the effect of the planned partition of the country strengthened the vision of a strong Center. The more decentralized aspects of the federal structure of the 1935 Act were rejected after the chaos of partition. Two key individuals supported the more centralized vision for India: Jawaharlal Nehru, who became India's first Prime Minister, and B.R. Ambedkar. Considerations of peacekeeping, coordination and a socialist economic vision all pushed Nehru toward centralization. Ambedkar, the Chairman of the Drafting Committee for the Constitution, had a strong preference for a unitary form of government. His conception of federalism was shaped accordingly: a division of powers between center and states, but with residuary powers at the center, and central ability to impinge severely on the states in special circumstances.

Thus, the Indian Constitution incorporated centralizing features that were not in earlier British legislation, though closer to British practice in India. Centralizing features included provisions for altering states or their boundaries, central supersession of state legislatures, and explicit restrictions on state powers. However, the Constitution did allow for states with elected governments and fiscal authority. This basic fact has permitted Indian federalism to exist and continue. While the political structures envisaged in the 1935 Act were largely abandoned in the Constitution, the details of assignments of expenditure and revenue authorities, as well as of revenue sharing and grants were preserved. Article 246 provides for a three-fold distribution of power, detailed in separate lists in the seventh schedule. These enumerate the specific exclusive powers of the center and the states, and those powers that are concurrently held. The three lists are long and close to exhaustive, though residuary powers are explicitly assigned to the center.[1]

Many centralizing constitutional provisions, governing the relative authorities of the center and the states, have not been exercised because other methods have sufficed. In particular, the center has been less concerned about explicit transfer of powers from the states to itself, or temporary suspension of state powers under constitutional provisions, because it has been able to exercise political control more directly through Article 356 of the Constitution. This allows the Governor of a state to advise the President that the government of the state was unable to carry on "in accordance with the provisions of this Constitution", and allows the President to assume "to himself all or any of the functions of the Government of the State". In practice, President's rule means rule by the Prime Minister and the ruling party at the center, and has provided a direct means to exercise central political control, bypassing the electoral will of the people as expressed at the state level.

[1] Another centralizing provision is Article 249, which empowers the upper house of parliament to transfer legislative jurisdiction from the states to the center. While the conditions for doing so are necessity or expediency in the national interest, the transfer requires only a two-thirds majority of members present and voting. In any case, Article 250 allows the central legislature to make laws with respect to matters in the state list. Furthermore, Article 353 (b) authorizes Parliament to make laws on matters not explicitly in the Union list. Finally, Article 354 empowers the President to order the suspension of the provisions of Articles 268 to 279 relating to transfers of revenues from the center to the states during a proclaimed emergency. However, all these centralizing features have not been availed of anywhere near to the extent that they might have been in 50 years of the Constitution's existence.

Political and Administrative Structures

India has been a constitutional democracy since 1950, now comprised of 28 states, six "Union Territories" (UTs) and a National Capital Territory (NCT), Delhi (see Table 1). The NCT and the UT of Pondicherry have their own elected legislatures, whereas the other UTs are governed directly by appointees of the center. All the states have elected legislatures, with Chief Ministers in the executive role. Each state also has a Governor, nominally appointed by the President, but effectively an agent of the Prime Minister. The primary expression of statutory constitutional authority in India comes through the directly elected parliamentary-style governments at the national and state level, as well as nascent directly elected government bodies at various local levels.[2]

Overlapping political authorities at the central and state levels have been dealt with through intra-party bargaining, and, more recently, through explicit bargaining and discussion. The Inter-State Council (ISC) was created in 1990,[3] and has become a forum where some political and economic issues of joint concern can be collectively discussed and possibly resolved. The ISC includes the Prime Minister, state Chief Ministers, and several central cabinet ministers as members. While the ISC is merely advisory, it has formalized collective discussion and approval of several important matters impinging on India's federal arrangements, including tax sharing and inter-state water disputes. Another, similar, body is older than the ISC, but narrower in scope. The National Development Council (NDC) serves as a forum for bargaining over five year plan allocations.[4]

Political and economic centralization have also been reflected in bureaucratic and judicial institutions. The Indian bureaucracy is provided constitutional recognition. The central and state level tiers of the "public services" are given shape through the provisions of Part XIV of the Constitution. Since each political layer of government requires its own administrative apparatus, any bureaucracy in a federation will have a federal character. In particular, state governments must be able to appoint and dismiss[5] bureaucrats to implement state-level policies. This is certainly the case in India, where there is a central bureaucracy as well as an independent bureaucracy in each state. However, the key component of the bureaucracy is the Indian Administrative Service (IAS), whose members are chosen by a centralized process, trained together, and then assigned to particular states. This structure was designed as a compromise between the desire to have an effective apparatus at the state level, and the fear of promoting

---

[2] These are all single constituency first-past-the-post elections, but with some seats reserved for disadvantaged groups, such as Scheduled Castes (erstwhile "untouchables") at each level.

[3] As early as the 1950s, the Second and Third Finance Commissions (see later) recommended an independent commission to re-examine central-state relations including an integrated examination of expenditures and non-financial as well as financial relations. The government was slow to act on this, though a commission was set up, and its report in 1987 led to the formation of the ISC. Meanwhile, India had gone through political developments and upheavals that posed new challenges. Many of these issues are still being discussed, in particular through a recent Constitutional Review Commission.

[4] The NDC is chaired by the Prime Minister, and its members include all cabinet ministers at the center, Chief Ministers of the states, and members of the Planning Commission (see later).

[5] In practice, dismissal is almost impossible, something that is true for the entire organized sector in India. However, state governments use (and misuse) the power to transfer bureaucrats to assert political control over the bureaucracy.

regional loyalties over national ones. This compromise has been problematic, since conflicts arise between state and central politicians (the latter acting through IAS members assigned to the central government) in directing state-level IAS bureaucrats.

At the national and state levels, the judiciary constitutes a distinct branch of government, though the legislative branch influences appointments. At the local level, IAS members are vested with some judicial authority. The Supreme Court stands at the top of the Indian judicial hierarchy. The President, in consultation with the Prime Minister, appoints its Justices. Its powers include broad original and appellate jurisdiction and the right to pass on the constitutionality of laws passed by Parliament. In practice, there has been conflict between the Supreme Court and the legislature/executive over the scope of these powers, and their boundaries remain subject to contestation. However, when specific issues of center-state relations have emerged with respect to taxation and property rights, to be adjudicated by the Supreme Court, the basic centralizing bias of the Constitution tilted the interpretation of the Court in favor of the center. At the state level, below the Supreme Court, are the High Courts. Each High Court's justices are appointed by the President, in consultation with the Chief Justice of the Supreme Court and the state's Governor. Paralleling the situation at the Center, the state's Chief Minister is in a position to influence the Governor's advice. High courts also have both original and appellate jurisdiction. In addition, they superintend the work of all courts within the state, including district courts, as well as various courts subordinate to the district courts.

