

Fiscal Federalism and State Finance: Case of Madhya Pradesh, India

Deepa Joshi¹, Anjali Jain²

Research Scholar*Prof. Of Economics**

Institute For Excellence In Higher Education Bhopal M.P. India.

Abstract: Public finance system is organised in different ways and designed with the multitier and hierarchical structure of government with different arrangements of powers of raising revenue to incur expenditure and to finance the developmental activities. Madhya Pradesh state finances experiencing alarming deterioration in during the last decade resulting fiscal and primary deficits, increases in the indebtedness and contingent liabilities, and decline in capital and maintenance expenditures. The state's fiscal performance is adversely affected by low buoyancy of central transfers and spill over of central pay revisions which is a matter of serious concern. This paper presents the various issues and challenges with reference to fiscal federalism in state of Madhya Pradesh India.

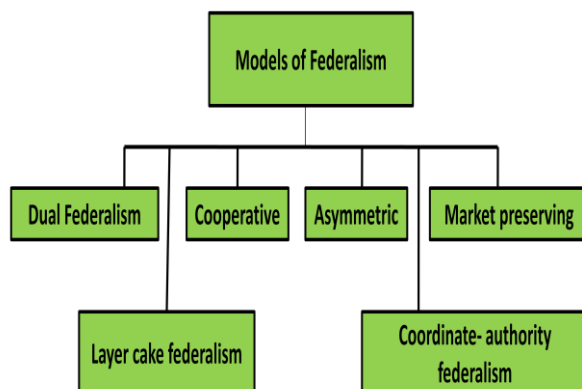
Keywords: Fiscal, , Madhya, buoyancy, compliance taxation.

I. Introduction

Federalism is one of the forms, is considered a form of political association in which two or more states constitute a political unity with a common government, but in which the member states retain a measure of internal autonomy. The Constitution provides for a federal system of government in India. The essence of the system is that the Centre and the State Governments should be independent of each other in their respective, constitutionally demarcated spheres of action with adequate financial independence. It has been observed that there is diversity of functions which a modern government is expected to perform and hence this is the rational of having different layers and division of the government authority in the country. On the grounds of efficiency and economy of administration it is preferable to divide the functions among different layers of government. To discharge these functions they require revenue which is arranged in the multi-level decentralized fiscal system known as fiscal federalism. Fiscal federalism studies the issues related to the ways in which the revenue of the country is shared between the different tiers of government. .

II. The Concept of Fiscal Federalism

Fiscal federalism is a subset of federalism that deals with the State as an aggregator of national preferences, and the allocation and distribution of resources for desirable governmental interventions at appropriate levels (Musgrave, 1998). One of the critical tents of federalism is the ability and entitlement of the states to elect their own leadership, frame their policies and also indigenously mobilise resources for revenue and expenditure obligations with in prescribed flexibility under the constitution . Federalism observes different forms as shown in fig.1



The theory of fiscal federalism observes that it is important for a federation that there is both independence of different tiers of government and interdependence among them. It is necessary that each of two levels of government should be guaranteed an independence of each other sufficient to enable them to engage the continuing support of significant element of political system.

Fig.1. Different forms of Federalism

Because the functions are distributed among different tiers of government each of which is responsible for its own sphere of activity, they should be assigned such sources of revenue which can be administered efficiently and which are adequate enough to enable them to shoulder the respectability assigned to them. There should be some principle deciding such division of revenue sources. Any mismatch between allocation of responsibilities and the availability of resources at different levels of government has the potential to undermine the efficacy of federalism. The two approaches to fiscal federalism view decentralisation with different angles.

- The First generation theory (FGT) is associated with decentralisation of expenditure responsibilities and centralisation of revenue responsibilities for the purpose of achieving ‘efficiency’ and ‘equity’ in the federation.
- The Second Generation Theory (SGT) is in favour of decentralisation of both expenditure and revenue responsibilities; and it gives minimal role to revenue-sharing and inter-governmental transfers and supports the of market-preserving federalism .

Broadly speaking, fiscal federalism is concerned with the proper assignment of expenditure and tax responsibilities between federal and sub-national level governments, and design of a proper transfer system. In theoretical terms (Rao and Singh, 2005) fiscal federalism helps to understand -

- the factors determining the optimal degree of fiscal decentralisation
- principles underlining the assignment of functions and sources of finance of governments of different vertical levels
- to design suitable inter-governmental transfer schemes to fulfil the objectives of ‘equity’ and ‘efficiency’ .

III. Fundamental Issue In A Federation: Allocation Of Responsibilities

Assignment problem or the allocation of expenditure, regulatory, and tax functions to various orders of government, is the most fundamental issue in a federation. The literature on fiscal federalism argues that finance should follow function. In other words, assigning responsibilities for spending, including the exercise of regulatory functions must precede the assignment of responsibilities for taxation because tax assignment is generally guided by the spending requirements of the different orders of government and cannot be determined in advance. It may be desirable to decentralize taxation at the same time provide for decentralizing spending, so that sub national governments will not have to rely exclusively on grants from the national government. If sub national governments are not responsible for raising at least some level of their own revenues, they may have too little incentive to provide local public services in a cost-effective way. Anwar Shash (1991) suggested broad theoretical guidelines for assignment of expenditure and tax responsibilities to different levels of governments

Table 1. Theoretical Guidelines for Assignment of Expenditure and Tax responsibility.

Tax	Tax Responsibility /Revenue			Expenditure Responsibility		
	Determina tion of base	Determina tion of rate	Tax collection And administra tion	Expenditu re Category	Service Responsibi lity	Provision of service
Customs	F	F	F	Defence	F	F
Income tax	F	F,S	F	Foreign affairs	F	F
Estate and gift tax	F	F,S	F	International trade	F	F
Corporate tax	F	F,S	F	Environment	F	S,L
Resource tax	F	F,S	F	Currency and banking	F	F
Retail sales tax	F	S	S	Inter-state commerce	F	F
Value added tax	F	F,S	F,Sc	Immigration	F	F
Excise	S	S	S	Airlines/Railways	F	F
Property tax	S	L	L	Industry and agriculture	F,s,L	S,L
User charges	F,S,L	F,S,L	F,S,L	Education,	F,S,L	S,L
				Health, social welfare	F,S,L	S,L
				Social welfare	F,S,L	S,L
				Police	S,L	S,L
				Highways	F,S,L	S,L
				Natural resources	F,S,L	S,L

Source : Anwar Shah, New Federalism in Brazil, World Bank Discussion Paper No. 124,1991, p.11.

1. Fiscal Federalism In India

The working of the federalism in India resemble the **coordinate-authority** model of dual federalism in which the states enjoy significant autonomy from the federal government, and local governments are simply handmaidens of the states and have little or no direct relationship with the federal government. Federal systems are seen to provide safeguards against the threat of centralized exploitation as well as decentralized opportunistic behaviour while bringing decision makers closer to the people. The principles of fiscal federalism are concerned with the design of fiscal constitutions – that is, how taxing, spending, and regulatory functions are allocated among governments and how intergovernmental transfers are structured. The Constitution provides a federal system of government in the country even though it describes India as ‘a Union of States’. The term implies that firstly, the Indian federation is not the result of an agreement between independent units, and secondly, the units of Indian federation cannot leave the federation. The Indian Constitution contains federal and non- federal features.

5, Features of Indian Constitution

Federation of India is characterized by constitutional demarcation of financial powers and responsibilities among the three levels of government, namely centre, state and local government. Under the Quasi- federal character of the Constitution, sufficient powers had been vested in the State but residual powers of taxation belonged to the Indian Union government. The Seventh Schedule of the Indian Constitution contains a detailed distribution of functions between the centre and state governments in the form of three lists i.e., union, state and concurrent lists.