3. IGFR Features

India has developed explicit as well as implicit channels for managing intergovernmental fiscal relations, and for making vertical transfers, particularly from the center to the states and UTs. This section reviews constitutional tax and expenditure assignments, the role of the Finance Commissions, Planning Commission, and central ministries in making intergovernmental fiscal transfers, and the nature and associated problems of subnational borrowing. It will be seen that India's intergovernmental fiscal transfer system is complicated by the existence of multiple channels, particularly the Planning Commission, which is charged with drawing up and implementing five-year economic development plans. Furthermore, while the bulk of transfers are general-purpose formulaic transfers, there is also a complex mix of specific purpose transfers, sometimes with *ad hoc* matching requirements, and often determined through political bargaining.

Expenditure and Tax Assignments

The Indian Constitution, in its Seventh Schedule, assigns the powers and functions of the center and the states. The schedule specifies the exclusive powers of the center in the Union list; exclusive powers of the states in the State list; and those falling under the joint jurisdiction are placed in the Concurrent list (see Table 2). All residuary powers are assigned to the center. The nature of the assignment of expenditure functions is fairly typical of federal nations, and broadly fits with economists' theoretical rationale.[6] The functions of the central government are those

---

[6] Economic theories of government are based on the idea that public (non-rival and non-exclusive) goods are not well provided by the market mechanism. In addition, if governments are not perfectly informed and intrinsically

required to maintain macroeconomic stability, international trade and relations, and those having implications for more than one state. The major subjects assigned to the states comprise public order, public health, agriculture, irrigation, land rights, fisheries and industries and minor minerals. The States also assume a significant role for subjects in the concurrent list, such as education and transportation, social security and social insurance.

The assignment of tax powers in India is based on a principle of separation, i.e., tax categories are exclusively assigned either to the center or to the states (see Table 3). Most broad-based (in principle though not in practice) taxes have been assigned to the center, including taxes on income and wealth from non-agricultural sources, corporation tax, taxes on production (excluding those on alcoholic liquors) and customs duty. A long list of taxes is assigned to the states. However, only the tax on the sale and purchase of goods has been significant for state revenues. This narrow effective tax base is largely a result of political economy factors that have eroded or prevented the use of taxes on agricultural land or incomes by state governments. The center has also been assigned all residual powers, so that taxes not mentioned in any of the lists automatically fall into its domain.

The tax assignment system has some problematic features. The separation of income tax powers between the center and states based on whether the source of income is agriculture or non-agriculture has opened up avenues for both avoidance and evasion of the personal income tax. Second, even though in a legal sense taxes on production (central manufacturing excises) and sale (state sales taxes) are separate, they tax the same base, causing overlapping and leaving less tax room to the latter. Finally, the states are allowed to levy taxes on the sale and purchase of goods (entry 54 in the State list) but not services. This, besides providing avenues for tax evasion and avoidance, has also posed problems in designing and implementing a comprehensive value added tax (VAT).

The realized outcome of the Indian assignments of tax and expenditure authority, their particular history of implementation, and the response of different levels of government and tax payers to the assignment has been a substantial vertical fiscal imbalance. In 2002-2003, the states on average raised about 38 percent of government revenues, but incurred about 58 percent of expenditures. Transfers from the center made up the balance – though perverse fiscal incentives for the states in this system have, in fact, increased the imbalance. In fact, the ability of the states to finance their current expenditures from their own sources of revenue has seen a long-run

---

benevolent, subnational governments may be better able to judge the desired levels of local public goods, and, potentially, can be given more specific electoral incentives to do so than national governments. The assignment of expenditure responsibilities then follows: wherever economies of scale, access to resources, and externalities or spillovers do not indicate otherwise, the expenditure assignment should match the locus of beneficiaries. With respect to revenue authority, tax assignments are what chiefly matter (borrowing is secondary). Since mobility across jurisdictions within a federation is greater than mobility across nations, leading to a shrinking base in response to a tax, it is harder for subnational jurisdictions to raise revenue from taxes than for the central government. However, mobility also depends on the relative benefits provided through public expenditures, so that jurisdictions are able to counter mobility in response to marginal taxes by also providing appropriate benefits at the margin to those who are taxed. If mobility of tax bases implies that more taxes should be collected by the center, there may be a mismatch between revenues and expenditures for subnational jurisdictions. Redistribution motives and collection efficiency may also favor centralized assignment of taxes. The result of the differing determinants of optimal assignments of expenditure and tax authorities can be a "vertical fiscal imbalance", where subnational governments rely on the center for revenue transfers. However, the divergence of revenue and expenditure decisions at the margin can have adverse incentive effects.

decline, from 69 percent in 1955-1956 to 52 percent in 2002-2003. In terms of total expenditure (including capital spending), the states were even more dependent on the center, with only 42 percent of their overall spending being covered by their own revenue receipts in 2000-01.[7]

Finance Commission Transfers

The Constitution recognized that its assignment of tax powers and expenditure functions would create imbalances between expenditure 'needs' and abilities to raise revenue. The imbalances could be both vertical, among different levels of government, and horizontal, among different units within a sub-central level. Therefore, the Constitution originally provided for the sharing of the proceeds of certain centrally levied taxes (e.g., non-corporate income tax, Article 270; and Union excise duty, Article 272) with the states, as well as grants to the states from the Consolidated Fund of India. Recent constitutional changes in this scheme have simplified this sharing arrangement, replacing it with an overall share of the Consolidated Fund. The shares of the center and the states, and their allocation among different states are determined by the Finance Commission, which is also a constitutional creation,[8] and is appointed by the President of India every five years (or earlier if needed). In addition to tax devolution, the Finance Commission is also required to recommend grants to the states in need of assistance under Article 275. Finance Commission transfers are, thus, all unconditional in nature.

The Finance Commissions' approach to federal transfers has consisted of (i) assessment of overall budgetary requirements of the center and states to determine the volume of resources available for transfer with the center during the period of recommendation, (ii) projecting of states' own revenues and non-plan current expenditures, (iii) determining and distributing the states' share of the consolidated fund of the center, and (iv) filling gaps between projected expenditures and revenues after tax devolution with grants.

Over the last fifty years eleven Finance Commissions have made recommendations to the central government and, barring a few exceptions, these have been accepted. In this process, the Commissions have developed an elaborate methodology for dealing with horizontal as well as vertical fiscal imbalances. In particular, the formula for tax devolution is quite complicated, as a result of attempts to capture simultaneously disparate (and even contradictory) factors such as poverty, 'backwardness', tax effort, fiscal discipline, and population control efforts (see Table 4). The result has been that the impact of Finance Commission transfers on horizontal equity (equalizing fiscal capacity across states) has been somewhat limited (see Table 5).[9] Despite the *ad hoc* nature of the tax-sharing formula, its persistence reflects the nature of precedent that has

---

[7] These figures are from various RBI Annual Reports, available at http://www.rbi.org.in/.

[8] At the time of independence, revenue sharing between the center and the states was governed by the 1935 Act. In 1947, some adjustments were made in the allocation percentages across provinces as a result of partition. When drafting the Constitution, the Constituent Assembly appointed an expert committee to advise on the financial provisions of the new document. This committee made some specific recommendations on what revenue pools should be shared between center and states, as well as percentages for some of these categories. Most importantly, the expert committee recommended the creation of an independent Finance Commission to deal periodically with center-state revenue sharing. The Constitution incorporated this latter recommendation, but left it to the new Finance Commission to recommend specific sharing percentages.