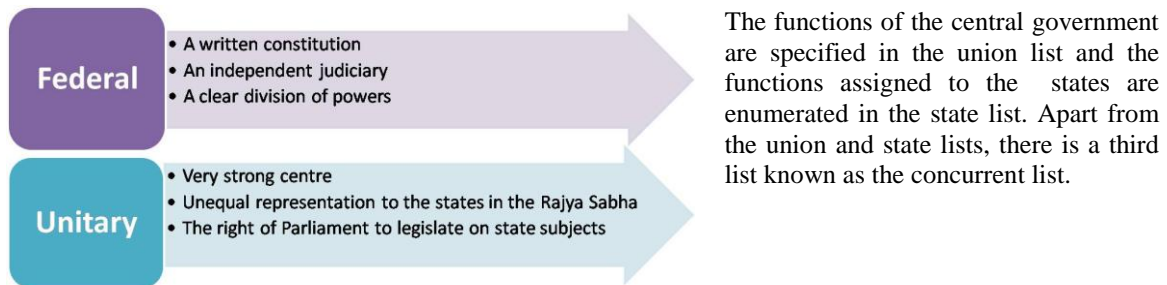


Fig.2 Features of India Constitution

Functions of inter-state nature have been placed under the concurrent legislative powers of the central and state governments. The theory of fiscal federalism observes that it is important for a federation that there is both independence of different tiers of government and interdependence among them. It is necessary that each of two levels of government should be guaranteed an independence of each other sufficient to enable them to engage the continuing support of significant element of political system. Division of functional responsibility and revenue raising powers show conformity to the theoretical guidelines suggested by Shah (1991). However there should be some principle deciding such division of revenue sources .fiscal federalism is expected to enable the national and sub-national governments to operate in such a way that leads to efficiency in the use of resources - not only in terms of the quality of services provided by the various levels of government but also in terms of creating the environment in which all economic agents use resources efficiently (Rangarajan,2004).To fulfil the expectation fiscal federalism is practiced in India by the three principles

- Division of Functions
- Division of Resources
- Fiscal Coordination

Division of Functions : There is three fold division of functions and powers. Union government has the executive power to make laws as enumerated in the list 1 in the seventh schedule of the constitutions, subjects of national importance include about 97 subjects.

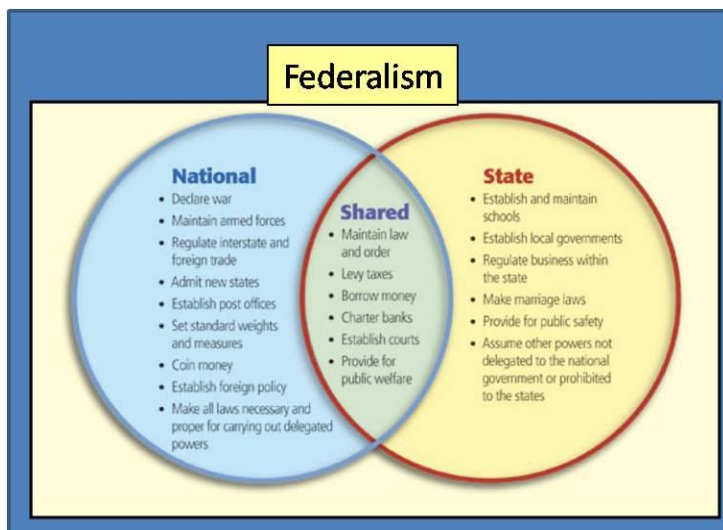


Fig. 3

State governments have legislative powers to make laws in the subjects listed in the second list, 66 subjects of regional and local importance. In addition, a few subjects are listed in the Concurrent List in respect which both the Union and the States have concurrent powers to make laws.