[9] The exception is the so-called 'special category' states, as can be seen from Table 5. These are hilly states on India's borders, with strategic importance as well as cost disabilities.

grown around the Finance Commission, even though it is not a permanent body, and lacks continuity in its staffing and its analysis.

Grants recommended by the Finance Commissions have typically been determined on the basis of projected gaps between non-plan current expenditures and post-tax devolution revenues. As with tax sharing, these grants have generally been unconditional, although some of the Commissions (particularly after the Sixth) also attempted to enhance outlays on specified services in the states by making closed-ended specific purpose non-matching grants. In either case, however, the incentive problems with this "gap-filling" approach are obvious. Some of the Commissions did attempt to take account of normative growth rates of revenues and expenditures in projections, but these attempts were selective and relatively unimportant. Table 6 provides statistics on the relative magnitudes of tax sharing and grants in the Finance Commission's transfers.

Despite the Finance Commissions' success in establishing guidelines and stability for center-state tax sharing, their methodology and processes have been criticized. The main criticisms are (i) the scope of the Finance Commissions through the Presidential terms of reference has been too restricted; and (ii) the design of their transfer schemes has reduced state government incentives for fiscal discipline (through 'gap-filling' transfers), while doing relatively little to reduce inter-state inequities.[10] Therefore one can argue that there is still an opportunity to improve this aspect of India's IGFR system.

Planning Commission

While the Finance Commission decides on tax shares and makes grants, a separate body, the Planning Commission,[11] makes grants and loans (in the ratio 30:70 for the major states) for implementing development plans.[12] Historically, as development planning gained emphasis, the Planning Commission became a major dispenser of such funds to the states. As there is no specific provision in the Constitution for such plan transfers, the central government channeled them under the miscellaneous, and ostensibly limited provisions of Article 282. Before 1969, plan transfers were project-based. Since then, the distribution has been done on the basis of a consensus formula decided by the NDC (see Table 7). As in the case of the Finance Commission formula, the Planning Commission also tries to aggregate extremely disparate objectives in its calculations, with the result that the overall impact is less than clear. One major contrast with the Finance Commission is the conditional nature of Planning Commission transfers. However, while the special category states receive plan transfers based on projects that they formulate and submit, the general category states' plan transfers are not related to the required size or composition of plan investments. Hence there is not even implicit matching of states' own resources in this channel, let alone an explicit matching formula.

[10] Note that both larger government deficits at the subnational level and, to some extent, increases in inter-state inequalities in the last decade, can be seen as partly endogenous to the functioning of India's intergovernmental transfer system.

[11] While there was no specific constitutional provision for a planning apparatus, the ideology of Nehru and many associates led to the formation of a Planning Commission through a resolution of the Cabinet. The Prime Minister has always chaired the Planning Commission, but even then, it has not always succeeded well in coordinating with or among the various ministries, as well as complicating the work of the Finance Commissions.

[12] The special category states receive a much higher proportion of Plan funds as grants.

The process for determining plan transfers is as follows. The Planning Commission works out five-year-plan investments for each sector of the economy and each state. With this as background, the states work out their respective annual plans for each year, based on estimated resource availability, which potentially includes the balance from current revenue (including Finance Commission transfers), contributions of public enterprises, additional resource mobilization, plan grants and loans, market borrowings, and other miscellaneous capital receipts. At this stage, a certain amount of bargaining for resources goes on through the NDC as well as in state-by-state discussions, to determine plan loans and grants. At the end of this process, the Planning Commission approves the state plans. Thus, at the margin, it is mainly the own resource position of the states that determines their plan sizes.

While there is no disincentive effect in this approach, neither is there a clear process of evaluating investment needs and priorities. A lack of coordination between the Finance and Planning Commissions, together with fungibility of transfers, further complicates the impact of these intergovernmental transfers. Table 6 reports the amount of plan transfers (grants only): the transfers discussed so far are in the category of ‘state plan grants’. Hence, one can see that these plan transfers are only about one-third to one-quarter of Finance Commission transfers in magnitude. Nevertheless, they represent an important source of revenue for the states. Most recently, reflecting their deteriorating fiscal positions, some states have been using plan transfers for meeting current salary obligations, illustrating the problems of the system.

Central Ministry Transfers

Finally, various ministries give grants to their counterparts in the states for specified projects, either wholly funded by the center (central sector projects) or requiring the states to share a proportion of the cost (centrally sponsored schemes). Both these categories are reported together as central schemes Table 6). The ostensible rationale for these programs is financing activities with a high degree of inter-state spillovers, or which are merit goods (e.g., poverty alleviation and family planning), but they are often driven by pork-barrel objectives.[13] These projects are supposed to be monitored by the Planning Commission, and coordinated with the overall state plans – which is why they are typically listed under Plan transfers in Table 6 – but both monitoring and coordination are relatively ineffective.

There are over 100 such schemes, and several attempts in the past to consolidate them into broad sectoral programs have not been successful. These programs have provided the central government with an instrument to actively influence states’ spending, replacing the pre-1969 plan transfers in this role. The proliferation of schemes may also have increased the size and control of the bureaucracy. While the NDC recently appointed an investigative committee that recommended scaling down and consolidating centrally sponsored schemes, implementation of this objective was weak.

While the specific purposes and matching requirements of central and centrally sponsored schemes make them potentially an important channel for dealing with spillovers, as noted, the implementation of these schemes has been problematic, with the issues including lack of transparency, poor selection of projects, and ineffective monitoring. Nevertheless, the

[13] For example, they can be for very specific local projects, and can have conditionalities such as employment requirements.

discretionary aspect of these intergovernmental transfers has made them attractive to central ministries, and, as can be seen from Table 5, their relative importance in overall transfers has increased.

Loans and Guarantees

In addition to explicit transfers, intergovernmental loans, to the extent that they are subsidized, also constitute implicit transfers to subnational governments. Ideally, borrowing should be to finance investment, but state governments have increasingly used borrowing to meet current expenditure needs (now approaching 50 percent). State governments can only borrow from the market with central government approval if they are indebted to the center, and this constraint binds for all the states. Central loans now constitute about 60 percent of the states' indebtedness, with another 22 percent being market borrowing, and the remainder made up of pension funds, shares of rural small savings, and required holdings of state government bonds by commercial banks (Rao and Singh, 2002; Srinivasan, 2002). While these captive sources of finance are limited, the states have been able to soften their budget constraints further by off-budget borrowing or nonpayment by their public sector enterprises (PSEs). For example, the State Electricity Boards (SEBs) have been tardy in paying the National Thermal Power Corporation, a central PSE (Srinivasan, 2002).

Other sources of softness in state government budget constraints include central government guarantees of loans made to state government PSEs by external agencies, and central forgiveness of past loans made to state governments, presumably to gain political advantage. Even in the case of attempts to impose conditions on state borrowing that would encourage fiscal reforms, the center has not been able to harden budget constraints. In particular, in 1999-2000, eleven states signed Memoranda of Understanding (MOUs) with the center, promising fiscal reforms in exchange for ways and means advances (essentially, overdrafts) on tax devolution and grants due to them. In some cases, however, the center has had to convert these advances into three-year loans. The Reserve Bank of India (RBI) reports stopping payments to three states (Reserve Bank of India, 2001), but the political difficulty of not bailing out states that are both poor and populous is obvious.[14]

In the 1990s, India has struggled with high fiscal deficits and the states have contributed significantly to this problem after 1997-98. Several states have also followed the center's lead in passing Fiscal Responsibility and Budget Management Acts to set targets for deficit reduction, and recently the Ministry of Finance has released a report outlining a roadmap for achieving deficit reduction targets. In addition to reforms in tax and transfer systems as ways of reducing subnational fiscal deficits, an important area of reform relates to the process of borrowing by the states, which has hitherto been *ad hoc* and opaque. Improvements in financial information, budgeting practices, regulatory norms and monitoring are all required here, as well as changes in the institutional rules (IMF, 2003; Hausmann and Purfield, 2004). These reforms parallel many of those required for the financial sector as a whole: state governments just happen to be among the most powerful among those taking advantage of poorly functioning credit markets to run up unpaid debts. Some reform is already taking place, including statutory or administrative

[14] These kinds of political considerations also constrain the center to make plan loans at the same interest rate to all states, removing that marginal incentive device as well.

borrowing ceilings, guarantee redemption funds, explicit restructuring and write-offs, and market-based borrowing mechanisms such as auctions conducted by the RBI.

Another approach to the states' indebtedness and continued high fiscal deficits has been to tie some portion of intergovernmental transfers to state-level fiscal reforms. The Eleventh Finance Commission worked out a scheme by pooling 15 per cent of revenue deficit grants and adding an equal amount to it to create an incentive fund to be allocated among the states based on fulfillment of targets of growth of tax and non-tax revenues and expenditures on salaries, interest payments and subsidies, as set in the fiscal restructuring plan detailed by the Commission. The incentive fund has been allocated to the states according to their population shares. A state will get its full amount if it fulfils the specified targets of the monitorable measure (revenue deficit as a percentage of total revenue receipts of the states) evolved for the purpose, with graduated rewards for partial fulfillment. However, the potential problems with this scheme include the relatively small size of the incentive fund, biases in the monitorable measure against smaller and poorer states, conflicts with other fiscal incentive programs, and opportunities for moving deficits off budget to manipulate the program outcomes.[15] One might also simply argue that India's intergovernmental transfer system is already complex and overburdened with multiple objectives: this theme is reprised in the next section.

4. Institutional Developments and Policy Imperatives

Several institutional developments and policy imperatives stand out in a review of India's IGFR system, and represent new opportunities and challenges. India has taken major strides in decentralizing government by creating a tier of local government that has constitutional status, and that requires another layer of intergovernmental transfers. At the same time, market-oriented economic reforms have weakened traditional hierarchical mechanisms of fiscal control, and require new institutional approaches, including reforms in several areas, particularly in the tax system. In this new era of redefining boundaries between government and market, regional inequalities remain a major concern.

Local Government

The status and powers of local government in India ebbed and rose throughout the colonial period. The Government of India Act of 1919 marked the first serious devolution to the local level, with chairmen of district boards (previously provincial officials) becoming elected officials, and municipalities and district and local boards increasing the scale of their activities, though still with relatively narrow expenditure assignments. However, local governments were reluctant to tax, or enforce collections, and revenues came primarily from provincial transfers. While municipalities used octroi (a local entry tax on goods) and personal income taxes, rural

[15] Another problem is a specific characteristic of recent political equations, where a coalition government at the national level gave pivotal status to ruling parties in some states, which then exercised their bargaining power with the national ruling coalition to soften their budget constraints. Hence, even ostensibly positive developments such as tying some portion of center-state transfers to implementation of economic reform can be distorted by political considerations.

boards depended on land revenue surcharges, supplemented by professions and vehicle taxes. Land revenue still represented the major source of provincial revenue, and served as a substitute for an agricultural income tax.

The 1935 Act (see Section 2) did not have much impact on local government structures. Typical local responsibilities, such as health and education, received little attention. World War II increased centralization of government, and it was only Mahatma Gandhi who continued to press for decentralization to the local government level. Gandhi's perspective received some acknowledgement in the Constitution's Directive Principles, but little more until the 1980s, when a few states shifted the emphasis in formulating and implementing economic plans from bureaucratic to political control, and generally strengthened rural local government. In 1988, a central committee recommended that *Panchayati Raj*[16] bodies should be given constitutional status. In 1991, two separate constitutional amendment bills were introduced, covering *panchayats* and municipalities respectively. These were brought into force as the 73rd and 74th amendments to the Constitution of India in 1993.

A key change brought about by the amendments was a reduction of state government discretion concerning elections to rural local government bodies. Direct elections to local bodies must be held every five years. Hence "voice" replaces "hierarchy" as the primary accountability mechanism (Hirschman, 1970; Rao and Singh, 2001). This is a positive step to the extent that it provides more refined incentives, subject to the caveat of effective monitoring and transparency being achievable. Local government reform also has changed the nature of tax and expenditure assignments to local governments,[17] and instituted a system of formal state-local transfers modeled on the component of the existing center-state system that is governed by the Finance Commission. While there are some serious issues with the new assignments, including problems of local capacity and efficiency of raising and spending money, we focus here on the new transfer system.

One view has been that formal transfers from the center and states to local governments have the potential to accentuate fiscal deficit problems. Alternatively, a formal, rule-governed system will make existing problems more transparent. In fact, the evidence suggests that this is the case. It is now apparent that local government finances, particularly for urban bodies, steadily worsened over the period before local government reform, under a system of hierarchical control and supposedly strict monitoring by state governments. The new State Finance Commissions (SFCs) have struggled to formulate the principles for sharing or assigning state taxes, tolls, and fees and for making grants-in-aid. There remains considerable variation in the quality of analysis, methodologies used, and implementation of transfers across the different states. Lack of political will at the state level and the states' own fiscal problems have both restricted progress in this dimension. On the other hand the current situation with respect to local governments seems no worse than the previous one of *ad hoc* and discretionary transfers and

---

[16] This term translates as 'rule of *panchayats*', the latter referring to traditional village ruling councils of five members, and now applied to any rural local government. In fact, there are three nested levels of rural local government, covering, in order of decreasing size, the district, block, and village or village group.

[17] For example, the 73rd Amendment created a list of 29 different areas of rural local government functional responsibility, considerably broader in scope than the previous situation, though the majority of these remain concurrent responsibilities with the state government.

control of local bodies by state governments, the new constitutional structures create a space within which local governments may become effective over time.