Division of Resources : As the functions are distributed among different tiers of government each of which is responsible for its own sphere of activity, they should be assigned such sources of tax and non tax revenue, which can be administered efficiently and which are adequate enough to enable them to shoulder the respectability assigned to them. The Indian constitution makes a clear division of fiscal powers between union and state governments. Revenue is raised through taxes by both the layers of the governments. The principle adopted for this classification is that taxes which have an interstate basis are levied by the union, while those with a local base are levied by the states and residuary powers relate to the union government. Taxes with union Jurisdiction can, therefore, be divided into four classes:

1. Taxes which are levied and collected by the centre but the proceeds are shared with states
2. Taxes which are levied collected and wholly retained by the centre.
3. Taxes which are levied and collected by the centre but the entire proceeds are assigned to the states
4. Taxes which are levied by the union but collected and appropriated by the states.

Fiscal Coordination : From the principle of division of resources, it is difficult to find many good regional taxes to enable the local government to finance the functional programmes assigned to them in accordance with their autonomy status. This division of resources and functions between the centre and the states has been made on the basis of efficiency and equity criteria of fiscal federalism.

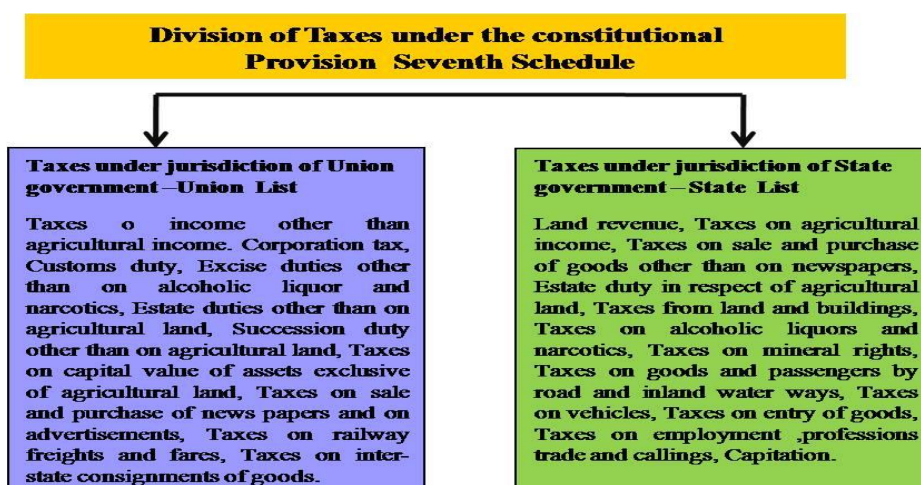
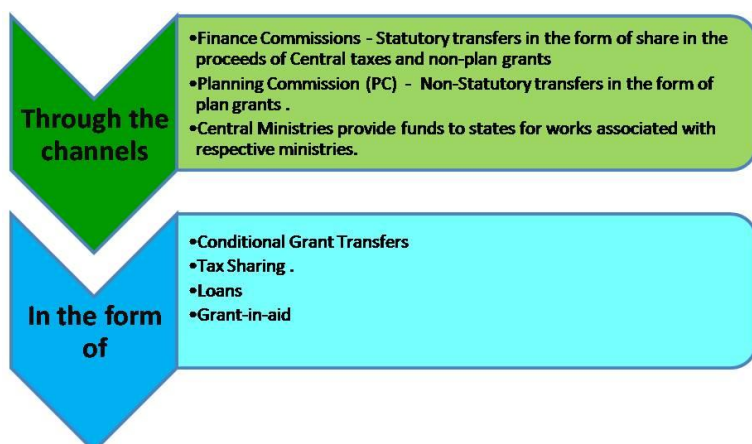


Fig.4 Division of Taxes

The elastic sources of revenue like personal income tax, corporation income tax, excise duty, customs duty have gone to the centre and the expensive functions have come to the states. Centre is assigned with taxes with higher revenue potential, States are assigned with more functional responsibilities. There is an asymmetry between the taxation powers and the functional responsibilities. As a result of this disequilibrium in the division of powers

and functions, financial imbalance has emerged between the centre and states. Whatever resources state governments can obtain from regional taxes may be sufficient only for a part of their functional performance.