After the last election, in May 2004, the new government at the center proposed transferring money directly to local governments. In the past, the states have received unconditional Finance Commission transfers earmarked for local governments, but have retained control of these monies. They have also controlled Planning Commission and central ministry conditional transfers that have ostensibly been targeted at district or block level rural government authorities. With local governments now enjoying constitutional status, the states are reluctant to permit new transfers direct to rural local governments, and they have opposed the center's proposals, fearing that they will lead to reductions in their own transfer receipts. One way out of this impasse may be for states to give local governments greater effective taxing powers, and to improve their collection capabilities.

Regional Inequalities and IGFR

The evidence from several studies suggests growing inequality among the Indian states in the past three decades, with the rate increasing in the 1990s.[18] Differences in infrastructure and institutions that seem to explain interstate differences have been persistent, and neither Finance Commission transfers, Planning Commission transfers, nor central ministry transfers have made a substantial dent in regional inequalities in India. Growing regional inequality is a concern, particularly because it can threaten political stability. Liberalization has meant a reduction in central government control of industrial investment and other aspects of regional economic policy, leaving the intergovernmental transfer system in the spotlight.

What are possible reforms that can be made in the transfer system, if growing regional disparities are a concern, and can they be politically feasible? One example of the political feasibility in the process of institutional reform comes from the case of tax-sharing arrangements. The Constitution specified certain categories of centrally collected taxes that were to be shared with the states, according to criteria to be determined by the Finance Commission. In particular, personal income taxes were a major component of tax transfers from the center to the states, which received 87.5 percent of such tax revenues. However, income tax surcharges were kept entirely by the center. Academic commentators suggested that there were obvious incentive problems with such arrangements, and the Tenth Finance Commission recommended alternative arrangements whereby a proportion of overall central tax revenues would be devolved to the states. This required bargaining and agreement among the center and the states, as well as a constitutional amendment, but this was all accomplished by 2000.

There is a case for the Finance Commission and Planning Commission overhauling their transfer formulae completely, to achieve greater simplicity. Such reforms would not solve problems of increasing inter-state inequalities, since the variation in SDP per capita is far greater than the level of per capita transfers. However, they would make the formal transfer system clearer and simpler, and make it easier to understand its objectives and its impacts. Removing a significant portion of center-state transfers outside the political economy arena, clearly targeting them toward horizontal equity objectives,[19] and doing so in a manner that does not create

[18] See Rao and Singh (2004a) for a summary of these studies.

[19] This is not achieved in the current system, as Table 5 illustrates.

perverse incentives for recipients, is feasible and desirable in itself. This approach is contrary to the idea of using the intergovernmental transfer system to provide very refined or targeted incentives to meet general fiscal balance goals, but we would argue that is most appropriate for the bulk of intergovernmental transfers.

Internal Common Market and Tax Reform

Theories of Market Preserving Federalism (e.g., Weingast, 1993) emphasize the positive role of a common internal market. In the United States, this idea was incorporated in the Interstate Commerce Clause, which eventually received strong support from the Supreme Court. The framers of the Indian Constitution, although aware of the need to ensure a common market in the federation, were not averse to the idea of placing restrictions if the situation so demanded. Article 301 of the Constitution states, "Subject to the other provisions of this part, trade, commerce and intercourse throughout the territory of India shall be free". At the same time, Article 302 empowers Parliament to impose restrictions on this in "public interest". An important fiscal impediment to free inter-state trade is the levy of inter-state sales tax. The tax is levied by the exporting state on inter-state sale of goods. The framers of the Constitution intended that the sales tax system in India should be destination based. According to Article 286 of the Constitution, "No law of a state shall impose, or authorise the imposition of the tax on the sale or purchase of goods where such sale or purchase takes place (a) outside the state, or (b) in the course of import of goods into, or export of goods out of, the territory of India." However, based on the recommendations of the Taxation Enquiry Commission of 1953, the Sixth amendment added clauses to enable the central government to levy taxes on inter-state transactions.

Under these provisions, the central government authorized the states to levy a tax on inter-state sale subject to a specified ceiling rate. Besides creating impediment to free movement of goods (through check-posts), this tax on export of goods from one state to another has converted the sales tax into an origin-based tax. The tax has also has caused significant inter-state exportation of the tax burden from the richer producing states to the residents of poorer consuming states (Rao and Singh, 1998). Also, entry 52 in the State list empowers the States to levy tax on the entry of goods into a local area for consumption, use or sale. In many states, the tax has been assigned to the urban local bodies and the tax is variously called "octroi" or "entry tax". Thus, taxes are levied not only on exports from one state to another but also on all imports into local areas including imports from other states. These taxes have complicated the tax system, created severe distortions, and caused severe impediments to inter-regional movement of goods.

Evolving a coordinated consumption-tax system remains a major challenge (Rao, 2000). Rao provides detailed recommendations with respect to issues such as rates, interstate sales taxes, and tax administration for a dual VAT coordinated between the Center and the states, and notes the problem created by the failure of the Constitution to explicitly include services within the scope of states' sales tax authority. Moving taxation of services from the Union list, where it implicitly lies through the Center's residual powers over taxes not explicitly specified in the Constitution, to the Concurrent list will require a constitutional amendment. Such an amendment must be proposed by the central government, but would benefit the states. One can incorporate political economy considerations by tying such an amendment to persuading the states to reduce and eventually eliminate taxation of interstate sales. This would remove some of the internal barriers that have plagued the development of a true national market within India. It would also smooth the implementation of a destination-based VAT for the states, which in turn could also reduce tax exporting by the richer states, complementing the role of transfers in keeping interstate divergence from becoming politically unacceptable.

5. Conclusion: Lessons and Challenges

We can summarize the lessons of this paper quite briefly. First, an understanding of historical forces and ideologies can be important in explaining the evolution of IGFR systems, as well as current structures. In particular, a historical perspective can help in realizing that the context has changed enough to require some institutional reform. In India, many features of its IGFR system were a product of colonial rule and the immediate post-independence environment. It can be argued that, over fifty years later, it is time for a major overhaul of India's system of IGFR.

This paper has laid out some of the complexity of India's IGFR system as it has evolved. A case can be made that greater simplicity, through reducing channels of intergovernmental transfers, as well as consolidating and simplifying formulae, will aid in achieving objectives of horizontal equity, as well as managing political challenges arising from increased regional inequality within the federation. Incentives for subnational fiscal discipline can also be built into the transfer system more effectively ("hard budget constraints"). While there will always be a role for political discretion, even its exercise can be made more efficient through more effective design of the transfer system.

Furthermore, decentralization is not antithetical to fiscal discipline, as long as the transfer system has appropriate incentives built into it for local governments as well, and there is no reason this cannot be done. Effective decentralization seems critical to improving the efficiency of government delivery of local public goods and services, particularly those that improve human capabilities. Thus, improvements in India's IGFR system must include reforming the system of tax and expenditure assignments, as well as the intergovernmental transfer system. Tax reforms go well beyond decentralizing tax authority more effectively in areas such as local property taxes, to a major overhaul of the system of indirect taxes to reduce economic distortions and increase tax efficiency.

Implementing systemic reforms in government is always a major challenge. Each of the areas we have discussed, taxation, intergovernmental transfers, fiscal deficits and decentralization, requires detailed policy formulation and implementation that must overcome inertia, resource constraints, and active opposition from vested interests. What is encouraging is that a considerable amount has been accomplished in the past decade, partly spurred by the acceleration of India's economic growth. It will be interesting to see how recent political changes at the center and several important states shape the debate about reforming India's governance in general, and its IGFR system in particular.

References

Hausmann, Ricardo and Catriona Purfield (2004), "The Challenge of Fiscal Adjustment in a Democracy: The Case of India," NIPFP-IMF Conference Paper, January

Hirschman, Albert O. (1970), *Exit, Voice, and Loyalty; Responses to Decline in Firms, Organizations, and States*, Cambridge, MA: Harvard University Press

International Monetary Fund (2003), *India: Country Report 03/261* (August)

Rao, M. Govinda (2000a), "Tax Reform in India: Achievements and Challenges", *Asia-Pacific Development Journal*, 7, 2, 59-74

Rao, M. Govinda, and Nirvikar Singh (1998), "Fiscal Overlapping, Concurrency and Competition in Indian Federalism", Working Paper 30b, Center for Research on Economic Development and Policy Reform, Stanford University.

Rao, M. Govinda, and Nirvikar Singh (2001), "India's Federal Institutions and Economic Reform", paper presented at the conference on India's Public Institutions, at Harvard University, February 9-10, 2001.

Rao, M. Govinda, and Nirvikar Singh (2002), "Fiscal Transfers in a Developing Country: The Case of India", paper presented at University of Birmingham conference on comparative federalism.

Rao, M. Govinda, and Nirvikar Singh (2004a), "The Political Economy of India's Federal System and its Reform," SCCIE and UCSC Working Paper, March

Rao, M. Govinda, and Nirvikar Singh (2004b), *The Political Economy of Indian Federalism*, forthcoming, Oxford University Press

Reserve Bank of India (2001), *Annual Report*, Mumbai: Reserve Bank of India

Srinivasan, T.N. (2002), "India's Fiscal Situation: Is a Crisis Ahead?", in A. Krueger, ed., *Economic Policy Reforms and the Indian Economy*, Chicago: University of Chicago Press.

Weingast, Barry (1993), "Constitutions as Governance Structures," *Journal of Institutional and Theoretical Economics*, 149, 233-261

Table 1

Some Characteristics of India's States

	Area (Sq. Km)	Popn. (in '000)	Density of Popn.	NSDP 1999-00 Rs. Million	Per capita NSDP (1999-00)	Percent of Total Area	Percent of Total Popn.	Percent of Total NSDP
High Income States	**601800**	**194065**	**322.5**	**4065770**	**22461**	**18.31**	**18.90**	**28.74**
Gujarat	196000	50597	258.1	896060	18685	5.96	4.93	6.33
Goa	3800	1344	353.7	58620	44613	0.12	0.13	0.41
Haryana	44000	21083	479.2	424880	21551	1.34	2.05	3.00
Maharashtra	308000	96752	314.1	2131510	22604	9.37	9.42	15.07
Punjab	50000	24289	485.8	554700	23254	1.52	2.37	3.92
Middle Income States	**725000**	**302633**	**417.4**	**4867930**	**17635**	**22.05**	**29.47**	**34.41**
Andhra Pradesh	275000	75728	275.4	1117530	14878	8.36	7.37	7.90
Karnataka	192000	52734	274.7	862980	16654	5.84	5.13	6.10
Kerala	39000	31839	816.4	569260	17709	1.19	3.10	4.02
Tamil Nadu	130000	62111	477.8	1143090	18623	3.95	6.05	8.08
West Bengal	89000	80221	901.4	1175070	14874	2.71	7.81	8.31
Low Income States	**1409300**	**458682**	**325.5**	**4022290**	**9013**	**42.87**	**44.66**	**28.44**
Bihar	94000	82879	881.7	383260	4813	2.86	8.07	2.71
Chhattisgarh	135100	20796	153.9	213310	10405	4.11	2.02	1.51
Jharkhand	79700	26909	337.6	232270	9223	2.42	2.62	1.64
Madhya Pradesh	308000	60385	196.1	677780	11626	9.37	5.88	4.79
Orissa	156000	36707	235.3	311950	8733	4.75	3.57	2.21
Rajasthan	342000	56473	165.1	710200	13046	10.40	5.50	5.02
Uttaranchal	53500	8480	158.5	na	na	1.63	0.83	na
Uttar Pradesh	241000	166053	689.0	1493520	9323	7.33	16.17	10.56
General Category States	**2736100**	**955380**	**349.2**	**12955990**	**14476**	**83.23**	**93.02**	**91.59**
Special Category States	**540500**	**55182**	**102.1**	**639300**	**12339**	**16.44**	**5.37**	**4.52**
Arunachal Pradesh	84000	1091	13.0	14270	13352	2.56	0.11	0.10
Assam	78000	26638	341.5	2533300	9720	2.37	2.59	1.79
Himachal Pradesh	56000	6077	108.5	106570	17786	1.70	0.59	0.75
Jammu & Kashmir	222000	10070	45.4	121820	12373	6.75	0.98	0.86
Manipur	22000	2389	108.6	28580	12721	0.67	0.23	0.20
Meghalaya	23000	2306	100.3	29040	12063	0.70	0.22	0.21
Mizoram	21000	891	42.4	12880	14909	0.64	0.09	0.09
Nagaland	17000	1989	117.0	23300	12594	0.52	0.19	0.16
Sikkim	7000	540	77.1	7580	14751	0.21	0.05	0.05
Tripura	10500	3191	303.9	41930	13195	0.32	0.31	0.30
All States	**3276600**	**1010562**	**308.4**	**13595290**	**14359**	**99.67**	**98.40**	**96.11**
UTs	**10974**	**16453**	**1499.3**	**549870**	**31211**	**0.33**	**1.60**	**3.89**
Total	**3287574**	**1027015**	**312.4**	**14145160**	**13778**	**100.00**	**100.00**	**100.00**

Notes: na – Not Available. All State NSDP figure does not include SDP from Uttaranchal. NSDP figure of UTs excludes SDP from Dadra & Nagar Haveli, Daman and Dieu and Lakshadweep.
Source: Rao and Singh (2004b), Table 4.1.