To address the issue of a gap in the resources assigned to States and their expenditure responsibilities, the Constitution provides an institutional mechanism for the transfer of resources from the Centre. In India, transfers from the Centre to States, comprising statutory and no statutory transfers, take place

Fig. 5 : Transfer of Resources

Finance commission recommends principles governing distribution of tax proceeds between centre and states and among states themselves and aims at correcting the differentials in revenue raising capacity and expenditure needs of the states, taking into account the cost disability factors to the extent possible. The Finance Commissions take the decision on the basis of

- factors reflecting needs, such as population and income;
- cost disability indicators, such as area and infrastructure distance
- Fiscal efficiency indicators such as tax effort and fiscal discipline.

The commissions have given different weights to these criteria.

Table 2. Criterion used for fund transfer/ Devolution of resources By Finance Commissions

Criterion	10 th F.C	11 th F.C.	12 th F.C.	13 th F.C.	14 th F.C.
Population	20	10%	25	25	17.5
Area	5	7.5%	10	10	15
Income Distance	60	62.5%	50	47.5	50
Index of Infrastructure	5	7.5			
Tax Efforts	10	5	7.5		
Fiscal Discipline		7.5	7.5	17.5	
Demographic Change					10
Forest Cover					7.5

Source : Various Finance commission Reports

Through the devolution of resources central government act to achieve the vertical balance the composition and character of the transfer have changed over time. The union government also provides grant-in aid to the states. States raise revenue through their own sources and receive their share in the taxes collected by them on behalf of union government. All these sources of revenue constitute the part of state finance.

6 State Finance of Madhya Pradesh

Madhya Pradesh is the central state of India, blessed with immense natural beauty and rich mineral and forest resource base. It is tenth of seventeen general category sates in the country. Agriculture is one of the most significant sectors of the economy as it provides not only employment to 3/4th of the workforce but also raw material to a large number of agro based industries. The services sector contributes around 45.7% in GSDP followed by the industry and agriculture sectors at 25.5% and 29.05% respectively in FY2012-13. Sectoral composition clearly shows that the economy of the state is gradually shifting from the primary sector to secondary and tertiary sectors. The state's industrial base is quite diverse and vibrant. Industry is largely resource-driven, leveraging the state's natural wealth in the form of limestone, coal, iron ore, silica, bauxite,

soya, cotton, etc. It occupies ninth position among all states in terms of GSDP. Fiscal scenario of the state has shown significant improvement thereby transforming the state's economy from revenue deficit to revenue surplus state. Such fiscal discipline has multiplier effect on the various components of the economy to develop and expand further. Under the framework provided by the constitution the state finance of M.P. government, as is of other states, is composed of own tax revenue non tax revenue, grants from the centre and share in central taxes (fig 6.)

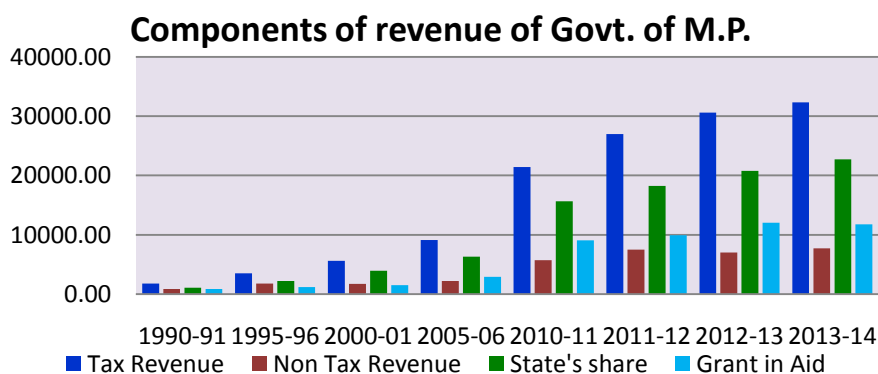


Fig 6. Components of revenue

Source : CAG Audit Reports M.P.