Table 2
Illustrative List of Developmental Subjects (Other Than Financial Subjects) Included in the Union, State, and Concurrent Lists in the Seventh Schedule of the Constitution

(A) Union List		
S. No.	**Entry No.**	**Subject**
1	6	Atomic energy and mineral resources necessary for its production
2	22	Railways
3.	23	Highways declared by or under law made by Parliament to be national highways
4.	24	Shipping and navigation on inland waterways, declared by Parliament by law to be national waterways, as regards mechanically propelled vessels the rule of the road on such waterways.
5.	25	Maritime shipping and navigation including shipping and navigation on tidal waters provision of education and training for the mercantile marine and regulation of such education and training provided by States and other agencies.
6.	26	Lighthouses, lightships, beacons and other provision for the safety of shipping and aircraft.
7.	27	Ports declared by or under law made by Parliament or existing law to be major ports, including 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 form of communications.
12.	41	Trade and commerce with foreign countries; import and export across customs frontiers; definition of customs frontiers.
13.	42	Inter-State trade and commerce.
14.	52	Industries, the control of which by the Union is declared by parliament by law to be expedient in the public interest.
15.	53	Regulation and development of oilfields and mineral oil resources; petroleum and petroleum products; other liquids and substances declared by Parliament by law to be dangerously inflammable.
16.	54	Regulation of mines and mineral development to the extent which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest.
17.	56	Regulation and development of inter-State rivers and river valleys to the extent to which such regulation and development under the control of the Union is declared by Parliament by law to be expedient in the public interest.
18.	57	Fishing and fisheries beyond territorial waters.
19.	65	Union agenda and institutions for - a. professional, vocational or technical training including the training of police officers; or b. the promotion of special studies or research; or c. scientific or technical assistance in the investigation or detection of crime.
20.	66	Coordination and determination of standards in institutions for higher education or research and scientific and technical institutions.
21.	68	Survey of India, the geological, botanical, zoological and anthropological surveys of India, meteorological organizations.

(B) State List		
S. No.	**Entry No.**	**Subject**
1	5	Local government, that is to say, the constitution and powers of municipal corporations, improvements trusts, district boards, mining settlement authorities and other local authorities for the purpose of local self-government or village administration.
2	6	Public health and sanitation; hospitals and dispensaries
3.	9	Relief of the disabled and unemployable.
4.	13	Communications, that is to say, roads, bridges, ferries, and other means of communication not specified in List I: municipal tramways; ropeways; inland waterways and traffic thereon subject to the provisions of List I and List II with regard to such waterways; vehicles other than mechanically propelled vehicles.
5.	14	Agriculture, including agricultural education and research, protection against pests and prevention of plant diseases.
6.	15	Preservation, protection and improvement of stock and prevention of animal diseases; veterinary training and practice.
7.	17	Water, that is to say, water supplies, irrigation and canals, drainage, embankments, water storage and water power subject to the provisions of entry 56 of List I.
8.	18	Land, that is to say, rights in or over land, land tenures including the relations of landlord and tenant, and the collection of rents; transfer and alienation of agricultural land; land improvement and agricultural loans; colonization.
9.	21	Fisheries
10.	23	Regulation of mines and mineral development subject to the provisions of List I with respect to regulation and development under the control of the Union.
11.	24	Industries subject to the provisions of entries 7 and 52 of List I.
12.	25	Gas and gas-works
13.	26	Trade and commerce within the State subjects to the provisions of entry 33 of List III.
14.	27	Production, supply and distribution of goods subject to the provisions of entry 33 of List III.
15.	32	Cooperative societies
16.	35	Works, lands and buildings vested in or in the possession of the State.

(C) Concurrent List		
S. No.	**Entry No.**	**Subject**
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 labor.
6.	27	Relief and rehabilitation of persons displaced from their original place of residence by reasons of the setting up of the Dominions of India and Pakistan.
7.	31	Ports other than those declared by or under law made by Parliament or existing law to be major ports.
8.	32	Shipping and navigation and inland waterways as regards mechanically propelled vessels, and the rule of the road on such waterways, and the carriage of passengers and goods on inland waterways subject to the provisions of List I with regard to national waterways.
9.	33	Trade and commerce in, and the production supply and distribution of - a. the products of any industry where the control of such industry by the Union is declared by Parliament by law to be expedient in the public interest and imported goods on inland waterways subject to the provisions of List I with regard to national waterways. b. foodstuffs, including edible oilseeds and oils; c. cattle fodder, including oilseeds and other concentrates; d. raw cotton, where ginned or unginned and cotton seed; and e. raw jute.
10.	36	Factories
11.	37	Boilers
12.	38	Electricity

Source: Rao and Singh (2004b)

Table 3
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	**Head**	**Entry in List II**	**Head**
82	Taxes on income other than agricultural income	45	Land revenue, including the assessment and collection of revenue, the maintenance of land records, survey for revenue purposes.
83	Duties of customs including export duties	46	Taxes on agricultural income
84	Duties of excise on tobacco and other goods manufactured or produced in India except- a. alcoholic liquors for human consumption; b. opium, Indian hemp and other narcotic drugs and narcotics; but including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.	47	Duties in respect of succession of agricultural land
85	Corporation tax	48	Estate duty in respect of agricultural land
86	Taxes on the capital value of the assets, exclusive of agricultural land of individuals and companies; taxes on the capital of companies	49	Taxes on lands and buildings
87	Estate duty in respect of property other than agricultural land.	50	Taxes on mineral rights subject to any limitations imposed by Parliament by law relating to mineral development
88	Duties in respect of succession to property other than agricultural land	51	Duties of excise on the following goods manufactured or produced in the State and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India: a. alcohol liquors for human consumption; b. opium, Indian hemp and other narcotic drugs and narcotics; but not including medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (b) of this entry.
89	Terminal taxes on goods or passengers carried by railway, sea or air: taxes on railway fares and freights.	52	Taxes on the entry of goods into a local area for consumption, use or sale therein.
90	Taxes other than stamp duties on transactions in stock exchanges and future markets	53	Taxes on the consumption or sale of electricity
91	Rates of stamp duty in respect of bills of exchange cheques promisory notes, bills of lading, letters of credit, policies of insurance, transfer of shares, debentures, proxies and receipts.	@54	Taxes on the sale or purchase of goods other than newspapers, subject to the provisions of entry 92A of List I.
92	Taxes on the sale or purchase of newspapers and on advertisements published therein.	55	Taxes on advertisements other than advertisements published in the newspaper @@ and advertisements broadcast by radio or television.

*92A	Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-State trade or commerce.	56	Taxes on goods and passengers carried by road or on inland waterways.
**92B	Taxes on the consignment of goods (whether the consignment is to the person making it or to any other person), where such consignment takes place in the course of inter-State trade or commerce.	57	Taxes on vehicles, whether mechanically propelled or not, suitable for use on roads including tramcars, subject to the provision of entry 35 of List III.
97	Any other matter not enumerated in List II or List III including any tax not mentioned in either or both the Lists.	58	Taxes on animals and boats
		59	Tolls
		60	Taxes on professions, trades, callings and employments
		61	Capitation taxes
		62	Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.
		63	Rates of stamp duty in respect of documents other than those specified in the provision of List I with regard to rates of stamp duty.

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

Source: Rao and Singh (2004b)

Table 4

Criteria and Relative Weights for Tax Devolution

Criterion	Weight (Percent)
1. Population (1971 Census)	10
2. Income (Distance Method)*	62.5
3. Area	7.5
4. Index of Infrastructure	7.5
5. Tax Effort**	5.0
6. Fiscal Discipline***	7.5

Notes: *The distance method is given by: $(Y_h-Y_i)P_i/\Sigma(Y_h-Y_i)P_i$ where, where Y_i and Y_h represent per capita SDP of the i^{th} and the highest income State respectively and P_i is the population of the i^{th} State .

** Tax Effort (η) is estimated as (η) = $(T_i / Y_i) / (0.5\ 1/Y_i)$ where, T_i is the per capita tax revenue collected by the i^{th} State and Y_i is the per capita State domestic product of the i^{th} State.