The non-tax revenue comprises of fiscal services, interest receipts, dividends and profits and other non-tax revenue on account of general, social and economic services. Receipts on account of non-tax revenue, which primarily comprises incomes from mining and forestry, however, has not been at par with other components and accounts for 18% of the total revenue receipt of the state in 1990-91 which has reduced to 10% in 2012-13. The primary reason for no increase in the non-tax receipts is that the payment of royalty for exploitation of natural resources of the state like forest and mines is made on the basis of volume rather than on the basis of monetary value of the resources (CAG Report 2012). The grants-in-aid from the Central government comprises of

- Non-Plan grants (provided either on the recommendations of the Central Finance Commission or central ministries)
- Plan grants that are received by the state for financing state plan schemes, central plan schemes and centrally sponsored schemes. Plan grant allocations are made according to the recommendations of the Planning Commission of India.

Grants-in-aid from the Central government flow to state in two forms, that is Plan and non-Plan grants. The non-Plan grants are again based on the recommendation of the Central Finance Commission and are based on objective criteria. The trend that emerged shows that it constituted 19% of total revenue receipts of the state in 1990-91 with contribution of Rs. 858.43 crore. The share of grant in total revenue receipt increased continuously with 6% per annum for a long period till 2000-01 and then registered improvement in the following years and grant in-aid increased with CAGR of 14% and 20% per annum till 2010-11. Its contribution reduced to total revenue receipt to 17% in 2012-13.

State's share in central taxes is a fixed proportion of the divisible pool of taxes collected by the Union government. The proportion is decided objectively and equitably by the Central Finance Commission for a period of five years. State's share in central taxes is an entitlement of the state. An increasing trend signifies good buoyancy in the central taxes rather than benevolence of the Union government towards the state. M.P. received Rs. 1089.35 crore as share of central taxes in 1990-91 and accounted for 25% of total revenue receipt of the state. It has increased by CAGR of 15% per annum between the period 1990-91 to 1995-96 but it could not increase with a lesser rate of growth of 13% in the next five years period between 1995-96 to 2000-01 and has reached to Rs. 3955.51 crore. The growth of state's share in central taxes could not manage to improve in terms of year on year growth rate and but reached to a higher level of Rs. 6341.35 crore in 2005-06. State received Rs. 20805.16 crore as its share in central taxes and experienced a good rate of growth of 20% per annum between the period 2001-02 to 2010-11.

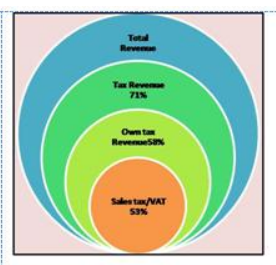
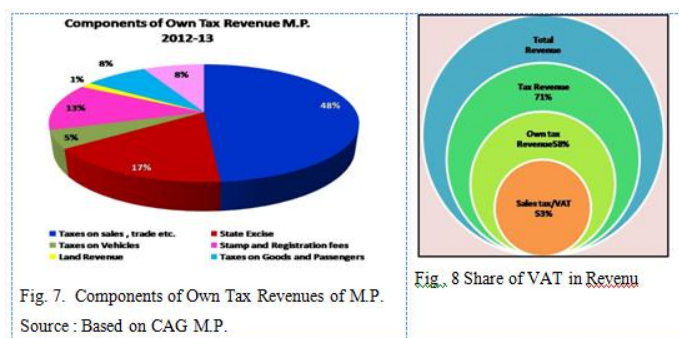
7. State's Own Tax Revenue

Constitution of India declares a specific jurisdiction within which the state government can levy and collect taxes. These tax constitute the own tax revenue of the state. Scope for raising own tax revenue varies according to the economy of the state. More developed states have more of economic activities and thus are in a position to raise more revenue through different taxes. M.P. is one of the developing state having much

dependence on agriculture has lesser excess to revenue through taxes. Though State's own tax receipt (SOTR) with 39% of total in 1990-91 is the largest contributor to the state's revenue receipts which continued to dominate the composition with 43% in 2012-13. It consists of tax on goods and services (85 per cent), tax on property and capital transaction (13 per cent) and tax on income and expenditure (2 per cent).

7.1 Components of Own Tax Revenue

State's own tax revenue comprises sales tax, state excise, stamps and registration, electricity duties, taxes on goods and passengers, taxes on vehicles, other taxes on income and expenditure, land revenue, other taxes and duties on commodities and services, hotel receipts and tax on immovable property other than agriculture land. The state's own tax revenue accounts for 61% of total tax revenue of the state. Sales tax dominates the own tax revenue with 48% of the revenue as evident from the fig 7 .



The dominant indirect tax Sales tax / VAT is the important part of own tax revenue and is a component of commodity taxation accounts for half of the own tax revenue. It is consumption tax imposed on all consumptions and rate of tax varies according to the nature of the commodity. Various indirect taxes are levied in the state among them sales tax/ VAT is the most important tax as shown in the fig. 8.

IV. Conclusion

The most important aspect of fiscal federalism is the division of resources and functions between different levels of governments. Like in other countries, the fiscal dimensions of federalism are a reflection of the political federal structure in India. The traditional subjects of concern of fiscal federalism, such as the assignment of taxes and responsibilities as well as the correction of vertical and horizontal imbalances, continue to remain important in India. Devolution of taxes and duties still constitutes the most significant dimension of fiscal federalism in India (Krishna, 2004). The state of Madhya Pradesh suffers with a lack of well placed information system and administrative machinery to implement taxes. The current tax system is complicated which needs to be simplified. There is a need to strengthen administration and enforcement of the tax. The lack of cooperation between various government departments makes the situation critical. In these circumstances taxation policy is not able to fulfil multiple objectives, thus adding to compliance cost and reducing revenue productivity. Another reason for the low and declining growth in non-tax revenues is state government's inability to recover reasonable returns from the large investments. In last decade due attention is not given to achieve efficiency by minimising distortions in tax policy and cost effective provision of services. State government need to restructure the taxation system with the help of reforms particularly in expenditure and tax systems. The fiscal reforms must be aimed at achieving fiscal balance and consolidation and generation of quality infrastructure and a competitive environment.

Reference

- [1]. Commission On Centre-State Relations(2010) " Report -Centre-State Financial Relations And Planning". Volume I .
- [2]. finance Commission " Report of fourteenth finance commission , available at www.fincomindia.nic.in
- [3]. Government of M.P. (2013) " Report of the Comptroller and Auditor General of India on State Finances", Available at www.agmp.nic.in
- [4]. Jha Raghendra,(2014), " Indirect Tax Reform and Fiscal Federaliam in India", ASARC Working Paper 2013/09.
- [5]. Rao Govinda and Sen Tapas (2011)," Federalism and fiscal reform in India" NIPFP,working paper no. 2011-84.
- [6]. Rao Govinda,(2004), "Changing Contours in Federal Fiscal Arrangements in India", available at – www.econ.hitu.ac.jp
- [7]. Rao G. Singh (2006) "The Political Economy of India's Fiscal Federal System and its Reform", MPRA Paper No. 1279, posted 31. December 2006.
- [8]. Shah Anwar, "Introduction: Principles of Fiscal Federalism "
- [9]. Vadra Ratna (2010) "Fiscal Federalism: Theory And Practice" International Conference On Applied Economics – ICOAE 2010.