*** Estimated as the improvement in the ratio of own revenue of a state to its revenue expenditures divided by a similar ratio for all States averaged for the period 1966-99 over 1991-1993.

Source: Rao and Singh (2004b)

Table 5
Revenues and Expenditures of the States – 2000-01

States	Per capita SDP (Rupees)	Poverty ratio (%) 1999-00	Per capita own revenue (Rupees)	Own Revenue as % of SDP	Per capita Transfers	Per capita current spending (Rupees)	Own revenue to current spending (%)
High Income States	**22461**	**17.83**	**2931.6**	**13.1**	**500**	**4386.6**	**66.8**
Gujarat	18685	14.07	2684.6	13.2	863	5167.6	52.0
Goa	44613	4.4	14310.3	15.8	588	11904.8	120.2
Haryana	21551	8.74	3209.7	12.1	502	4107.9	78.1
Maharashtra	22604	25.02	2741.3	11.1	448	3852.6	71.2
Punjab	23254	6.16	3333.2	10.2	494	4712.7	70.7
Middle Income States	**17635**	**20.3**	**1868.8**	**10.6**	**658**	**3400.4**	**55.0**
Andhra Pradesh	14878	15.77	1930.2	10.7	713	3320.2	58.1
Karnataka	16654	20.44	2148.1	11.3	686	3580.9	60.0
Kerala	17709	12.72	2295.8	10.2	690	3689.4	62.2
Tamil Nadu	18623	21.12	2342.5	11.3	658	3594.3	65.2
West Bengal	14874	27.02	1091.0	5.5	576	3092.7	35.3
Low Income States	**9013**	**34.28**	**846.8**	**9.4**	**673**	**2243.4**	**37.7**
Bihar	4813	42.6	338.2	8.9	724	1515.5	22.3
Chattisgarh	10405	NA	1264.0	4.9	NA	2455.2	51.5
Jharkhand	9223	NA	1128.0	9.0	NA	2229.4	50.6
Madhya Pradesh	11626	37.43	1061.9	11.5	624	2695.5	39.4
Orissa	8733	47.15	900.5	9.3	969	2785.3	32.3
Rajasthan	13046	15.28	1297.2	10.4	693	2864.2	45.3
Uttaranchal	NA	NA	1295.5	NA	NA	4912.7	26.4
Uttar Pradesh	9323	31.15	791.2	8.1	598	2135.6	37.0
General Cat. States	**14476**	**25.97**	**1594.0**	**11.0**	**660**	**3045.3**	**52.3**
Special Cat. States	**12339**		**1155.9**	**9.4**	**2896**	**5715.4**	**20.2**
Arunachal Pradesh	13352	33.47	1067.8	5.3	7985	9992.3	10.7
Assam	9720	36.09	798.7	7.2	1216	3317.0	24.1
Himachal Pradesh	17786	7.63	1660.5	7.8	3070	7420.6	22.4
Jammu & Kashmir	12373	3.48	1150.4	7.9	4602	6080.0	18.9
Manipur	12721	28.54	406.0	3.1	3971	6032.3	6.7
Meghalaya	12063	33.87	1066.8	6.3	3149	5878.4	18.1
Mizoram	14909	19.47	679.0	3.8	9602	12845.6	5.3
Nagaland	12594	32.67	506.8	3.7	6332	7291.0	7.0
Sikkim	14751	36.55	5998.1	15.9	7945	12200.6	49.2
Tripura	13195	34.44	729.6	4.8	3376	5838.9	12.5
All States	**14359**	**26.1**	**1570.1**	**10.9**	**768**	**3191.1**	**49.2**

Source: Rao and Singh (2004b)

Table 6
Composition of Central Transfers to States (Rs. Billion, Percentages)

Plan Periods / Years	Finance Commission Transfers			Plan Grants			Other Grants	Total
	Tax Devolution	Grants	Total	State Plan Schemes	Central Schemes	Total		
Fourth Plan (1969-74)	45.60 (54.35)	8.60 (10.25)	54.20 (64.60)	10.80 (12.87)	9.70 (11.56)	20.50 (24.43)	9.30 (11.08)	83.90 (100.00)
Fifth Plan (1974-79)	82.70 (50.21)	28.20 (17.12)	110.90 (67.33)	29.10 (17.67)	19.30 (11.72)	48.40 (29.39)	5.40 (3.28)	164.70 (100.00)
Sixth Plan (1980-85)	237.30 (56.97)	21.40 (5.14)	258.70 (62.11)	73.80 (17.72)	69.00 (16.57)	142.80 (34.29)	15.10 (3.63)	416.50 (100.00)
Seventh Plan (1985-90)	494.60 (54.17)	62.70 (6.87)	557.40 (61.04)	155.20 (17.00)	165.10 (18.08)	320.30 (35.08)	35.20 (3.85)	913.10 (100.00)
Annual Plan 1991-92	172.00 (52.22)	34.50 (10.47)	206.40 (62.66)	57.20 (17.36)	55.40 (16.82)	112.50 (34.15)	10.20 (3.10)	329.40 (100.00)
Eighth Plan (1992-97)	1318.50 (55.56)	147.20 (6.20)	1465.70 (61.76)	483.40 (20.37)	364.70 (15.37)	848.40 (35.75)	58.40 (2.46)	2373.10 (100.00)
1997-98	404.11 (62.52)	16.80 (2.60)	420.91 (65.12)	120.08 (18.58)	67.56 (10.45)	187.64 (29.03)	37.80 (5.85)	646.35 (100.00)
1998-99	394.20 (62.29)	14.20 (2.24)	408.40 (64.54)	132.70 (20.97)	71.10 (11.24)	203.80 (32.21)	20.60 (3.26)	632.80 (100.00)
1999-00	441.21 (59.03)	19.88 (2.66)	461.09 (61.69)	163.16 (21.83)	82.03 (10.98)	245.19 (32.80)	41.14 (5.50)	747.42 (100.00)
2000-01 RE	518.27 (52.28)	121.69 (12.28)	639.96 (64.56)	157.59 (15.90)	136.76 (13.80)	294.35 (29.69)	56.99 (5.75)	991.30 (100.00)
2001-02 BE	603.5 (55.41)	95.34 (8.75)	698.84 (64.17)	190.67 (17.51)	152.52 (14.00)	343.19 (31.51)	47.04 (4.32)	1089.07 (100.00)

Notes: RE: Revised Estimates, BE: Budget Estimates
Source: Rao and Singh (2004b)

Table 7
Formula for Distributing State Plan Assistance

Criteria	Share in central plan assistance (per cent)	Share of grants and loans	Distribution criteria non-special category states
A. Special category States	30	90:10	
B. Non-special category States	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 non-special category 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

Notes: 1. The formula is as revised in December, 1991; 2. Fiscal management is assessed as the difference between States' own total plan resources estimated at the time of finalizing annual plan and their actual performance, considering latest five years; 3. Under the criterion of the performance in respect of certain programs 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.

Source: Rao and Singh (2004b)